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, February 13, 1973, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Bucher
Mr. Coldwell
Mr. Eastburn
Mr. MacLaury
Mr. Mitchell
Mr. Robertson
Mr. Sheehan
Mr. Winn

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

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

Mr. Holland, Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. O'Connell, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Boehne, Bryant, Gramley, Green, Hersey, Hocter, Kareken, and Link, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. Coyne, Assistant to the Board of Governors
Mr. McIntosh, Director, Division of Federal Reserve Bank Operations, Board of Governors 1/
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer, Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mrs. Rehanek, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Sherman, Secretary, Office of the Secretary, Board of Governors

Mr. Black, First Vice President, Federal Reserve Bank of Richmond
Messrs. Eisenmenger, Parthemos, Taylor, Scheld, and Andersen, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, and St. Louis, respectively
Mr. Doll, Vice President, Federal Reserve Bank of Kansas City
Mr. Cooper, Assistant Vice President, Federal Reserve Bank of New York
Mr. Bisignano, Economist, Federal Reserve Bank of San Francisco

At Chairman Burns' suggestion the participants in the meeting stood for a moment in silence in memory of Aubrey N. Heflin, President of the Federal Reserve Bank of Richmond and alternate member of the Committee, who had died late in the day on January 16, 1973, the date of the previous Committee meeting.

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1/ Attended first part of meeting only.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on December 19, 1972, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on December 19, 1972, was accepted.

Chairman Burns said he might comment briefly about the international monetary disturbances of recent days and about the actions taken by the U.S. Government. In particular, he would call to the Committee's attention certain points in the statement on foreign economic policy issued by Secretary of the Treasury Shultz last evening and provide some background information regarding that statement.[1/]

The Chairman noted that the basic decision on the policies announced by Secretary Shultz yesterday had been made by the President on the previous Tuesday, February 6, in the course of a meeting with the Secretary and himself. On the following afternoon Under Secretary Volcker had left by air for Japan, and he had subsequently traveled to Bonn, London, Paris, Rome, and again Paris, to consult with officials of the major industrial nations. During his trip Mr. Volcker had been in continual contact with Washington, and all indications were that he had carried out a most difficult

1/ Copies of the Secretary's statement had been distributed to the members in advance of this meeting and a copy has been placed in the Committee's files.

assignment with distinction. The arrangements agreed upon were very similar to those in the plan worked out with the President. The principal disappointment was that Japan did not revalue the yen. It should be recognized, however, that the Japanese authorities were faced with special internal problems that made a revaluation very difficult at this time. Nevertheless, it was expected that the yen would be permitted to float upward, into a relationship vis-a-vis other currencies "consistent with achieving a balance of payments equilibrium not dependent on significant government intervention," in the words of the Secretary's statement.

The basic U.S. action, Chairman Burns continued, was the 10 per cent reduction in the par value of the dollar which the Secretary announced would be proposed to Congress by the President. With that devaluation, the official price of gold would be increased from \$38 to \$42.22 per ounce and the par values of other currencies for which there was an effective par value would rise by 11 per cent in terms of the dollar. The specific list of foreign currencies which would rise by that amount was not clear at the moment, but it would include the French franc, the German mark, the Benelux currencies, and probably those of the Scandinavian countries. As for the floating currencies, he did not know what would happen to the Swiss franc, but the yen was likely to appreciate by more than 11 per cent.

Secondly, the Chairman said, the Secretary's statement set forth the outlines of the trade legislation the President would seek. If the proposals were approved by Congress, and he thought they would be, the President would have broad powers to reduce tariffs within certain limits. He would also have broad powers to raise tariffs--across the board, against products of individual countries, and against products of specific types. Those who favored a liberal commercial policy would, of course, be disturbed by legislation authorizing higher tariffs. However, given the difficulties which the United States faced in achieving anything close to equilibrium in its international transactions, it might well prove necessary to have such a club in the closet. Obviously, the club carried dangers as well as opportunities. In any case, it was unlikely that any trade legislation could be passed by the Congress that did not provide authority for raising as well as reducing tariffs.

Third, Chairman Burns noted, the Secretary's statement dealt with the U.S. capital restraint programs--the interest equalization tax, the controls of the Office of Foreign Direct Investment, and the Federal Reserve's Voluntary Foreign Credit Restraint program. Those programs were to be phased out and terminated no later than December 31, 1974, approximately 2 years from now.

The Chairman said he might add a word about the implications of those decisions for the Federal Reserve. The first implication was that the System would experience losses on its outstanding swap drawings as a result of the devaluation of the dollar. A second implication--and in his view, a happy one--was that the Voluntary Foreign Credit Restraint Program would be coming to an end soon. In general, he thought the decision to phase out the controls on capital flows was a wise one. While termination of the program obviously was desirable and had been promised repeatedly in recent years, an abrupt termination at this time would have been regarded abroad as an act of monetary belligerency on the part of the United States--as an attempt to force the maximum revaluation or appreciation of foreign currencies--and accordingly it would have created a great deal of bitterness. Under the course decided on, the phase-out would not begin at once and it would proceed over the next 2 years at a rate to be determined.

A third implication, the Chairman continued, was that the System would not be making any swap drawings for the time being, and probably not for some time to come. As the members knew, in recent weeks the System had intervened in the exchange market on a modest scale, using foreign currencies from balances and obtained by swap drawings. The decision to intervene was made quite deliberately, for the purpose of indicating that the United States had not abandoned its willingness to cooperate in supporting the Smithsonian parities, which it had done through its exchange market operations last July. However, in contrast to last July, when the System had been prepared to engage in massive operations if necessary, the intention this time was to operate on only a minor scale. The System's losses were increased somewhat by the recent operations, but in the circumstances that could be viewed as a good investment.

However, the Chairman observed, the intervention did involve a risk of another sort--that other countries would view it as a precedent and take the position that the United States had an obligation to intervene under similar circumstances in the future. That in fact had happened in connection with the System's exchange market operations of last July. During the negotiations that led up to the Smithsonian agreement, the possibility of U.S. exchange market intervention was never discussed nor, to his knowledge, even mentioned, and the operations in July were greeted with surprise and delight around the world. While there was no doubt in his mind that those operations were justified on both psychological and political grounds, they had created an impression in some foreign capitals--voiced strongly as recently as a few days ago--that this country had an obligation to intervene again. To prevent any such misunderstandings in the future, the Secretary's statement said explicitly that the United States had "undertaken no obligations for the U.S. Government to intervene in foreign exchange markets."

That, of course, did not preclude intervention if it appeared likely to serve a useful purpose.

A fourth point, the Chairman remarked, concerned the implications for price stability. Since a devaluation meant higher prices for imported goods, there was now a new force serving to raise prices. He could not say how strong that force would be. Calculations made after the Smithsonian agreement suggested that the direct effect of the exchange rate changes made then would be to raise domestic prices by less than one-half of one per cent. Such changes also had indirect effects, but he thought it was fair to say that the impact of the current devaluation on domestic prices would be quite small. While that might be true as an objective matter, however, there also were psychological factors to reckon with. In the view of many, devaluation was almost synonymous with inflation, and there was a significant danger that the price effect would be magnified in people's minds. An effort had been made in the Secretary's statement to deal with that danger, but it was not clear that the effort was sufficient. Any move the Government could take in the direction of trade liberalization would be particularly useful in that connection because it would mean a reduction in the prices of imported goods. While the scope for trade liberalization would be quite limited in the short run, a few moves in that direction could be helpful on psychological grounds.

Chairman Burns noted that Mr. Coombs would no doubt have further comments on the events leading up to the decisions announced yesterday. Meanwhile, he would be happy to respond to any questions the members had regarding his summary.

Mr. Coldwell asked whether the subject of a possible reduction in U.S. military obligations in Europe was discussed in last week's conversations with foreign officials.

The Chairman replied in the negative. That subject was not being neglected, but to have raised it in the present connection would have served only to increase the difficulty of conversations that already had been made difficult by the internal situation in the other countries involved. In Germany, for example, the government was committed to maintaining the parity of the mark, and in France an election campaign was in process. In any case, the defense problem was one that could be handled only at the summit level; when it was resolved, it would be by heads of state.

Mr. Mayo asked whether the recent events were likely to hasten or delay the current negotiations of the Committee of 20 regarding more permanent international monetary reform.

Chairman Burns replied that there was now a sense of urgency about the need for reform that had not existed earlier;

as the members would recall, at the previous Committee meeting he had expressed his concern about the relaxed attitudes toward the subject that he had encountered on his trip to Europe in January. If exchange markets became calm again, however, the present attitudes might not persist. On balance, he thought progress toward reform would be faster than it would have been in the absence of the crisis, but he did not know whether the change in attitudes would be dramatic.

Mr. Brimmer said he was interested in the passage in Secretary Shultz's statement which read as follows: "Other countries may also propose changes in their par values or central rates to the International Monetary Fund. We will support all changes that seem warranted on the basis of current and prospective payments imbalances, but plan to vote against any changes that are inappropriate." That statement implied that the United States would object if certain other countries proposed to devalue their currencies.

The Chairman agreed with that interpretation. In response to a question by Mr. Mitchell, he said he would not expect the United States to object if Latin American currencies were devalued by the same amount as the dollar.

Before this meeting there had been distributed to the members of the Committee a report from the Special 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 January 16 through February 7, 1973, and a supplemental report covering the period February 8 and 9, 1973. Copies of these reports have been placed in the files of the Committee.

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

> The currency crisis that forced the closure of the exchange markets yesterday was comparable in intensity to that of August 1971. Over a period of 3 weeks more than $8 billion moved across the exchanges into foreign central bank hands, despite the array of defensive exchange controls that have proliferated during the past 18 months.
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> In the absence of Federal Reserve and Treasury intervention in the market, the crisis probably would have reached its climax somewhat sooner. During the first 10 days of the crisis our operations helped keep the mark away from its ceiling while tempering speculative anticipations, and the German government has publicly expressed its appreciation of this assistance. In this phase of our operations we employed the entire $165 million of Federal Reserve mark balances, with full Treasury concurrence. Somewhat to our surprise, the Treasury then requested us--on Thursday, February 1--to operate aggressively in the market with the remaining $46 million of Treasury mark balances. Later that evening Under Secretary Volcker asked me to inform the German Federal Bank that we would be prepared to employ the swap line up to a total of $200 million. Over the

course of last week confidence in the Smithsonian agreement rapidly crumbled as the market was repeatedly thrown into turmoil by ticker reports suggesting official consideration of a mark float, of a 2-tier mark system, or of another devaluation of the dollar. In these circumstances, which were rapidly becoming hopeless, we limited our daily intervention to comparatively minor amounts in an effort to keep the market from becoming too disorderly. Through last Friday System drawings on the German swap line totaled $105 million, only slightly more than half the amount authorized. Meanwhile, the German Federal Bank took in roughly $5 billion. Thus, our share of the joint intervention last week came to about 2 per cent of the total.

