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, March 9, 1971, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Kimbrel
Mr. Maisel
Mr. Mayo
Mr. Mitchell
Mr. Morris
Mr. Robertson
Mr. Sherrill

Messrs. Coldwell, Eastburn, and Swan, Alternate Members of the Federal Open Market Committee

Messrs. Heflin and Francis, Presidents of the Federal Reserve Banks of Richmond and St. Louis, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Bernard and Molony, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Hexter, Assistant General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Eisenmenger, Gramley, Hersey, Reynolds, Scheld, Solomon, and Taylor, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Kenyon, Deputy Secretary, Board of Governors
Mr. Leonard, Assistant Secretary, Board of Governors
Mr. Cardon, Assistant to the Board of Governors

Mr. O'Brien, Special Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Bryant, Associate Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Ormsby, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Miss Orr, Secretary, Office of the Secretary, Board of Governors

Messrs. MacDonald and Strothman, First Vice Presidents, Federal Reserve Banks of Cleveland and Minneapolis, respectively
Messrs. Parthemos and Craven, Senior Vice Presidents, Federal Reserve Banks of Richmond and San Francisco, respectively
Messrs. Hocter, Andersen, Billington, and Green, Vice Presidents, Federal Reserve Banks of Cleveland, St. Louis, Kansas City, and Dallas, respectively
Messrs. Gustus and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively
Messrs. Meek and Schadrack, Assistant Vice Presidents, Federal Reserve Bank of New York

The Secretary reported that advices had been received of the election by the Federal Reserve Banks of members and alternate members of the Federal Open Market Committee for the term of one year beginning March 1, 1971, that it appeared that such persons were legally qualified to serve, and that they had executed their oaths of office.

The elected members and alternates were as follows:

Frank E. Morris, President of the Federal Reserve Bank of Boston, with David P. Eastburn, President of the Federal Reserve Bank of Philadelphia, as alternate;

Alfred Hayes, President of the Federal Reserve Bank of New York, with William F. Treiber, First Vice President of the Federal Reserve Bank of New York, as alternate;

Monroe Kimbrel, President of the Federal Reserve Bank of Atlanta, with Philip E. Coldwell, President of the Federal Reserve Bank of Dallas, as alternate;

Robert P. Mayo, President of the Federal Reserve Bank of Chicago, with the person who shall become President of the Federal Reserve Bank of Cleveland as alternate;

George H. Clay, President of the Federal Reserve Bank of Kansas City, with Eliot J. Swan, President of the Federal Reserve Bank of San Francisco, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after February 29, 1972, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, as the case might be, they would cease to have any official connection with the Federal Open Market Committee:

Arthur F. Burns	Chairman
Alfred Hayes	Vice Chairman
Robert C. Holland	Secretary
Arthur L. Broida	Deputy Secretary
Normand R. V. Bernard and Charles Molony	Assistant Secretaries
Howard H. Hackley	General Counsel
David B. Hexter	Assistant General Counsel
J. Charles Partee	Economist

Stephen H. Axilrod, Robert W. Eisenmenger, George Garvy, Lyle E. Gramley, A.B. Hersey, John E. Reynolds, Karl A. Scheld, Robert Solomon, Charles T. Taylor, and Clarence W. Tow — Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Federal Open Market Committee after February 29, 1972.

By unanimous vote, Alan R. Holmes and Charles A. Coombs were selected to serve at the pleasure of the Federal Open Market Committee as Manager of the System Open Market Account and as Special Manager for foreign currency operations for such Account, respectively, it being understood that their selection was subject to their being satisfactory to the Directors of the Federal Reserve Bank of New York.

Secretary's Note: Advice subsequently was received that Messrs. Holmes and Coombs were satisfactory to the Directors of the Federal Reserve Bank of New York for service in the respective capacities indicated.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on February 9, 1971, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee held on January 12 and February 9, 1971, were accepted.

> The reports of audit of the System Open Market Account and of foreign currency transactions, made by the Board's Division of Federal Reserve Bank Operations as at the close of business on September 25, 1970, and submitted by Mr. Schaeffer, Chief Federal Reserve Examiner, were accepted.

In connection with the preceding action, Chairman Burns commented that in the future it might be useful to have an independent auditing firm participate along with the Board's examining force in the annual audit of the System Open Market Account. He suggested that the Committee members think about that possibility and be prepared to discuss it at the next meeting.

Reference was made to the procedure authorized at the meeting of the Committee on March 4, 1955, and most recently reaffirmed on March 10, 1970, whereby, in addition to members and officers of the Committee and Reserve Bank Presidents not currently members of the Committee, minutes and other records could be made available to any other employee of the Board of Governors or of a Federal Reserve Bank with the approval of a member of the Committee or another Reserve Bank President, with notice to the Secretary.

It was stated that lists of currently authorized persons at the Board and at each Federal Reserve Bank (excluding secretaries and records and duplicating personnel) had recently been confirmed by the Secretary of the Committee. The current lists were reported to be in the custody of the Secretary, and it was noted that revisions could be sent to the Secretary at any time.

Chairman Burns observed that Committee members had received a memorandum from the Secretariat dated March 5, 1971, recommending that the Secretary be authorized to act on the Chairman's behalf in considering proposals for the addition of members of the Board's staff to the list of those with access to Committee minutes and other records.[1/] As the memorandum noted, he (Chairman Burns) concurred in that recommendation.

> It was agreed to retain the existing procedure for making minutes and other records of the Committee available to employees of the Board of Governors and the Federal Reserve Banks, and to authorize the Secretary to act on the Chairman's behalf in considering proposals for the addition of members of the Board's staff to the list of those having access to Committee minutes and other records.

Chairman Burns noted that a memorandum from the System Account Manager, dated March 3, 1971, and entitled "Review of System Lending of Government Securities," had been distributed on March 4.[1/] He asked Mr. Holmes to comment.

Mr. Holmes observed that when the Committee had amended the continuing authority directive on October 7, 1969, to add

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1/ A copy of this memorandum has been placed in the Committee's files.

a third paragraph authorizing the lending of Government securities from the System Open Market Account, it had been understood that the authorization would be reviewed semi-annually. As indicated in his memorandum, there had been no essential change in the underlying factors that had led to the original authorization. Accordingly, he recommended that the Committee continue the authorization on the same basis as before--namely, to avert or minimize delivery failures.

Mr. Robertson said he had some questions about the legality of the lending operations which he had expressed on earlier occasions. However, since such operations had been authorized by the Committee he would not oppose them now.

Mr. Brimmer remarked that it would be helpful to have the opinion of the Committee's Counsel on the question of legality.

Mr. Hackley said it was still his opinion that the lending operations could properly be regarded as authorized under the incidental powers of the Federal Reserve Banks if the Committee determined that they were reasonably necessary to the effective conduct of open market operations and the effectuation of open market policies. In his judgment the facts as presented in Mr. Holmes' memorandum supported the view that the lending operations were still reasonably necessary for those purposes.

Mr. Brimmer then said he would concur in the Manager's recommendation that the authorization be continued.

Mr. Daane remarked that the Manager's memorandum demonstrated clearly that the operations in question were useful, and Mr. Mitchell indicated that he also would favor continuing them.

It was agreed that the authorization for the lending of Government securities from the System Open Market Account should be retained at this time.

Consideration was then given to the continuing authorizations of the Committee, according to the customary practice of reviewing such matters at the first meeting in March of every year.

Secretary's note: It had been agreed at the meeting on March 10, 1970, that certain authorizations among those that the Committee had reviewed annually in the past would remain effective until otherwise directed by the Committee, and would no longer be submitted routinely for review each year. Instead, it was understood that these authorizations would be called to the Committee's attention before the first meeting in March of each year and that members would be given an opportunity to raise any questions they had concerning them. Accordingly, copies of the authorizations in question (listed below) had been distributed to the Committee on January 21, 1971, with a request that the members advise the Secretariat if they wished to have any placed on the agenda for consideration at today's meeting. No such requests were received.

The authorizations in question were as follows:

1. Procedure for allocations of securities in the System Open Market Account.
2. Distribution list for periodic reports prepared by the Federal Reserve Bank of New York.
3. Authority for the Chairman to appoint a Federal Reserve Bank as agent to operate the System Account in case the New York Bank was unable to function.
4. Resolutions providing for continued operation of the Committee, and for certain actions by the Reserve Banks, during an emergency.
5. Resolution relating to examinations of the System Open Market Account.

By unanimous vote, the continuing authority directive to the Federal Reserve Bank of New York with respect to domestic open market operations, as shown below, was reaffirmed:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed (1) $125 million or (2) 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York, whichever is the lower;

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, or, if the New York Reserve Bank is closed, any other Federal Reserve Bank, to purchase directly from the Treasury for its own account (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate 1/4 of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

3. In order to insure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the the Committee may specify from time to time.

Chairman Burns noted that at its meeting on December 15, 1970, the Committee had delegated to a subcommittee consisting of Messrs. Hayes, Robertson, and himself responsibility for dealing with a problem that had been raised by the central banks of Belgium and the Netherlands, among others, concerning procedures for liquidation of swap drawings under the System's reciprocal currency arrangements with those central banks. As indicated in a memorandum to the Committee from the subcommittee dated February 18, 1971, the subcommittee had authorized the

Special Manager to negotiate with the central banks in question on a basis described in the memorandum.[1] The subcommittee's memorandum had also expressed the view that an amendment to the authorization for System foreign currency operations would be desirable when the negotiations had reached a certain stage.

The Chairman then asked Mr. Coombs to summarize the current status of the matter.

Mr. Coombs observed that all of the relevant documents had been circulated to the Committee as attachments to the subcommittee's memorandum. As the members would recall, the Common Market central banks had originally requested last fall that all swap operations be conducted at par rather than at market rates. At the end of January the subcommittee had agreed that a counterproposal should be made, the essence of which was that any residual balance outstanding under a swap drawing could be liquidated at the same rate as that at which the drawing was made. It was specified that nothing should preclude repayments of swap drawings by the Federal Reserve through purchase of the foreign currency needed in the market, or directly from the foreign central bank, or from the U.S. Treasury, at market rates.

1/ A copy of this memorandum has been placed in the Committee's files.

Mr. Coombs remarked that the Swiss National Bank, which had partly associated itself with the Common Market banks, had now accepted the subcommittee's proposal, and had asked that it be made applicable to a $150 million repayment of a swap drawing scheduled for tomorrow. Accordingly, he would recommend that the Committee approve today a proposed amendment to paragraph 3 of the foreign currency authorization, copies of which had been distributed this morning. He noted that the subcommittee concurred in the recommended amendment.

