MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 16, 1975, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Volcker, Vice Chairman
Mr. Baughman
Mr. Coldwell
Mr. Eastburn
Mr. Holland
Mr. Jackson
Mr. MacLaury
Mr. Mayo
Mr. Mitchell
Mr. Wallich

Messrs. Balles, Black, Francis, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. Clay, Kimbrel, and Morris, Presidents of the Federal Reserve Banks of Kansas City, Atlanta, and Boston, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Gramley, Economist (Domestic Business)
Mr. Solomon, Economist (International Finance)
Messrs. Boehne, Davis, Green, Kareken, Reynolds, and Scheld, Associate Economists

Mr. Holmes, Manager, System Open Market Account
Mr. Pardee, Deputy Manager for Foreign Operations
Mr. Sternlight, Deputy Manager for Domestic Operations

Mr. Coyne, Assistant to the Board of Governors
Mr. Keir, Adviser, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Adviser, Division of International Finance, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Messrs. Eisenmenger, Parthemos, Doll, and Sims, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Kansas City, and San Francisco, respectively
Messrs. Hocter, Brandt, and Balbach, Vice Presidents, Federal Reserve Banks of Cleveland, Atlanta, and St. Louis, respectively
Mr. Sandberg, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on November 18, 1975, were approved.

By unanimous vote, the memorandum of discussion for the meeting of the Federal Open Market Committee held on October 21, 1975, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account on foreign exchange market conditions and on

Open Market Account and Treasury operations in foreign currencies for the period November 18 through December 10, 1975, and a supplemental report covering the period December 11 through 15, 1975. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Holmes made the following statement:

> The dollar has been relatively strong, on balance, since the last meeting of the Committee. With the underlying position of the dollar remaining buoyant, the "compromise" on New York City financing and the leveling off of our interest rates removed many of the market's concerns about the dollar.
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> As far as other currencies are concerned, the German mark continues to be relatively weak within the snake, as interest rates in Germany remain low relative to rates elsewhere and as the economic recovery there, while clearly in progress, is far from robust.
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> The Swiss franc, on the other hand, has been in heavy demand, not only in response to a clear improvement in the underlying Swiss payments position this year but also because of the speculative reaction to the very sharp rise of the franc rate itself. Bidding for francs had an unsettling effect on the market on several days, leading to a broader bidding up of European currencies against the dollar. The Swiss National Bank intervened almost daily in Zurich as well as through us in New York on one occasion. Mr. Pardee and I have discussed the possibility of joint intervention with Dr. Leutwiler, President of the Swiss National Bank, but we have done nothing up to this moment.
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> Another situation worth mentioning is that of the Japanese yen. Earlier, with strikes in Japan weighing on market psychology, the yen came under heavy selling pressure in November and early December. The Bank of

Japan, intervening at specific levels for several days at a time, found itself having to back away in the face of heavy sales of yen, with the result that the rate has fallen very close to the Smithsonian level. The Bank of Japan believes this to be a temporary weakness, but the situation bears watching.

In general at this point, the markets have turned fairly quiet, except for the Swiss franc, as banks and corporations around the world square their books for the year end. In our own market operations during the period, we purchased about \$15 million worth of marks to add to our balances and \$4 million worth of Belgian francs. We did not otherwise intervene.

I am happy to report that at long last we have reached agreement on procedures for repaying our Belgian franc swap debt. Late in November the Belgian Government fulfilled its promise to confirm the exchange rate adjustment for our long-outstanding swap indebtedness in Belgian francs. The adjustment of our swap drawing involved a net loss of \$54 million to the System after taking account of the 1971 and 1973 devaluations of the dollar and the small revaluation of the Belgian franc.

At Basle we had very constructive conversations with the Belgians. They have agreed with our suggestion that we begin a program of purchasing modest amounts of Belgian francs in the market each day--a program we have undertaken--and that they share with us the proceeds of any significant intervention in dollars by them in the Belgian market. Moreover, to the extent that the Belgian franc figures in forthcoming drawings on the IMF oil facility, the Belgians have agreed that we can acquire part of the francs involved. All of this has been cleared with the Treasury. The Belgians suggested that we should have an objective of repaying some \$100 million worth of franc debt per quarter. With the balances we have already accumulated, we have repaid a swap drawing of about \$8 million equivalent that otherwise would have come up for its eighteenth renewal in mid-January. This has been a fairly arduous negotiation extending over nearly 5 years, and I believe that the procedures that are now in place are reasonable. You can be sure that we will press every effort to hasten the complete repayment of this debt, perhaps over a shorter period of time than contemplated by the Belgians if market conditions are favorable.

Our chances of repaying our large Swiss franc indebtedness are not particularly good at the moment, given the strength of the Swiss franc. Mr. Pardee and I discussed this matter also with Dr. Leutwiler in Basle. We agreed to explore various possible means of acquiring Swiss francs in addition to market purchases. One approach suggested by Dr. Leutwiler, which we are actively discussing with our European colleagues, is the possibility of using third currencies--which might be more readily available in the market--to acquire Swiss francs. The Swiss have a regular need for Italian lire--for remittances back to Italy from Italian workers in Switzerland--and at times for German marks. This may be a fruitful approach, but any substantial repayment will probably have to await better market conditions which the Swiss expect to see develop some time next year.

As a first step to the eventual liquidation of our Swiss franc indebtedness, however, I recommend that the System adjust the exchange rate on our Swiss franc swap debt to 3.3784 Swiss francs per U.S. dollar to take account of the devaluations of the dollar. This rate has long been agreed to in principle but actual implementation will result in a substantial loss of $195 million--a loss that we have always known would be incurred. A further substantial loss--over $300 million--would be involved in the difference between current market rates and the adjusted swap rate. The Swiss have agreed in principle to share in any such loss, and I recommend that the Committee authorize me to negotiate a specific loss-sharing arrangement, subject of course to final Committee approval. We will submit a memorandum on this matter.

Turning to our broader approach to the exchange market, as you know, the U.S. and French Treasuries signed an agreement at Rambouillet that carried direct implications for central bank consultation and intervention procedures. As a follow-up to that agreement, in Basle last week Mr. Pardee and I worked out an extension of our regular consultation procedures with the other major central banks. The EC central banks are linked together in what has been called the daily "concertation"--three conference calls per day among the various participants. In these calls there is a mutual interchange of information on exchange rates, intervention, and market conditions. Under the new procedure the leader of the concertation process, which rotates among the participating central banks on a daily basis, calls our Desk around 11:00 a.m. with the full results of those calls. We, in turn, pass that information on to the Representative Office of the Bank of Japan in New York and to the Bank of Canada. At the close of our day, we send out a round-robin cable to all participants, informing them of the closing rates in New York, our intervention, if any, and a brief market comment. I think this arrangement is a very useful addition to the direct bilateral contacts, which we will maintain as before. The arrangement was put into effect last Thursday (December 11) and we are getting good information on a uniform basis.

Although not specifically mentioned in the document, one of the features of the Rambouillet agreement was the presumption that the Federal Reserve would become somewhat more active in the exchange markets, especially to counter "erratic movements" of exchange rates. What this will mean in practice will probably become clear only as developments unfold in the market. As a starter, however, I believe it would be useful to continue our accumulation of foreign currencies in the market. We now hold just over $70 million equivalent--mainly German marks. At the September meeting, I suggested, and the Committee agreed, that we should accumulate up to $100 million. I would now suggest that we aim towards accumulating up to $150 million, as market conditions permit.

As to future intervention, I would suggest prudent experimentation, working in close consultation with our central bank colleagues and the Treasury, which at some point may decide to acquire some balances of its own. Should the dollar continue strong or strengthen further I can visualize a gradual buildup in these balances. Should the dollar later weaken we would have some ammunition for intervention without being forced to borrow under a swap line.

> At Basle there was some feeling that the European central banks carried too large a share of the burden of intervention. The old concept that we would intervene to maintain orderly conditions in the New York market and the European central banks in their markets was questioned. As they pointed out--quite rightly, I think--there is really only one market. In fact, the thinness of the New York market has at times led U.S. banks to accumulate large customer orders and execute them only after the European markets had opened the next day. I believe we should try to find ways of broadening and strengthening the New York market, although I have nothing specific to suggest at this time.
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> Finally, I am happy to report that on Thursday the Bank of Mexico will repay in full the $360 million of drawings on the Federal Reserve, taken down in late September and early October. As you recall, they had requested the drawing on the expectation that they would have to ask for a renewal after 3 months. However, the turnaround in their payments position has been more rapid than expected and they are repaying prior to the first maturity.

Chairman Burns said he had found Mr. Holmes' report to be exceptionally interesting and constructive.

Mr. Holland indicated that he was highly gratified not only by the successful conclusion of the negotiations with the Belgians but also by the Desk's work in planning for the future. He looked forward with enthusiasm to approving Mr. Holmes' recommendations.

Chairman Burns noted that one of Mr. Holmes' recommendations was for the System to acquire up to $150 million in foreign currencies. As Mr. Holmes had indicated, the Committee had reached an understanding at the September meeting that such acquisitions should be limited to about $100 million, although the Manager formally had authority to purchase up to $250 million equivalent under the Committee's Authorization for Foreign Currency Operations.

In reply to a question by Mr. MacLaury, Mr. Holmes said he was not proposing to limit purchases to German marks; when opportunities arose, he thought it would be desirable cautiously to accumulate small amounts of certain other currencies.

Mr. MacLaury said he would question any presumption that it would be useful for the System to acquire a substantial volume of foreign currencies rather than to rely on the swap lines to obtain currencies needed for exchange market intervention. It seemed to him that the System could never know in advance what currencies would prove useful in particular situations, and accordingly, he viewed use of the swap network as a more flexible approach. However, he did not consider a stock of $150 million as substantial, and he would not object to building up the System's holdings to that amount.

Mr. Pardee commented that the Account Management had in mind the possible acquisition, in addition to German marks, of relatively small amounts of French francs and Dutch guilders for the sake of increased flexibility in operations. For example, there might be a need for such currencies at 3:00 p.m., New York time, when it was difficult to arrange a System drawing on a European central bank.

In answer to a question by Mr. Mayo, Mr. Holmes said he thought the value of holding a modest amount of foreign currencies had been illustrated in October, when German marks acquired in September were sold to support the dollar. At this stage he would not suggest anything more than a modest buildup of foreign currency balances. While it was important to recognize that such balances involved exchange risks, he thought the Committee should be prepared to take such risks so long as holdings were not substantial. Large holdings would have to be justified on grounds other than those he had in mind.

Mr. Mayo said he would be inclined to share Mr. MacLaury's cautionary view, particularly if the dollar was expected to strengthen so that losses on foreign currency holdings would be sustained. However, he could see a justification for acquiring a modest amount of currencies as a sort of permanent working capital for the System.

Mr. Mitchell noted that System officials had chastised commercial bankers for speculating in the foreign exchange market. The Committee certainly would not want the System's examiners to raise similar questions about the Desk's operations.

However, he did not believe the criteria used in the private sector could be applied to System operations, in part because the System had access to better information and System officials could be expected to operate in a temperate manner. Nonetheless, like others around the table, he was not anxious to have the System build up a big position in foreign currencies, and he understood that the Manager thought it would be inadvisable to do so.

Mr. Holmes indicated that Mr. Mitchell's understanding was correct.

Mr. Coldwell asked how the Desk invested System holdings of foreign currencies and whether the Manager intended to engage in any forward operations, including perhaps the matching of forward positions against spot positions.

In reply to the first question, Mr. Pardee said that investment procedures varied from currency to currency, and specific procedures had been worked out with individual central banks concerned. In some cases the System's holdings of foreign currencies were invested in accounts with central banks. In other cases, foreign currency balances were deposited with the BIS at Euro-currency rates.

Responding to Mr. Coldwell's second question, Mr. Holmes noted that the Desk's recent purchases of foreign currencies had all been on a spot basis. The System had engaged in forward operations in the past, but he saw no need for such operations at present.

In reply to a further question by Mr. Coldwell, Mr. Holmes indicated that the Treasury had acquired foreign currencies in the past, and indeed the Treasury had participated in tandem operations with the System on both sides of the market and might well do so again. However, Treasury officials had not reached a decision about building up foreign currency balances at this time.

Mr. Holland commented that the relatively small buildup of foreign currency balances under consideration seemed desirable to him, especially if the acquisitions were cyclically oriented in a world of more flexible exchange rates. If past cyclical experience provided any guide to the future, there would be times when it would make sense for the System to run a bit of a surplus in its holdings of foreign currencies and times when it would be advisable to incur a deficit in the sense of making net drawings on the swap line facilities. However, he did not think it would be desirable--and he gathered this was also the sentiment around the table--to build up surpluses during periods of cyclical strength for the dollar that were as large as the deficits that the System might be willing to incur during periods of cyclical weakness. Nonetheless, he thought a cyclical buildup in foreign currency balances to something greater than zero would represent a better policy than the one followed in recent years, especially given the difficulties the System had experienced in repaying swap debts.

Mr. Wallich said he thought the size of the System's holdings of foreign currencies should be viewed in accordance with the circumstances under which intervention was considered appropriate in a regime of floating exchange rates. If the System carried net balances over a period of time, one might argue that it was doing more than maintaining orderly markets. It was true that one could argue that holding some net balances was consistent with the minimal objective of maintaining orderly markets because the balances might be needed for intervention at any given moment. If, however, the System were to vary its holdings cyclically, it would be engaging in a broader form of intervention.