The German decision to hold firm through last Friday was attributable to more than pride, stubborness, or domestic political considerations. As they saw it, their trade position had remained strong but it was fully offset by deficits on tourist and other invisibles account, so that Germany's current account position in 1972 was not far from balance. Just a month or so ago, the mark was being quoted only slightly above par. To the Germans, the "falling domino" effects of the adoption of a 2-tier system by the Italians and the floating of the Swiss franc seemed to be external events that hardly called for an adjustment of the mark parity. The continuing deficit in U.S. trade obviously threatened the whole Smithsonian parity alignment, but German--as well as other European--officials were well aware of the fact that the bulk of our deficit is with Japan and Canada. Accordingly, they took the view that the yen-dollar exchange rate was the basic source of disequilibrium in the exchange market.

There is, however, one very good reason why the wave of speculation tended to converge on the mark. By last week most of the major foreign currencies had strong defenses against speculative inflows--in the form of tight exchange controls for the yen, 2-tier systems for the French and Belgian francs, and a floating rate for the Swiss franc. By contrast, the German market remained wide open--and so the mark suffered the brunt of the speculative inflows. I suspect that the German authorities have learned something from this episode and will now move toward some new system of exchange controls on capital inflows.

The decision announced last night to devalue the dollar by a further 10 per cent, on the understanding that the yen would be allowed to float temporarily, should go far to rectify the basic disequilibrium in the yen-dollar exchange rate. Whether that will in fact be the outcome will depend in particular on whether the yen is allowed to float upward without restraint or is, rather, tied to the mark or other European currencies.

The eventual extent of dollar devaluation against other foreign currencies remains somewhat uncertain. The Latin-American currencies will presumably move with the U.S. dollar, and the rate for the floating Canadian dollar should not change much either. Sterling, the Swiss franc, and now the lira are also floating and may not rise appreciably above their current rates against the dollar; indeed, there is a fairly good chance that both sterling and the lira will move the other way. The Scandinavian currencies remain a question mark. The main candidates for appreciation against the dollar are the mark, guilder, French franc, and Belgian franc. Here again, however, some uncertainties arise. During the period of crisis, when $8 billion moved into foreign central banks, the Bank of France took in almost no dollars; only a month ago the French franc was selling below par; and the swing to the left in the French election polls may weaken the franc still further. The guilder, too, was relatively weak before the recent crisis, and the Dutch continue to suffer from the highest rate of inflation on the Continent. In both cases it is somewhat less than certain that the currency can be safely appreciated by 10 per cent against the dollar. Only the mark and the Belgian franc may have the requisite inherent strength to live with a 10 per cent devaluation of the dollar.

In general, we face a fluid situation in the exchange markets which may continue for some time to come. The ultimate outcome no doubt will be determined primarily by such fundamentals as the comparative price performance in Europe and the United States.

In reply to a question by Mr. Brimmer, Mr. Coombs said a profit of $11.4 million had been realized on the recent sale of marks and guilders that had been owned outright by the System and the Treasury. There would, of course, be losses on the sale of marks obtained by drawing on the swap line. For example, if the System were to acquire the marks to repay those drawings this week, when the mark rate was likely to be at the floor with respect to the new central rate, a loss of $6.6 million would be incurred. On that basis, there would be a net profit of $5 million on the recent market operations. It was difficult to estimate the System's likely losses on the swap debt still outstanding from the drawings of August 1971, since the bulk of the remaining debt was in Swiss francs and it was not clear where the exchange rate for the franc would eventually settle down. In any case, he thought it was important to keep in mind that as a result of the devaluation the Treasury would be realizing a profit of about $1.4 billion on its holdings of gold and other reserve assets, including a profit of $300 million on the $3 billion or so of reserve assets that would have been demanded by foreign central banks in August 1971 had the System not drawn on the swap network to that extent. The $300 million figure far exceeded any conceivable additional losses the System might incur.

Chairman Burns observed that that was an important point. He added that the System's recent foreign exchange operations had been among the most skillful of any he had observed, and that a good deal of money had been saved to the Federal Reserve as a consequence.

Mr. Brimmer noted that System repayments on its Swiss and Belgian franc swap debts had been proceeding slowly before the crisis because of a reluctance on the part of the foreign authorities to have the System buy their currencies in the market at a rapid rate. He asked whether that situation would continue.

Mr. Coombs replied that he could not say at this point what position the Swiss and Belgian authorities would take on the matter, and he doubted whether they could either. The System would, of course, attempt to repay those debts as rapidly as feasible. There should be no problem in buying the marks needed to repay the new drawings on the German Federal Bank since their amount--$105 million--was small relative to the size of the market in that currency.

Mr. Winn asked whether anything was known about the identity of those who had moved $8 billion across the exchanges.

Mr. Coombs replied that both U.S. and foreign funds no doubt were involved; some indication of the relative importance of each would be provided by the balance of payments figures that would become available next week. To a large extent the flows probably represented a shift in leads and lags in favor of mark holdings. Multinational concerns had borrowed a sizable amount of marks in recent years, and to the extent they had uncovered debt in that currency they must have acted to acquire cover. Many such concerns probably also took a speculative position in marks. In addition, there were indications that a fair amount of Middle East money had also moved into marks. To his mind, that was a disturbing development. An increasing threat to the functioning of the whole international financial system was posed by the accumulation in the hands of Middle East countries of foreign bank balances that could be moved quickly, and in large volume, from one currency to another.

Chairman Burns remarked that there was no question but that the future of exchange markets was clouded by the large accumulations of funds that could be moved rapidly by multinational corporations and governments, particularly now that there had been a certain breakdown in discipline. It seemed clear that currencies would be devalued far more easily in the future than they had been in the past. In the United States, for example, ten years ago a devaluation would have been interpreted by the financial world and the public generally as a disaster, whereas now it was being viewed as a quasi-triumph. Obviously, the large amount of volatile money around the world was a great threat.

At the same time, the Chairman continued, it seemed fair to say that speculators--whether they were individuals, corporations, or Middle Eastern countries--had performed a useful function in moving governments to do what they should have done previously on their own account. Speculators had been right; rather than being the source of the trouble, they had precipitated crises which forced governments to take needed action.

Chairman Burns added that he, for one, did not know what could be done about the problems posed by the large accumulations of volatile funds. He thought the question should be investigated by the research staffs at the Board and the New York Bank, as well as others.

By unanimous vote, the System open market transactions in foreign currencies during the period January 16 through February 12, 1973, were approved, ratified, and confirmed.

Chairman Burns then observed that Messrs. Bucher and Daane from the Board had attended the Basle meeting held this past weekend. Yesterday morning Mr. Daane had joined Mr. Volcker in Paris, at the latter's request, and accordingly was not present at today's FOMC meeting.

Noting that the Basle meeting was the first Mr. Bucher had attended, the Chairman invited the latter to report his impressions.

Mr. Bucher said he would first comment briefly on a conversation Mr. Daane and he had had with Dr. Stopper and Dr. Leutwiler of the Swiss National Bank on Friday afternoon. In the course of that conversation Dr. Stopper had stressed his concern about last week's speculative activity in the Euro-dollar market by multinational corporations with headquarters in the United States. According to information received by the Swiss National Bank, such companies appeared to have taken large long positions in the Euro-currency market during the last 2 days of the week. Dr. Stopper suggested that U.S. officials should review the problems created by such operations and perhaps consider ways of controlling them in the future. He reiterated that view during the Sunday afternoon meeting of the governors.

Mr. Bucher remarked that he had not found the Saturday meeting of the standing committee on the Euro-currency market to be particularly fruitful; the questions discussed were of fairly minor importance. The Sunday meeting of the governors was marked by an atmosphere of gloom that could not be wholly attributed to the weather. The participants were aware that they were out of the main stream of the negotiations under way, and some--particularly those from smaller countries--were disturbed by the fact that even their governments were out of that stream.

Chairman Burns said it was easy to understand such attitudes but it was not easy to find a solution. It was understandable that many countries would feel that they had a vital stake in the outcome of negotiations of the kind carried on last week. At the same time, such negotiations could be conducted effectively only if the number of participants was sharply limited.

Mr. Hayes observed that as the crisis was developing there had been press reports that another Smithsonian meeting might be held. While he was inclined to agree with the Chairman that negotiations were more effective when conducted in small groups, he wondered if the alternative of a large meeting had in fact been considered.

Chairman Burns replied that some thought had been given to the possibility of holding a meeting of the Committee of 20 or of the Group of 10. However, those ideas were dismissed at a rather early stage on the ground that a large meeting would be too lengthy. Apart from the procedure finally decided upon --of having Under Secretary Volcker travel to a selected number of foreign capitals--the only alternative seriously considered was that of holding a meeting of the Finance Ministers of, say, six countries.

Mr. Bucher then said he might add a few other comments about the Sunday afternoon discussion at Basle. There was a candid discussion of three alternative solutions to the immediate problem set forth by the German representative. At the conclusion of that discussion the group was in general agreement that the primary problem concerned the bilateral situation between Japan and the United States. The French representative presented his position on the role of gold and urged that gold not be ignored in the current discussions. The Japanese representative commented on the political problems facing his government in the present situation. The German representative mentioned the large loss the Federal Bank was incurring on the devaluation of the dollar but seemed to accept that loss philosophically.

Finally, Mr. Bucher observed, Mr. Daane and he had had a rather lengthy conversation with President Zijlstra. The latter expressed some reservations about discussing the lack of progress on the part of the Committee of 20 at Basle, but he did not make his reasons clear. Mr. Daane mentioned the subject at the Sunday afternoon meeting, and he (Mr. Bucher) had been pleased to see the comment in Secretary Shultz's statement to the effect that the C-20 discussions were progressing too slowly and that a greater sense of urgency was required.

Chairman Burns asked Mr. Coombs, who had also attended the Basle meeting, whether he had anything to add.

Mr. Coombs remarked that he had been impressed by the intensity of the arguments made during the weekend that the United States should take action to control capital outflows. In response to such comments he had noted that even if the United States imposed controls of the sort suggested, multinational corporations--including those based in the United States--could easily avoid them by operating through the Euro-dollar market. It was his feeling, particularly against the background of Secretary Shultz's statement regarding the phasing out of the existing controls, that the Europeans would now undertake to devise controls as air-tight as they could manage on unwanted inflows from abroad. In the end U.S. corporations might well find themselves subject to more severe restraints on movements of funds from this country than existed under current U.S. controls.

In response to a question by Mr. Sheehan, Mr. Coombs said the Swiss did not have very effective controls over inflows of funds by multinational corporations with headquarters in their country. Indeed, that was one of the reasons Swiss officials had cited for floating the franc; large inflows had been stimulated by their recent credit-tightening measures--which they now believed had been carried too far--and the Swiss National Bank could not afford to continue to accumulate dollars. They probably would regard such a situation as intolerable and take steps to avoid its repetition.

In reply to a question by Mr. Eastburn, Chairman Burns said that the International Monetary Fund had been consulted before the Secretary's statement had been released, and foreign governments had been informed through the State Department. It was clear that the IMF would have no objections to the U.S. measures.