Mr. Coombs added that the Common Market central banks had replied to the subcommittee's proposal with an alternative proposal which, from the System's viewpoint, was not much of an improvement over their original position. Negotiations were continuing and he would keep the Committee, as well as the U.S. Treasury, informed of further developments.

After discussion, the Committee agreed that it would be appropriate to amend the authorization in the manner Mr. Coombs had recommended.

By unanimous vote, the authorization for System foreign currency operations was amended to read as follows:

AUTHORIZATION FOR SYSTEM FOREIGN CURRENCY OPERATIONS

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, and with the Bank for International Settlements:

Austrian schillings
Belgian francs
Canadian dollars
Danish kroner
Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Mexican pesos
Netherlands guilders
Norwegian kroner
Swedish kronor
Swiss francs

B. To hold foreign currencies listed in paragraph A above, up to the following limits:

(1) Currencies purchased spot, including currencies purchased from the Stabilization Fund, and sold forward to the Stabilization Fund, up to $1 billion equivalent;

(2) Currencies purchased spot or forward, up to the amounts necessary to fulfill other forward commitments;

(3) Additional currencies purchased spot or forward, up to the amount necessary for System operations to exert a market influence but not exceeding $250 million equivalent; and

(4) Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $200 million equivalent.

C. To have outstanding forward commitments undertaken under paragraph A above to deliver foreign currencies, up to the following limits:

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to the limit specified in paragraph 1B(1) above; and

(2) Other forward commitments to deliver foreign currencies, up to $550 million equivalent.

D. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	200
National Bank of Belgium	500
Bank of Canada	1,000
National Bank of Denmark	200
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000

Bank of Italy	1,250
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	300
Bank of Norway	200
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,000

3. Currencies to be used for liquidation of System swap commitments may be purchased from the foreign central bank drawn on, at the same exchange rate as that employed in the drawing to be liquidated. Apart from any such purchases at the rate of the drawing, all transactions in foreign currencies undertaken under paragraph 1(A) above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces.

4. It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested insofar as practicable, considering needs for minimum working balances. Such investments shall be in accordance with Section 14(e) of the Federal Reserve Act.

6. A Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman

of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) is authorized to act on behalf of the Committee when it is necessary to enable the Federal Reserve Bank of New York to engage in foreign currency operations before the Committee can be consulted. All actions taken by the Subcommittee under this paragraph shall be reported promptly to the Committee.

7. The Chairman (and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors) is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities; and

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

10. The Special Manager of the System Open Market Account for foreign currency operations shall keep the Committee informed on conditions in foreign exchange markets and on transactions he has made and shall render such reports as the Committee may specify.

By unanimous vote, the foreign currency directive shown below was reaffirmed:

FOREIGN CURRENCY DIRECTIVE

1. The basic purposes of System operations in foreign currencies are:

A. To help safeguard the value of the dollar in international exchange markets;

B. To aid in making the system of international payments more efficient;

C. To further monetary cooperation with central banks of other countries having convertible currencies, with the International Monetary Fund, and with other international payments institutions;

D. To help insure that market movements in exchange rates, within the limits stated in the International Monetary Fund Agreement or established by central bank practices, reflect the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public; and

E. To facilitate growth in international liquidity in accordance with the needs of an expanding world economy.

2. Unless otherwise expressly authorized by the Federal Open Market Committee, System operations in foreign currencies shall be undertaken only when necessary:

A. To cushion or moderate fluctuations in the flows of international payments, if such fluctuations (1) are deemed to reflect transitional market unsettlement or other temporary forces and therefore are expected to be reversed in the foreseeable future; and (2) are deemed to be disequilibrating or otherwise to have potentially destabilizing effects on U.S. or foreign official reserves or on exchange markets, for example, by occasioning market anxieties, undesirable speculative activity, or excessive leads and lags in international payments;

B. To temper and smooth out abrupt changes in spot exchange rates, and to moderate forward premiums and discounts judged to be disequilibrating. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified or curtailed unless upon review and reassessment of the situation the Committee directs otherwise;

C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions. Whenever exchange market instability threatens to produce disorderly conditions, System transactions may be undertaken if the Special Manager reaches a judgment that they may help to reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. In such cases, the Special Manager shall consult as soon as practicable with the Committee or, in an emergency, with the members of the Subcommittee designated for that purpose in paragraph 6 of the Authorization for System foreign currency operations; and

D. To adjust System balances within the limits established in the Authorization for System foreign currency operations in light of probable future needs for currencies.

3. System drawings under the swap arrangements are appropriate when necessary to obtain foreign currencies for the purposes stated in paragraph 2 above.

4. Unless otherwise expressly authorized by the Committee, transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken only (i) to prevent forward premiums or discounts from giving rise to disequilibrating movements of short-term funds; (ii) to minimize speculative disturbances; (iii) to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders; (iv) to allow greater flexibility in covering System or Treasury commitments, including commitments under swap arrangements, and to facilitate operations of the Stabilization Fund; (v) to facilitate the use of one currency for the settlement of System or Treasury commitments denominated in other currencies; and (vi) to provide cover for System holdings of foreign currencies.

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 February 9 through March 3, 1971, and a supplemental report covering the period March 4 through 8, 1971. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the free market price of gold had continued to fluctuate just under the $39 level despite fairly reliable reports that the Russians had re-entered the market with sales of gold running around $2 to $3 million per week.

Regarding the exchange markets, Mr. Coombs continued, the period of easy financing of the U.S. payments deficit that had been enjoyed during all of 1970 and the early weeks of 1971 now seemed to be over, and he thought that the financing problem was now moving into the danger zone. Meanwhile, the U.S. official settlements deficit continued to run well above 1970 levels, with an ominous bulge in foreign central bank reserve gains--more than $750 million--during the first week of March. There now seemed to be a tendency for foreign central bank reserve gains to accelerate. The underlying deficit in the U.S. payments balance continued to be amplified--perhaps several times over--by outflows of short-term capital attracted by the broad disparity between foreign short-term interest rates and those available in the United States. Until recent weeks the market had remained relatively free of speculative influences, responding primarily to interest rate differentials. Now he thought some speculation was appearing, in the form of leads and lags in favor of European currencies and heavy buying of Japanese securities. The recent forward operations of the German Federal Bank also had revealed speculative influences. Those influences, which he thought were still in an early stage, had been stimulated by publication of figures indicating that the U.S. official settlements deficit in 1970 had been nearly $11 billion, together with weekly announcements of continuing dollar gains by the European central banks. He thought that in coming weeks and months the U.S. Treasury might have to show repeated losses of gold and other reserve assets, and that those reports would add a little more fuel to the situation.

In his judgment, Mr. Coombs continued, there was likely to be a rapidly growing risk of a sudden burst of speculation against the dollar, which could be triggered by any number of events--particularly by some indiscreet comment or speech by some political official on either side of the Atlantic. Such indiscreet statements in 1968 and 1969 had caused the movement of billions of dollars into German marks; and the scope for such speculative flows today was many times greater, since not just the mark but many other currencies could be affected. The main risk was that market participants might get the impression of an impending confrontation--a real showdown--between Europe and the United States over the outflow of dollars, and that they might suddenly bring matters to a head by dumping $10 billion or $15 billion more in a matter of weeks on the European central banks. The members were well aware of the hardening resistance of the European central banks to recent dollar flows. Sooner or later--and he suspected that it would be sooner--the central bank complaints now being voiced privately would become known to the market, which might then decide to protect itself against the risk of a sudden break in the structure of exchange parities.

Mr. Coombs commented that the weakness of the dollar in the exchange markets had shown up again in the recent effort of the German Federal Bank to increase the discount on the forward mark from 1.2 to 2.0 per cent. That market operation, which had cost the Federal Bank more than $510 million in forward dollar purchases over an 8-day period, was now being phased out as a total failure, and he thought the flow of dollars to the Federal Bank could be expected to continue.

With respect to System swap operations, Mr. Coombs noted that the Desk had managed, with the assistance of the U.S. Treasury, to clear up the debt to the Swiss and the Dutch, leaving $420 million outstanding under the Belgian franc line. He would be discussing with the Treasury possibilities of paying off the Belgian franc debt. There might be a difficulty, however; the Belgians might be unwilling to take on large additional amounts of special drawing rights, and the supply of Belgian francs available from the Fund also was closely limited.

More generally, Mr. Coombs continued, since the beginning of 1970 the System had made swap drawings totaling $1.7 billion, virtually none of which had proved reversible; in nearly every case the Treasury had had to use reserve assets to clear up the drawings. If the U.S. deficits continued large, as they now threatened to do, the System could easily absorb their initial impact by use of the swap lines, but eventually the Treasury would have to arrange for settlement. Thus, as time went on, there would inevitably be more and more pressure on the Treasury's stock of gold and SDR's and on the U.S. position in the International Monetary Fund. There was a major risk that reports of those changes would amplify the outflow of dollars; and the final risk was that events in the market would take over.

In response to a question by Mr. Brimmer, Mr. Coombs said that the Federal Reserve Bank of New York had acted as agent for the German Federal Bank in that Bank's operations in forward marks. Officials of the Federal Bank had indicated that the directors of that Bank had approved such forward operations, and had asked the New York Bank's view regarding their technical feasibility--but not their desirability. The Germans could, of course, have worked through other agents. In any case, as the operations proceeded the New York Bank had advised the German authorities that any effort to increase the forward discount to more than 1-1/2 per cent would probably uncover a very big demand. Such demand had materialized, and at the Basle meeting this past weekend officials of the Federal Bank indicated that they had become disillusioned with the forward operations. When they had asked for his opinion as to whether the operations should be discontinued, he had suggested that they be phased out gradually rather than suddenly cut off.

Mr. Brimmer then asked whether the demands for gold which Mr. Coombs had indicated might be in prospect were likely to originate with the monetary authorities of countries other than Belgium.

Mr. Coombs said he could think of at least three other countries that might ask for gold in rather sizable amounts. As he had mentioned, there might be problems in some cases in using SDR's to settle System debt. He might also note a problem that had arisen in connection with British and French repayments of debts to the Fund. Because the Fund was no longer able to accept repayments in dollars, the French and British would have to buy currencies of other countries with dollars, and the central banks of those countries might well ask the United States to take over the dollars they so received by one means or another. It seemed clear that the Treasury was facing increasingly difficult problems of international financing.

Mr. Coldwell asked whether it was likely that the interest rate structure in Europe might decline relative to that in the United States in the near future.

Mr. Coombs replied that the European monetary authorities seemed to be unwilling to see their domestic interest rates decline. They felt that they were suffering from strong inflationary pressures, and that actions to bring their rates down in line with declining U.S. rates would seriously undermine their efforts to control inflation. He did not recall any discount rate reductions by European central banks in recent weeks, although the German authorities might find such action to be necessary in the near future. In any case, it had been clear at Basle that there were fairly strong feelings on the matter among the Europeans.