Mr. MacLaury referred to Mr. Holland's observation regarding a cyclical buildup of System holdings of foreign currencies, and commented that the United States was in a unique position. Countries on the other side of the Atlantic could always use holdings of dollars to offset cyclical pressures on their currencies. For the United States, however, there was no single currency that could serve the same purpose and there was no way of knowing in advance how useful particular currencies might be for market intervention during cyclical swings.

Mr. Holland said he thought he was in basic agreement with Mr. MacLaury. His remarks were meant to underscore the fact that, if the System were to follow a somewhat more active policy of intervention, a tendency for some sort of cyclical pattern in the System's holdings of foreign currencies was likely to emerge. Indeed, a general understanding of economic behavior and of the likely behavior of exchange rates should provide the Committee with a useful running guideline on when to expect System foreign currency balances to start increasing or declining. The recognition of such cyclical patterns should serve as a useful reminder that balances should not be allowed to move too far in either direction.

Mr. Solomon said he might make two comments that seemed relevant to the discussion thus far. One was that the Rambouillet agreement talked about offsetting erratic movements in exchange rates. While that concept had not yet been fully spelled out, it was not at all clear that cyclical movements would be defined as erratic; in fact, it was his guess that cyclical movements would be viewed for the most part as having a fundamental economic character. Accordingly, it was not evident that there would necessarily be a large amount of intervention to offset such movements. However, the meaning of the agreement remained to be seen as it was implemented.

His second comment, Mr. Solomon continued, related to the issue of risks on System holdings of foreign currencies. He was not urging that the System acquire large balances, but he thought the risks on System holdings of, say, $150 million in foreign currencies were minimal in relation to the risks incurred by foreign central banks that were holding tens of billions of U.S. dollars.

Chairman Burns observed that there was a difference in that foreigners were willing holders of large amounts of dollars.

Mr. Volcker said the use of the term "cyclical" created a bit of a problem for him because he did not think of the System's intervention policies in terms of business cycles, which involved rather long periods of time. There could, of course, be other sorts of cycles in the foreign exchange market. In any case, he thought that foreign currencies should not be acquired just for the sake of building up balances; if they were acquired, it should be as a by-product of market intervention that otherwise seemed desirable. For example, if the Committee followed a policy of moderating movements in dollar exchange rates, it might find that it was a net purchaser of foreign currencies because of the direction in which exchange rates were moving. Such intervention would not be possible unless the Desk was authorized to hold the resulting balances. The notion of building up foreign currency holdings when the dollar was strong was in his view completely symmetrical with that of drawing on the System's swap lines for intervention purposes when the dollar was weak and any previously accumulated holdings had run out. In his view, therefore, the issue before the Committee was whether the Manager was to be given authority to engage in intervention operations when the dollar was tending to appreciate. Of course, the System could use acquisitions of foreign currencies to repay any previous swap drawings, but if it started from a balanced position it would not be able to intervene unless the Desk could hold foreign currency balances.

In response to a question by Mr. Coldwell, Mr. Volcker said he presumed that Desk acquisitions of foreign currencies would result primarily from market intervention operations. While he could imagine some exceptional circumstances that would justify other acquisitions, he did not believe that buying foreign currencies solely to build up balances would be desirable as a general matter.

Mr. Holmes said he did not think there was necessarily a conflict between an expectation of cyclical movements in the System's foreign exchange position, which Mr. Holland appeared to have in mind, and the notion of System intervention to prevent disorderly markets. It was almost a foregone conclusion, if the dollar was weakening, that there would be days when the dollar would be disorderly on the downside and intervention would be appropriate under almost any intervention rule. Conversely, if the dollar was strengthening, there would be days when it tended to become erratic on the upside and the Desk would want to acquire foreign currencies.

Mr. MacLaury commented that there still seemed to be a difference between Mr. Volcker's interpretation of the purposes for which foreign currency balances might be acquired and what he understood to be Mr. Holmes' view. The difference came down to a question of whether or not one expected the central bank to operate around a zero balance over time. The issue was very subtle--if indeed it wasn't completely arcane--because in the real world one could never be sure whether $150 million on either side of zero was not in fact equivalent to zero. Nonetheless, it seemed to him that, conceptually at least, one could be talking either in terms of aiming over time for a zero balance--assuming the dollar was in equilibrium--or for some positive balance. Perhaps the issue was more a matter of academic interest than one of concern to market operators. The Committee was not talking about building up balances that were so large as to make any real difference in practice.

Mr. Wallich commented that a test of a neutral intervention policy--one that did not counter fundamental trends--was whether the System accumulated net balances over time. He was not referring to holdings of small balances, as recommended by Mr. Holmes, which could serve a useful purpose late in the day when it might not be feasible to make arrangements to draw on a swap line. Another test of whether intervention was being limited to the correction of disorderly market conditions in both directions was whether operations yielded net profits.

Mr. Pardee said he thought the latter would be true only if the exchange rate was stable. If the rate was moving persistently in one direction or the other, the System could lose money in the process of trying to cushion disorderly market movements. The System could not be sure about the trend in the exchange rate and, of course, that was a reason for being cautious in market intervention.

Mr. Wallich said that if operations were limited to leaning against the wind, rate fluctuations in both directions should enable the System to avoid losses over time even though there might be a trend in exchange rates.

Mr. Mitchell inquired whether the Treasury, in its agreement with the French at Rambouillet, had in effect changed the ground rules for System intervention in the foreign exchange market without consulting the Committee.

Chairman Burns said he did not think the agreement had changed any ground rules, although its tone suggested that intervention might be more active than in the past. However, the language of the agreement was so loose that its meaning could be determined only in the course of experience.

Mr. Wallich observed that the language appeared to have been broadened by the introduction of a reference to "erratic markets" in addition to "disorderly markets" in describing the reasons for intervention.

Chairman Burns added that the term "erratic" was used as a synonym for "disorderly" in one passage of the agreement. In another passage, however, a distinction was made between the two, but it was not defined. The language was imprecise.

Mr. Mitchell then asked Mr. Holmes whether, as a result of the Rambouillet agreement, he intended to recommend any changes in the Committee's guidelines for market intervention.

Mr. Holmes replied in the negative, noting that the Subcommittee on Foreign Currency Instruments was examining that issue. In his view, the agreement did not change anything significantly. It might be described as calling for a bit more of the same kind of intervention.

Chairman Burns said he would answer Mr. Mitchell's question a little differently. He thought the American position on intervention would be unchanged, and he did not anticipate a need to alter the Committee's guidelines as a result of the agreement. It was an evolving situation, however, and he would not rule out the possibility that some day the Committee would be asked to change those guidelines. In any case, the Committee's authority over the System's foreign exchange operations was undiminished, and no changes in foreign exchange operations would be made without authorization by the Committee.

Mr. Mitchell asked whether the System's losses on its foreign operations were shown separately in the Board's Annual Report to the Congress and whether the loss on such operations would be larger in 1976 than in 1975.

Mr. Pardee said profits or losses on foreign exchange operations were shown in the Annual Report. In recent years losses on such transactions had been reported and had been attributed to the devaluations of the dollar since late 1971. Whether losses would be greater in 1976 than in 1975 would depend upon the outcome of negotiations with the Swiss.

Mr. Holmes added that, as Mr. Pardee had indicated, the System was now taking losses that had been incurred when the dollar was devalued in 1971 and 1973. He had felt a little uneasy over the fact that the System swap debts were carried on the books at rates that did not reflect the changes in currency values since 1971. The Treasury had revalued its foreign currency debts a long time ago.

Mr. Volcker observed that the Treasury had announced the losses on its foreign currency indebtedness at the time of both devaluations and he believed that the System had done so as well.

Chairman Burns said he had called the losses to the attention of the Congress during the course of testimony.[1/] He had also pointed out that the losses were offset by gains from the increase in the official price of gold.

Mr. Mayo inquired whether an argument could be made in favor of amortizing the loss on the Swiss franc debt over a period of years rather than taking it all at one time.

Mr. Holmes said he thought the matter could be argued either way. Since the losses arising from the two devaluations of the dollar had already been announced, however, it seemed to him that nothing was to be gained by not taking them all at once.

1/ Chairman Burns testified on the System's losses from devaluations on March 2, 1972 before the House Committee on Banking and Currency; on September 15, 1972 before the Subcommittee on International Exchange and Payments of the Joint Economic Committee; and on March 7, 1973 before the Subcommittee on International Finance of the House Committee on Banking and Currency.

Mr. Volcker noted that the System's losses on Swiss francs included not only those resulting from the two devaluations of the dollar but also further sizable amounts stemming from the appreciation of the Swiss franc in the market.

Mr. Holmes said some part of the loss from the appreciation of the franc would be taken by the Swiss. Moreover, the loss would be reduced if the dollar strengthened against the franc. He thought that at this time the System should take only the losses resulting from the devaluations and that it should take any further losses resulting from exchange market developments as the swap drawings were repaid. Consideration might be given to establishing an account to reflect the potential loss arising from the changes in exchange rates that had occurred since the formal devaluations and to amortizing such loss over time.

Mr. Mayo observed that Mr. Holmes' approach seemed reasonable.

Chairman Burns asked whether there were any comments concerning Mr. Holmes' recommendation for rewriting the System's Swiss franc debt to take account of the dollar devaluations in 1971 and 1973.

Mr. Holland commented that in principle he favored rewriting the Swiss franc debt and recording the associated losses, as Mr. Holmes had proposed. Given the size of those losses and the further losses stemming from the appreciation of the Swiss franc in the market, however, he believed it would be useful for the Committee to endorse some general principles for taking losses rather than to make decisions on an ad hoc basis. He realized that such principles lay behind Mr. Holmes' recommendations and he thought he agreed with them. Nevertheless, he felt that Mr. Holmes should provide the Committee with a memorandum setting forth his philosophy of loss-taking, of which Committee action on the debt in Swiss francs would be one part, even though action on the Swiss franc debt would have to be put off until the next meeting. In that connection, he believed it made good sense for the Committee to establish a reserve for losses that might be incurred in foreign exchange transactions. An advantage of such a reserve would be to give the System more flexibility in the timing of its losses.

Mr. Holmes remarked that earlier action to adjust the Belgian franc debt for the two devaluations provided a precedent for rewriting the Swiss franc debt. He recommended action now with respect to that part of the loss, which had been agreed in principle for years and had already been announced. The question of further losses stemming from movements in market rates was somewhat different and was one that he would prefer to keep separate. He would prepare a memorandum that would recommend an approach to such losses.

Mr. Holland said he agreed with Mr. Holmes' recommendation. He hoped the memorandum would include recommendations concerning losses due to any future devaluations as well as those due to changes in market rates. He suggested that a case could be made for spreading the losses in Swiss francs over 2 years. For example, the loss of $195 million resulting from the two devaluations might be put in 1975, while some of the losses stemming from the market appreciation of the Swiss franc might be taken in 1976.

Mr. Mitchell commented that if as much as 5 years might be required to liquidate the System's drawings that had been outstanding for so long, he would not take losses above those caused by the devaluations of the dollar until the debts were paid off. To proceed otherwise would be similar to requiring banks to revalue their security holdings at market prices, which served no useful purpose. In developing a philosophy for System losses on debts in foreign currencies, one had to keep in mind the possibility that changes in exchange rates over the last couple of years would be reversed.

Chairman Burns said he would conclude from the Committee's discussion that the members wanted to proceed very cautiously. They were not interested in intervening on a large scale, and if the amount of intervention was to be increased, the Committee would want to proceed deliberately. That was the inference he drew from the comments made by members of the Committee, and in due course the Committee's thinking would have to be communicated to the Treasury.

In response to the Chairman's inquiry, the members indicated their agreement with his summary.

> By unanimous vote, an adjustment in the exchange rate on the System's outstanding Swiss franc swap debt, to reflect the December 1971 Smithsonian realignment of currency values and the February 1973 devaluation of the dollar, was authorized.

Chairman Burns then noted that the Committee's foreign currency authorization set a limit of $250 million on System holdings of uncovered foreign currencies. In keeping with Mr. Holmes' recommendation and the Committee's discussion, he suggested that the Desk not acquire more than $150 million equivalent of foreign currencies without consulting further with the Committee.

There was no objection to that suggestion.

By unanimous vote, the System open market transactions in foreign currencies during the period November 18 through December 15, 1975, were approved, ratified, and confirmed.

Secretary's note: Notes by Governor Wallich on the December BIS meeting, which were distributed at this meeting, are appended to this memorandum as Attachment A.

Chairman Burns then called for the staff report on the domestic economic and financial situation, supplementing the written reports that had been distributed prior to the meeting. Copies of the written reports have been placed in the files of the Committee.

Mr. Gramley made the following statement:

Recent incoming statistics indicate a further slowing in the pace of economic expansion. Last month, industrial production rose by just 0.2 per cent, as growth in output of materials was appreciably smaller than in earlier months. Production of business equipment, after declining in October, rose a little in November, and most other categories of industrial output also showed small gains.

In the labor market, the slowing pace of expansion was evidenced in November by a rise of just 40,000 in nonfarm payroll employment, by a further reduction in the proportion of nonfarm industries adding to their work forces, and by a small decline in the average length of the factory workweek. The fall in the unemployment rate, to 8.3 per cent, was the result of a sharp reduction in the civilian labor force.

There have been some concurrent indicators of economic activity showing a stronger performance recently. For example, housing starts rose 15 per cent in October, and the November rate of residential construction activity increased 5 per cent from the

October pace. Estimates of retail sales for September and October were revised upward, and the advance figure for November indicates a further gain of 1 per cent. The weight of evidence, however, points to more slowing in the pace of expansion during the fourth quarter than the staff had bargained for a month ago. Our present estimate is that real GNP will increase at around a 5 per cent annual rate this quarter--a very sharp reduction from the double-digit pace of the past summer.