In response to a question by Mr. Robertson, the Chairman said he did not anticipate any significant problems in connection with Congressional action on the measures contemplated.

The Chairman 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. Partee made the following statement:

The news of the domestic economy during the past month has been broadly in line with our expectations. There is nearly universal recognition that economic activity rose rapidly--and generally more than anticipated--in the closing months of 1972. And the view seems very widely held that further substantial improvement is in store, extending probably through at least the rest of 1973. These impressions appear in virtually all of the District summaries in the red book,1/ are widely reported from gatherings of businessmen and surveys of consumer attitudes, and underlie most of the formal projections of GNP and related measures that have come to our attention.

Most recently, however, there has been a sense of disquiet about various aspects of the economic outlook. The stock market dropped significantly in price over the past month, although there has been a sharp reversal beginning last Friday and extending into this morning, when the Dow-Jones average for industrials rose 16 points in the first half hour of trading. Consumers are beset by soaring food prices, and there is a good deal of apprehension that prices generally may be rising faster under Phase III guidelines than before. Wage rate increases have accelerated considerably in recent months and, with productivity gains moderating, unit labor costs are again moving upward. To top it off, the sudden wave of currency speculation and the resulting international

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

crisis--though only dimly perceived by the vast majority of investors, businessmen and consumers--indicated that all was not well with the U.S. dollar and perhaps, by implication, with the U.S. economy. There could be, I believe, the seeds here for a deterioration in public confidence and a possible pulling back in optimistic spending and investment plans.

Thus far, however, the incoming economic data have continued very favorable. Employment and industrial production both increased further in January, though somewhat less strongly than in the latter part of 1972. Retail sales advanced sharply last month, following an upward revision in the December estimates, and new car sales were at a new record annual rate of 12-1/2 million units. Business capital spending indicators continue strong, with new equipment orders and construction contracts at the high end of their recent range and output of business equipment apparently up by two full percentage points in January. And business inventory accumulation gives every evidence of being in a rising trend. Stock-sales ratios remain quite low, a very large proportion of purchasing agents continue to report slower deliveries, and despite sustained over-all accumulation, the figures indicate that manufacturers' inventories of finished goods were actually drawn down during the fourth quarter.

The underlying thrust of our GNP projection, therefore, remains much as it was before. We continue to foresee substantial, though gradually moderating, strength in private sector demands, and we have not allowed for any general deterioration in public psychology--which seems possible but, at this point, still improbable. The projection is revised in important respects, however, because of changes in our policy assumptions. Specifically, we have attempted to take into account the implications of Phase III and other recent developments in the wage and price area; we have incorporated the new projections of Federal expenditures as presented in the Budget document; and we now assume a somewhat more restrictive monetary policy stance, in line with recent Committee decisions and the higher level of short-term interest rates that has evolved. I have asked Mr. Gramley to sort through these various new policy assumptions today in terms of their implications for our projection results.

Mr. Gramley made the following statement:

The current staff GNP projection assumes that $M_1$ will grow at a 5 per cent rate in 1973 instead of 6 per cent as in our previous projection. Short-term interest rates are therefore expected to attain somewhat higher levels than we had earlier assumed. Leaving aside current distortions in the interest rate structure associated with bill purchases by foreign central banks, we believe a 5 per cent growth rate of $M_1$ would produce a bill rate of around 6 per cent by early spring and 6-1/2 per cent by year-end. The average for the year would be roughly one-half of a percentage point higher than previously projected. This would imply diminished inflows of savings deposits to banks and nonbank intermediaries, particularly in the second half, and some tightening of mortgage credit supplies. It would also mean added pressure on long-term interest rates.

Past experience suggests a lag of one or two quarters before any visible effect of additional monetary restraint would be seen in total expenditures. The lag could be a bit longer this time because of the substantial overhang of outstanding mortgage commitments, the relatively high levels of corporate and institutional liquidity, and the sustainment of large savings inflows to savings and loan associations early this year. Nonetheless, we may be seeing some effects of monetary restriction on consumption spending--through the impact of rising interest rates on equity prices, net worth, and expectations--by late spring, and increasing effects on housing and other forms of investment in the fall and early winter months.

This change in the course of monetary policy, taken by itself, would reduce nominal GNP by around \$6 billion by the fourth quarter of 1973. Virtually all of this reduction would reflect lower real activity rather than prices--because the lags between changes in monetary policy and wage-price adjustments are thought to be much longer than a few quarters.

On the fiscal side, we have brought our assumptions into line with the January budget document. This meant lowering our estimate of total NIA expenditures a little and altering the distribution to include more Federal purchases and less of other kinds of expenditures, especially grants to State and local governments.

These changes in our Federal spending estimates were so small, however, that the GNP outlook was relatively unaffected. This does not mean that the Administration's program of fiscal restraint will not work. It simply means that the fiscal picture outlined in the January budget document was very close to what we had been expecting.

Our price projections incorporate the implications of the more flexible Phase III controls, as best we can assess them. They also take into account the deterioration in the outlook for consumer food prices and the effects of market forces in raising wage rates faster over recent months than we had expected.

No one has a good fix yet on what Phase III will mean for wages and prices. The present program is more flexible than Phase II in a variety of ways. Prenotification and advance approval are no longer required except for firms in food, health services, and construction; reporting and record-keeping requirements have been relaxed; the profit-margin constraint has been liberalized in that prices may be raised up to 1-1/2 per cent, if justified by increases in costs, before the profit-margin test applies; rent controls have been abolished for the portion of units still under control at the end of Phase II; and the rules of behavior for both wages and prices will be largely self-administered and based on voluntary compliance. Also, there is an evident intention to police the program by means of intervention in selected cases, rather than through the more detailed scrutiny maintained in Phase II.

Our tentative staff judgment is that wage rates and prices will rise more under Phase III than under a continuation of Phase II, but that the incremental amounts involved will not be large. For wage rates, the 5-1/2 per cent guidelines probably will be replaced by tests of "reasonableness" applied on a case-by-case basis. Given the cooperative attitude of the trade unions thus far, a wage explosion seems unlikely. We would not be surprised, however, at major collective bargaining settlements in the 7 to 8 per cent range. With wage rates elsewhere being lifted by strengthening demands for labor, compensation per manhour may increase at around a 7 per cent rate during 1973--excluding the effect of the rise in the social security tax rate in the first quarter.

On the price side, we expect the initial adjustments to Phase III to show up more in the first half, but the bulge in prices may be held down by recognition on the part of larger firms that they would be inviting reimposition of mandatory controls if their price increases were large and very visible.

We translate this into a fixed-weight price index for private GNP that rises at an annual rate of around 4-1/4 per cent during most of 1973. Average prices in the first two quarters will be raised by further increases in consumer food prices, by the effects on costs of the rise in social security tax rates, and by the initial wage and price adjustments occasioned by the move to Phase III. In the latter half of the year, these special effects will become less important. But by that time, productivity gains seem likely to slow, and unit labor costs to rise further, so that upward pressures on prices would continue.

By the fourth quarter of 1973, we are now projecting an average price level about 1/2 per cent higher than in the last green book;1/ most, though not all, of this increase reflects the projected effects of the switch to Phase III. We are projecting a level of real GNP in the fourth quarter about 1/2 per cent lower than last time. This is mainly the effect of greater monetary restriction. Nominal GNP, therefore, is at about the same level in the fourth quarter, since the real and the price effects are about offsetting.

In conclusion, let me remind you that judgmental forecasters thrive on continuity. Incorporating into a GNP projection changes in two or more basic assumptions gives rise to large elements of uncertainty. We recognize that our views may change as time goes on and more information comes in on how the economy is

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

> responding to the new policy environment. We also recognize that the policies assumed--particularly with respect to the budget--may not work out exactly as we now project, and that new problems may come to have sizable implications for the domestic economy.

Mr. Hayes observed that output was still rising more rapidly than productive capacity and that the margin of unused resources was continuing to shrink. Projections of economic activity made by the New York Bank's staff and those made by the Board's staff--which continued to be generally similar--clearly reflected considerably less optimism on prices than suggested by the Administration. Indeed, the price outlook was more discouraging now than at any time since early August 1971. The vigor with which the Administration intended to use its "club in the closet" was an unknown factor in the situation; there had been a burst of increases in industrial prices recently; and the near-term outlook for food prices was very unfavorable. Moreover, advances in compensation per manhour and average hourly earnings had tended to accelerate even before the announcement of Phase III. Finally, the red book conveyed an impression of a broad-gauged intensification of inflationary expectations around the country. Perhaps the only bright spot in an otherwise discouraging picture was the Federal budget. Clearly, fiscal stimulus would show a significant and needed moderation if the President's program to curb expenditures was realized. The

Administration's revenue estimates seemed, if anything, conservative for both fiscal years 1973 and 1974. The degree of Congressional support for the program was not clear, but the seriousness of the President's intent to get spending under control was beyond question.

Mr. Eastburn, noting that the green book indicated that the annual rate of increase in compensation per manhour had risen to 7.4 per cent in the fourth quarter of 1972, asked whether the new staff projection had been based on an assumption that such a rate of increase would continue into 1973.

Mr. Gramley replied that the rate of increase in compensation per manhour in the fourth quarter of last year was unusual and that the assumed increase in 1973 was around 7 per cent, excluding the effects of the first-quarter increase in social security taxes. For the year as a whole, the tax increase would add about eight-tenths of a percentage point. Therefore, the over-all rise projected from the fourth quarter of 1972 to the fourth quarter of 1973 was about 7.8 per cent, which was larger than the increase in 1972.

Mr. Mitchell asked whether the staff's GNP projections would have been much different if estimates of refunds of Federal taxes in early 1973 had been $5 billion lower. He also asked whether the staff had changed its judgment concerning the proportion of refunds that consumers would spend for goods and services. He would guess that recent events had reduced the expenditure proportion.

In reply, Mr. Partee commented that since June 1972 staff projections had reflected an assumption that 50 per cent of the tax refund would be spent. A $5 billion difference in the amount of the refund, consequently, would make a considerable difference in the projection for consumption expenditures, although not as much of a difference as would a $5 billion shortfall in disposable income attributable to other causes. With respect to a judgment about the division of the refund between expenditures and saving, there was no historical experience that was especially useful. In his view, however, the current environment might well favor a larger consumer expenditure effect than did that of last summer.

Chairman Burns remarked that the prospective expenditure share now might appear higher than in June 1972 but lower than in December.

Mr. Coldwell noted that Mr. Partee had mentioned a number of developments--including the foreign exchange disturbances--that might have contributed to deterioration in public confidence, and he questioned whether they might not affect the proportion of the tax refund that would be spent.