By unanimous vote, the System open market transactions in foreign currencies during the period February 9 through March 8, 1971, were approved, ratified, and confirmed.

Chairman Burns noted that Mr. Daane had attended the Basle meeting, and invited him to comment on developments there.

Mr. Daane observed that the Sunday afternoon session at Basle had been broken into two parts. Following a short regular meeting of the governors, there was a special meeting which included representatives of additional countries--for example, Austria and Denmark--devoted solely to the question of the renewal for another two-year period of the Second Group Arrangement for sterling. The only development of significance to the Committee at the abbreviated governor's meeting was one Mr. Coombs had just touched on--the indication that a downward movement in German interest rates was quite likely in the near future despite their clear preference for maintaining the present rate level. At the special meeting there was agreement in principle, subject to confirmation by some individual governments, to renew the sterling arrangement for another two-year period--but without establishing a precedent thereby, and without prejudice to any subsequent changes in the arrangement that might be considered desirable on general grounds or to reflect British participation in the Common Market. The French did not attend the special meeting.

At the meeting Sunday night, Mr. Daane continued, two questions were discussed at length. The first concerned the implications of economic and monetary integration of the Common Market countries for the decision-making process--including such questions as whether decisions to raise or lower the band of their exchange rates against the dollar should be subject to a rule of unanimity or made by majority vote--and the nature of the problems that would be faced, after integration had been achieved, with respect to the fiscal and monetary policies applicable to differing country positions. The second concerned the situation with respect to the dollar. He thought the latter discussion could be summarized fairly by saying that there was increasing concern regarding the dollar and very definite concern about the short-term rate structure in the United States. As he had reported at the previous meeting of the Committee, at the February Basle meeting the Europeans had expressed the hope that the Federal Reserve would not find it necessary to push U.S. rates down any further. As Mr. Zijlstra had said in his summary at the March meeting, the group hoped that view would now be conveyed to the Committee in even stronger terms. Indeed, the Europeans probably would be happier with somewhat higher U.S. rates, particularly in the short-term area, if that was compatible with recovery efforts--the need for which they clearly recognized.

In conclusion, Mr. Daane noted that the Steering Committee chaired by Mr. Zijlstra had met in Amsterdam on February 18 to plan further consideration of the Euro-dollar market, and would meet again in Paris on March 26.

The Chairman then called for the staff reports on the balance of payments and on domestic economic and financial developments, 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. Solomon said that before he made his statement he might say a word about European interest rates, in further response to Mr. Coldwell. As Mr. Coombs had indicated, there had not been any further discount rate reductions in Europe in recent weeks. However, market rates--particularly short-term rates--had come down in most European countries other than England, in large part, no doubt, because of the inflows of short-term funds. At the same time, levels of domestic rates in Europe were still much higher than in the United States or the Euro-dollar market.

Mr. Solomon then made the following statement on the balance of payments:

> I would like to begin today by presenting two facts. One set of facts tells us that the balance of payments deficit in the first two months of this year was enormous. The liquidity deficit is estimated at $1-1/2 billion, or an annual rate of $9 billion in January-February. The official settlements deficit may have been as high as $2-1/2 billion, an annual rate that I would prefer not to compute. The second set of facts tells us that the monetary aggregates have been growing very rapidly. While M_1 has speeded

up only recently, M_2 grew at an annual rate of 13 per cent in December, 11-1/2 per cent in January, and about 22 per cent in February. The adjusted credit proxy grew at an annual rate of 16-1/2 per cent in December, 10-1/2 per cent in January, and about 13 per cent in February. Total reserves grew at an annual rate of 18-1/2 per cent in December, 12 per cent in January, and 11 per cent in February. These are very sizable rates of growth.

What connects these two sets of facts is the very steep decline in short-term interest rates. It is not surprising, therefore, that the short-term capital outflow has been extremely large. Banks have continued to repay Euro-dollar liabilities, and other forms of capital outflow, as yet unidentified, have speeded up. We may well be on the verge of seeing a speculative move out of the dollar on top of interest-induced outflows.

With this as background, I would like to state briefly what I believe to be the three principal international considerations that the Committee may want to bear in mind as it formulates policy at this meeting.

The first consideration has to do directly with the U.S. balance of payments. A moderate firming of short-term rates from present levels would tend to reduce capital outflows and reduce the size of the official settlements deficit.

Secondly, considerable resentment has been built up abroad, especially among financial officials in Europe, over what they regard as an undermining of their own monetary policies resulting from the massive short-term capital outflows from the United States and from the steep decline in short-term rates. The impression exists that, aside from the Export-Import Bank issues, the U.S. has completely ignored the effects its policies are having on the rest of the world. This resentment among European, and perhaps Japanese, officials is likely to affect their willingness to be cooperative in the future. What I have in mind in particular is that there is a significant probability that we shall require a realignment of exchange rates before too long in order to prevent, or to work our way out of, an international crisis. The more cooperative and outward looking U.S. policy is now, the more likely it is that other countries will act cooperatively with us. This second consideration, then, has to do with the apparent posture and attitude of U.S. policymakers. An attitude of benign neglect toward the rest of the world is certainly likely to intensify resentment abroad and to make cooperation less likely.

Third, and perhaps most important, expansion of the monetary aggregates at recent rates, if it continues for long, could stimulate too rapid an expansion in total demand later on, with unfortunate effects on domestic prices and costs and on the balance of payments.

If I were asked what conclusions follow from these considerations, I would say that they point toward alternative B or C of the draft directives.1/ I would also say that the Federal Reserve should look seriously at matched sale-purchase transactions or other selective devices designed to discourage the repayment of Euro-dollars by U.S. banks.

Mr. Partee made the following statement concerning economic developments:

Among economists, the search goes on for convincing evidence that the economy has now moved into a solid recovery trend. Optimists are citing the third monthly rise (in January) for the leading indicators, the second monthly decline (in February) for unemployment, and the strength since mid-December in department store sales. A more cautious view emphasizes that much of the apparent recent firming in business is due to the unusual situation in autos and steel, that employment figures continue quite generally on the weak side, and that total retail sales--except for autos--have advanced little beyond the fourth-quarter average. The February industrial production index is likely to provide further grist for the debate. Preliminary indications, with physical output data still incomplete, point to a decline last month of a half point or so.

Regardless of the behavior of the current monthly indicators, a large rise in first-quarter GNP seems assured. We have raised our sights to $29 billion, up $2-1/2 billion from a month ago. But this result is profoundly affected by the resumption of output at General Motors late last quarter, and by steel

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

stockpiling in anticipation of a strike this summer. We estimate that these special influences, which show up variously in consumption, business investment, and inventories, will account for fully $20 billion of the first-quarter GNP rise. Excluding these two elements, in fact, our projected first-quarter increase would be the smallest of the past four quarters, again making allowance for the strike-related variations in autos.

Basically, there does not yet appear to have been much strengthening in the economy. This is indicated in a number of ways. In employment, for instance, the number at work in manufacturing in February was more than 500,000 below the levels of last August, before the auto strike commenced. Total nonmanufacturing employment over this six-month period increased by 600,000, but this too was a good deal less than normal--from early 1969 to early 1970 such employment had risen by more than 1.6 million--and less than will be needed to employ projected sizable increases in the civilian labor force. In the area of production, the industrial production index for January and February appears to have been close to 6 per cent higher, at annual rates, than in the fourth quarter. But this gain was entirely accounted for by autos and steel. Excluding these industries, the February index is estimated to be 1 per cent below the fourth-quarter average, with the weakness most pronounced in output of defense, business equipment, and home goods. Similarly, manufacturers' durable goods orders in January--exclusive of autos and steel--were only 1-1/2 per cent above the third-quarter average, little if any more than the probable rise in average prices over the period.

Retail sales also continue generally lackluster. Deliveries of domestic autos in both January and February were at an 8.1 million annual rate, lower than the pace last summer and well below the indicated 9 million rate for February and March production schedules. Total retail sales, based on weekly data, are estimated to have increased less than 1 per cent in February, following a 1-1/2 per cent January gain. But if autos and building materials are excluded, sales in these two months averaged very little above the fourth-quarter rate. Sales of furniture and appliance stores, and of apparel stores, are reported to have been especially weak, although volume in the general merchandise stores--which compete in both areas--strengthened measurably. Perhaps consumers are tending to shift buying to the larger outlets, where promotional sales are apt to be regarded as more genuine.

There are some current elements of strength in the economy, of course. Housing starts and building permits continue strong, despite the expected January decline, and mortgage money has eased markedly well in advance of the spring home-buying season. The continuing large volume of tax-exempt bond issues points to a big year in State-local capital spending projects, although construction outlays by these units have not risen much as yet. The decline in manufacturing inventories in December and January should also be regarded as a positive factor for the future, since inventory ratios in most lines remained high through the fall and seem to have been pointing to the need for some retrenchment. Finally, indications are that there may be a little more strength in business capital spending later on this year than we have been projecting. The latest Commerce-SEC survey, released today, shows a 4.3 per cent increase in capital spending plans for 1971. This compares with a 3-1/2 per cent rise in business fixed investment carried in our green book[1/] projection. All of the increased strength is indicated to be in the second half of the year, when manufacturers anticipate an upturn in their outlays. These surveys have had a poor track record in recent quarters, with actual spending having fallen consistently below prior expectations, but the pattern indicated for 1971 is at least consistent with a developing business recovery.

We continue to believe that the low point in the economy has already been passed, and that an irregular uptrend in activity will take place over the year ahead. But we also expect that the recovery will be modest in real terms, and that prices--propelled by cost-push--will continue to rise at a substantial, though gradually moderating, pace. If the economy grows at only around a 3-1/2 per cent rate, as we expect, the unemployment rate would likely be moving upward, on balance, over much of the year. The declines reported for January and February do not alter our view, since they appear to have reflected a faulty seasonal factor in January and an abnormally large drop in the labor force in February.

Any additional public policy stimulus, therefore, would seem very likely to be adding to aggregate demands that are well below potential, given reasonable lags, and hence should serve to stimulate real output far more

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

than they do inflationary pressures. I continue to favor some further stimulus as a general principle. In view of the recent sharp increases in the monetary aggregates and the further substantial increases projected for the second quarter, however, I would not advise further easing in money market conditions at this time.

In view of the continuing unsatisfactory degree of economic recovery projected by the staff, some Committee members requested at the last meeting that we work out the implications of a more ambitious program of monetary and fiscal stimulus. Such alternative policies were to include, if feasible, the actions we would judge necessary in order to bring our projections up close to the Administration's stated target of a $1,065 billion GNP for 1971. Mr. Gramley will present briefly the results of our investigation.