The current lull in the pace of activity has generated uneasiness in the stock market and elsewhere that the economic recovery may already be faltering. The issue is clearly of substantial importance for monetary policy, and I would therefore like to spend the bulk of my time this morning dealing with this question. I have passed out a few charts that may be helpful to the discussion.1/

The first point I want to make is that temporary slowdowns in the course of a cyclical expansion are not uncommon. The first chart, covering the last few decades, shows six earlier periods--indicated by the rectangular boxes--in which the rise of industrial production faltered--for reasons not readily explainable by strikes--but then resumed again instead of culminating in a cyclical downturn. Some of those pauses lasted just 2 or 3 months; others, as in 1962, were rather prolonged. And there were about as many of those temporary periods of very slow growth as there were cyclical declines, which are indicated by shading. Thus, a slowdown such as we have experienced recently may or may not have predictive value; we need to know why it happened.

One source of the recent slowdown has been the response of producers to the leveling out of consumer buying during the late summer and early fall months shown in the next chart. Total retail sales in constant dollars, shown in the upper right-hand panel, began rising much earlier in the current recession and recovery than they had in the 1957-58 cycle, but the extent of recovery to date in total retail sales

1/ Copies of the charts referred to are appended to this memorandum as Attachment B.

has been about the same as in 1957-58. The recovery in consumer goods production, however, has been considerably less this time than in the 1957-58 cycle--for both durable and nondurable goods--as businesses have been following very conservative inventory policies. Since inventory positions of retailers are in quite good shape now--perhaps even on the lean side for nondurable goods--any significant rise in real consumer purchases would likely elicit a fairly prompt production response. Consumer buying has strengthened since September and appears to be gathering some momentum. Total retail sales in the last 2 weeks for which we have data have been fairly strong, and we hear reports from various sources, including the red book,1/ of heavy Christmas buying. Domestic new car sales also rose in the first 10 days of December to an 8-1/2 million annual rate. It therefore seems reasonable to expect a renewed upswing fairly soon in consumer goods production--especially for nondurables.

A second source of the recent slowdown is found in developments in the materials-producing industries, shown in the next chart. Output growth in these industries has slowed a good deal during recent months. Production of nondurable materials fell much more during the recent recession than in the 1957-58 cycle, and it also rebounded more during the first 7 months of recovery. For durable materials, the recovery of production has been weaker this time than in 1957-58. In part, this reflects the relatively moderate improvement thus far in final demands for durable goods, especially business equipment. But it also reflects a heavy overhang of inventories of durable materials at the onset of the recession; these excess stocks have not yet been worked off.

We have developed from the production index a measure of the monthly change in physical inventories of materials, shown in the bottom panel. These inventories are still being liquidated, though at a less rapid rate than a few months ago. While we cannot break down this inventory measure into its durable and nondurable components, collateral evidence indicates that the liquidation going on now is in the durables area.

1/ The report, "Current Economic Comment by District," prepared for the Committee by the staff.

The fact that inventories of durable materials are still relatively high is a negative factor in the business outlook. But the continued liquidation of materials inventories at this stage of the cycle is a favorable sign. It means that even if real final demands do no better than hold to present levels, production of materials--and especially durables--will eventually have to rise from current rates to prevent an undue runoff of stocks. An increase of real final demands for durables would, of course, strengthen measurably the outlook for production of durable materials.

A likely source of expanding final demands for durables in the months ahead is a rise of business fixed capital outlays, plotted on the next chart. Production of business equipment has shown few signs of recovery thus far, but corporate profits are rising rapidly, and advance indicators of plant and equipment spending are beginning to show improvement. The recent Commerce survey of anticipations indicates a probable increase in current dollar expenditures of around 10-1/2 per cent, at annual rates, between this quarter and the second quarter of 1976. In recent years, the November Commerce survey has been fairly accurate in forecasting expenditures over the next half year. An upturn of business fixed capital outlays in the months ahead thus seems a pretty good bet.

This line of reasoning has led the staff to the view that the current recovery is not now in serious danger of aborting, and our real GNP projection for 1976 in this green book[1/] is about the same as it was a month ago. We are still expecting real GNP growth over the four quarters of 1976 to average between 4-1/2 and 5 per cent at an annual rate. This is a relatively moderate growth rate, but it would be enough to reduce unemployment by about one-half percentage point by the fourth quarter of next year.

Our price projections are also about the same as they were a month ago. We still anticipate a further moderation in the pace of inflation to around a 5 to 5-1/4 per cent annual rate by late next year, as measured by the fixed-weight price index for private GNP.

1/ The report, "Current Economic and Financial Conditions," prepared for the Committee by the Board's staff.

> I should alert the Committee, however, to the fact that we have made no allowance in this projection for any effects on food prices of a possible resumption of sizable grain purchases by the Soviet Union. Such a development does not seem likely at this time, but there is some danger of more pressures on farm and food prices from this source than we have allowed for.

In reply to a question by Mr. Coldwell, Mr. Gramley observed that there had been a sharp increase in production of consumer goods beginning in March of this year and then a definite tapering off in the last several months. As he had indicated in his statement, he expected a renewed upswing fairly soon.

Mr. Kimbrel noted that in conversations with businessmen in the Atlanta District during recent weeks he had heard a surprisingly large number of expressions of concern about the possibility that wage and price controls would be reimposed.

Chairman Burns remarked that the uneasiness to which Mr. Kimbrel had referred probably could be attributed to a number of factors. They included the revival of incomes policies in Great Britain and the Netherlands, the spread of sentiment for such policies on the continent, the wage and price freeze in Canada, the acceleration of the rise in U.S. price indexes since midyear, and the likelihood of large wage increases in forthcoming collective bargaining settlements in this country.

Mr. Kimbrel then observed that in his District actual transactions prices appeared to be deviating from list prices for many commodities. He asked whether that phenomenon was occurring nationally, and if so, whether the staff had taken it into account in its projections.

Mr. Gramley replied that he had heard reports of the kind Mr. Kimbrel had mentioned, particularly with respect to the metals industries, where it was alleged that recent price increases had not held because of the persistence of excess stocks. Such reports had contributed to the staff's judgment that efforts to raise prices now for the purpose of increasing profit margins were likely to be more or less self-limiting. As a result, the rate of price advance projected for 1976 was roughly in line with the expected increase in unit labor costs.

Mr. Partee added that the specific price measure used in the staff's projections--the gross private product fixed-weight deflator--was composed mainly of elements of the consumer price index, which in turn was based on prices actually prevailing in the market. Accordingly, fictitious increases in list prices were not likely to pose a serious problem for the staff's projections.

Mr. Eastburn observed that he had talked with a number of corporate executives during the past week or two in an effort to determine the extent to which changes in list prices were illusory. The impression he had received was that list prices were holding rather firmly for metals. There was some discounting for chemicals, but even in that area, list prices were fairly firm. Moreover, further increases in list prices were anticipated, and they were expected to hold fairly well.

The Chairman observed that the problem of possible differences between list and transactions prices applied mainly to the industrial component of the wholesale price index. As Mr. Partee had noted, it applied not at all to the consumer price index and only in small degree to the fixed-weight private GNP deflator, on which the staff relied so heavily.

In response to a question by Mr. Francis, Mr. Gramley said that manufacturers' rebates were reflected in the price figures for automobiles used in the consumer price index.

Mr. Winn remarked that there were some questions in his mind about the projected upturn in business fixed capital outlays. First, it was his impression that a change had occurred in business thinking: businessmen had become more concerned about current profits and less about market shares. Secondly, part of the anticipated capital expenditures would represent mandated outlays for pollution control, and thus would not contribute to production capacity. Finally, he could detect no evidence that businessmen were expecting increases in interest rates next year of the magnitude projected by the staff; in particular, they did not seem to be scrambling now to arrange financing for their planned capital outlays. That, of course, might be explained by the highly liquid condition of many industrial firms. But such firms presumably would have to resort to external financing at some point, and if they encountered higher interest rates than they now expected, many of them might well cut back on their expenditure plans.

Mr. Morris observed that Mr. Gramley's final chart reflected figures on anticipated capital outlays in dollar terms. If the figures charted had been expressed in real terms the outlook would, of course, have appeared much weaker.

Mr. Morris added that Mr. Gramley had made a valid point when he noted that slowdowns like the present one had often occurred during past recoveries without leading to cyclical declines. It should also be noted, however, that the financial constraints now affecting the economy were greater than had existed at so early a stage in any prior business expansion within his memory. Accordingly, he found the charts distributed today less reassuring than Mr. Gramley evidently did, and he thought the Committee had to be alert to the fact that the risk of aborting the present recovery was rather high.

Chairman Burns remarked that if by "financial constraints" Mr. Morris meant the level of interest rates and the mood of caution that had spread through the business and banking community, he was undoubtedly correct in observing that the constraints were now greater than in past recoveries. However, corporate profits had risen sharply thus far in the current expansion. That, of course, was a source of financial strength.

Mr. Volcker observed that, even after the recent sharp rise, the level of corporate profits relative to GNP remained low by historical standards.

Mr. Gramley said he might make one point in response to Mr. Morris' comments. He hoped that the Committee had not interpreted his remarks today to indicate that the staff had changed its basic view of the outlook to one of great optimism. For some time the staff had been forecasting a relatively weak overall recovery because of basic problems in a number of industries, including problems resulting from the existing financial constraints. The staff still held to that view; under its latest projections, the rate of growth in real GNP would slow in 1976 to the 4-1/2 to 5 per cent area and unemployment at year-end would still be quite high. The point he had intended to make this morning was that recent developments had not caused the staff to modify its general view of the outlook.

Mr. Wallich observed that the recent rise in corporate profits was due in good part to large increases in productivity, and that a slowing of the rate of growth in real GNP ordinarily would be associated with an increase in unit costs. He asked whether the staff expected the rise in productivity to remain substantially above normal even if the rate of growth in real GNP fell to 4-1/2 or 5 per cent.

Mr. Gramley replied that the staff expected the rise in productivity to fall back to the neighborhood of the long-term trend rate, which was about 2-3/4 per cent.

Mr. Wallich then asked whether the staff thought a down-trend in the rate of inflation was likely, given the apparent rise in corporate profit margins and possible difficulties in upcoming wage negotiations.

Mr. Gramley replied that the staff was projecting a relatively moderate reduction in the rate of inflation--to a rate of about 5 per cent by late 1976. Even if profit margins did not rise further, aggregate profits were expected to continue to increase as economic activity expanded.

In response to a question by Mr. Black, Mr. Gramley said the Bureau of Labor Statistics for some time had been working on a revision of the wholesale price index. It was his understanding that the revision would apply to future measurements and would not be carried back to historical periods.

Mr. Francis said he rather liked the outlook for real product portrayed in the staff's projections because its contour was somewhat less cyclical than in many past recoveries. There had been no real hope that the rapid rate of growth of the third quarter could be maintained. While continuing growth at a rate in the range of 4-1/2 to 6 per cent might represent a somewhat slower recovery than many observers would like to see, such growth might make it possible to avoid a later need to adopt restrictive economic policies.

Mr. Baughman remarked that in recent conversations with businessmen in his District he had found an erosion of confidence with respect to the continuing strength of the economy. One reason for that erosion was a lessening in the flow of new orders and a decline in the backlog of outstanding orders. He wondered whether similar developments were apparent on a national scale.

Mr. Gramley replied that the circumstances underlying such attitudes no doubt were the same as those leading to the decline in the rate of increase of industrial production in October and November. In his judgment that slowdown, which affected orders as well as other economic magnitudes, would not persist; a resumption of orders was likely, particularly for nondurable goods--and also, after some time, for durable goods.

Chairman Burns observed that he had asked the staff to prepare a list of the economic statistics that had become available since the November meeting of the Committee. Because they were of general interest, he would cite some of the figures in the list, starting with the monthly figures showing increases, whether large or small.

In October, the Chairman noted, private housing starts--a physical volume series--rose 15 per cent. Personal income increased at an annual rate of 12 per cent. Machine tool orders rose 4.9 per cent. New orders for manufacturers' durable goods--a series bearing on Mr. Baughman's point--rose 0.3 per cent. Orders for nondefense capital goods--which, looking to the future, might be a more significant series--rose 4.2 per cent. Value of construction contracts awarded went up 6 per cent. Construction contracts for commercial and industrial floor space, a physical unit measure, rose 8 per cent.

In November, the Chairman continued, construction expenditures rose 2 per cent in both current and constant dollars. In October the dollar value of shipments of manufactured goods rose 1.5 per cent. In November the unemployment rate fell to 8.3 per cent and nonfarm payroll employment rose 41,000. Retail sales--a dollar value series--had been revised up for September and October and rose 1 per cent in November. In October sales of existing homes were up 2.5 per cent, and in November industrial production rose 0.2 per cent.

Next, Chairman Burns said, he would list the monthly series that were unchanged or declined. Unchanged in October were residential building permits, new home sales, and real earnings--that is, average hourly earnings deflated by the consumer price index. In November hours of employment in manufacturing fell 0.25 per cent, the household survey figures on total employment declined 163,000, and the average manufacturing workweek fell 0.1 of an hour. In October new home sales were unchanged.

Turning to the weekly and other series, the Chairman noted that in recent weeks retail sales had strengthened and unemployment insurance claims had shown no change. Domestic auto sales rose in the first 10 days of December.

Chairman Burns said he might mention a few other recent developments. The New York crisis had abated; the City's situation looked better now, and municipal bond yields had declined. Finally, he had heard reports that the figures for housing starts in November would show a decline, and that the Commerce Department's current estimates of real GNP suggested a larger rise in the fourth quarter than the Committee's staff was currently projecting.