Mr. Partee commented that very recent developments, as Chairman Burns had suggested, might tend to lower the proportion of the refunds that would be spent. Historically, surveys of consumer attitudes had indicated that expectations of inflation were associated with a reduction in planned expenditures, and the survey conducted in November-December by the University of Michigan's Survey Research Center indicated that consumers were expecting more inflation than they had previously. The announcement of Phase III since then might have raised the expected rate of inflation still further. If rising food prices contributed to a substantial acceleration of the increase in the consumer price index in January and February, the expected rate of inflation might become quite high. It should be remembered, however, that expectations of inflation tended to raise business demands--both for fixed investment and for inventory.

Concerning yesterday's devaluation of the dollar, Mr. Partee continued, it really was too early to appraise the effects. It might contribute to a sense of disquiet about various aspects of the economic situation, although in time it would tend to expand domestic business activity by stimulating exports and shifting domestic demands from imports to domestically produced goods. It was also true that devaluation of the dollar would raise dollar prices of some major imports, such as petroleum products.

Chairman Burns remarked that in one respect the devaluation might very well have cleared the atmosphere. Businessmen all over the world had difficulty in coping with uncertainty, and the devaluation had removed one source of uncertainty in their operations.

Mr. Winn observed that a relatively high proportion of auto instalment contracts were being written for amounts in excess of dealer costs of the automobile and that delinquencies in payments on instalment contracts and mortgage loans--particularly mortgages associated with Federally subsidized housing programs--had risen. He asked Mr. Partee to comment on the general problem of the quality of credit.

In response, Mr. Partee agreed that easier credit terms probably had contributed to an increase in delinquencies. To date, however, lenders had not indicated that delinquencies were a serious problem or were affecting their credit extensions. That situation could well change, however, when and if the expansion in employment and consumer incomes began to slow.

Mr. Robertson asked whether the increase in the number of new car contracts being written with 48-month maturities was a source of concern.

Mr. Partee replied that a few banks around the country were making greater use of longer maturities but there had not been a major move to maturities of 48 months. Such a development would become more probable when new car sales lagged significantly since one or more of the "captive" sales finance companies might well decide to write more contracts with 42- and 48-month maturities in a competitive drive for sales. That did not seem likely before late spring or summer at the earliest.

Mr. MacLaury noted that some economists engaged in projecting developments had already suggested the possibility of a recession in 1974. Considering that the Federal budget was becoming restrictive and that more of a deceleration in economic growth was being suggested by the latest staff projections than by those made a month earlier, he asked whether any staff evaluation of prospects beyond 1973 had yet been made.

Mr. Gramley replied that in view of all the uncertainties in the present situation, projections for more than four quarters ahead were especially tenuous, and the staff had not attempted to make any. However, the staff had examined prospects for inventory demands because of their special importance in relation to turning points in business activity. If the staff projections for 1973 should be realized, the inventory-sales ratio would decline further in the first half and level off in the second half. In the fourth quarter inventory accumulation would absorb about 1.2 per cent of the value of total GNP, which was just a little higher than the long-term average. Thus, the inventory situation projected for the end of 1973 would suggest further substantial accumulation thereafter rather than a liquidation that might lead to a downturn in business activity.

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 January 16 through February 7, 1973, and a supplemental report covering the period February 8 and 9, 1973. Copies of both reports have been placed in the files of the Committee.

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

> Open market operations over the period since the Committee last met have continued to be aimed at restraining the growth of nonborrowed reserves relative to the banking system's demand for total reserves. In light of the Treasury financing, the Desk moved early to achieve restraint on reserve expansion, and the Federal funds rate moved up to 6-3/8 per cent--the upper end of the Committee's range of tolerance--in the second full week of the period. Subsequently, as growth of the monetary aggregates began to show signs of moderating, the Desk sought to stabilize money market conditions at the higher level of the Federal funds rate already achieved.
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> The Government securities market weakened over much of the period, mainly because of uncertainties about the effectiveness of Phase III and expectations that, with the economy growing vigorously, monetary policy would become more restrictive. With the Federal funds rate rising, these expectations tended to be reinforced, and yields rose in all maturity areas. Later in the period expectations of foreign purchases of Government securities arising from the massive intake of dollars by foreign central banks, the stabilization of money market conditions, and the success of the Committee on Interest and Dividends in rolling back increases in prime rates brought about an improved market atmosphere. Considerable uncertainty remains, however, over the impact of the devaluation on

domestic markets and over the implications that the CID's strong stand on the prime rate might have for interest rates in the open market.

Treasury bill rates, which had moved up by as much as 50 basis points in the 3-month area, turned lower again on expectations of foreign official buying. In the regular weekly auction, held on Friday because of the Monday holiday in some areas, average rates of 5.42 and 5.62 per cent were set for the 3- and 6-month bills, respectively, up 15 and 8 basis points from the levels set in the auction just preceding the last Committee meeting. Early this morning, bill rates have tended to back up by 10 to 12 basis points from the auction levels as it now appears there will not be any further accumulation of dollars by foreign central banks.

At the end of January, the Treasury offered holders of two notes maturing on February 15 a 3-1/2-year, 6-1/2 per cent note priced to yield about 6.60 per cent. It also announced an auction on February 7 of $1 billion of 6-3/4-year, 6-5/8 per cent notes. The terms of the refunding were deemed generous by the market, but demand for the 6-1/2 per cent note was quite light, with little activity in the secondary market for rights and when-issued securities. Attrition was high, at 47 per cent, but it was about what the market had expected, and it can be readily absorbed by the Treasury's strong cash position. Investment demand in the auction for the 6-3/4-year note was conspicuous by its absence and nearly 70 per cent of the issue was taken down by dealers. After some shaky trading just after the books closed, both new issues closed at premiums last Friday. This morning prices of medium-term Government securities have changed little while those on longer-term issues have risen by 1/4 to 3/8 of a point.

As a result of the exchange market crisis, foreign central banks had taken in nearly $8 billion by last Friday. This was clearly well in excess of the amount that the Treasury bill market can absorb, and the reserve outlook was such that System sales to foreign accounts could not be of much help. The Treasury has already issued $2 billion of special nonmarketable certificates to foreign central banks and will probably have to issue additional special securities for most of the nearly

$4 billion that foreign accounts will have available to invest tomorrow. Thus, the Treasury may well have raised about three-quarters of its cash needs for the rest of the fiscal year from this source alone, although if a sharp reflow of funds should develop in the exchange markets following the devaluation, the Treasury might well decide to redeem some of the special securities. It will, of course, be carrying for a time a cash balance well in excess of needs. In order to minimize the Tax and Loan Account balances held in commercial banks, because of past Congressional criticism of large balances, the Treasury will probably want to maximize balances held at the Federal Reserve Banks. To the extent that this is compatible with our own objectives, I believe we should be as accommodative as we can.

As far as open market operations are concerned, the move to a more restrictive reserve stance early in the period was facilitated by the absorption of a substantial amount of reserves by market factors, which firmed the money market without overt action by the Trading Desk. In fact, as the written reports to the Committee indicate, we were on balance a net supplier of reserves to the market until the very end of the period. We did run into a problem during the statement week ending last Wednesday. On Friday, February 2, the atmosphere surrounding the Treasury refunding was very poor, and with the money market firm, the System bought $280 million Treasury bills in the market with the thought that there would be ample opportunities to reverse the operation after the weekend--if the reserve situation required--by selling bills to foreign accounts that were accumulating dollars in their exchange market operations. As it turned out, an unexpected bulge in float of $800 million and a jump in borrowing at the discount window of $1.6 billion over the weekend left banks with a substantial amount of excess reserves by Monday morning. Although the System absorbed reserves over the rest of the week by selling $680 million of Treasury bills to foreign accounts and by making nearly $3 billion in matched sale-purchase agreements, the Federal funds rate eased temporarily to 5-3/4 per cent on Tuesday and Wednesday. We were able to recapture the desired degree of restraint before last weekend, but discount window borrowing bulged again--to over $2 billion--over the weekend. This time, however, it appears that banks really needed the reserves and there should not be any major problem in maintaining the desired degree of reserve restraint. In fact the Federal funds rate at the moment is up to 6-3/4 per cent, and we are resisting that by making repurchase agreements.

The behavior of the aggregates has been discussed in some detail in the blue book1/ and in the other written reports to the Committee, and I have little to add. The zero growth in $M_1$ in January takes away some of the sting of the rapid December growth and has been widely noted in the market. The anticipated February growth rate is quite strong, however, at 7.5 to 8 per cent. Meanwhile the market is viewing with some alarm the explosion in bank loans. Some part of this growth is undoubtedly related to the strength of the economy and to the international situation. But it also appears that some of it is precautionary borrowing in anticipation of a further firming of monetary policy and some shift out of the commercial paper market. Nonbank related commercial paper, on a nonseasonally adjusted basis, actually declined by about $140 million in January compared with increases of $900 million to $1.4 billion in January of the last 4 years. Whether or not this expansion in bank loans presages another burst of $M_1$ expansion, as some market observers fear, or whether it is a temporary phenomenon that may bring the day of bank rationing of loans nearer to hand remains to be seen.

Finally, I should report that we plan to add John Nuveen and Co. to the list of dealers with whom we do business, raising the total to 24. Nuveen has been on our reporting list since November 1971 and has finally reached a level of activity that makes it worthwhile to commence operations with that firm. As you know, a number of other firms have aspirations of becoming government dealers, and we will be reporting on their progress from time to time.

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

Chairman Burns observed that a sizable part of the U.S. Government debt now was owned by foreign official institutions and that he and other members of the Committee ought to understand fully the implications that such ownership might have for the U.S. economy, for financial markets, and for Federal Reserve policy. He asked that the staff present a tentative report as soon as possible pending the preparation of a more intensive study.

Mr. Mitchell asked about Desk operations to deal with the effect that foreign central bank buying of Treasury bills was having on U.S. financial markets. He was concerned about the possible effect of such buying not only on bill rates but also on U.S. bank reserves because of the existence of Euro-dollar balances that were not part of the U.S. money supply and were not subject to the reserve requirements applicable to deposits at domestic member banks.

In reply, Mr. Holmes noted that bill rates had declined rapidly in response to inflows of dollars to foreign central banks. Most recently bill rates had recovered part of the decline as market participants apparently had concluded that the outflow of dollars was coming to an end. Now that currency relationships had been realigned once again, reflows of dollars might develop, and central banks would have to liquidate dollar securities in order to support their currencies in the foreign exchange markets. In the event of very large reflows, sales of bills on behalf of the central banks might exert excessive upward pressures on bill rates, but techniques were available to moderate those pressures. For one, the System might buy bills directly from the foreign accounts and, with the cooperation of the Treasury, offset the reserve effects by allowing the Treasury balances to decline at commercial banks--where they were large--and to rise at the Federal Reserve. For another, the Treasury might redeem some of the special securities that had been issued to foreign central banks. It might be recalled, however, that the massive reflow of funds that had been expected and prepared for after the December 1971 Smithsonian agreement did not develop.