Mr. Gramley made the following statement:

In approaching the assignment to investigate the effects of a more expansive set of policies, it seemed worthwhile to consider more stimulative fiscal as well as monetary policies. Once put in effect, fiscal policies have a more rapid impact on spending. Also, a balanced use of fiscal and monetary tools would appear to be the better course for stabilization policies to follow at this juncture.

It might be helpful to begin by reconsidering the longer-run effects of the policy assumptions underlying the current green book projection. An extrapolation of that projection through 1972 has been computed. This extrapolation, which might be called Alternative 1, is based heavily, although not exclusively, on the Board's econometric model.

Perhaps most interesting are the results in terms of actual relative to potential output and unemployment for the last quarter of 1971 and all of 1972. The unemployment rate would not begin coming down until early 1972--and would only drop a little below 6 per cent by late next year. By the fourth quarter of 1972, real output would be back to about 95 per cent of its full employment potential. (These results for 1972 are a little different from those presented by Mr. Partee last time--but not enough to merit discussion.)

The more expansive policy assumptions that underlie our second projection, Alternative 2, include growth in M_1 at an 8 per cent rate through mid-1972 and at a

6 per cent rate thereafter. On the fiscal side, we assume a considerably stronger growth trend for Federal expenditures--with fiscal 1972 outlays about $8 billion higher than in Alternative 1. Part of this increase in expenditures is in Federal purchases, and is assumed to begin promptly.

We also assume additional stimulus from the tax side. The increase in the social security tax base scheduled for this year is postponed until 1973, and some of the income tax reform measures now scheduled for 1972 and 1973 are accelerated to calendar 1971. The tax reform measures are assumed to go into effect on July 1, and to be made retroactive to the first of this year. The total tax package adds almost $7-1/2 billion to disposable income, at annual rates, and considerably more in the second half of this year because of the retroactivity feature.

With this much monetary and fiscal stimulus, a strong pickup in economic activity develops that is sustained into 1972. The unemployment rate under Alternative 2 begins dropping in the latter half of this calendar year, and is falling toward 4 per cent by the close of 1972. The gap between actual and full employment real output would be virtually closed by the end of next year under Alternative 2. Under Alternative 1 a sizable gap would remain.

I might note in passing that the annual GNP figure for 1971 under Alternative 2 is $1,057 billion. Thus, even with the stimulative fiscal policies assumed in Alternative 2, a still more expansive monetary policy would have to be pursued to get to $1,065 billion. We can crank out an answer with our model as to how much more monetary stimulus would be needed--the answer is a 12 per cent rate of growth, or thereabouts, for M_1. The monetary requirement is this large because the lags are relatively long. A 12 per cent rate of growth for M_1 is, however, far beyond the range of historical experience. Consequently, the usefulness of the model in predicting the effects of such an extreme course of action is questionable.

The main benefit of a projection exercise such as this one is, in my view, to place the current problems of policy in somewhat broader perspective. There are perhaps three general points that stand out.

First, very high rates of real growth will be required over a substantial period to get us back to full employment. Roughly speaking, if the annual rate of real growth averaged around 7-1/2 to 8 per cent, it would take about two years to get back to the 4 to 4-1/2 per cent zone for the unemployment rate. If private spending propensities are as weak as the Board staff believes, there is little risk that a continuation of the present course of monetary and fiscal policies would rejuvenate excess demand, either this year or next.

Second, the model suggests that the degree to which the rate of price increase abates would not be affected much by the policies underlying these alternative paths of economic expansion. In both cases, the rate of increase in the GNP deflator tapers off to around 3-1/2 per cent by the latter half of 1972. Excess demand does not reemerge with either alternative; the source of the price increases is the pressure of rising costs, which--according to the model--would not be influenced appreciably by the differences in the two alternative paths of economic expansion.

Third, if cost-push inflation continues in, say, a 3 to 4 per cent range, growth rates of nominal GNP will have to be exceptionally high by historical standards to make significant progress in reducing the degree of resource slack over the next couple of years. This, in turn, will require supplies of money and credit that are also on the high side of historical experience.

Personally, my own conviction is that the urgent need in stabilization policies now is for more stimulus from the fiscal side. But I can see good reason for moving toward a longer-range target for the money supply somewhat above the 6 per cent growth rate of the past year.

Chairman Burns then called for general discussion of the economic and financial situation and outlook. He suggested that, in addition to expressing their views on economic conditions and prospects, the members bring to the attention of the Committee any significant new information that had come their way and any additions to the staff analysis they thought would be useful. They might also note any points at which their judgments differed from the staff's. He hoped it would not be necessary to devote much time to purely technical questions.

Mr. Brimmer remarked that he had had an opportunity to talk with a number of prominent bankers and industrialists in connection with a meeting of the Board of Overseers of Harvard University from which he had just returned. Their general feeling was that the Federal Reserve had gone too far too fast, both in promoting growth in the monetary aggregates and in bringing about reductions in short-term interest rates.

With respect to the staff analysis, Mr. Brimmer said he was pleased with the emphasis on the outlook for the longer term. He had some difficulty, however, in accepting the staff's conclusions regarding the price deflator; he would expect the more expansive policy Mr. Gramley had described to have a much sharper impact on prices. In his judgment businessmen would react to persisting cost-push pressures not only by continuing to search for means of economizing on labor but also by passing on part of the cost increases to customers through higher prices.

Mr. Hayes observed that, in general, his views on the economic outlook were not very different from those of Mr. Partee. There seemed to have been no substantial change in either the current business situation or the outlook over the past month. Putting aside the auto and steel industries, the economy appeared to have remained fairly close to dead center--as, indeed, it had for several months. The February decline in the unemployment rate was, of course, welcome, but it was necessary to face the fact that one or two months' figures could be deceptive, and to recognize that unemployment could drift up for a few months.

While there was little evidence that resumption of adequate real growth had begun, Mr. Hayes said, he continued to feel that a strengthening of the economy would get under way within a reasonable period of time. Business plans for plant and equipment spending seemed to be at least holding up. Industrial production, which has been conspicuously weaker than real output as a whole this past year, was no longer showing the sort of declines that had occurred earlier in the business contraction. On the other side, to be sure, consumer spending had yet to show any real strength and inventories appeared to be still a shade on the high side in some areas.

While the resumption of a satisfactory rate of expansion in the economy still remained a matter of hopes and projections rather than of current reality, Mr. Hayes continued, he thought it was important to emphasize again the enormous improvement in financial conditions and liquidity that had taken place over the past several months, partly as a result of the Committee's moderately expansive monetary policy. In his view those financial developments had clearly set the stage for renewed expansion although, as usual, some time was required for their effects to materialize. The risk always inherent in such delays was that the failure to get immediate results would lead the Committee to go too far.

Perhaps the most that could be said about the business situation at this early point in 1971, Mr. Hayes remarked, was that so far it had not seemed consistent with the very rapid--and to his mind, perhaps excessively rapid--growth embodied in a $1,065 billion figure for GNP. On the other hand, developments to date in 1971 had not provided any real grounds for doubting that a more moderate and orderly pickup would materialize.

Mr. Hayes observed that the price picture had included one or two bright spots recently, but it would be premature to conclude that a significant turn for the better had taken place. The much better performance of the consumer price index in January and the slower rise in the industrial wholesale price index in February were encouraging, but more time would be needed to judge their significance. He was discouraged by the breakdown of attempts at voluntary wage and price controls in the construction industry. He was afraid that the Administration's response would prove entirely too mild to produce significant results.

Mr. Hayes added that he had also heard comments, similar to those reported by Mr. Brimmer, to the effect that the System was pushing too fast toward monetary ease. He detected little sentiment in New York for the view that inflation was under control and would diminish steadily; attitudes there seemed considerably less optimistic than the Board staff's projections would suggest. He continued to feel that more had to be done in the general area of incomes policy.

Mr. Mayo remarked that he also had been hearing from bankers and, to some extent, from industrialists, to the effect that the System had gone as far as it should in easing monetary policy. The directors of the Chicago Bank were not opposed to a quarter-point cut in the discount rate, but when they were asked for their views on monetary policy in general comments had been made to the effect that policy was becoming too easy in light of the problems of inflation and of deterioration in the balance of payments.

Mr. Mayo then said that, like Mr. Brimmer, he had some question about the small difference in the consequences for prices of the two alternative policy courses Mr. Gramley had described. He wondered whether the model would still show only a small effect on the deflator under policies designed to yield a 1971 GNP of $1,065 billion. If so, he would be even more skeptical about the use of models for projection purposes; the margin for error in the price projections would appear to be very wide.

Mr. Kimbrel said it would seem that the Committee could no longer ignore the impact of its actions on the balance of payments and on the standing of the dollar in foreign exchange markets. He agreed that there were questions about the present state of the economy, and that the unemployment rate in particular remained unsatisfactory. Even so, he had found no sentiment among bankers or businessmen for a more expansive monetary policy; rather, many of them were disturbed by the sharp declines in short-term interest rates, including the discount rate, that had already occurred. Perhaps their feeling of unease was not justified, but the fact that they felt that way nevertheless had to be taken into account. Bankers and businessmen would interpret a further decline in short-term interest rates--even if brought about for the purpose of producing modest growth in M_1--as a signal that the System was easing further, and the result then might be a loss rather than a strengthening of confidence.

Mr. Coldwell said that after studying the staff materials prepared for today's meeting and reviewing the comments he had heard from bankers and others in his District, he had concluded that the state of the economy was still hesitant and uncertain. In part the problems were seasonal. However, the situation was complicated by the simultaneous occurrence of high unemployment and dull business performance, on the one hand, and rising prices and continuing inflationary expectations on the other. He still heard disturbing comments about the threat of policy conflicts. There was concern that increased credit might lead to rises rather than declines in long-term interest rates; and that easing for domestic purposes might create international problems. Similarly, the deficit scheduled in the Federal budget for fiscal 1972 appeared to have heightened businessmen's qualms about fiscal policy.

In his judgment, Mr. Coldwell continued, the consumer remained the main question mark in the economic outlook. He did not know when consumers would loosen their purse strings, although there were some minor indications that they were beginning to do so. Given the rises in disposable income, the increased availability of credit, and the large accumulations of savings, there was a real potential for an explosive rise in consumer spending. He thought the time at which consumer spending would turn up was coming closer, but consumers probably would have to be more confident about the future than they were now before it would arrive. In the housing area the problem was no longer one of credit availability--more credit was available now than could be used--but the fact that rising construction costs were creating difficulties for growing numbers of potential home buyers.