Mr. Morris remarked that tensions in the market for municipal bonds were now related more to the financial problems of New York State than to those of the City. In view of the potential impact of New York's problems on New England States and on State and local spending in general, he asked whether Mr. Volcker had an appraisal of the prospects for resolving them.

In response, Mr. Volcker observed that a coherent assessment of the situation probably could not be made at this time. An intense political debate was in progress over the means of balancing the State's budget. All sides agreed in principle that the budget should be balanced, but estimates of the size of the prospective deficit varied greatly and ranged up to $700 million. Governor Carey held that the State government ought to act now--and immediate action made economic sense in that it would have a calming effect on financial markets--but for various reasons his political opposition preferred to delay action until after the beginning of the new year.

Continuing, Mr. Volcker said New York State agencies were limping along from month to month in meeting their obligations. At 11:30 last night a law finally had been enacted, which--as he understood it--committed a State insurance fund to sell holdings of Federal agency and Treasury securities to a syndicate of banks and other financial institutions in order to acquire funds to lend to the State Housing Finance Agency, enabling the latter to redeem securities that matured yesterday. The redemption was accomplished by 11:55 p.m. Repetition of that kind of process would undermine confidence in the market.

Mr. Volcker observed that several of the smaller school districts in the State were unable to raise funds in the market in the normal way. None had yet gone into default, but defaults had been avoided by last minute rescues, typically achieved through a combination of a small amount of funds from the State and of the proceeds of a private placement with one or more local banks. It was uncertain whether that process could be relied upon for very long. In summary, confidence had eroded further, and it was not likely to be restored until the State took decisive action. The credit of the State agencies was dependent on the credit of the State.

Mr. Morris noted that 2 months ago the Massachusetts legislature had approved a balanced budget, but the market for the State's obligations had not returned to normal. He asked Mr. Volcker whether he had reason to think that New York's experience would be different.

Mr. Volcker replied that he did not. However, the State was in a more or less fortunate position in that essentially it would have sufficient funds to redeem all of its securities maturing until late March, and it had no additional short-term obligations beyond March. However, from the last day of March through the second quarter it would have to finance a deficit of $3-1/2 billion to $4 billion. If the State acted promptly to balance its budget, it would have a few months in which a climate of market receptivity might be restored. The idea was to balance the budget--not in this fiscal year, which was not possible, but over this and the next fiscal year combined--in order to demonstrate that the borrowing required next spring would be repaid from revenues in the following winter. Even then, it was doubtful that the deficit in the spring could be financed through normal market operations. A substantial volume of funds probably would be available from the State pension funds, but a sizable amount would remain to be financed. The question was whether the State would take the fiscal actions necessary to lay a foundation for an abnormal kind of financing operation through some sort of a nation-wide syndicate of banks or in some other manner.

Mr. Mayo remarked that he would add price indexes for common stocks to the Chairman's list of statistics becoming available since the November meeting. The failure of stock prices to respond significantly to the improvement in the New York City financial situation was one of a succession of disappointments in the market. That was a source of concern, even if the relationship between the behavior of the market and subsequent economic developments was rather loose.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period November 18 through December 10, 1975, and a supplemental report covering the period December 11 through 15, 1975. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Sternlight made the following statement:

> In aiming for moderate growth of the monetary aggregates since the last meeting of the Committee, Desk operations were directed steadily at maintaining a climate of reserve availability consistent with Federal funds remaining around 5-1/4 per cent. It was contemplated at the time of the last meeting that the Account Management would, after about a week, encourage a move from the then-prevailing 5-1/4 per cent funds rate to a point midway in the agreed 4-1/2 to 5-1/2 per cent Federal funds range. However, evidence on the aggregates received early in the period suggested greater-than-expected strength, and thus a more accommodative stance did not appear appropriate. Toward the close of the interval, data on the aggregates provided a more mixed picture--with M_1 expected to be in the lower part of its preferred range for November-December and M_2 in the upper part of its range, though with both aggregates relatively strong in the November portion of the period for which actual data were available. In these circumstances, given also that today's meeting was then but a few days off, the Account Management continued a steady policy of reserve availability.
>
> Close attention was paid throughout the period to financial market developments, giving particular care to the New York situation. While a number of uncertainties remained in regard to New York City, State, and State agency finances, the over-all situation appeared much less bleak after the President's Thanksgiving eve endorsement of limited seasonal financial assistance for the City.

Following the typical pattern of recent months, the Desk provided reserves in large size in the early part of the inter-meeting period to offset the need from such factors as the rising Treasury balance. Outright purchases in the opening days of the period included $354 million of Treasury coupon issues and $921 million of bills. Reserves were also supplied through repurchase agreements. Later, as market factors supplied reserves, including the usual early-in-the-month run-down in Treasury balances, reserves were withdrawn through the redemption of $400 million of Treasury bills and extensive use of day-to-day matched sale-purchase transactions. Projections indicate a very large reserve need for the week beginning December 18, and it will most likely be appropriate to meet an appreciable part of it through outright purchases of Treasury and agency securities. Indeed, we got a small start on that job yesterday by purchasing $204 million of bills from foreign accounts, and we may buy agency issues today.

Interest rate changes were relatively moderate during the past inter-meeting period. Bill rates have risen by some 4 to 20 basis points as the market continued to absorb fresh supplies from the Treasury against the background of steady day-to-day conditions of reserve availability. In yesterday's auction of 3- and 6-month bills, average issuing rates were 5.49 and 5.91 per cent, respectively, compared with 5.47 and 5.80 per cent just before the last Committee meeting. With day-to-day fi ancing costs holding below these levels, dealers have been willing to hold large inventories of bills.

Yields on Treasury coupon issues also rose modestly over the period--most issues were up in the range of about 5 to 20 basis points. Much of the rise came in reaction to reports of large money supply increases and attendant concern that the System might move to a firmer stance. Anticipation of new Treasury sales of coupon issues also placed some upward pressure on yields, but with actual new sales temporarily at low ebb, dealers managed to work down their inventories of issues having maturities in excess of 1 year by nearly $1.5 billion during the period. That respite in new issuance is now at an end, and today the market is bidding on $2.5 billion of 2-year notes to refund a maturing issue and raise $1 billion of new cash. Next Monday, the Treasury will auction $2 billion of 4-year notes for payment in early January, thus getting a start on the very heavy cash needs of the next quarter.

The corporate and municipal markets registered little net change for the full period. Corporate issues were under pressure at times, as the market worked through a fairly heavy calendar in early December, but a better tone had emerged by the close of the period, possibly reflecting views that the pace of business recovery, and credit demands, would be moderate for some months to come.

Developments in the tax exempt market remained mixed and still burdened with questions about the New York City and State situations. The passage of legislation to provide temporary Federal aid for New York City was helpful to the markets, although considerable uncertainties remain about the legality of the State-imposed moratorium on repayment of maturing City notes. Questions remain, too, about the finances of New York State and its agencies, although there has been progress in recent days in recognizing the underlying budget realities facing these borrowers.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period November 18 through December 15, 1975, were approved, ratified, and confirmed.

Mr. Axilrod made the following statement on prospective financial relationships:

I can be very brief this morning, since our basic financial outlook is little changed from what it was at the previous meeting. We still expect interest rates to rise gradually during the first half of next year in order to keep the monetary aggregates on target. But the timing of the projected rise is once again a little further in the future than it was, and the degree of rise is a shade less than indicated at the last meeting and considerably more moderate than expected last summer.

A new development affecting interpretation of the monetary aggregates in the period immediately ahead is the sizable increase that has been occurring in corporate savings deposits at banks. Such deposits were permitted by regulation beginning November 10. The staff believed that these accounts would begin growing quite slowly. That turned out to be an erroneous assumption.

Through December 3, these accounts at weekly reporting banks expanded by $530 million. The increase was concentrated outside the major money center banks. Thus, the accounts would appear to be attracting mainly medium- and smaller-size businesses, and it is therefore reasonable to believe that at least a similar rise occurred at other, non-weekly reporting banks. It would also be reasonable to believe that at least half, and probably more, of the funds represented shifts from demand deposits.

We believe that recent M_1 growth has been reduced by 1 to 1-1/2 percentage points because of shifts out of demand into savings accounts in response to the new regulation. Our expectations for M_1 growth in the December-January period have also been reduced by about that amount because of continuation of such shifts.

These shifts in funds out of demand into savings accounts rather clearly entail a reduction in the demand for M_1 for any given GNP and level of interest rates. Thus, the Committee would probably wish to make explicit allowance for them by permitting somewhat lower M_1 growth than otherwise during the transition period. M_2 would, of course, not be affected by shifts out of demand deposits. However, to the extent that some of the funds going into saving accounts come out of market instruments, there would be a slight upward influence on M_2.

We have assumed that the transition period over which corporations readjust deposit holdings to the new regulation will be relatively short. Specifically, we expect one-time stock adjustments to be virtually completed by late winter. As a result, we anticipate that M_1 targets would be affected for only a few months or so. Nevertheless, we cannot be certain of the length of the transition period nor of the size of the adjustment. Thus, the recent behavior of corporations, and attendant uncertainties, once again

> illustrate the essential instability of M_1 in the short run and the need to take account of broader measures of money, as well as M_1, in setting guidelines for open market operations.

Mr. Balles asked for the staff's latest projections of growth in M_1 and M_2 in December.

Mr. Axilrod stated that on the basis of the old seasonals December growth was projected at annual rates of 2.0 per cent and 6.5 per cent for M_1 and M_2, respectively. Based on the new seasonals, growth in M_1 and M_2 was projected at rates of 0.8 per cent and 5.9 per cent, respectively.

Mr. Holland asked whether any adjustments to the December-January ranges of tolerance for growth in M_1 and M_2 had been made to take account of the shift in business deposits from demand to savings accounts.

Mr. Axilrod replied that the assumption of continuation of the shift had caused the range for M_1 over the 2-month period to be about 1-1/2 percentage points lower than it would have been and the range for M_2 to be about 1/2 percentage point higher than otherwise.

In response to questions by Mr. Mitchell, Mr. Axilrod said the staff was planning to make a special survey soon after the end of the year in order to obtain a benchmark total of business savings accounts at commercial banks. He had assumed that the total was twice the amount indicated by weekly reporting member banks, but that estimate could be off by a considerable amount.

Mr. Wallich observed that staff projections of growth in the money supply had been significantly in error and that the current level of interest rates was associated with a much lower volume of money than had been anticipated. In other words, the income velocity of money had increased without a rise in interest rates. As Chairman Burns had indicated on past occasions, monetary velocity had been extraordinarily flexible. He wondered what the equations now were suggesting about the behavior of the money supply and whether, as he had heard, the New York Bank staff's equations over-predicted growth in the money supply to an even greater extent than did the Board staff's equations.

In response, Mr. Axilrod said he was not familiar with New York Bank projections of monetary growth over the longer run. For the short run--the December-January period--the New York Bank had projected a somewhat lower rate of monetary growth, at given interest rates, than had the Board staff. The staff's projection, in turn, was somewhat lower than that suggested by its model. In view of the recent projection errors of the model, the staff had tended to lower the level of interest rates it associated with any assumed rate of monetary growth. In other words, the staff now was assuming less demand for money, given nominal GNP, than it had earlier.

Mr. Volcker commented that after watching the performance of the money market equations for some time, he had concluded that none was any good.

Mr. Wallich remarked that the equations seemed to have performed reasonably well for a long time. However, something peculiar had happened over the past six quarters.

Mr. Jackson asked why it was that the projected rates of monetary growth for the third quarter of 1976 shown in the blue book[1/] were higher under the most restrictive alternative--C-- than under the least restrictive alternative--A.[2/]

In response, Mr. Axilrod said the explanation was to be found in the different behavior of interest rates under the two alternatives. Under alternative C, the Federal funds rate was assumed to begin to move up promptly in the next inter-meeting period but then to level off at around 6-1/2 per cent in the second and third quarters of 1976. Under alternative A, the Federal funds rate was assumed to decline in the short run and then to rise sharply in the second and third quarters of next year to levels higher than under alternative C. Therefore, monetary growth under alternative C was slower than under

1/ The report, "Monetary Aggregates and Money Market Conditions," prepared for the Committee by the Board's staff.

2/ The alternative draft directives submitted by the staff for Committee consideration are appended to this memorandum as Attachment C.

alternative A in the first and second quarters of next year and faster than under alternative A in the third quarter.

Chairman Burns commented that over the period from the third quarter of 1975 to the third quarter of 1976 growth in M_1 under all three alternatives was projected to be 6-1/4 per cent--the midpoint of the longer-run range adopted by the Committee. Therefore, if growth under alternative C was less rapid than under alternative A in the early part of the period, it had to be more rapid later in the period.

Chairman Burns then called for a discussion of monetary policy and the policy directive. He suggested that in their prescriptions for policy, members of the Committee not attach too much weight to minor arithmetical differences. On some past occasions when such differences had been debated with considerable feeling, the specifics of those debates had been difficult to recall just a month or two later. He invited the Committee's Chief Economist, Mr. Partee, to open the discussion by offering his advice to the Committee.

Mr. Partee remarked that the main point he would like to emphasize to the Committee today was that the task of projecting rates of growth in the various monetary aggregates was particularly difficult for the month of December. In the decade or so that he had been involved in making such projections, he had found December rates of growth in the aggregates the hardest of all to predict with any confidence, probably because many business and financial institutions customarily made adjustments to cash and debt positions for purposes of year-end financial statements. He had the impression that in the past the staff's projections for December had been off the mark by as much as 10 percentage points; moreover, the projections had not been consistently above or below the realized rates of growth. If a probability index relating the staff's monthly projections to actual monetary growth were constructed, its low point would most likely be for December.