Mr. Holmes went on to say that there was no net effect on U.S. bank reserves arising from the foreign central bank buying of Treasury bills with the dollars taken in through their exchange markets, no matter what the initial source of the dollars being used to purchase foreign exchange. The process by which a foreign central bank sold its own currency against dollars in the foreign exchange market involved a transfer to the central bank of an existing deposit in a U.S. bank. The subsequent transfer of that deposit to the central bank's account at the New York Reserve Bank resulted in an absorption of reserves, but then the purchase of Treasury bills on behalf of the central bank restored the reserves.

Mr. Brimmer noted that over two successive weekends member bank borrowings had been quite high, and he asked Mr. Holmes whether the borrowing had been primarily by money market banks and what the explanation for it might be.

Mr. Holmes replied that both money market and other banks had borrowed over the two 3-day holiday weekends. Over the latest weekend banks had needed reserves, and they had borrowed heavily in preference to bidding for reserves in the Federal funds market. Although firm, the funds rate had not risen above 6-3/8 per cent. On Friday the actual amount of reserve needs had been uncertain, with Board and New York Bank estimates differing by $600 million, and with the Federal funds rate at 6-3/8 per cent reserves might reasonably have been provided. However, many market participants believed that the System would back away from its recent more restrictive policy stance, and from a psychological point of view it seemed better to operate on the assumption that the lower estimate of reserve needs was correct. As it developed, reserve needs were actually greater than had been assumed.

Mr. Brimmer observed that despite the high level of member bank borrowings, the volume of borrowings by banks under administrative pressure was small. Indeed, the amount under such pressure had declined in recent weeks.

Chairman Burns asked if any of the Presidents could comment on whether member banks were abusing the borrowing privilege to take advantage of the spread between the discount rate and other short-term interest rates.

Mr. Hayes remarked that as the pressure had built up in the money market, banks had made greater use of the discount window to meet their reserve needs--which was the way a restrictive policy tended to work. As a bank's use of the window increased, the opportunity for counseling with the bank also increased. In recent weeks the New York Bank had talked with three or four of the large commercial banks and they had responded by becoming very cautious about borrowing. Given the spread between the discount rate and the funds rate, banks were exposed to an incentive to borrow, but banks in his District were not abusing the privilege in any substantial way.

Mr. Mayo commented that the situation in the Chicago District was the same.

Mr. Francis observed that in the St. Louis District borrowings had increased partly because loan demand had expanded in areas that had not experienced much increase before and partly because some banks had taken advantage of the rate spread. In recent weeks, the

St. Louis Reserve Bank had had considerable conversation with some member banks.

Mr. Balles referred to Mr. Holmes' comments about the bulges in member bank borrowings over the last two weekends and asked whether unanticipated fluctuations in borrowings tended to contribute significantly to the problems of attaining the Committee's targets for reserves.

Mr. Holmes replied that when actual borrowings exceeded projected levels during a statement week the Desk attempted to offset the effect on total reserves in that week by reducing the volume of nonborrowed reserves it supplied. While the Desk was not always able to fully achieve that objective, on the whole it had been reasonably successful.

Mr. Axilrod added that the demands for borrowed reserves had been somewhat greater than projected in the blue books for the past few months. As Mr. Holmes had indicated, the Desk had compensated by providing fewer nonborrowed reserves.

Mr. Coldwell remarked that the Desk presumably would have more difficulty in offsetting unexpected movements in borrowings when they occurred late in the statement week--say, on Wednesdays.

In reply, Mr. Holmes said that the major problems had tended to occur in connection with weekend periods.

Mr. Balles then referred to Mr. Brimmer's remark about the small volume of borrowings by banks under administrative pressure.

Under the ground rules for discount window administration, a member bank that borrowed a relatively modest proportion of its required reserves for a relatively brief period would not come under administrative pressure--unless, of course, the bank was a net seller of Federal funds in a week in which it borrowed. However, the total volume of borrowing in a District could be built up to a sizable figure by modest borrowings for one, two, or three weeks of a not very large number of banks. That, in fact, had happened in the San Francisco District recently. Nevertheless, it was true that any borrowings at the current discount rate could be called borrowings for profit, in the sense that the discount window was a less expensive source of funds than available alternatives. That was simply a way of saying that the discount rate was out of line.

Mr. Brimmer, agreeing that the discount rate was out of line, raised the question whether the guidelines with respect to administrative pressure were appropriate to the present situation.

Mr. Clay remarked that there were a few banks in the Kansas City District that were quick to try to profit from the spread between the discount rate and other rates. Those banks were watched closely when they borrowed, and although they might take a little longer than others to terminate their borrowings, they did so in a reasonable period of time. It was necessary to know the attitudes of a bank's management and to be alert to the possibility of misuse of the borrowing privilege. In some cases, however, attitudes toward borrowings had changed; one bank in his District that until 3 years ago had made it a rule not to borrow from the Federal Reserve now was willing to do so.

Mr. Black observed that administrative pressure could take many different forms. When a member bank in the Richmond District began to move out of line, the officer in charge of the Reserve Bank's discount department would have a conversation with the manager of the member bank's money position, whom he generally knew on a personal basis. In that way, frictions were avoided and effective control over borrowings was maintained.

Mr. Black then asked Mr. Holmes whether he had seen any evidence that member banks had borrowed at the discount window to finance holdings of foreign currencies.

Mr. Holmes said he had not seen evidence that banks had borrowed for that purpose. However, it seemed likely that some of the bulge in business loan demand--which had increased reserve needs and, in consequence, member bank borrowings--was related to the international monetary disturbance.

Chairman Burns asked whether any information was available to determine whether U.S. commercial banks had purchased foreign currencies for their own account and whether they had made loans to foreign official institutions for the purpose of speculating in foreign exchange.

In response, Mr. Pizer commented that the evidence relating to the period of currency speculation in 1971 might suggest how banks had behaved in the recent period. In 1971 there was no evidence that banks had significantly increased their own holdings of foreign currency assets, but they had increased their loans to foreigners. Those loans were chiefly to foreign commercial banks, not to official institutions. However, the regularly published detailed statistics on outstanding loans to foreigners and on other claims of commercial banks on foreigners were provided by a monthly report, and the data would not reveal loans that were both extended and repaid between reporting dates.

Chairman Burns remarked that the System ought to have systematic data relating to the foreign borrowing.

Mr. Brimmer commented that the series for weekly reporting banks contained information on loans to foreign commercial banks and to foreign governments as of each Wednesday. Those data would provide some broad indication of the behavior of the large commercial banks.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period January 16, through February 12, 1973, were approved, ratified, and confirmed.

Mr. Axilrod made the following statement on the monetary relationships discussed in the blue book:

The main point to be made about the outlook for monetary aggregates and interest rates is that we believe that the money market tightness already in place will be working to restrain the demand for money over the months ahead. Thus, reserve expansion consistent with a 5 to 6 per cent longer-run growth in $M_1$ may not lead to any appreciable further tightening of money market rates in the near-term. Indeed, one of our models suggests that adherence to such a reserve path would likely bring an easing in money market rate pressures at some point, possibly by early spring.

I would not discount this result completely. But it does not appear prudent at this point to permit any significant decline in the funds rate, should it tend to develop--with 6 per cent appearing to be a reasonable lower limit. One reason, of course, is that given the large expansion of the aggregates in the second half of 1972, together with continued strong demands for goods and services, it would appear economically more desirable for a while to let the chips fall on the side of slow expansion in the aggregates rather than on the side of a significant drop in interest rates. Second, even if there were a greater slowing in $M_1$ growth in the first half of this year than expected at around current interest rates, the danger of a resurgence in the second half is quite real. Nominal GNP is still expected to be expanding at about an 8-1/2 per cent annual rate at that time, thus indicating continued comparatively strong transactions demands. Under those conditions, any significant slippage in short-term interest rates in the months immediately ahead could make the task of controlling monetary expansion that much more difficult in the latter part of the year, assuming the outlook for GNP does not weaken.

Thus, there appear to be good economic and monetary control reasons for not permitting much slippage in money market tautness in the period immediately ahead, even if this were to mean some shortfall in reserves from target. Conversely, though, there does not appear to be a strong reason for forcing a significant tightening in money market conditions at this point. Not much will be lost in terms of longer-run monetary control from a wait-and-see attitude for a month, assuming the aggregates in February-March, influenced by the special reasons noted in the blue book, do not expand much more rapidly than indicated in connection with alternatives B and C.[1/]

The relation of the foreign exchange crisis to monetary aggregates and interest rates is, of course, an important question for System operations. We are not able at this point to estimate how much of the inflow of dollar funds to key foreign official accounts represents a net shift out of U.S. domestic demand deposits, how much is financed by borrowing, and how much reflects sales of financial market instruments or run-offs of time deposits. I would guess that a minor amount of the dollar flow so far has represented a direct shift out of U.S. demand deposits. But to the extent that there has been such a shift, there would be a tendency for short-term interest rates generally to decline if the System attempted to maintain $M_1$ at the pre-existing, but no longer desired, level. In that case, it would seem best to maintain the level of interest rates and let $M_1$ grow less on the grounds that there has been a downward shift in the demand for money relative to GNP.

Most of the dollar flows probably do not reflect a shift in demand for money, however. Rather, the flows more likely reflect a reduced demand for domestic interest-earning liquid assets or an increased demand for domestic borrowing. In such circumstances, there would not be a shift in demand for $M_1$ relative to GNP, so that there would be no need for the Committee to change its view as to what pace of expansion in the aggregates is desirable on domestic grounds. And the level of interest rates in the U.S. market should tend to change little on average, given pre-existing $M_1$, because desired sales of dollar assets or borrowing would be offset by foreign official purchases of dollar assets.

There will, of course, be--and there have been--special downward interest rate effects in the bill market because foreign official account demands are concentrated in that market. However, except in the case of direct shifts out of cash, there should be a

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

countervailing net reduction in demands for other domestic assets, so that markets in general should not tend to ease.

In the short run, however, there is the possibility--though a rather remote one at the moment--that short-term markets as a whole might tend to ease as a result of dollar flows abroad, partly for psychological reasons, given the key role of the bill market in shaping attitudes, and partly because some of the countervailing demand reduction may come out of longer-term securities or cash. To minimize possible adverse repercussions of a drop in the bill rate, should the tendency continue despite yesterday's announcement of a U.S. devaluation, the Committee may wish to see the Manager utilize coupon or longer-term Agency issues as much as feasible in providing reserves, or employ market swaps involving bill sales and coupon or Agency purchases. Maintenance of the funds rate would also, of course, tend to communicate the view that a declining bill rate does not necessarily herald declines in other rates.

Yesterday's statement on foreign economic policy, however, may lead to a cessation of dollar outflows, and possibly to some return flow. A return flow would work toward exerting upward pressure on bill rates, and could possibly also lead to a temporary rise in demand deposits to the extent that businesses, for example, replenish cash balances that may have been temporarily depleted by such things as prepayment of mark debts.