Mr. Coldwell remarked that obviously there no longer was a shortage of money. Indeed, bankers had been asking him what they were to do with the deposit inflows they were receiving. And they were reporting that their profit margins were narrowing, as yields on earning assets declined and rates paid on time deposit funds remained unchanged. In view of the availability of funds domestically and the implications of recent developments in the international area, he thought the balance of Committee priorities should begin to shift toward international considerations.

Mr. Francis observed that since the previous meeting of the Committee he had been in contact with a good cross-section of the business leadership of his community and had found that their views were similar to those reported by others today. There was great concern that the Federal Reserve was in the process not of stopping inflation but possibly of letting it get out of hand again.

According to his own analysis, Mr. Francis continued, economic activity appeared to be responding to the stimulative monetary actions of the past year. As he understood it, the Board's staff estimated that total spending in the first quarter would be at an annual rate of $1,019 billion, up at a 6 per cent rate from the third quarter of 1970. By comparison, total spending had risen 4.6 per cent in the previous four quarters.

Mr. Francis thought that some progress had been made in reducing the rate of inflation, and that the stage had been set--if excess total spending was avoided--to effect a gradual return to relative price stability. Given the serious imbalances in the economy because of the excessive growth from 1965 through 1968 in Federal expenditures, money, and total spending, the System's actions in providing for money growth of 3 per cent in 1969 and 5 per cent in 1970 were effectively restrictive. The course of the economy had been as one would have expected; that is, price increases had decelerated slowly while transitional costs in lost production had remained moderate.

Mr. Francis observed that, in view of the strong inflationary momentum and the lagged effect of monetary actions, quick results in obtaining price trend moderation and a reduction of transitional unemployment could not be expected. Attempts to obtain a very rapid increase of real product and decline of unemployment now would probably cause more serious problems of excessive spending and inflation later.

Mr. Swan said he agreed that the economic situation was mixed. He might report that there had been a decline in the unemployment rate in California in February despite further problems in the aerospace industry in the southern part of the State. Some of the drop apparently was due to increased activity in the construction industry--perhaps partly because of better weather--and some to a decline in the labor force such as had also occurred elsewhere.

Mr. Swan remarked that he continued to be impressed by the persisting heavy flow of funds into savings accounts, with the resulting higher growth rates in the broader monetary aggregates. The savings and loan associations on the West Coast were wondering what they could do with all the funds they were receiving. As Mr. Coldwell had pointed out, the build-up of savings balances was contributing to the potential volume of consumer spending. Accordingly, he thought the Committee should not be overly concerned with the performance of narrowly defined money.

Mr. Maisel observed that he had received impressions on recent trips away from Washington which tended to confirm the staff's judgment that people were not optimistic. Indeed, with respect to employment they were quite pessimistic; even firms that were doing well indicated they were cutting back on their employment.

Clearly, Mr. Maisel continued, the problem of unemployment was going to persist for some time, and it was important that policy makers not consider the problem in wholly impersonal terms. That point had been well made in a letter published in the New York Times a day or two ago, which suggested ironically that anyone who was a party to the use of unemployment to combat inflation had a moral duty to lead the way, either by relinquishing his job or by contributing his income to the support of the involuntarily unemployed.

Mr. Maisel then referred to the views of bankers in opposition to further declines in interest rates that several members had cited this morning. He thought it should be recognized that such views were consistent with the bankers' self-interest, and not necessarily with the needs of the economy. Indeed, at present it seemed clear that interest rates would have to decline further if monetary policy was going to have the impact desired.

Mr. Heflin asked whether Federal and Federally assisted borrowing might act to keep a floor under long-term interest rates over the rest of the year.

Mr. Partee responded that that was not likely to be the case with respect to borrowing by Federal agencies. Such borrowing was already at a very low level, and it might become negative later in the spring as a result of sizable repayments of advances to the Federal Home Loan Banks by savings and loan associations--advances which carried a substantial penalty if repaid before then. The Treasury itself would be borrowing quite heavily, presumably largely in the short-term area. That would tend to hold short rates up, and higher short rates might tend to limit declines in long rates. Also, the Treasury might offer long-term bonds sometime this spring or summer if Congress enacted pending legislation removing the 4-1/4 per cent interest rate ceiling for a certain volume of bonds. However, he was confident that the Treasury would approach any such offering carefully, scheduling it at a time when long rates were not under upward pressure.

Mr. Eastburn asked whether the staff had any comments on the questions regarding prices that had been raised earlier. He would be particularly interested in knowing whether the staff thought that its projections of the deflator took adequate account of the likely persistence of cost-push pressures, and what its expectations for the deflator would be if money were to expand at an annual rate of 12 per cent.

In reply, Mr. Gramley said he might first note that the projections did not reflect simply the output of the econometric model; staff judgments were introduced. With respect to the deflator, for example, for the projection incorporating the more expansive monetary and fiscal policy assumptions, the model indicated that the rate of increase would taper off to about 3 per cent by the fourth quarter of 1971. The staff had raised the figure to 3.5 per cent, partly in light of the cost-push considerations Mr. Eastburn had mentioned. He did not know whether the amount of judgmental adjustment of the model's estimate of prices was correct, and he doubted whether anyone could be sure at this juncture. The point to be stressed, however, was that the analysis implied that so long as excess demands did not emerge progress against inflation would continue in coming quarters.

As to the consequences of a 12 per cent growth rate in money, Mr. Gramley noted, the analysis--that is, the results produced by the Board's econometric model, modified on a judgmental basis--suggested that there would be a significant price effect. In particular, the analysis indicated that in the latter part of 1972 the deflator would be rising at a 4 per cent rate and accelerating, rather than at a 3.5 per cent rate and decelerating. He would not want to place much weight on the specific figure; the important implication was that with a 12 per cent growth rate in money, together with the more expansive fiscal policies assumed in the projection exercise, emerging demand pressures would be sufficient to put upward pressures on prices.

Mr. Eastburn observed that the assessment of the inflationary implications of the Alternative 1 and 2 policy courses might have been different if the projections had been extended into 1973.

Mr. Partee concurred in Mr. Eastburn's observation. He noted that under the Alternative 2 policy course, by the fourth quarter of 1972 the unemployment rate would be down to 4.2 per cent and the ratio of actual to potential output would be up to 99.4 per cent. Under those conditions there obviously would be a danger that new inflationary pressures would emerge in 1973. Such a prospect might well lead the Committee to favor a lower growth rate for M_1 in early 1972 than the 8 per cent assumed for purposes of calculation.

Mr. Eastburn remarked that one might question whether the Federal Reserve had the knowledge and expertise necessary to slow the growth rate in money by the right amount at the right time. Personally, he was not sure that the System was capable of exercising the degree of fine tuning that would seem to be required.

Chairman Burns said he wanted to endorse Mr. Maisel's earlier comments. It was natural that Federal Reserve officials should be fully informed about the views of people in the financial community, since they met with such people frequently in the normal course of their duties. Ordinarily, however, System officials had much less opportunity to meet with unemployed people. He had found a recent conversation with one unemployed person to be a moving experience, and quite different from that of learning about unemployment indirectly through statistical reports. And one should think not only of the unemployed but also of the millions of employed persons who were worried about their jobs and those of other members of their families. He had found that members of Congress were deeply concerned about unemployment--no doubt partly because they were continually in touch with people in all walks of life. He was endorsing Mr. Maisel's comments so heartily mainly because little had been said along such lines in the discussion today.

Turning to the economic situation, the Chairman observed that the recovery now under way was fragile. It might well prosper, but there was not yet evidence to suggest that it would. Indeed, the current recovery was one of the least robust of any that he could recall.

In such a situation, Chairman Burns continued, a back-up in interest rates was one of the worst things that could happen; rising rates could prove fatal to the prospects for recovery. He hoped the members would keep that thought in mind. He was well aware of the balance of payments problem, and found it most worrisome. But the Federal Reserve was not solely--or even chiefly--responsible for the balance of payments. Some of the comments made in the preceding discussion concerned basic questions of international financial policy, responsibility for which lay outside the Federal Reserve. The System should do whatever it could to help; in particular, he agreed that it would not be desirable at present to take measures that would result in further reductions in short-term interest rates. At the same time, he thought the System should do whatever it could to reduce long-term rates. The fact that yields on new corporate bonds had risen by about 100 basis points over the past month or so was highly disturbing, and the Committee should try to insure that that rise was a temporary development.

Chairman Burns expressed the view that monetary policy over the past year had, by and large, been appropriate. There still was a job to do, and in his judgment monetary policy should continue on the moderate course it had been following. He thought, however, that fiscal policy might have to be changed. If the economy needed more stimulation it would be appropriate for fiscal policy to play a role, so that monetary policy would not carry the whole burden. There were fiscal measures that could readily be taken; for example, the scheduled increase in the social security tax base could be delayed for a year, the income tax reductions called for by the Tax Reform Act of 1969 could be advanced by a year or two, and the investment tax credit--which in his judgment should never have been removed--could be reinstated. Reinstating the tax credit would be a desirable structural reform, and the economic effects of the other actions he had mentioned would be limited in time. In contrast, if main reliance were to be placed on monetary policy and the Federal Reserve consequently had to pump funds into the banking system at a rapid rate, there would be undesirable consequences for a long time to come.

Mr. Mitchell said he agreed completely with the Chairman's view that the Committee should concentrate on long-term interest rates at this point, doing what it could in light of the existing problems in the international area to bring those rates down. Some of the best-managed corporations in the country were floating bond issues now, apparently on the assumption that long-term rates were as low as they were going to get for an extended period. That viewpoint, which had developed rather suddenly, reflected a failure to assess correctly, the implications of the kind of monetary policy that the System would be pursuing--or, at least, that he hoped it would pursue. In his judgment the current levels of long-term rates were not consistent with an economic recovery brought about by monetary stimulation. Those rates had to come down--and he thought they would come down, given a little time. There had been several comments today to the effect that bankers did not know what to do with all the funds they were receiving. He would suggest that they should begin making term loans, and to borrowers with less than a prime rating to which banks appeared to have been limiting themselves for some time. When that happened he thought interest rates in capital markets would begin to decline.

Mr. Mitchell remarked that he also shared the Chairman's view that it would be better at this point to provide any additional stimulation needed through fiscal rather than monetary policy. He had been disturbed by the implication of the discussion in the blue book[1] that the only way to get long-term rates down was by reducing short-term rates still further. He thought short rates were now about as low as they should go for the time being, and that any additional declines would be fatal to public understanding of the Committee's intentions. If there were no other route, the Committee would simply have to wait and hope. Alternatively, it could instruct the Manager to continue to buy longer-term Treasury issues. And it might also consider authorizing the purchase of longer-term agency issues.