In addition, Mr. Partee observed, projecting the aggregates had been further complicated recently by the difficulty of analyzing the effects of the November 10th amendment to regulations that permitted corporations, partnerships and other profit-making organizations to maintain savings accounts in amounts of up to $150,000 at member banks. Not only was the initial stock adjustment now taking place difficult to assess, but there was no basis whatever for projecting the extent to which flows into such accounts might be maintained over coming months.

He had emphasized the difficulty surrounding the projections, Mr. Partee said, because at the moment he could see no clear reason for the Committee to change the current posture of policy. The sharp rise in the money supply in November had brought the level close to the path in line with the Committee's minimum longer-run rates for growth in the aggregates, and in interpreting this path some allowance should now be made for the growth in business savings accounts. Moreover, he had been persuaded by Mr. Gramley's remarks that the prospect of a near-term resumption of the recovery in business activity was good. Judging by historical relationships between indicators of demands for goods and the index of industrial production, recent developments suggested that output and employment would rise over the next few months. Accordingly, he did not see the advent of a period of economic stagnation ahead; in fact, he thought the evidence would support the opposite conclusion.

In sum, Mr. Partee remarked, if the Committee ever was inclined to specify operations in terms of money market conditions, there appeared to be seasonal grounds in support of doing so in December and early January. He saw nothing that would preclude him from recommending that course to the Committee today. Specifically, he would recommend maintaining current money market conditions until there were clear indications concerning the course of the aggregates or of the economy. Accordingly, he would suggest that the Committee narrow the range for the Federal funds rate and specify, say, 5 to 5-1/2 per cent--a range centered on the 5-1/4 per cent rate prevailing during the period since the previous meeting. He would change the range only in response to some significant financial or economic development.

Mr. Morris observed that in large part he agreed with Mr. Partee. The performance of the aggregates over the past 5 weeks suggested that a 5-1/4 per cent funds rate was compatible with a healthy rate of monetary growth. Accordingly, he would maintain current money market conditions unless evidence to the contrary emerged. However, he would not narrow the funds rate range. To his mind, the 4-3/4 to 5-3/4 per cent range of alternative B was narrow enough; he preferred to allow the Manager some leeway should growth in the aggregates prove inconsistent with expectations. While he could accept the funds rate range of alternative B, he could not accept the specifications for the aggregates under that alternative. Those specifications would call for an increase in the funds rate if growth in M_1 over the December-January period appeared to be exceeding a 6 per cent annual rate. In light of the sluggishness of the economy and the current shortfall in the aggregates from the Committee's longer-run objectives, he doubted that many members of the Committee would favor an increase in the funds rate if the 2-month rate of growth in M_1 appeared to be greater than 6 per cent. He thought the Committee had been wise last month to widen the ranges for the aggregates and he would suggest that it do so again today.

Specifically, he favored ranges of 4 to 9 per cent for M_1 and 7 to 12 per cent for M_2.

Mr. Kimbrel remarked that he drew confidence from recent conversations with business leaders and the directors of his Bank and also from incoming economic data, and he continued to feel reasonably optimistic about the economic outlook. Retailers seemed to expect good Christmas sales, and auto manufacturers appeared to be somewhat more optimistic. Prospects for a pick-up in business capital spending and in housing appeared to have improved. While the behavior of wages and industrial prices called for close monitoring over the near term, recent developments did not suggest any intensification of inflationary pressures. On the other hand, commercial banks and thrift institutions appeared to have adequate funds to accommodate demands so that a step-up in the rate at which the System provided funds would not seem to serve any worthy purpose at this juncture.

Mr. Kimbrel observed that those considerations led him to favor the specifications of alternative B, although with the range for the Federal funds rate narrowed to 5 to 5-1/2 per cent as suggested by Mr. Partee. He thought that upward pressures on interest rates still were in prospect for the near term, and he would not want to see policy directed toward reducing interest rates because of the likelihood that any declines would have to be reversed shortly. Neither would he want to see rates move up. This was a time for stability.

Mr. Coldwell remarked that he was not at all satisfied with the progress of the recovery recently or with the prospects suggested by the staff projection--particularly the outlook for an unemployment rate still close to 8 per cent at the end of 1976. In his judgment, it was time for the Committee to take a measure of stimulative action with a view to achieving a faster rate of growth in economic activity promptly. The expansion in consumer spending that many were counting on to bolster the recovery was, in his opinion, quite uncertain. Interest rates were too high, and bank lending policies were too tight for a period of recovery. To his mind, the Committee's emphasis on M_1 had caused policy to be erratic and perhaps had contributed to public misunderstanding. Apprehension about possible bank failures and about New York's financial problems had created uncertainties that called for some counter-balancing action. In the absence of more monetary stimulus over the next few months, Congressional uneasiness about the recovery might generate sizable fiscal actions, which he would regard as extremely undesirable.

Mr. Coldwell said he agreed with Mr. Partee's observation concerning the great uncertainty surrounding projections of the aggregates in this period. However, he would not narrow the range for the Federal funds rate; rather, he would widen the ranges for the aggregates. Specifically, he would suggest ranges of 4 to 7 per cent for M_1 and 7 to 10 per cent for M_2. For the Federal funds rate, he favored continuing the 4-1/2 to 5-1/2 per cent range specified at the last meeting.

Mr. MacLaury said he agreed with the thrust of Mr. Gramley's remarks that the economy was currently in a period of pause and not a period of stagnation. The extremely rapid and clearly unsustainable pace of expansion in the third quarter tended to magnify the recent slowdown. As he had indicated at the previous two Committee meetings, he believed that the economy would be stronger in 1976 than projected by the staff, although his confidence in that prediction was not very robust.

With regard to the specifications, Mr. MacLaury observed that his prescription for policy was similar to Mr. Coldwell's, but for different reasons. He would set a range of 4 to 7 per cent for M_1--with whatever range for M_2 was consistent with that--and a range of 4-1/2 to 5-1/2 per cent for the Federal funds rate. He regarded those specifications as representing a policy of no change, and that was what he favored at this time.

Mr. Jackson remarked that he was in general agreement with the specifications suggested by Messrs. Coldwell and MacLaury. However, he was concerned that the substantial financing demands anticipated over the next few weeks might exert some upward pressure on market rates of interest. Accordingly, he thought it might be necessary to nudge the Federal funds rate down a bit in order to maintain the broader spectrum of interest rates at about prevailing levels. To achieve the broad concept of interest rate stability he had in mind, he would advocate a 4-1/2 to 5-1/2 per cent funds rate range--perhaps with an instruction to the Manager to exert slight downward pressure on the rate. For M_1, he favored the widened range of 4 to 7 per cent.

Mr. Francis said he believed that the recovery was making reasonably good progress. The extremely rapid rate of expansion in the third quarter of this year obviously could not be maintained into the fourth quarter and the quarters that follow. Consequently, he was not concerned about the leveling off of economic activity in the current quarter. For the coming period he tended to favor the specifications of alternative B in the blue book--although he saw little difference between those of alternatives B and C. He would not narrow the funds rate range; to his mind, the width of the ranges shown in the blue book would provide the appropriate degree of flexibility for Desk operations over the coming inter-meeting interval.

Mr. Mayo remarked that operations during the period since the last meeting had proceeded quite satisfactorily within the 4-1/2 to 5-1/2 per cent Federal funds rate range that had been specified, and he favored continuing that range for the coming period. In his judgment, an added degree of flexibility was called for at this juncture, and he thought it desirable to depart from the general practice of setting out to move the funds rate toward the midpoint of its specified range. Looking ahead 45 days to the publication date of the policy record for this meeting, a change in the funds rate range--say, to one of 4-3/4 to 5-3/4 per cent or 5 to 5-1/2 per cent--to encompass a midpoint of 5-1/4 per cent would require more of an explanation than he would care to attempt to provide.

With respect to the monetary aggregates, Mr. Mayo said the current situation presented an excellent opportunity for the Committee to emphasize to the public that the behavior of both M_1 and M_2 were taken into account in its decision-making process. Presently, the projections for M_2 were subject to less uncertainty than those for M_1. Like others who had spoken earlier, he favored widening the 2-month ranges of tolerance for M_1 and M_2 to 4 to 7 per cent and 7 to 10 per cent, respectively. Those specifications were consistent with growth in the aggregates at rates within the Committee's longer-term target ranges. He interpreted the Committee's longer-term objectives as growth rates within the ranges specified, rather than at the midpoints of the ranges. It would be a mistake to focus on the midpoints. Accordingly, he preferred to err a little on the side of ease now, even if that necessitated action to slow the rate of monetary growth later on.

He might note in passing, Mr. Mayo continued, that RPD's had become obsolete as a short-run policy variable. On strictly economic grounds, he would recommend dropping RPD's from the list of variables for which the Committee set specifications. However, since the absence of that variable from the list would be noticed and its presence did no harm, he would retain it among the specifications until the Subcommittee on the Directive made its recommendations.

Chairman Burns remarked that he agreed completely with the specifications Mr. Mayo had suggested. He favored widening the 2-month range of tolerance for M_1 to about 4 to 7 per cent. He would continue the 4-1/2 to 5-1/2 per cent range for the Federal funds rate, but he would view the range asymmetrically. Thus, he would seek to maintain the funds rate at about the currently prevailing 5-1/4 per cent level unless incoming data suggested that the rates of growth in the monetary aggregates were deviating significantly from the midpoints of their specified ranges.

Mr. Wallich said he agreed with the view that the economic expansion was not proceeding satisfactorily. Like Mr. Coldwell, he was concerned about the fiscal actions that might be taken next year if the Federal Reserve did not give some indication of a more stimulative policy. In light of the current projections for economic activity, however, he would hesitate to push strongly in that direction. In any event, the effect of any action taken now would not be seen immediately but would be delayed, perhaps until next summer. Moreover, given the longer-term target of 5 to 7-1/2 per cent M_1 growth, the result of a significantly more stimulative policy now would be greater upward pressures on interest rates next summer, and sharp increases in rates then would be detrimental. He would argue, therefore, that specifications along the lines of those shown under alternative B were directed more to achieving continued economic expansion during 1976 than those under alternative A, which would lead to intensification of upward pressures on interest rates around midyear.

He was troubled, Mr. Wallich said, by the recent erratic behavior of M_1. Because he was uncertain whether that sort of behavior would continue, he would place less emphasis on M_1 and more emphasis on interest rates in this period. He thought the avoidance of a rise in interest rates was particularly important at this juncture; accordingly, he would not want to specify an upper limit for the funds rate range above 5-1/2 per cent. Although he usually favored a wide range for the funds rate, he tended to agree that a narrowing of the range made sense at this time. If the funds rate were pushed down too far in the period immediately ahead, policy would become more stimulative in the short run and might have to be reversed later on. Consequently, a 5 to 5-1/2 per cent funds rate range appeared reasonable to him. For the aggregates, he found the specifications of alternative B broadly acceptable, but at this time he would pay considerably less attention to M_1.

Mr. Balles remarked that he, like Mr. Coldwell, was concerned about the economic outlook and the level of interest rates. Moreover, he had the impression that business confidence was not as favorable as business statistics might suggest. For example, business executives viewed the substantial rise in corporate profits that had been noted earlier in the light of proposals for "price level accounting" and of the adjustments not only for inventory valuation but also for inadequate depreciation allowances. After such adjustments, corporate profits were below the levels reached 3 or 4 years ago.

Chairman Burns noted that the staff had made a special report on corporate profits to the Board recently, and he asked Mr. Gramley to comment.

Mr. Gramley remarked that corporate profits, adjusted for inventory profits, as a proportion of corporate gross product had returned to about the levels reached in 1969 but remained below earlier peak levels. However, the recovery in corporate profits had been stronger during the current upswing than in any previous business cycle.

Mr. Volcker observed that, as he had noted earlier, corporate profits relative to GNP were low by historical standards.

Chairman Burns commented that the data for corporate profits after inventory valuation adjustment suggested remarkable improvement relative not only to the recession low but to levels in other recent years. He suggested that a copy of the recent staff report be sent to the Reserve Bank Presidents.1/

Mr. Coldwell remarked that a great deal of the recent improvement had occurred in the third quarter of this year.

Mr. Balles said the point he had wanted to emphasize was that corporate profits as viewed both by corporate executives and by financial analysts were not as favorable in terms of levels or rates of growth a^ the nominal figures might suggest. The behavior of business investment outlays in the months ahead was the great uncertainty in the outlook, and he was concerned about prospects in that area not only because of the profits situation, but also because of the levels of long-term interest rates, which adversely

1/ The staff report, dated December 8, 1975, and entitled "Corporate Profits," was distributed to the Reserve Bank Presidents on December 18, and a copy has been placed in the Committee's files.

affected businesses' willingness to undertake external financing for expansion of plant and equipment. Moreover, the efforts of many large banks to absorb loan losses stemming from the excesses of the past several years had made banks fairly selective in lending to businesses, and conservative loan policies were not helping to promote a vigorous recovery.

Turning to his prescription for policy, Mr. Balles observed that he favored the specifications recommended by Mr. Mayo and endorsed by the Chairman: 4 to 7 per cent for M_1, 7 to 10 per cent for M_2, and 4-1/2 to 5-1/2 per cent for the Federal funds rate. Because of his concern that the apparent pause in the economic expansion might turn out to be of longer duration than currently anticipated by the staff, he would resolve any doubts by moving slightly in the direction of ease.