I would like to make one final point related to the domestic monetary impact of exchange market flows. While measures to deal with the foreign exchange crisis have been announced, there still may be at least transitional uncertainties on the part of domestic investors, businessmen, and consumers about foreign reactions to the measures and about the implications for domestic economic policies. This could be associated with a protective move to liquid assets, including cash, in this country. In these circumstances, the Committee might wish to permit expansion in the aggregates to accommodate higher domestic liquidity demands, but there is no evidence that we are at this stage yet, and hopefully the announced policy measures will themselves diminish the likelihood of reaching such a stage.

Chairman Burns then called for Committee discussion of monetary policy and the directive, beginning with Mr. Hayes.

Mr. Hayes said he thought there were a variety of reasons for maintaining the firmer stance of policy that had recently been achieved. They included the strong prospects for the economy and their inflationary implications, and the latest foreign exchange crisis, which stemmed, at least in part, from fears here and abroad that the rate of inflation in this country might accelerate. Also, he believed that monetary policy should do its part to help make the devaluation effective.

Noting that Federal funds had recently been trading around 6-3/8 per cent, Mr. Hayes said he would favor setting the range of tolerance for that rate at about 6 to 6-3/4 per cent. The longer-run targets for growth rates in the monetary aggregates agreed upon at the previous meeting--including the 5 to 6 per cent target range for $M_1$--still seemed reasonably appropriate, although he would prefer to have $M_1$ grow at a rate nearer to 5 than 6 per cent. Also, he was pleased to see that in connection with the alternative sets of targets discussed in the blue book the growth rates for the bank credit proxy had been increased to levels which he considered more realistic than the rate adopted at the previous meeting. He would expect member bank borrowings to continue to average something over $1 billion.

In sum, Mr. Hayes observed, he would favor specifications intermediate to those associated with alternatives B and C. For the operational paragraph of the directive he preferred alternative C. Also, he would suggest one modification in the staff's draft of the preceding general paragraphs of the directive, to take note of the recent bulge in business loans at banks. Specifically, following the statement in the second paragraph regarding January deposits developments, he would add a sentence along the following lines: "A sharp and pervasive increase has taken place in bank loans to businesses."

Chairman Burns remarked that this would be an appropriate time to consider the draft of the general paragraphs as a whole. He asked first whether there were any objections to the change Mr. Hayes had proposed, and none was heard. He then noted that the staff had prepared a revision of the language on foreign exchange developments contained in its earlier draft, to take account of the statement by Secretary Shultz released last night. The revised language, which would follow rather than precede the sentence on merchandise trade, read as follows: "Heavy speculative movements out of dollars into German marks and some other currencies developed in late January and early February. On February 12 the Government announced that the United States would devalue the dollar by 10 per cent."

The Committee agreed that the revised language proposed by the staff should be used. No other changes in the draft of the general paragraphs were suggested.

Mr. Hayes said he had only one further comment, relating to the discount rate. In his view, the substantial rise in short-term market rates that had occurred since the increase of January 15 suggested that the time was near when another half-point increase in the discount rate would be appropriate. It might be argued that a brief delay would be desirable in view of the recent Treasury financing, and perhaps with some consideration of the current controversy over the prime rate. On the other hand, international considerations would suggest that the sooner the increase the better. Specifically, an increase in the discount rate would be interpreted in foreign exchange markets as consistent with the objective of making the devaluation effective, and thus would have a useful effect on market attitudes.

Mr. Francis remarked that the actions announced late yesterday by Secretary Shultz should have a wholesome influence on the external affairs of the country. Also, he thought the longer-run growth rate for $M_1$ of 5 per cent which the staff had introduced in its latest GNP projections was realistic and consistent with the goals for internal economic developments. It seemed to him that the short-run specifications associated with alternative C were at least close to what would be needed to achieve the longer-run objectives. The language of alternative C also struck him as quite good, since it would make clear that the Federal Reserve expected to do its part in attaining the nation's economic goals.

Mr. Kimbrel referred to Mr. Axilrod's comment that a longer-run growth rate in $M_1$ of 5 to 6 per cent might be associated with no further increase in short-term interest rates. He observed that the staff at the Atlanta Bank expected money demand later this year to be stronger than that comment implied, assuming GNP grew at the rates projected. He went on to say that inflationary pressures appeared to be strong at present, and that price advances would no doubt lead unions to ask for substantial wage increases in forthcoming labor negotiations. Moreover, District businessmen with whom he had recently talked were of the view that the economic advance was reaching boom proportions. In light of such considerations, he was inclined to favor a longer-run target for $M_1$ of 4 to 5 per cent, as shown under alternative C. For the short run he also favored the specifications of C, perhaps shaded a bit toward those of B. For the funds rate, he preferred a constraint of 6 to 6-3/4 per cent.

Mr. Robertson said he had seen no indication in the discussion so far that participants were being diverted in their thinking on policy by satisfaction over the new international monetary settlement on the one hand or over the zero growth rate for $M_1$ in January on the other. That delighted him, because he was convinced that complacency now would be a serious tactical error; the economy continued to grow vigorously, and the biggest intermediate-term risk was too much expansion and too much generation of inflationary pressures.

In his judgment, Mr. Robertson observed, the proper course for policy was to maintain steadily the kind of pressure that was now being exerted. While he would not advocate further deliberate tightening, he would want to guard against giving off any misleading signals of easing in the money market. It seemed to him that that could be best achieved by specifications close to those of alternative C--except for the Federal funds rate, for which the alternative B range would be acceptable so long as there was no money market easing. The alternative C language of the operational paragraph also appealed to him.

Mr. Mitchell said it was his impression that the Committee had got a lot of mileage out of the recent increase in the Federal funds rate. According to the blue book, attainment of the alternative C targets for the aggregates was likely to involve a further rise in the funds rate during the coming period to 6-7/8 per cent. He would be apprehensive about adopting the C specifications; while a decline in the longer-run growth rate in $M_1$ into the 4 to 5 per cent range associated with C would not disturb him, he would be disturbed if the funds rate were raised to virtually 7 per cent at this time in an effort to achieve that growth rate for $M_1$. Such a rise in the funds rate would lead to a substantial escalation in short-term rates, and he understood from other staff analysis that further increases in short-term rates at this point were likely to result in substantial advances in long-term rates.

In response to questions, Mr. Axilrod said that under alternative B, which called for retention of the present 5 to 6 per cent longer-run target growth rate for $M_1$, the staff expected money market conditions to change relatively little during the coming period. As Mr. Mitchell had implied, however, the staff believed that the aggregate growth rates shown under alternative C would be consistent with an increase in the funds rate to near the top of the indicated 6-1/8 to 6-7/8 per cent range by the time of the next Committee meeting. With respect to long-term rates, the spreads from short-term rates had now been reduced to amounts that might be characterized as "normal," at least in terms of the experience in the first half of the 1960's. Accordingly, a further significant rise in short-term rates at this point--even assuming that inflationary expectations played a neutral role--would involve the danger of upward pressure on long-term rates.

Chairman Burns remarked that, without intending to debate or question Mr. Axilrod's comment, he would like to record the fact that during the past year the Committee had repeatedly been concerned about the impact a rise in short-term rates might or would have on long-term rates, and such fears had proved to be misplaced.

Mr. Mitchell agreed, but added that during that period the spreads between short- and long-term rates had been much wider than they were now.

The Chairman remarked that that point, which Mr. Axilrod had made, was significant. However, it was also worth keeping in mind his own observation about the accuracy of the Committee's expectations for long-term rates.

Mr. Brimmer observed that if the funds rate were to rise well above 6-1/2 per cent the commercial paper rate could be expected to increase also. Assuming the prime rate remained at 6 per cent, business firms could then be expected to shift from borrowing in the commercial paper market to borrowing at banks. He asked whether such a development would not result in a faster expansion in bank credit than indicated in the blue book under alternative C.

Mr. Axilrod agreed that under the circumstances Mr. Brimmer had described it was likely that business borrowers would shift from the commercial paper market to banks, and that bank demands for large-denomination CD funds would increase substantially. That likelihood had been taken into account in the blue book analysis; indeed, the allowance made for a rather sizable expansion in outstanding CD's was the main reason why the estimated February rates of growth in bank credit were higher relative to growth rates in the money stock than in the previous blue book. It was worth noting, however, that despite the rapid growth in bank credit expected under C, such a policy course would still be restrictive because of the higher interest rates that would emerge.

Mr. Mayo said he was aware that the Committee's worries last year about long-term rates had proved unfounded. Nevertheless, he thought there were grounds for concern now, particularly in view of the significant increases in short-term rates that had already occurred. In the Seventh District there was a good deal of comment--by investment advisers, among others--that this was the time to issue long-term securities because long rates were finally about to move up. There was another important difference from a year ago: last year businessmen were not persuaded that the economic outlook was strong, but now, if anything, they were overestimating the strength of the expansion.

As to policy, Mr. Mayo observed that he would be quite happy to retain the longer-run target of 5 to 6 per cent for the growth rate in $M_1$. With respect to short-run specifications, he favored the range for the funds rate of 5-7/8 to 6-5/8 per cent shown under alternative B. However, he would have no objections to modifying the February-March $M_1$ growth rate from the 7 to 9 per cent range shown under B to 6 to 9 per cent. He favored alternative C for the directive.

Mr. MacLaury said he would not repeat comments already made about the strength of the economy, but he would note that there seemed to be reason for somewhat more concern now about the outlook for wages and prices than there had been a month ago. The profile of the GNP projections for 1973--indicating second-half growth rates somewhat below the high rates of the first half--suggested to him that it would be undesirable to risk having the monetary aggregates get out of hand in the first half. Indeed, it might be useful to exert a little extra pressure on the aggregates now, in the expectation of easing up if and as that appeared desirable in the second half.

Mr. MacLaury remarked that there was some risk that the Committee might mislead itself in assessing the 5-1/2 per cent growth rate in $M_1$ anticipated for the first quarter under alternative B. That figure reflected a zero rate of growth in January and 8 per cent growth rates in both February and March. While he realized that anyone could select time periods for averaging purposes to suit his own tastes, he would point out that the average growth rate in December and January was 6-1/2 per cent, and that the average rate over the second half of 1972 was higher. Against that background, he would prefer not to see $M_1$ grow at an 8 per cent rate in both February and March if such growth could be avoided.

Mr. MacLaury observed that he would like to second Mr. Hayes' comment about the role of international considerations in today's policy decision. Unlike the situation when the dollar was last devalued in August 1971, the domestic economy now was not slack. Accordingly, there was less reason now for avoiding monetary policy actions that would signify an intent to lay the domestic groundwork to back up the devaluation.

Mr. MacLaury said he considered the recent sizable increase in money market rates to have been quite appropriate and had been delighted to see it develop. At present he would not want to move much further; he would favor a range for the Federal funds rate of 6 to 6-3/4 per cent, and would not be disturbed if the rate did not move above 6-1/2 per cent so long as the aggregates were not growing at an unduly rapid pace.

Finally, Mr. MacLaury remarked, he was in a quandary with respect to the discount rate. On the one hand, he would not want to have the directors of his Bank conclude that administered rates, including the discount rate, in effect were being set by the

Government. On the other hand, it was highly important to maintain the Committee's ability to influence market interest rates through whatever policy actions it considered desirable, and he would not want to prejudice that ability by following an unacceptable policy with respect to the discount rate.