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 February 9 through March 3, 1971, and a supplemental report covering the period March 4 through 8, 1971. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Holmes commented as follows:

> Early in the period after the Committee last met, the monetary aggregates turned out weaker than the Committee desired, and System open market operations were directed towards moving the Federal funds rate a notch lower--to 3-1/2 per cent, as the Committee had specified. Subsequently M_1, M_2, and the bank credit proxy all exhibited greater strength, with February levels now estimated to be at or above the relatively high growth rates expected at the time of the last

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

meeting. The further easing of money market conditions required to work towards the Committee's aggregative targets, together with a heavy demand for Treasury bills from foreign and other sources, led to further sharp falls in short-term interest rates. In order to avoid pushing the Treasury bill rate still lower, the Desk concentrated on the purchase of coupon issues in supplying reserves and met some of the heavy foreign demand for bills out of sales from the System portfolio. In yesterday's regular weekly Treasury bill auction, average rates of 3.31 and 3.36 per cent were established for 3- and 6-month bills, respectively, down 54 and 48 basis points from the levels established in the auction just prior to the last Committee meeting.

In contrast to the behavior of short-term interest rates, long-term rates generally moved higher as the prolonged rally in the corporate and municipal markets came to an abrupt end under the weight of a record volume of new issues. Rates moved sharply higher in the corporate new issue market, but by the close of the period a more stable atmosphere prevailed at the higher rate levels.

As noted earlier, foreign central banks were heavy buyers of dollars in the exchange market and the Desk had to invest over $2 billion for foreign accounts during the interval since the Committee last met. Had this entire amount been dumped into the Treasury bill market, bill rates might have declined by substantially more than they in fact did. The Treasury helped to resist the downward pressure on bill rates by selling a strip of $1.2 billion bills in the market and by issuing $780 million special Treasury certificates to central banks. In addition, the Desk sold $600 million bills directly to foreign accounts, concentrating on the purchase of Treasury coupon issues to meet longer-term reserve needs. Unfortunately, we are not at the moment in a particularly good position to resist additional pressure on the bill rate that might stem from further dollar accumulations by foreign central banks. The Treasury is currently precluded by debt ceiling considerations from issuing any more special certificates. At the same time, the System probably cannot continue to acquire additional amounts of coupon securities on the scale of the past three weeks without becoming too dominant a factor in that market. System purchases of about $620 million coupon issues over this period represented only about 5 per cent of the total trading volume in coupon issues (although the percentage was substantially higher in the case of longer maturities). Our operations undoubtedly had a significant rate impact, however, and accounted for about 80 per cent of the net decline in dealer positions in over-one-year maturities. In this respect it would be helpful to have the Committee's views as to its concern about a further decline in the bill rate, and some indication of how far the Desk should resist by providing reserves through the acquisition of coupon issues or by other means.

As the blue book notes, the Treasury will be raising cash in the interval between Committee meetings but the timing of operations is uncertain, depending in part on how fast the Senate acts on debt ceiling legislation. While even keel considerations may come into play in the period they do not appear likely to pose much of a constraint on open market operations. Affirmative action by the House on the proposal to lift the 4-1/4 per cent interest rate ceiling on Treasury borrowing of up to $10 billion with a maturity of more than 7 years is a milestone opening up new vistas for Treasury debt management. With long-term Treasury bond yields well out of line with corporate issues of comparable maturity, use of the new privilege--if confirmed by the Senate--will probably have to be cautious in order to avoid overly sharp rate adjustments. The redevelopment and improvement of trading in long-term Government securities, in fact, will be a major challenge for the Government securities market in the months ahead.

With M_1 finally having broken out of its stubborn pattern of shortfalls from a moderate growth rate, the blue book projections look for a continuation of growth in the months ahead even if money market conditions tighten somewhat. Broader measures of money and credit are expected to grow even more rapidly than M_1 but not quite so fast as in recent months. The alternative directives presented for the Committee's consideration cover a broad range of money market conditions, with the Federal funds rate ranging from 3 to 4-3/4 per cent, and second-quarter growth rates for the aggregates ranging from 6 to 10 per cent for M_1, 11 to 16 per cent for M_2, and 9 to 13 per cent for the credit proxy. Whether these projected relationships are in fact realistic only time can tell, with much depending on the actual course of economic developments and the vigor with which the banks press an aggressive lending and investing policy. Whether or not the blue book specifications turn out to be right, there obviously will have to be some sort of trade-off between money market conditions--with implications for other interest rates, both short and long--and growth of the aggregates. In the course of choosing a directive, the light shed by the Committee discussion on that trade-off will be most helpful for the Desk in trying to carry out the Committee's policy decision.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period February 9 through March 8, 1971, were approved, ratified, and confirmed.

Chairman Burns then asked Mr. Axilrod to comment on the monetary relationships discussed in the blue book.

Mr. Axilrod made the following statement:

Two financial developments stand out since the last meeting of the Committee. First, corporate and municipal bond yields have risen substantially, even while short-term rates have declined further. Yields on long-term U.S. Government securities have been about unchanged, however, in part because of sizable System open market purchases of coupon issues. Second, the narrowly defined money supply (M_1)--after four months of net growth that was well below FOMC anticipations--apparently grew sharply in February. A rapid growth was, of course, targeted for the month just past, as GNP recovery proceeded and bank loan growth picked up. That the result was somewhat faster than targeted appears to be partly explained by an actual $600 million drop in U.S. Government deposits from January on average to February on average, whereas the staff had earlier expected a rise of $200 million.

The broad money supply (M_2) grew very rapidly but about as expected last month, while the adjusted credit proxy rose more than anticipated. The more rapid growth in the credit proxy reflected more active seeking of large CD funds by banks than was foreseen. Even so, growth in outstanding large CD's was considerably slower than it had been in earlier months.

These developments need to be put in a longer-run context, of course. The sharp February growth in M_1 went a considerable way towards making up past shortfalls and brought the growth rate over the fourth quarter of last year and the first two months of this year to an annual rate of just over 5 per cent. Over the same period M_2 has grown at more than a 12 per cent annual rate, with growth particularly rapid over the last three months when a sharp drop in market interest rates led to massive shifting of funds from market instruments to consumer-type time and savings deposits. This was in a period when banks, as well as other savings institutions, have lagged in making downward adjustments on deposit rates; and when, according to attitudinal surveys, there was generally a continuing lack of consumer confidence in the economy.

With respect to long-term interest rates, the high-grade corporate bond yield, after rising a full percentage point since late January, is now at its high for 1971 and about equal to its average in December 1970. This yield is unusually high relative to short-term market yields, the prime loan rate, and mortgage interest rates. The uncertainty still remaining as to the strength of the economic recovery suggests to me that at this point little purpose would be served by a market adjustment that brought these other rates up over the near-term. If current rate relationships are unsustainable, therefore, it would seem more desirable for the corporate bond yields to drop. Prospects for such a drop may not be too bright over the near term in view of the large March-April calendar of new issues, but the recent rise in rates has in part discounted the forthcoming volume and we expect that offerings may well taper off later in the spring. Moreover, long-term interest rates may work down if, and as, economic news indicates that economic recovery is not overly robust.

Whatever the direction of influence of investor and borrower attitudes on corporate bond yields, I certainly would not suggest that System open market policy itself encourage a rise in long-term interest rates over the near-term, and would hope that policy would be accommodative to, if not encouraging of, long-term rate declines. At least between now and the next meeting of the Committee, I believe that it would be desirable to keep money market conditions about as they are at present. Such conditions would not encourage further long-term rate increases, and might perhaps be accompanied by declines from current levels for reasons previously noted. I would suggest continuing to use coupon issues extensively in reserve-supplying operations.

There are certain risks to this approach to money market conditions. In its effects on monetary aggregates, some may consider it reminiscent of late 1967 and 1968, but economic conditions are different, with far more slack in the economy now. If the staff's analysis is to be believed, maintenance of a 3-1/2 per cent funds rate would lead to a 9 per cent annual rate of expansion of M_1 in the second quarter. In March, however, only a 6 per cent growth rate for M_1 is thought to be consistent with prevailing money market conditions, with growth expected to move up to 8 per cent in April. Such growth rates for March and April would, if realized, bring the annual rate of increase for M_1 over the seven months since September back up to a little over 5-1/2 per cent. M_2 is expected to be growing more slowly in March-April than in February, though still at a healthy clip. Growth in the bank credit proxy is not expected to slow, however, until later in the spring, with the ups and downs largely reflecting sizable swings in U.S. Government deposits. Over the seven-month period ending in April, M_2 and the credit proxy would expand at annual rates of 13 and 11-1/2 per cent, respectively.

To achieve less rapid rates of increase in the aggregates in March-April would, insofar as we can now judge, appear to require a tightening of money market conditions from prevailing levels. This would in my view have undesirable effects, given domestic economic uncertainties, on over-all credit conditions.

A reasonable compromise among the various financial and economic objectives of the Committee would be to adopt, for now, within the framework of a directive phrased like alternative A, the alternative B growth paths for March-April--which yield an average M_1 increase of 6 per cent in that two-month period--but to associate with it prevailing money market conditions and to instruct the Manager to let M_1 and the other aggregates rise as much as indicated by the alternative A growth paths for March-April without tightening from the current 3-1/2 per cent funds rate. This has the danger that later in the spring the Committee might need to tighten the money market quite sharply in order to keep growth in aggregates down. But that is a risk worth taking in view of uncertainties as to the basic future strength of GNP, not to mention uncertainties as to staff estimates of the relationships between monetary aggregates and money market conditions.

Mr. Daane noted that the second-quarter growth rate for M_1 associated with alternative A was 9 per cent, and that the proviso clause of that alternative called for modifying money market conditions if the aggregates were deviating "significantly" from the expected growth paths. He asked how much of a downward deviation in M_1 was contemplated before the proviso clause would be implemented.

In reply, Mr. Axilrod said that for the period until the next meeting--which was scheduled for April 6--he would recommend focusing on the growth paths expected for March and April, rather than on those for the second quarter. On that basis, he would suggest planning to lower the funds rate from 3-1/2 to 3-1/4 per cent if the estimated March growth rate for M_1 fell below 5 per cent.

In response to a further question by Mr. Daane, Mr. Axilrod said that if the funds rate were reduced that much the bill rate probably would decline somewhat--perhaps to 3-1/4 per cent also.

Mr. Mitchell asked what the implications for long-term rates might be if the bill rate moved up to around 4 or 4-1/2 per cent.

Mr. Axilrod replied that long-term markets at present seemed to be discounting an expected rise in short rates. If bill rates were to drift up modestly--say, to the 3-1/2 to 3-3/4 per cent area--some temporary uncertainty might be created in capital markets, but over time long rates probably would still trend down. However, he would expect some reaction in long-term markets if bill rates were to move up quickly to levels above 4 per cent.