Mr. Volcker remarked that he was in general agreement with the views expressed by Mr. Wallich and thought that the emphasis in Mr. Partee's prescription for policy was about right. He was uncertain about the business outlook, but he had no disagreement with the staff's analysis of prospective developments. While he believed that some risk of aborting the recovery still existed, he thought that if economic activity deviated from the staff's projections, it was more likely to be on the side of greater than less strength.

Against that background, Mr. Volcker said, he agreed with the general sentiment expressed so far today that no tightening should be undertaken; he could, perhaps, be convinced that some easing might be appropriate. But he could not agree with a policy prescription that gave much weight to the behavior of M_1 in this period--particularly in light of Mr. Partee's remarks about the uncertainty surrounding projections for the month of December. The chances were unusually great that growth in the aggregates in the December-January period would fall outside any ranges that the Committee was likely to specify. The potential for erratic movements in the aggregates was too great to justify a range only 2 or 3 percentage points in width. Consequently, he would be disturbed if operations were to be directed toward changing the funds rate significantly on the basis of incoming data for the aggregates.

Chairman Burns remarked that there was a degree of protection in that the Committee set ranges of tolerance for rates of growth in the aggregates over 2-month rather than 1-month periods.

Mr. Volcker said much would depend on interpretation of the weekly data becoming available and on the projections for the remainder of the period. Personally, he would not be greatly concerned if monetary growth appeared to be relatively rapid in this period, and he would not be quick to react if it appeared to be slow. In sum, whatever the precise specifications adopted, he would favor a money market directive so that the major emphasis of policy would be on maintaining stable--or if the Committee desired, somewhat easier--money market conditions. In any case, he would not want to see movements in the funds rate triggered by short-term fluctuations in money supply growth. Consequently, he would specify a range for M_1 of 2 to 8 per cent and a range for the Federal funds rate either of 5 to 5-1/2 per cent, as recommended by Mr. Partee, or a range of 4-1/2 to 5-1/2 per cent, to be interpreted asymmetrically, as suggested by the Chairman.

Mr. Mayo remarked that he had the impression that most members were willing to place more than usual emphasis on M_2 during the coming period.

Mr. Volcker indicated that such a course would alleviate his problem somewhat, but he was not at all certain that the behavior of M_2 would be free from short-term aberrations.

Chairman Burns said he thought that most Committee members typically regarded M_1 as an index of the bundle of monetary aggregates, but that a majority attached more importance to M_1 than to the other monetary aggregates. In view of the increasing evidence of the changing character of the nation's payments system, he believed that Committee members should increase the weight they placed on M_2 relative to M_1.

Mr. Volcker remarked that the behavior of business savings accounts since the recent regulatory changes permitting such accounts was an argument in support of the Chairman's suggestion.

Mr. Baughman said he was in sympathy with those who favored a mild easing, which might take the form of an inclination toward a slightly lower Federal funds rate and a greater tolerance toward increases in the rates of growth in the monetary aggregates. Among the major reasons for that view was the evidence available on business attitudes and expectations. Also, retailers with whom he had been in touch recently had indicated that credit sales currently were smaller relative to cash sales than a year ago, which might suggest that consumer expenditures--which were a key element in the business outlook--would be less vigorous than had been expected. A third consideration was his belief that bank lending rates were a bit high relative to general credit market conditions. A slightly easier monetary policy posture would help avoid a premature rise in those rates and might even nudge them down.

Mr. Baughman observed that he was concerned about the continuing indications that wages and prices were able to move independently of the utilization rates of industrial and labor resources. In addition to doing what appeared appropriate with respect to monetary policy, System officials should continue to call attention to that development--as the Chairman had been doing--in the hope of at least taking the edge off the aggressiveness with which wages and prices were pressing upward. He had noted with interest that West Coast retailers apparently anticipated some weakening in upward price pressures over the months immediately ahead. Retailers in the Eleventh District had a contrary view; they were encountering higher wholesale prices as they endeavored to replace goods sold from inventories, and they warned that there might be fairly large price advances in the first 3 months of next year. Nevertheless, he thought the general economic environment was one in which it would be appropriate for the Federal Reserve to resist any tendency for credit markets to tighten or for interest rates to rise.

Mr. Eastburn remarked that his concerns about the economy had been effectively expressed by Mr. Coldwell. He was also concerned about the fact that the rates of growth in both M_1 and M_2 were still low relative to the Committee's longer-run targets. Faster growth in those aggregates was needed, and he would prefer to see it occur early rather than late in the target period. The alternative A specifications would best serve that end. However, in view of the various uncertainties, noted by Mr. Partee, that were particularly prevalent at this time of year, he was prepared to accept a policy prescription like that the Chairman and others had suggested, calling for widening the 2-month ranges for the monetary aggregates and retaining the present 4-1/2 to 5-1/2 per cent range for the Federal funds rate.

Mr. Winn said he wondered whether the Committee was not suffering from myopia in focusing on specifications for a 2-month period. He was particularly sobered by the table in the blue book showing four-quarter projections of the Federal funds rates that would be needed to achieve the Committee's longer-run aggregate targets for each of the three sets of short-run specifications. If the pattern reflected in those projections was about right, the figures would almost argue for raising the funds rate now in order to permit a reduction later when credit demands would be greater. However, he would not find such a course acceptable.

Mr. Winn observed that myopic thinking might also be involved in the concentration on interest rates and monetary aggregates. Raising the investment tax credit was one obvious means of stimulating investment. Because an increase in the tax credit would add to the Federal deficit, he would not advocate such action in isolation. He wondered, however, whether it would not be feasible to adjust the general level of tax rates in order to offset the revenue loss that would be incurred. In any case, policy-makers operated under a handicap when they considered only a narrow range of instruments.

With respect to specifications for monetary policy, Mr. Winn remarked, he agreed with those who favored retaining a 4-1/2 to 5-1/2 per cent range for the Federal funds rate and widening somewhat the 2-month ranges for the monetary aggregates.

Mr. Holland observed that, despite some discouraging aspects of the current economic situation and of the staff's projections, the economy appeared to be passing through a period of adjustment. A whole complex of economic and financial adjustments were under way; for the most part, they seemed to be constructively resolving existing problems and positioning the economy for better performance in the future.

Personally, Mr. Holland continued, he anticipated a somewhat better economic performance than suggested by the staff's projections, given the amount of monetary and fiscal stimulus assumed in those projections. That was a subjective judgment, not one based on some elaborate econometric model. He believed, however, that the present situation offered the System some reasons for proceeding with caution--perhaps resolving doubts on the side of a slight easing, in contrast to the approach last summer when doubts were resolved by leaning toward more firmness. He certainly was not ready for any major policy move.

While he would not mind shading policy a bit toward ease, Mr. Holland remarked, he would much prefer to have any action of that kind take the form of another small cut in reserve requirements rather than increased provision of reserves through open market operations. Accordingly, he favored the specifications of alternative B, with modifications like those suggested by Chairman Burns and Mr. Coldwell. For the operational paragraph of the directive he favored the "monetary aggregates" proposal, calling for moderate growth in the aggregates, rather than any of the "money market" alternatives.

Mr. Clay said he was rather pleased with the over-all economic situation. The economy was not as vigorous as he would like it to be or as he hoped it would be later. However, it was about as vigorous as it could be if the long-range problem--that of inflation--was to be overcome. He was also pleased with the nation's attitude, as he sensed it, that it was necessary to accept a somewhat slower recovery in order to overcome inflation.

With respect to policy, Mr. Clay continued, he certainly would favor maintaining money market conditions near their current levels. That course would be consistent with the specifications shown under alternative B in the blue book. He would not be unhappy with a widening in the 2-month range for M_1 from 4 to 6 per cent to 4 to 6-1/2 or 4 to 7 per cent. He also would be willing to widen the range for the Federal funds rate, perhaps to 4-1/2 to 6 per cent. He would prefer a directive formulated in terms of the monetary aggregates.

Mr. Black observed that almost all of the points he had intended to make had already been made by others. He would stress Mr. Clay's observation that inflation remained the primary longer-run problem; while some progress had been made in that connection, it was certainly important that the Committee maintain adequate control over the longer-run growth rates in the monetary aggregates. He was inclined to agree with Messrs. MacLaury and Holland that the economy would prove somewhat stronger than the staff's projections suggested, although he recognized that there were legitimate grounds for reaching the opposite conclusion.

In any event, Mr. Black remarked, in light of the prevailing uncertainties this was not a time to rock the boat. The Chairman's proposal that the present range be retained for the Federal funds rate struck him as wise, and he concurred in Mr. Partee's suggestion that recently prevailing money market conditions be maintained, unless it became pretty clear that the aggregates were departing significantly from the prescribed limits. Finally, he favored the 2-month ranges for the aggregates that Mr. Coldwell had suggested.

Chairman Burns observed that the speaking order in the policy discussion today was not entirely accidental. Mr. Partee had spoken first and Mr. Mitchell, whose term of office would soon reach its end, would have the last word.

Mr. Mitchell remarked that he could not help but recall today the statement made by Abbott Mills, a former member of the Board and the Committee, at the last FOMC meeting he had attended. On that occasion Mr. Mills had had the audacity and the courage to say he had been wrong in his policy views ever since he had become associated with the Federal Reserve. He (Mr. Mitchell) was on the verge of making the same statement about himself.

As the members knew, Mr. Mitchell continued, he had long been an advocate of the monetary aggregates as guides to policy; over the years, he had encouraged staff work on the aggregates and had urged their use on the Committee. What a monster had been produced! H felt most unhappy about the product, and did not know what exactly to recommend. He thought, however, that when the Committee wrestled with the problem--as it would have to do--it would be well advised to give attention to the variables over which it could exert close control. Open market operations, through their effect on bank reserves, could directly influence the behavior of the banking system; indirectly, they could influence the liquidity of the whole economy. For the narrower purpose of assessing the direct effects of open market operations, he thought the bank credit proxy was much superior to M_1 because it was subject to closer control. Accordingly, he would suggest that the Committee consider discarding M_1 entirely and resurrecting the proxy in its place. For measuring the broader effects of policy, some measure of over-all liquidity would be desirable. He suspected that the Committee would eventually find itself using some such approach. While he could not say when that would be, he was quite sure that M_1 was not a useful guide to policy and that at some point the Committee would recognize that fact.

Chairman Burns observed that the Committee appeared to be close to agreement on specifications. However, the question of the operational paragraph of the directive remained to be decided. He asked the members to indicate informally whether they preferred the "monetary aggregates" proposal or one of the "money market" proposals--presumably alternative B, which called for maintaining prevailing conditions. For the moment, he would not express his own preference.

The poll indicated that the preferences of the remaining 10 members present were evenly divided between the two directives.

Mr. Mayo expressed the view that some oversimplification was involved in the short-hand descriptions of the two types of directives, since both money market conditions and monetary aggregates were taken into account in each. Thus, the so-called "monetary aggregates" language called for "bank reserve and money market conditions consistent with moderate growth in monetary aggregates," and the so-called "money market" language called for maintaining "prevailing bank reserve and money market conditions...provided that the monetary aggregates appear to be growing at about the rates currently expected." The difference was one of emphasis.

The Chairman observed that Mr. Mayo's interpretation seemed to be a fair one.

Mr. Volcker said it could be argued that the "monetary aggregates" language should always be acceptable since it was hard to conceive of circumstances under which the Committee would not want moderate growth in the aggregates. By the same token, however, that language did not convey much meaning. If the Committee intended at this time to seek stability in the money market--or perhaps a slight easing--he thought it should use directive language that said so.

Chairman Burns remarked that he also preferred the money market formulation, for the reason Mr. Volcker had cited. He suggested that the Committee vote on a directive consisting of the staff's draft of the general paragraphs and alternative B of the money market proposals for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following short-run specifications. The ranges of tolerance for growth rates in the December-January period would be 4 to 7 per cent for M_1, 7 to 10 per cent for M_2, and the range for RPD's determined by the staff to be consistent with those for M_1 and M_2.[1/] The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 4-1/2 to 5-1/2 per cent, with the understanding that the range would be viewed asymmetrically, in the manner he had suggested earlier.

In response to a question, the Chairman observed that under the Committee's customary procedures the full range specified for the Federal funds rate would be available for use.

Mr. Baughman observed that, while he would have preferred somewhat higher ranges for the monetary aggregates, he was prepared to cast an affirmative vote.

Mr. Holland remarked that he also planned to vote affirmatively on the proposal. He would do so on the assumption that, in the event some other System policy action was taken during the interval before the next meeting, the Manager would not interpret

1/ The staff subsequently determined that an RPD range of 4 to 7 per cent would be consistent with the ranges specified for M_1 and M_2.

the instruction to "maintain prevailing...conditions" to require him to offset completely any effects the other action might have.

By unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions for the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that output of goods and services--which had increased very sharply in the third quarter--is expanding more moderately in the current quarter. In November the rise in industrial production and in nonfarm payroll employment slowed further. The dollar volume of retail sales rose again, however, and residential construction activity expanded, reflecting recent substantial increases in private housing starts. The unemployment rate--which had risen 0.3 percentage points to 8.6 per cent in October--fell back to 8.3 per cent in November, reflecting a sizable decline in the civilian labor force. The increase in average wholesale prices of industrial commodities, although below that in October, was still relatively large; prices of farm products declined appreciably, following 2 months of large increases. The advance in average wage rates in November was again substantial.

The exchange value of the dollar against leading foreign currencies has risen somewhat since mid-November. The net outflow of bank-reported private capital appears to have declined from the high rate reported for October. In October the U.S. foreign trade surplus remained substantial.

M_1--which had declined in October--rose sharply in November. Growth in M_2 and M_3 was substantial, as inflows of consumer-type time and savings deposits to banks strengthened while inflows to nonbank thrift institutions remained relatively favorable. Long-term interest rates have fluctuated in a narrow range in recent weeks, while short-term market rates have risen somewhat.