Mr. Eastburn remarked that it was now one year since the Committee had undertaken its experiment with the RPD approach, and he wondered whether this meeting--or perhaps the next one--might not be an appropriate occasion for evaluating the experiment. His own tentative reaction was that it had been a mixed success. On the one hand, it had led the Committee to focus more sharply on the trade-off between interest rates and the monetary aggregates. On the other hand, the effort to use RPD's as a "handle" for current operations had not been a complete success; more often than not the Committee tended to look past RPD's to $M_1$.

The Chairman remarked that the experiment with RPD's might well prove to be less than a complete success, and perhaps even a dismal failure. It should be noted, however, that some of the difficulties experienced last year were not a consequence of the use of RPD's but rather of employing too wide a range for the growth rate specified. Recently, of course, the ranges shown in the blue book under the various alternatives had been narrowed.

Mr. Eastburn added that there also was the problem, touched on earlier in the discussion today, of the difficulties of controlling RPD's in the short run when there were large fluctuations in borrowings.

Turning to policy, Mr. Eastburn said he would be inclined not to be overly aggressive at present in light of the many prevailing uncertainties. Mr. MacLaury's point about anticipating the problems likely to arise later in the year was a pertinent one. On balance, he favored specifications midway between those of alternatives B and C.

Mr. Coldwell remarked that the success of the devaluation of the dollar would depend heavily on the kinds of internal stabilization policies pursued in this country and abroad. He hoped it would not prove necessary to repeat the action a year from now.

In general, Mr. Coldwell continued, the situation called for restraint in monetary policy as well as in other policy areas, including Federal expenditures. At this point he would like to see monetary policy proceed a little further along the path of restraint it had been following in the last few months. He would favor the alternative C specifications, except that he would prefer a 6 to 6-3/4 per cent range for the Federal funds rate.

Mr. Coldwell added that the Federal Reserve was going to have to make a decision with respect to Regulation Q at some point in coming months. Specifically, it would have to decide whether or not it would again include the Q ceilings among the tools used in implementing a restrictive monetary policy.

Mr. Sheehan said he was deeply troubled by a number of factors suggesting that inflationary pressures might become very strong over the course of the year. Despite the 5 per cent unemployment rate and the existence of a fair amount of slack in industrial capacity, a strong economic expansion was already under way, and it was quite possible that the rates of growth in real and nominal GNP would be considerably larger in 1973 than the staff's projections suggested. Business inventories might well be one major source of additional thrust. While data for December indicated that stock-sales ratios in manufacturing and trade had remained low--which at first glance might well be taken as an encouraging sign--it seemed likely that businesses were about to launch extensive inventory building programs. One large company with which he was familiar, for example, had recently found itself sold out in its traditional product lines for the first time in his recollection. That company was doing everything it could to expand inventories, and it was also moving rapidly in the area of capital expansion.

In addition, Mr. Sheehan observed, the devaluation of the dollar together with the appreciation of the floating yen might well prove to be highly stimulating to domestic activity, particularly through its impact on the demand for domestically produced automobiles. He had been rather surprised that the Smithsonian realignment of exchange rates had had little net effect on foreign penetration of the U.S. auto market; in January, for example, sales of foreign cars, at about a 2 million annual rate, accounted for about 17 per cent of total sales--approximately their share prior to August 1971. Now, however, if the further improvement in the competitive position of American producers enabled them to cut significantly into the foreign share of the market, the contribution to economic expansion could be great. The effect would be felt, of course, not only on the auto industry directly, but also on all of its supplying industries--steel, glass, rubber, and so on--and there could be further substantial effects given the impact of the foregoing on business psychology.

Also troubling, Mr. Sheehan continued, was the recent and prospective situation with respect to wage costs. There had been sizable gains in productivity over the past year, but their effects on unit labor costs had been considerably offset by the absence of an appreciable slowing in the rate of advance in wages. According to the green book, wage increases in major contract settlements during 1972 averaged 6.4 per cent over the life of the contract. That represented progress from 1971, when the corresponding figure had been 8.1 per cent, but it was hardly dramatic progress. Moreover, the green book went on to indicate that when account was taken of fringe benefits as well as wages, the progress was even less: from an 8.8 per cent rate of advance in 1971 to a 7.3 per cent rate in 1972. In considering the outlook for wages, he had been encouraged by the willingness of national union leaders to participate in Phase III. At the same time, he was concerned about the pressures for large wage increases that were likely to arise at the local level, particularly if food and other prices were advancing rapidly while negotiations were in process. In any case, the average rate of advance in wages was likely to be somewhat greater under Phase III than under Phase II. Combining that with the prospect that gains in productivity would slacken as the economy moved closer to full capacity, it seemed likely that substantial cost-push pressures would emerge later in the year.

Mr. Sheehan remarked that in view of the prospects for an ebullient economy--which would be further stimulated by large refunds of overwithheld income taxes during the spring--and for growing cost-push pressures, he was more troubled about the prospective inflationary pressures than at any time since he had become a member of the Committee. Given the recent sharp tightening in monetary policy, there was merit in the argument that the Committee should pause a bit before tightening further, but he nevertheless would prefer to have any errors with respect to growth rates in the aggregates occur on the side of lower rates. With respect to the range for the Federal funds rate, he would favor setting the lower limit at 6 per cent; on psychological grounds he thought it would be desirable to avoid having the weekly average rate fall below that level. He appreciated the force of Mr. Mitchell's comments, and would set the upper limit at about 6-5/8 per cent. He preferred the aggregate growth rates of alternative B, shaded towards those of C; and he favored alternative C for the directive.

Mr. Bucher referred to Mr. Sheehan's remarks about the likely effect of the devaluation on economic activity in the United States and said it was not clear to him that U.S. manufacturers would have enough capacity available to make full use of the competitive advantage given to them by the devaluation.

More generally, Mr. Bucher continued, he agreed with almost all of the points made in the discussion so far, and would add only two comments. First, he was pleased that the Committee's worries last year about the effects on long rates of rising short-term rates had proved unwarranted and at present he was less concerned about such effects than he was about the possible consequences for long rates of growing inflationary expectations. His second comment related to the international situation. While the measures announced yesterday were constructive, it was necessary to continue to focus on the basic needs--including continued improvement in productivity and abatement of inflationary pressures. However, the key question from the international viewpoint concerned the rates of increase in wages and prices in this country relative to those abroad, and in Europe last weekend he had been impressed with the lack of significant progress there in coping with inflationary pressures. At the moment prices were rising at a 7.5 per cent annual rate in Switzerland and at similarly high rates in other countries.

As to policy, Mr. Bucher said he thought the Committee should continue along the path it had recently been following. He would not be displeased with a Federal funds rate in the 6 to 6-3/4 per cent area and he would favor maintaining the longer-run target for $M_1$ in the 5 to 6 per cent range, possibly leaning toward 5 per cent.

Mr. Morris observed that he was sympathetic to the position taken by Mr. Mitchell. He thought the Committee had created difficulties for itself last fall by its reluctance to see the Federal funds rate rise much. However, that was no longer a problem; the funds rate had advanced by 100 basis points since the end of December. He was not sure that it was possible as yet to evaluate the effect of that firming on growth rates in reserves and the money supply, and he would be inclined to hold the ground for another month in order to get a better basis for judging those effects. Accordingly, he favored alternative B today.

Chairman Burns remarked that this would be a good time to hear the advice of the Committee's Senior Economist.

Mr. Partee said he continued to believe that from the point of view of the domestic economy the appropriate longer-run target for $M_1$ was a growth rate of about 5 per cent. As had been noted earlier, that growth rate, along with the higher interest rates that would be associated with it, had been introduced in the staff's latest GNP projections, and the results suggested that real GNP would grow at satisfactory--but not ebullient--rates for the remainder of the year. Given the existence of a considerable problem of inflation, he thought such a pattern of activity was a reasonable objective for the economy and therefore that a 5 per cent $M_1$ growth rate was a reasonable target for policy. In his judgment, considerable progress had been made in the past 4 weeks toward the goal of slowing the growth of the monetary aggregates; while there had been a tendency recently to place less credence in projections made with econometric models, he was still persuaded that the tighter reserve conditions that had been achieved recently and the interest rate increases that had resulted would moderate the growth of the money stock over the months to come.

While he would not want to give up that progress, Mr. Partee continued, he could not see any great need at the moment for moving toward a still tighter stance. The policy course he would recommend today was one between alternatives B and C. That would be consistent with a 5 per cent longer-run growth rate for $M_1$; also, for the funds rate constraint it would imply an upper limit somewhat below the 6-7/8 per cent upper bound of C, and a lower limit above the 5-7/8 figure associated with B. As to the directive, he might note that the phrase in alternative C calling for "somewhat slower growth in monetary aggregates than occurred on average in the past 6 months" called, in effect, for growth in $M_1$ at an annual rate somewhat below 6.3 per cent. He thought that was an appropriate objective, and therefore that the language of C was appropriate for the directive.

Mr. Balles remarked that he was greatly impressed by the strength of the economy; the situation was being widely interpreted--in his view, correctly--as approaching boom conditions. And he was quite concerned about the prospects, outlined both by the Committee's staff and by the staff at his Bank, for a higher rate of inflation as a result of both demand and cost pressures. He did not take much comfort from the zero rate of growth in $M_1$ in January, and hence the low rate in the projection for January and February combined, because of the frequent sizable revisions in such data.

For reasons already made clear he strongly preferred the language of alternative C. He favored specifications between those of alternatives B and C, including a range for the Federal funds rate of 6 to 6-3/4 per cent.

Mr. Balles added that, like Mr. MacLaury, he was unsure about the appropriate role of the discount rate under current conditions, particularly because of his concern that the maintenance of a 6 per cent prime rate might lead to some undesirable changes in the composition of bank credit. Specifically, a continued substantial shift of business borrowing from the commercial paper market to banks--given the priority that business loans received under outstanding lines of credit and loan commitments--could well mean some reduction in the availability of bank credit for the consumer, mortgage, and State and local government categories.

Mr. Clay noted that in discussing industrial production developments in January the green book said "production worker manhour data indicate a continued low level of activity in the aircraft industry." The staff at his Bank had developed information from discussions with firms in the aircraft industry which was inconsistent with that statement, and which was worth reporting because it provided further evidence of boom conditions in the economy. The firms reported that sales of all types of commercial aircraft were unusually strong. One major manufacturer that produced planes mostly for commercial airlines reported that sales were ahead of projections, and that commitments for deliveries in 1973 were already about one-fourth higher than 1972 deliveries. Commitments were up not only in total but for each of the several different models of aircraft the firm made. Two manufacturers of business aircraft reported that orders currently were running at least double those of a year ago; indeed, for one orders were four times those of last year. Employment in the industry was so strong that smaller companies indicated that they were losing workers to the firms in the major aircraft manufacturing centers.