Mr. Maisel noted that bill rates typically were under downward seasonal pressures during the period from now until midyear. As a result, the funds rate would have to be raised more than would otherwise be the case to attain higher bill rates.

Mr. Holmes agreed, adding that the funds rate might have to move to 4 per cent or above to produce a significant rise in the bill rate.

In response to questions by Mr. Daane, Mr. Holmes said he concurred in Mr. Axilrod's view that some slight rise in short-term rates would not necessarily hinder a decline in long-term rates. The Desk could help foster declines in long rates by continuing to buy coupon issues, but as he had indicated he thought it would be very difficult to maintain the recent pace of such purchases.

In response to questions by Mr. Mitchell, Mr. Holmes observed that, as the members knew, he had long-standing reservations about the desirability of engaging in outright operations in agency issues. However, operations in agencies, including longer-term issues, would be feasible from a technical viewpoint, and such operations no doubt would be helpful in fostering declines in long-term rates.

Mr. Brimmer asked how long it would take to gear up for operations in agencies if they were authorized by the Committee.

Mr. Holmes replied that very little lead-time would be needed--perhaps as little as three or four days. The problems he anticipated were not of the sort that could be resolved by spending somewhat more time in preparation.

Mr. Morris remarked that the blue book seemed to pose a dilemma for the Committee by implying that growth in M_1 over the second quarter could be held to a 6 per cent rate only by sharply increasing the Federal funds rate. If that dilemma were real it would be a serious one, since significant increases in short-term rates had to be avoided because they would affect investor expectations and put upward pressure on long-term rates.

However, Mr. Morris continued, it was not at all clear that the apparent dilemma was real. In his judgment, the view that M_1 would grow very rapidly in the second quarter if the funds rate was maintained at its current level was not consistent with the staff's GNP projections portraying a sluggish economy in that quarter. He wondered whether the staff's assessment of the outlook for money had not been unduly influenced by the sharp increase in M_1 in February. As Mr. Axilrod had noted, that increase was explained in part by an unexpected drop in Government deposits. To the degree that the large rise in M_1 was attributable simply to a shift of deposits from public to private hands, it could not be expected to persist for any extended period.

Mr. Morris observed that he would be interested in Mr. Axilrod's opinion on the matter. In particular, he wondered how much confidence Mr. Axilrod thought could be placed in the blue book analysis of the probable relationships between the funds rate and money growth over the second quarter.

Mr. Axilrod said he might first comment on the implications of the behavior of Government deposits in February. At the time of the last meeting, when such deposits were projected to rise modestly, the expectation had been that M_1 would increase in February at a 9 per cent annual rate, largely because of the pick-up in activity in the aftermath of the auto strike. The actual decline in Government deposits during the month helped account for the fact that growth in M_1 was even more rapid than anticipated--but not for the fact that it was rapid.

With respect to Mr. Morris' main question, Mr. Axilrod remarked that growth in M_1 was expected to be rapid in the second quarter partly because it was thought that a reduction in money market rates had effects on the growth rate of money that built up over a period of three or four months. Thus, the recent money market easing was expected to have a greater average effect in the second quarter than in the first. Also, nominal GNP was projected to rise rather substantially in the second quarter--although less, of course, than in the first quarter. He might also note that the relationships shown for the second quarter were consistent with both the staff's judgmental forecasts and the results produced by the money market model the staff was currently using; for February the model had provided a better estimate of M_1 than the judgmental process had.

Nevertheless, Mr. Axilrod continued, he shared some of Mr. Morris' doubts about the second-quarter projections for the monetary aggregates, even though they did not appear unreasonable at this point. Indeed, he had suggested that in the current period the Committee might want to focus on the figures for March and April partly because he thought a high degree of uncertainty attached to those for later months.

Mr. Axilrod added that he agreed completely with the view that any significant rise in short-term rates at this juncture would confirm the market's current impression that long-term rates were going to rise.

Chairman Burns then called for the go-around of comments on monetary policy and the directive. He suggested that the main focus should be on policy for the next four weeks; in view of the uncertainties attaching to the second quarter there seemed to be little point in speculating extensively today about that period, particularly since the Committee would be meeting again on April 6. He hoped that in the course of the go-around each Reserve Bank President would say a word or two about discount rate policy and about the desirability of a near-term reduction in reserve requirements. It would also be useful for all of the members to express their views regarding the desirability both of continuing to operate in coupon issues on a fairly vigorous scale and of undertaking outright operations in agency issues.

In reply to a question by Mr. Daane, Chairman Burns said he had not meant to rule out comments by Board members on the subjects of discount rates and reserve requirements, but only to indicate that the Board would find the views of the Presidents helpful. The Chairman then invited Mr. Hayes to begin the go-around.

Mr. Hayes made the following statement:

> I believe the time has come to stop, look, and listen before pushing further in the direction of monetary ease. It is true that we still lack convincing evidence of a general strengthening in the economy, but staff projections as well as numerous signs point to the likelihood of gradually renewed economic growth as the year progresses. Certainly during recent months we have eased the way for such a recovery by facilitating a vast increase in bank liquidity and, less directly, in corporate and consumer liquidity. After months of frustratingly slow growth in the narrowly defined money supply, we now seem well on the way to achieving the currently targeted 6 per cent rate of growth for the first quarter. The broader aggregates are expanding at much faster rates, so fast indeed that sustained

growth at current rates could be a source of trouble later on. As far as the narrow money supply is concerned I would be satisfied with the growth currently projected for the first quarter, which would get us back to a longer-term sustainable track.

Both inflation and unemployment remain serious problems, and widespread pessimism as to Government determination to overcome inflation is clearly one factor contributing to the recent reversal in long-term interest rates, although an enormous calendar of new issues is doubtless the main cause.

Meanwhile the international monetary situation threatens to become critical. The trade balance continues to dwindle, largely as a result of a surprisingly strong growth of imports. With short-term rates continuing to weaken in this country, to a considerable extent reflecting this Committee's policy, dollars continue to flow into foreign official hands at a massive pace, more questions are being raised abroad about our policies, and confidence in the dollar could weaken precipitously.

In the light of these circumstances there would seem to be good reason to keep expansion of the aggregates to a moderate pace, while at the same time welcoming some firming of money market conditions if consistent with desired monetary growth. Thus, I would favor returning to the form of directive we were using two or three meetings ago, rather than using the recent version placing primary stress upon money market conditions. I prefer the language and aggregate growth rates of alternative C, although I could not object very strongly to those of alternative B. I would reject the 9 and 10 per cent second-quarter growth rates in M_1 associated with alternatives A and D as being too liberal. Considerable weight should also be given to M_2 and the credit proxy, and I would not be disturbed if growth rates for these variables tended to fall somewhat short of the very high rates currently being projected for them over the next few months.

I would welcome some firming of money market conditions if the aggregates are behaving. Between now and the next meeting, I would be happy to see some shading upward of the Federal funds rate, perhaps centering around 3-3/4 per cent or a bit higher. I believe this should take place very gradually to avoid any major wrench to market expectations that the Federal Reserve will continue on a course of moderate expansion. We should also be alert to the possibility that the general financial situation could deteriorate as the result of problems in the aerospace industry.

The Board might find it well worth considering a cut in demand deposit reserve requirements as the banking system enters into the immediately forthcoming period of seasonally heavy demand for reserves. Such a move--if characterized as a technical action rather than an overt move to further ease--might take some downward pressure off the bill rate. The opportunities for further use of coupon purchases for the same purpose seem rather limited in view of the very large volume of such purchases in recent weeks, which have brought us close to the edge, in my judgment, of playing too dominant a role in this part of the market.

Our directors voted last week to continue the existing discount rate, despite the further downward movement of short-term market rates. They felt that any further cut at this time or in the near future would run the risk of adding impetus to the downward movement in short-term market rates at a time when market factors and prospective domestic economic developments suggest that such rates may become firmer. They also felt that a further discount rate reduction might create expectations that would make more difficult the resolution of our inflation problem and could only worsen our payments position, with a risk of impairing the effective functioning of the international financial system. I find myself in full agreement with that view.

Mr. Hayes added that he thought the proposal for outright operations in agency issues involved important policy questions that had been discussed from time to time in the past but never resolved. He would hope that there would be ample opportunity for further discussion before any final decision was taken on the matter.

Chairman Burns observed that conditions might arise which would call for a quick decision. Accordingly, it would be helpful to have the members' views on the subject today.

Mr. Hayes then said he would oppose outright operations in agencies, partly because the market was so fragmented that System operations could easily lead to charges of favoring one agency over another. Also, new offerings were made so frequently that it would be difficult to avoid the appearance of supporting particular new issues--a practice the System had avoided in connection with Treasury offerings.

Mr. Hayes said he might also add a note on the subject of long-term rates. The fact that the yield curve had been unusually steep recently--as steep as at any time he could recall--suggested that it was reasonable to expect long rates to drift down even if short rates rose somewhat, provided that the rise in short rates was not sharp or sudden.

Mr. Francis observed that the money stock, reinforced by rapid growth in the past month, had risen about 6 per cent during the past twelve months. That rate was as great or greater than in 91 per cent of all other consecutive twelve-month periods since the beginning of 1960. That monetary expansion had been contributing to the recent acceleration in growth of total spending, while at the same time gradual progress was made toward ultimately purging inflationary pressures from the economy.

If future excess spending and acceleration of inflation were to be avoided, Mr. Francis continued, monetary growth had to be moderated from the rate of the last year. In the past the System had, on occasion, persisted in a policy course too long. Knowledge of current developments in the economy was available only with a delay, and the effects of monetary actions on spending, production, prices, and employment continued for months. In addition, as the rate of price advance slowed, the rate of growth of total spending required to obtain a given growth of real output and employment declined. As the optimum rate of increase in total spending receded, a reduced rate of monetary expansion would become desirable.

Mr. Francis remarked that all four of the proposed directives provided for a more rapid money growth than he believed was desirable. A rate of growth in the money stock from December 1970 of not more than 5 per cent seemed most appropriate at this time. Such an increase, according to the estimates of his staff, would be consistent with continuation of the current rate of growth of total spending and acceleration of production growth this year, while avoiding a sharp jump in spending that would intensify inflationary pressures later.

In reply to a question by the Chairman, Mr. Francis said his staff's estimates suggested that the unemployment rate at the end of this year would be approximately 6 per cent.

Mr. Francis added that he had no great enthusiasm for a further reduction in the discount rate at the present time, but he thought there might be reason for some downward adjustment in reserve requirements. It would be desirable, in his judgment, to consider a tie-in between a cut in reserve requirements and a lengthening of the deferment schedule on check collections. As to operations in coupon issues, it seemed to him that the primary purpose of open market operations was to affect the supply of bank reserves, and he was not so sure that past System operations in coupon issues had accomplished anything more than that. He was inclined to hope that the Committee would not get into outright operations in agency issues.