In light of the foregoing developments it is the policy of the Federal Open Market Committee to foster financial conditions that will encourage continued economic recovery, while resisting inflationary pressures and contributing to a sustainable pattern of international transactions.

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to maintain prevailing bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates appear to be growing at about the rates currently expected.

Secretary's note: The specifications agreed upon by the Committee, in the form distributed after the meeting, are appended to this memorandum as Attachment D.

Chairman Burns noted that the Secretariat had distributed two memoranda, dated December 4, 1975, regarding the release of the Committee's memoranda of discussion for the year 1970.[1/] He asked Mr. Broida to comment.

Mr. Broida said the Secretariat recommended that the Committee's 1970 memoranda of discussion be released in January 1976, under the customary schedule of making public the memoranda for a calendar year shortly after the close of the fifth succeeding year. As usual, staff at the Board and the New York Bank

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1/ Copies of these memoranda, have been placed in the Committee's files. The first, from Mr. Broida, was entitled "Release of FOMC memoranda of discussion for 1970." The second, from the Secretariat, was entitled "Passages recommended for deletion when FOMC memoranda of discussion for 1970 are released."

had reviewed the memoranda for the purpose of identifying potentially sensitive passages that the Committee might wish to have withheld when the memoranda were initially released. Two such passages, both of which occurred on one page of the memorandum of discussion for January 15, 1970, had been identified, as indicated in the second of the two memoranda from the Secretariat.

After discussion, the Committee concurred in the Secretariat's recommendations.

> By unanimous vote, transfer to the National Archives of the FOMC memoranda of discussion for 1970, on the basis described in the memoranda from the Secretariat dated December 4, 1975, was authorized.

It was agreed that the next meeting of the Committee would be held on January 20, 1976.

Thereupon the meeting adjourned.

Arthur L Broida

Secretary

ATTACHMENT A

Henry C. Wallich
December 16, 1975

Monthly Meeting of Bank for International Settlements
December 7-8, 1975

The BIS meeting of December 7-8 focused on three principal matters:

Eurocurrency statistics, the control of central bank operations in gold, and the French-American agreement on exchange arrangements.

(1) Concerning Eurocurrency reporting, it was agreed to approach the major offshore Eurocurrency centers in order to broaden the present coverage of the statistics assembled by the BIS. Some acceleration of on-going data collection also was envisaged.

(2) In the discussion of central bank gold trading, both in the technicians' and the governors' meeting, much the same differences surfaced as in the November meetings. There are firm and less firm attitudes on three of the four major issues -- the prohibition against pegging, the determination and safeguarding of the ceiling for the official gold stock, and reporting requirements. On the issue of admission of countries outside the G-10, it was agreed that the system should be an open one, but that there was no need for meetings in Basle of all adherents.

On _pegging_, a compromise was reached to the effect that any evidence pointing to such a practice should be discussed at monthly meetings of the BIS.

Concerning the _ceiling_, no agreement was reached between those who argued for a firm ceiling, monitored by continuous reporting and vigorous action to remedy any breach, and the proponents of the opposite view, who have a slight majority. This disagreement will have to be presented to the ministers at the G-10 meeting.

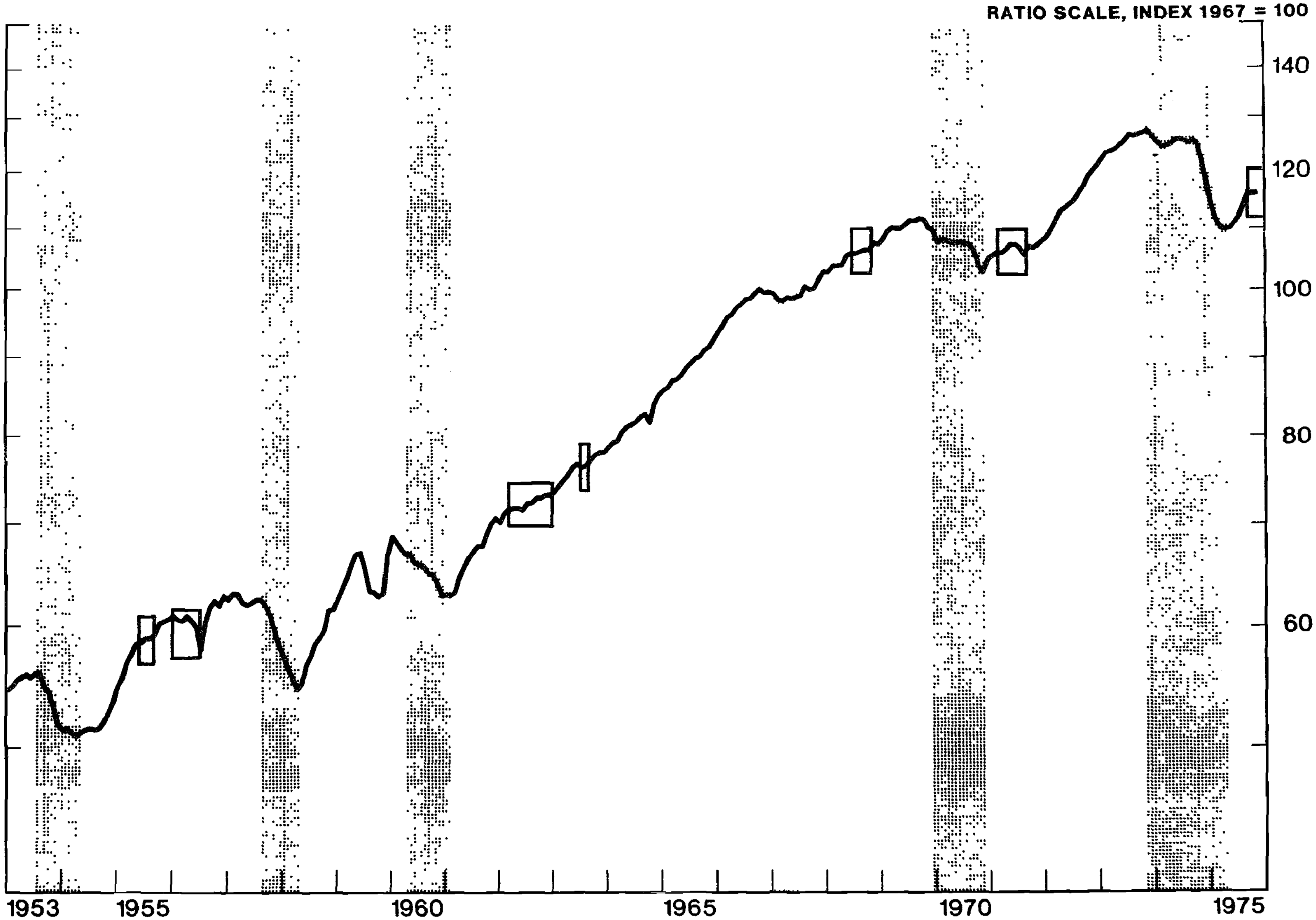
On the _reporting issue_, no precise agreement between those who want immediate reporting of each transaction with respect to volume and price, and the other side who prefer monthly reporting, perhaps without price details, was reached. As a pragmatic solution, it was suggested that central banks planning to purchase gold should check with the agent (BIS) whether there was leeway under the ceiling, on which occasion the agent could update the latest information if necessary. In view of the uncertainty as to the frequency of central bank gold transactions, there appeared to be no need to resolve the reporting issue immediately.

On the _French-American exchange agreement_, the French representative made no comment. The U.S. representatives stressed that the most important aspect was a removal of previous differences between the U.S. and France, and a better understanding of the condition in which exchange rate stability should be pursued. The condition in which central bank intervention was appropriate had been broadened slightly by the agreement through emphasis on "erratic" fluctuations. Slightly greater intervention activity might be expected as a result, but with no fundamental changes. No fixed rates or bands were contemplated as far as the dollar was concerned.

More intensive consultation and better information were to be regarded as important gains from the agreement. A procedure under which the Federal Reserve Bank of New York would receive daily details on European exchange markets and intervention was discussed and has already been put in place.

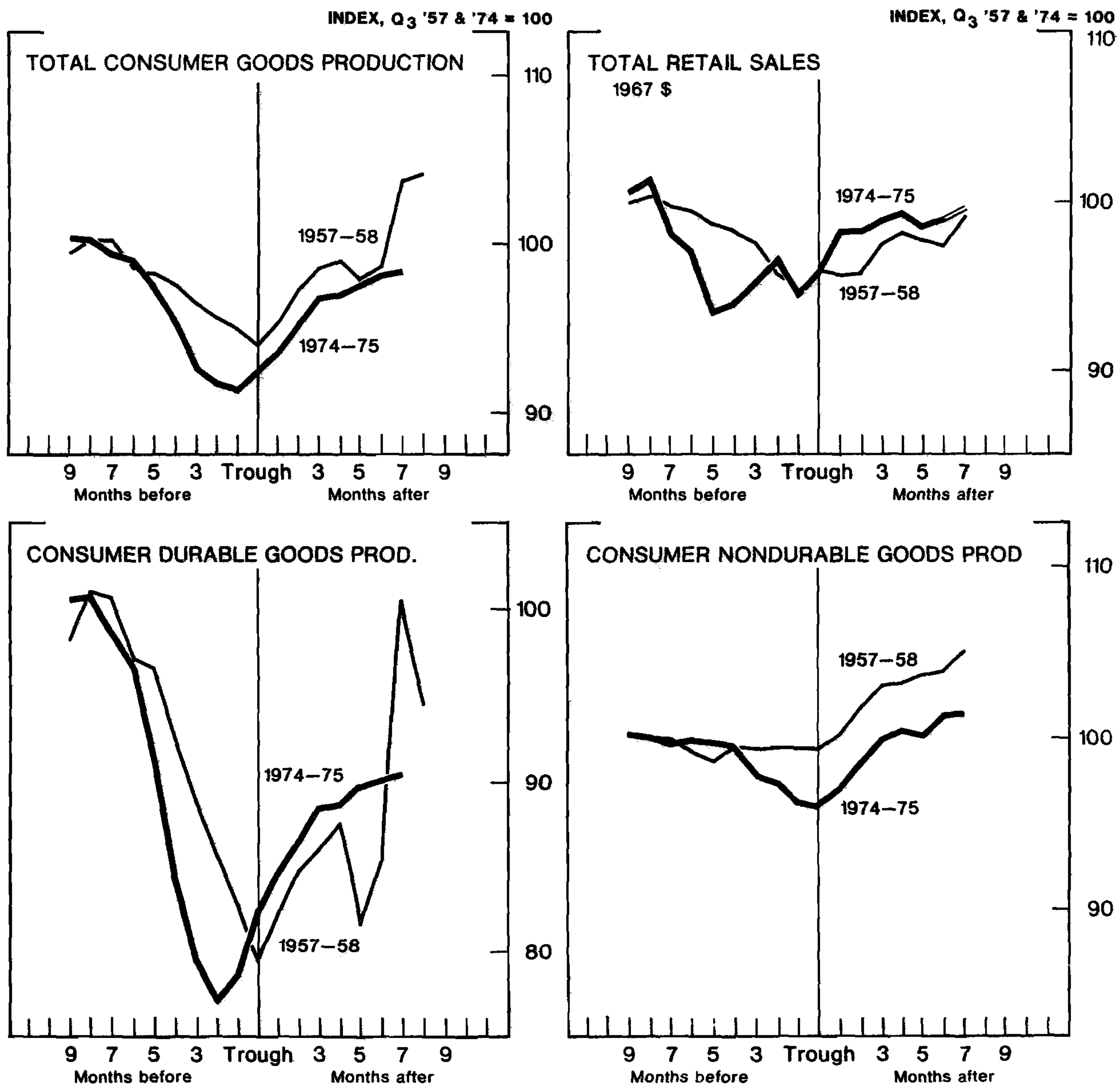
As regards the weekly or monthly reviews among finance ministry deputies, the Board representative pointed out that the Federal Reserve would be a full and equal partner therein. Representatives of some other central banks expressed concern, partly at the meeting and more often in private, as to the position in which the French-American agreement would place their institutions.