With respect to policy, Mr. Clay said he would prefer specifications between those of alternatives B and C. However, the specifications of B would be acceptable to him.

Mr. Black remarked that the domestic economic situation seemed to him to differ from that at the time of the Committee's previous meeting in two basic respects. First, businesses were now beginning to rebuild inventories. Secondly, despite statements regarding Phase III such as Chairman Burns had made recently, it was his impression that people were becoming increasingly doubtful that Phase III controls on prices would be as effective as those of Phase II.

Mr. Black expressed the view that those domestic considerations, together with the new devaluation of the dollar, argued for restoring growth in the monetary aggregates to acceptable long-run rates. Specifically, he would like to see the growth rate of $M_1$ brought down into a 4 to 6 per cent range. However, it might be wise to pause for a bit before tightening further. For one thing, there was some evidence that the recent firming had served to slow the growth in the aggregates, and it was desirable to see how persistent that effect would be. Secondly, there might be some unsettlement in domestic money markets in the period ahead, particularly if a substantial reflow of funds from abroad should develop. On both counts he thought it would be appropriate to hold to the alternative B specifications today, recognizing that it might appear desirable at the time of the next meeting to adopt specifications like those shown under alternative C.

Mr. Brimmer noted that he had not expressed a preference for policy in his earlier comments. On the basis of Mr. Partee's assessment of the situation, with which he concurred, he would favor specifications between those of alternatives B and C, with the Federal funds rate in a range of 6 to 6-3/4 per cent. Also, he would like to underscore Mr. Balles' observations regarding the possible impact on the composition of bank credit of the pattern of market rates and bank lending rates that was emerging. He hoped the Committee would not be insensitive to that consideration.

Chairman Burns said he would first offer a word or two by way of summary and then put some specific suggestions to the Committee. He thought the members were agreed that the economy was advancing briskly. They also were agreed--with the slack in the economy diminishing, with food prices soaring recently and likely to continue sharply upward at least for the next 2 or 3 months, with signs that wage increases were again becoming somewhat larger, and with productivity improvements reasonably expected to be appreciably smaller this year than last--that serious concern about the dangers of inflation was very much warranted, quite apart from the shift from Phase II to III. Fortunately, there was a mood not only in the Administration but also in the Congress to get the nation's fiscal house in order. While the probable effectiveness of Phase III remained a question in his own mind, there were increasing indications that the Administration, which had previously emphasized the voluntary dimension of the program, was now placing greater stress on its mandatory aspects; the President had made some strong statements about his own determination to use "the club in the closet" if necessary. Those indications were encouraging.

Turning to monetary policy, the Chairman expressed the view that the Committee should change its longer-run targets for the aggregates only after adequate deliberation. Since the subject had not been fully explored today, he suggested that the Committee retain the present target of 5 to 6 per cent for the annual rate of growth in $M_1$ over the first half of 1973, and that it plan on discussing longer-run targets at its March meeting. With respect to the directive, there was strong sentiment within the Committee in favor of alternative C for the operational paragraph. He shared that sentiment. Indeed, he would say that it was imperative to use language along the lines of C in a directive adopted the day after a devaluation of the dollar had been announced; to employ weaker language would be to suggest to observers here and abroad that the System's response was inadequate.

With respect to short-run operating constraints, Chairman Burns continued, there was rather widespread agreement on a 6 to 6-3/4 per cent range for the weekly average Federal funds rate in the period before the next meeting. As to the February-March growth rates for the monetary aggregates, his suggestions were based partly on the Committee's discussion and partly on his own reflections on the problem, including the need to convey the message that the Committee was not resting on its oars because $M_1$ had shown no growth in January. He suggested that the Committee adopt the upper limits for growth rates in the aggregates specified under alternative C, but once again proceed in asymmetrical fashion and reduce the lower limits. Specifically, he proposed the following ranges for February-March growth rates: for $M_1$, 3 to 8 per cent; for $M_2$, 2 to 7 per cent; and for RPD's, -2-1/2 to +2-1/2 per cent. He was advised by the staff that specifications he had described were reasonably consistent.

The Chairman added that the pursuit of such a policy course might temporarily produce a little more firmness than desired on a steady basis. Personally, he saw nothing wrong in pursuing a zig-zag policy course in the short run. Apart from the fact that it was not always easy to specify the straight path to monetary policy objectives, deviations, within limits, had the advantage of depriving speculators of the free ride offered to them when the course of policy was made crystal clear.

Chairman Burns then asked the Manager whether the policy he had described would pose any difficulties for the Desk's operations.

Mr. Holmes said he thought it would not. Decisions on day-to-day operations would, of course, have to be made in light of actual developments, since it was often difficult to foresee the market response to additional restraint. The Desk might also have to modify operations if large-scale international flows developed.

Chairman Burns remarked that the Desk would have adequate authority to deal with such problems under the language of alternative C. He then asked whether the members had any comments or questions about the proposed approach to policy.

Mr. Coldwell said he was concerned about the possibilities of some sharp expectational reactions in the markets. He hoped there would be enough flexibility to cope with such reactions if they developed.

The Chairman observed that Federal Reserve people followed developments day by day and hour by hour. He had no doubt that, if some unforeseen disturbance should develop, the System would be a position to deal with it.

Mr. Brimmer asked whether the staff planned to make a chart presentation on the economic outlook at the March meeting of the Committee.

Mr. Holland replied that for various reasons it had been decided to postpone the chart presentation, originally scheduled for March, until the April or May meeting.

Mr. Partee added that the staff would, of course, make a thorough review of its GNP projections, retaining the assumption of a 5 per cent growth rate for the money supply.

Chairman Burns said it would be helpful if the staff presented alternative projections in which the longer-run growth rate of money was assumed to be, say, 4, 5, and 6 per cent, respectively. He then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs with the two changes that had been agreed upon earlier, and alternative C for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the specifications he had described.

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 current economic policy directive:

The information reviewed at this meeting suggests continued substantial growth in real output of goods and services in the current quarter, although at a rate less rapid than in the fourth quarter of 1972. The unemployment rate has declined slightly further. In recent months wage rates have increased at a relatively rapid pace, and unit labor costs turned up in the fourth quarter of 1972. The rise in consumer prices slowed in December when retail prices of foods changed little, but prices of foods and foodstuffs at earlier stages of distribution rose sharply in both December and January. The excess of U.S. merchandise imports over exports remained large in December. Heavy speculative movements out of dollars into German marks and some other currencies developed in late January and early February. On February 12 the Government announced that the United States would devalue the dollar by 10 per cent.

The narrowly defined money stock changed little in January after having increased sharply in December, and growth over the 2 months combined was at an average annual rate of about 6-1/2 per cent. Growth in the more broadly defined money stock slowed less abruptly from December to

January as inflows of consumer-type time and savings deposits to banks accelerated. A sharp and pervasive increase has taken place in bank loans to businesses. In recent weeks market interest rates generally have risen further, with increases substantial for short-term rates and relatively moderate for long-term rates. Most recently, however, Treasury bill rates have moved back down under the influence of foreign official buying.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions consonant with the aims of the economic stabilization program, including further abatement of inflationary pressures, sustainable growth in real output and employment, and progress toward equilibrium in the country's balance of payments.

To implement this policy, while taking account of possible domestic credit market and international developments, the Committee seeks to achieve bank reserve and money market conditions that will support somewhat slower growth in monetary aggregates over the months ahead than occurred on average in the past 6 months.

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

Mr. Holland noted that there had been some uncertainty earlier about the date at which it would be best for the Committee to hold its March meeting, because of a possible conflict with a meeting of the Committee of 20. It now appeared sufficiently definite that the originally scheduled date of March 20 would be clear for the Committee to plan on that date. However, since the final, official advice concerning the date of the C-20 meeting had not yet been received, the members might want also to hold open the alternative date of March 22 for the time being.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, March 20, 1973, at 9:30 a.m.

Chairman Burns said he might add a final word about the meeting that the Reserve Bank Presidents had held in Chicago on February 2 on the subject of cost reduction. He had been pleased to hear the results of the meeting and understood that the program was off to a good start. He was grateful to the Presidents for their splendid cooperation and prompt actions, and he hoped to see the results come quickly.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

February 12, 1973

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on February 13, 1973

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests continued substantial growth in real output of goods and services in the current quarter, although at a rate less rapid than in the fourth quarter of 1972. The unemployment rate has declined slightly further. In recent months wage rates have increased at a relatively rapid pace, and unit labor costs turned up in the fourth quarter of 1972. The rise in consumer prices slowed in December when retail prices of foods changed little, but prices of foods and foodstuffs at earlier stages of distribution rose sharply in both December and January. Most foreign central banks have temporarily suspended operations in foreign exchange markets following the heavy speculative movements out of dollars into the German mark and some other foreign currencies that had developed in recent weeks. The excess of U.S. merchandise imports over exports remained large in December.

The narrowly defined money stock changed little in January after having increased sharply in December, and growth over the 2 months combined was at an average annual rate of about 6-1/2 per cent. Growth in the more broadly defined money stock slowed less abruptly from December to January as inflows of consumer-type time and savings deposits to banks accelerated. In recent weeks market interest rates generally have risen further, with increases substantial for short-term rates and relatively moderate for long-term rates. Most recently, however, Treasury bill rates have moved back down under the influence of foreign official buying.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions consonant with the aims of the economic stabilization program, including further abatement of inflationary pressures, sustainable growth in real output and employment, and progress toward equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPHS

Alternative A

To implement this policy, while taking account of international developments, the Committee seeks to achieve bank reserve and money market conditions that will support growth in monetary aggregates over the months ahead at about the average rates of the past 6 months.

Alternative B

To implement this policy, while taking account of international developments, the Committee seeks to achieve bank reserve and money market conditions that will support moderate growth in monetary aggregates over the months ahead.

Alternative C

To implement this policy, while taking account of possible domestic credit market and international developments, the Committee seeks to achieve bank reserve and money market conditions that will support somewhat slower growth in monetary aggregates over the months ahead than occurred on average in the past 6 months.

ATTACHMENT B

February 13, 1973

| Points for FOMC guidance to Manager in implementation of directive | | Specifications (As agreed, 2/13/73) |
|---|---|---|
| A. Longer-run targets (SAAR): (first and second quarters combined) | $M_1$ | 5 to 6% |
| | $M_2$ | 6 to 7% |
| | Proxy | 7 to 8% |
| | RPD's | 7 to 8% |
| B. Short-run operating constraints: | | |
| 1. Range of tolerance for RPD growth rate (February-March average): | | -2-1/2 to +2-1/2% |
| 2. Ranges of tolerance for monetary aggregates (February-March average): | $M_1$ | 3 to 8% |
| | $M_2$ | 2 to 7% |
| 3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings): | | 6 to 6-3/4% |
| 4. Federal funds rate to be moved in an orderly way within range of toleration | | |
| 5. Other considerations: account to be taken of international and domestic credit market developments. | | |

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.