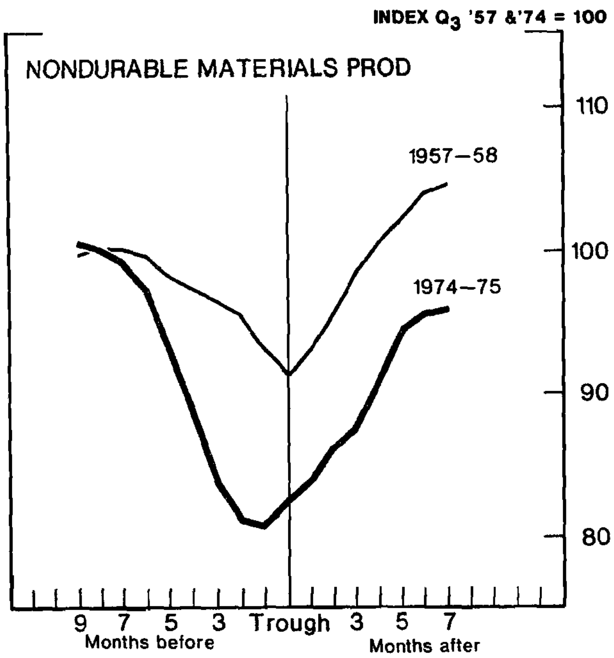
INDUSTRIAL PRODUCTION

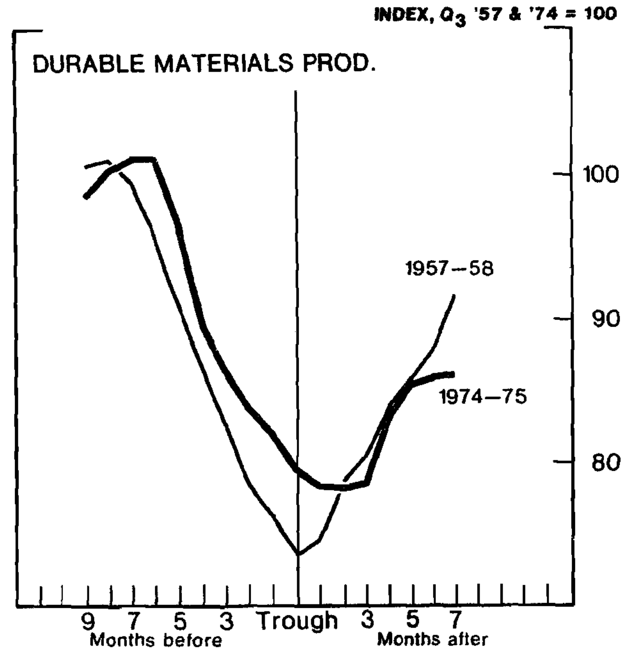


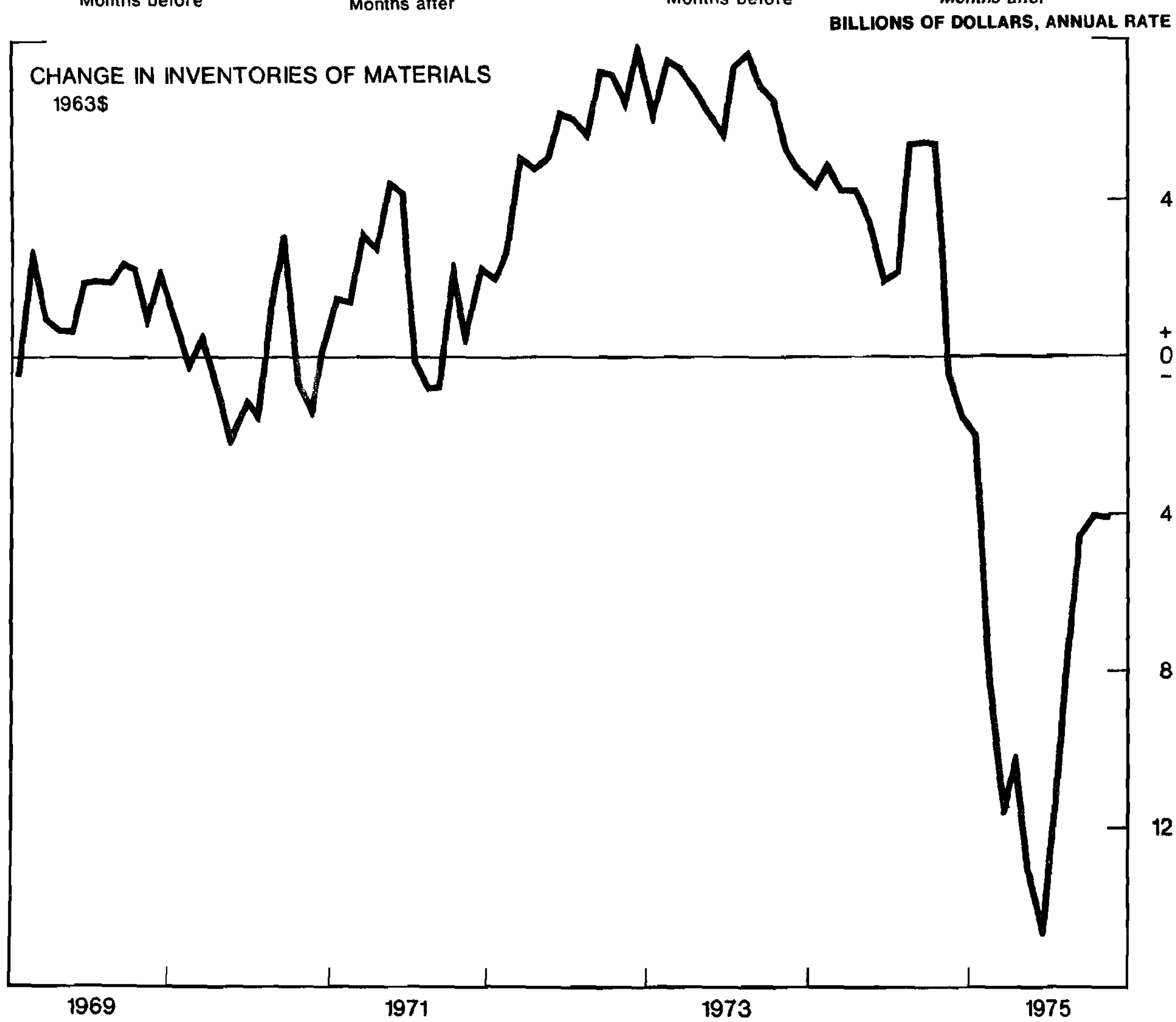
ATTACHMENT B

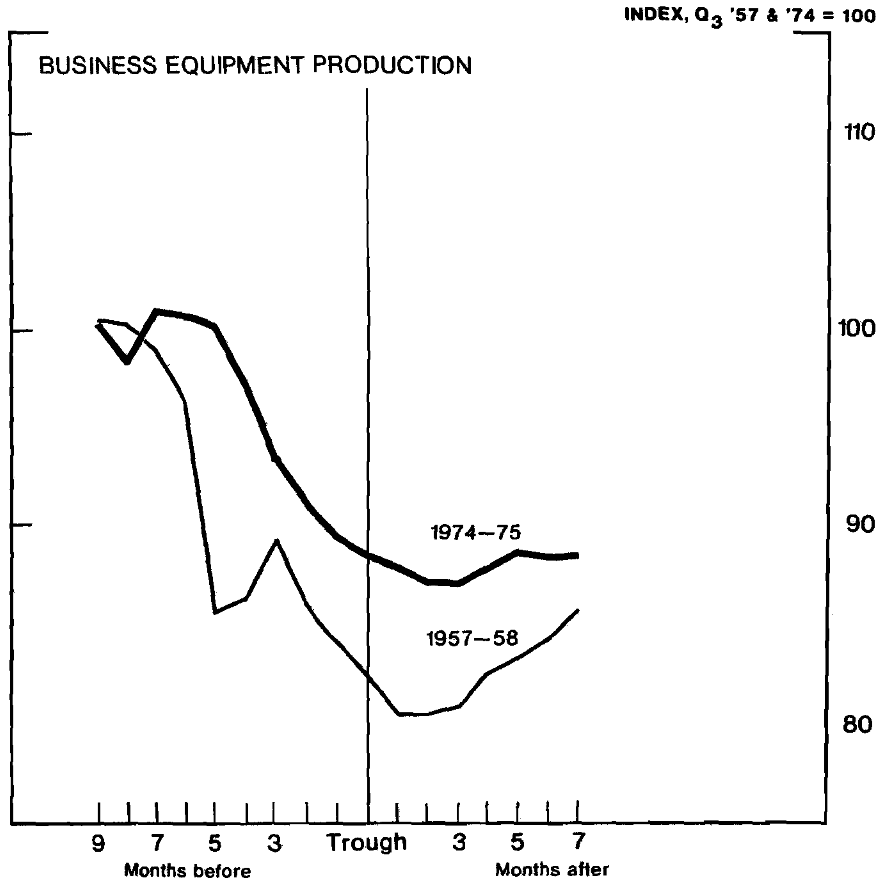
CONSUMER GOODS PRODUCTION AND RETAIL SALES

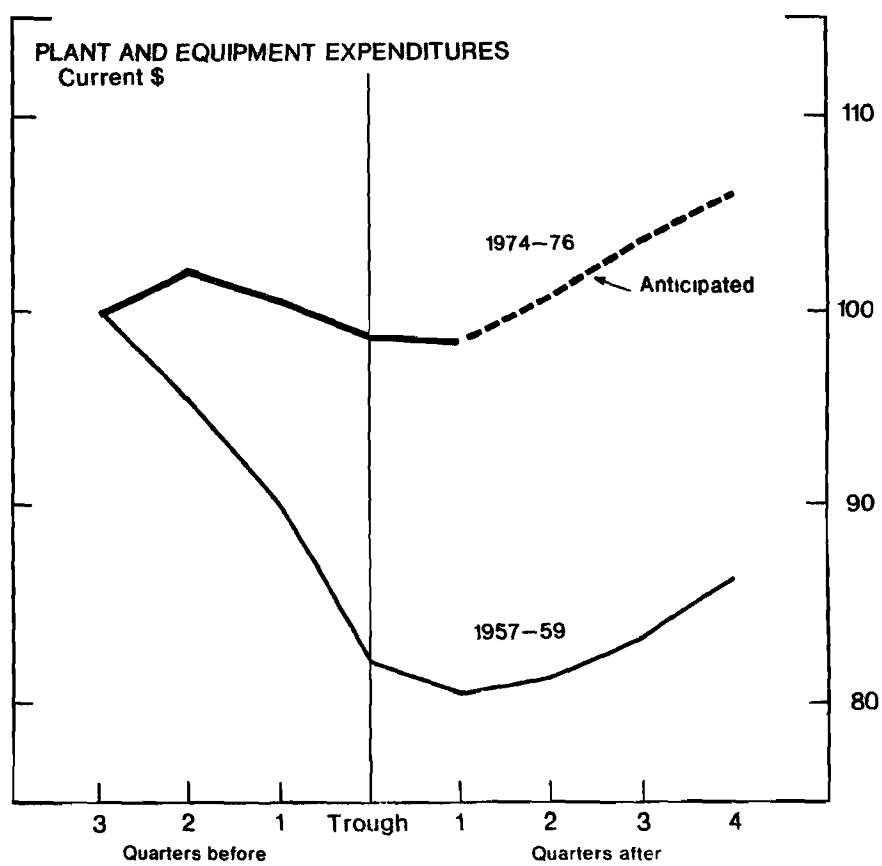



INDEX Q3 '57 &'74 = 100
NONDURABLE MATERIALS PROD
110
100
90
80
1957–58
1974–75
9 7 5 3 Trough 3 5 7
Months before
Months after


INDEX, Q3 '57 & '74 = 100
DURABLE MATERIALS PROD.
100
90
80
1957–58
1974–75
9 7 5 3 Trough 3 5 7
Months before
Months after


BILLIONS OF DOLLARS, ANNUAL RATE
CHANGE IN INVENTORIES OF MATERIALS
1963$
4
+
0
-
4
8
12
1969
1971
1973
1975


INDEX, Q3 '57 & '74 = 100
BUSINESS EQUIPMENT PRODUCTION
110
100
90
80
1974–75
1957–58
9
7
5
3
Trough
3
5
7
Months before
Months after


PLANT AND EQUIPMENT EXPENDITURES
Current $
110
100
90
80
1974–76
Anticipated
1957–59
3
2
1
Trough
1
2
3
4
Quarters before
Quarters after

ATTACHMENT C

December 15, 1975

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on December 16, 1975

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that output of goods and services--which had increased very sharply in the third quarter--is expanding more moderately in the current quarter. In November the rise in industrial production and in nonfarm payroll employment slowed further. The dollar volume of retail sales rose again, however, and residential construction activity expanded, reflecting recent substantial increases in private housing starts. The unemployment rate--which had risen 0.3 percentage points to 8.6 per cent in October--fell back to 8.3 per cent in November, reflecting a sizable decline in the civilian labor force. The increase in average wholesale prices of industrial commodities, although below that in October, was still relatively large; prices of farm products declined appreciably, following 2 months of large increases. The advance in average wage rates in November was again substantial.

The exchange value of the dollar against leading foreign currencies has risen somewhat since mid-November. The net outflow of bank-reported private capital appears to have declined from the high rate reported for October. In October the U.S. foreign trade surplus remained substantial.

M_1--which had declined in October--rose sharply in November. Growth in M_2 and M_3 was substantial, as inflows of consumer-type time and savings deposits to banks strengthened while inflows to nonbank thrift institutions remained relatively favorable. Long-term interest rates have fluctuated in a narrow range in recent weeks, while short-term market rates have risen somewhat.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions that will encourage continued economic recovery, while resisting inflationary pressures and contributing to a sustainable pattern of international transactions.

OPERATIONAL PARAGRAPH

"Monetary Aggregate" Proposal

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Alternative "Money Market" Proposals

Alternative A

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve somewhat easier bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates do not appear to be growing at rates above those currently expected.

Alternative B

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to maintain prevailing bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates appear to be growing at about the rates currently expected.

Alternative C

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve somewhat firmer bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates do not appear to be growing at rates below those currently expected.

ATTACHMENT D

December 16, 1975

Points for FOMC guidance to Manager in implementation of directive		Specifications
A. Desired longer-run growth rate ranges (as agreed, 10/21/75): (QIII '75 to QIII '76)	M_1	5 to 7-1/2%
	M_2	7-1/2 to 10-1/2%
	M_3	9 to 12%
	Proxy	6 to 9%
B. Short-run operating constraints (as agreed, 12/16/75):		
1. Range of tolerance for RPD growth rate (December-January average):		4 to 7%
2. Ranges of tolerance for monetary aggregates (December-January average):	M_1	4 to 7%
	M_2	7 to 10%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		4-1/2 to 5-1/2%
4. Federal funds rate to be moved in an orderly way within range of toleration.		
5. Other considerations: Account to be taken of developments in domestic and international financial markets.		

C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.