Mr. Kimbrel remarked that the blue book warned the reader of the problematical nature of the second-quarter projections of monetary aggregates and interest rates. Nevertheless, the projections associated with alternative C suggested that to get back to what he would consider a moderate rate of expansion of the aggregates would require a sharper tightening in money market conditions than could be tolerated. The projected second-quarter growth rates under alternative A, which called for no change in money market conditions, were unacceptably high. Since he believed it was necessary to get back to a moderate rate of growth, a directive along the lines of alternative B--or perhaps between B and C--seemed to be desirable.

Mr. Kimbrel observed that a rise in short-term rates, so long as it was not too great or too sudden, might well be absorbed without serious repercussions. Indeed, as had been suggested earlier today, such a rise may have already been discounted. As he recalled it, when the Committee began to pay more attention to monetary aggregates there had been a general understanding that short-term rates might be expected to rise temporarily even at times when the general direction of policy was toward ease.

Mr. Kimbrel said he would view the adoption of alternative B as a part of a gradual move back toward a moderate rate of growth in the aggregates, and not as a commitment to "sustained growth" in the second quarter. Consequently, he would find the language of alternative B more acceptable if the words "to promote sustained growth" in the first sentence was replaced by "to move toward a more moderate rate of growth." At its next meeting the Committee could evaluate the degree of success achieved in getting back to moderate rates of growth.

Mr. Kimbrel noted that the Atlanta Bank directors favored maintaining the present discount rate. In their judgment a reduction would contribute to expectations of lower short-term market rates. As to operations in coupon issues, he continued to favor some probing but he was not enthusiastic about massive operations. He had some reservations about operations in agency issues; in particular, he would be reluctant to add another dimension to market concerns at this time.

Mr. Kimbrel thought that a reduction in reserve requirements might help in getting the aggregates back to a more moderate growth path without an overreaction in the money market. He supposed that any action taken by the System to supply more reserves would be bound to have some kind of an interest rate effect, whether it involved changes in open market operations or in reserve requirements. The immediate impact on short-term rates, however, might be less from a reduction of reserve requirements than from open market operations. Since he believed that a further reduction in short-term rates was not desirable at the present time, he would hope that serious consideration might be given to supplying some of the additional reserves that might be needed to provide for monetary growth by reducing reserve requirements.

Mr. Eastburn noted that the broader monetary aggregates had been growing rapidly for some time, and that more recently growth in M_1 also had accelerated. He would be reluctant to see growth continue at the high rates associated with alternatives A and D. He agreed that long-term interest rates recently had been significantly influenced by expectations, and he thought the best means available to the System for improving those expectations would be to demonstrate that it was following a moderate course with respect to the aggregates. He would have preferred alternative C for the directive except for the fact that it implied an increase in short rates that could have effects on longer rates. On balance he favored alterative B, on the understanding that the Manager would resist any sharp increases in short rates.

Mr. Eastburn noted that the directors of his Bank had acted to reduce the discount rate. He believed such a move was appropriate, and he would not expect it to result in changes in short-term market rates of a magnitude that would prove embarrassing to the System. He thought the Board should give serious consideration to a reduction in reserve requirements, hopefully in a manner that would accomplish some restructuring. He would support continuing operations in coupon issues. He also was inclined to favor operations in agency issues, although he thought the Committee should be sure of its ground on the policy questions involved before making a final decision.

Mr. MacDonald said it was his view that financial developments in the last four weeks were generally in line with the directive adopted at the last meeting of the Committee. The decline in money market yields reflected both System actions and the continued strength in short-term investment demand. However, capital market yields had turned up as a result of the large volume of new issues, a growing calendar of future offerings, and an apparent change in expectations. Recent projections showed considerable strength in the key monetary aggregates for the first quarter. The narrowly defined money supply, the adjusted bank credit proxy, and total reserves were all running ahead of the target paths for the first quarter, and the broad money supply measure was right on target. The slightly accelerated rates of growth in the aggregates were appropriate for a short period of time, but they were probably excessive as longer-term targets of policy. Therefore he would support alternative B for the remainder of the first quarter, but would then prefer to move gradually to the rates of growth for the monetary and credit aggregates implied by alternative C. One disturbing factor in connection with each of the directives was the wide swing in total reserves suggested between May and June.

As to the discount rate, Mr. MacDonald said, two weeks ago some of the Cleveland Bank directors had expressed concern about another decrease for reasons similar to those advanced this morning--including possible adverse effects on psychology and on the balance of payments. He would expect some opposition to a cut at the meeting of the directors to be held on Thursday. He agreed with Mr. Eastburn regarding the desirability of considering a reduction in reserve requirements.

Mr. Sherrill commented that the present recovery--if in fact a recovery was under way--was still far from showing any real strength. For that reason he thought economic policy should remain stimulative. It would appear, however, that there was not much more that monetary policy could do; in particular, any further declines in short-term interest rates were likely to prove counter-productive. At the same time, he thought a significant increase in short-term rates could be quite harmful at this point. More generally, he would want to avoid giving any signals that could be interpreted as reflecting a move toward greater monetary restraint.

On the basis of those considerations, Mr. Sherrill said, he would be inclined to maintain prevailing money market conditions, including a Federal funds rate of about 3-1/2 per cent. For the directive he would favor the language of alternative A, but without the proviso clause relating to the monetary aggregates. The March growth rate for M_1 shown in the blue book under alternative A--6 per cent--was reasonable. Indeed, he thought an average growth rate below 6 per cent would not be desirable for the longer run. He would not be particularly concerned, however, about a deviation in either direction in a single month. The figure shown for April--8 per cent--was marginal with respect to desirability, and the 10.5 per cent figure for May was disturbingly high. But, as had already been noted, any projections made now for those later months were quite uncertain.

Mr. Sherrill observed that he would favor purchasing coupon issues as aggressively as feasible, given the limitations on the possible scale of operations the Manager had cited earlier. He also believed it was now time to begin outright operations in agency issues, if only to be responsive to the intent of Congress. Over recent years the Committee had repeatedly considered the desirability of such operations and further discussion at this point was not likely to contribute anything new. Although he suspected that operations in agencies would not prove to be very helpful in attaining the Committee's market objectives, he thought it would be worthwhile to determine whether that was the case.

Mr. Brimmer said he thought the Committee should resolve any doubts at this time in the direction of moderating the pace of growth in the monetary aggregates. While the Committee had been focusing to an increased extent on money market conditions at recent meetings, its policies over 1970 had encouraged the public to concentrate on the aggregates. Thus, a record of rapid expansion might lead the public to conclude that the Committee had chosen as a specific target the very high growth rate in M_1 that it had been urged to adopt by some.

Mr. Brimmer noted that the language of alternatives B and C differed only with respect to one word--B called for "sustained" growth in the aggregates and C called for "moderate" growth. However, even if the Committee aimed at moderate growth it might well end up with sustained growth. For that reason, although he could accept either alternative his preference would be for C.

In his judgment, Mr. Brimmer observed, the Desk should continue to probe for a reduction in long-term rates by concentrating purchases in coupon issues as far as possible. The Manager had indicated that he probably would not be able to buy an amount of coupon issues approaching the $600 million purchased in the recent period without exerting an undue influence on the market, but he (Mr. Brimmer) assumed that purchases of roughly half that amount would be possible. He considered it desirable to initiate probing operations in agency issues at this time, and he was hopeful that purchases of agencies would contribute a bit to the desired effect on long-term interest rates. Unlike some, he thought any agency issues acquired would not have to be held in the System's portfolio until maturity; the operations could include market sales as well as purchases.

Mr. Brimmer expressed the view that short-term rates should not be permitted to decline further at this point and that no resistance should be offered to a little back-up, if one were to develop. He would not comment on the desirability of a reduction in reserve requirements but would note, as he had at the last meeting, that the proposed revamping of the discount window would help to relieve the System membership problem--an objective sought by many who favored reserve requirement action. He hoped the Reserve Bank Presidents would give some thought to that consideration in coming weeks.

Mr. Maisel remarked that, basically, his reasoning followed that of Mr. Sherrill. He believed this was not the time to change policy either by tightening or by easing. Therefore, he supported the "no change" alternative A. He thought the Desk should continue to buy coupon issues, and he always had been in favor of outright operations in agency issues.

With regard to general policy, Mr. Maisel observed, he was happy that he could hold to the statements he made at the January and February meetings, to the effect that operations should be in line with current money market conditions unless there were serious shortfalls in the aggregates. On the other hand, he thought money market conditions should not be altered between now and the next meeting if the increases in the aggregates exceeded the blue book estimates, even by large amounts. One reason for "benign neglect" of any overshoots in the aggregates was that even under alternative A--for which the blue book showed higher growth rates than it did for alternatives B and C--the level projected for M_1 in April was well below that which would have been achieved at the rate of expansion that the Committee had decided was desirable at its January meeting. Thus, the recent pickup was making up only in part for past shortfalls in money. Secondly, the pickup was occurring during a quarter in which GNP was expanding at a rate faster than expected for any subsequent quarter of the year. As Mr. Morris had implied, the pull of GNP on the monetary aggregates would be reduced in future quarters. It was desirable to permit some of this quarter's rapid expansion in activity to show through in the monetary aggregates, rather than to raise the Federal funds rate--and by that process affect expectations and long-term rates--in an effort to slow the aggregates down.

Furthermore, Mr. Maisel continued, it would be desirable for GNP to expand in coming quarters by more than the amounts projected in the green book. In fact, it would be good if the average rate of growth in the last three quarters of 1971 was as large as the expansion anticipated for the first quarter. Since the current configuration of money market conditions was not expected to be as favorable for GNP growth in the rest of the year, the Committee should become disturbed only if the increases in the monetary aggregates were extremely large.

For those reasons, Mr. Maisel said, he would support alternative A today. He would be happy to retain the one-way proviso used in the previous directive. If, however, the two-way proviso shown in the staff's draft was adopted, he obviously would want the words "deviating significantly" to be interpreted as allowing a large growth in the aggregates before the Manager was required to take any tightening action.

Mr. Daane said he was uneasy about the domestic economy on the one hand, and he was even more uneasy about the international standing of the dollar on the other. Accordingly, he found it quite difficult today to reach a judgment about appropriate monetary policy. As he had argued vigorously during the Sunday evening session at Basle, he thought the worst of all possible outcomes for the free world as a whole would be a cumulative recession in the United States. Thus, he would not want to do anything that would damage the chances for the fragile recovery now under way to develop to the point at which actual growth in the economy was close to the long-run potential. And he certainly did not tend to consider unemployment simply in statistical terms.

At the same time, Mr. Daane continued, it seemed to him that the System had gone about as far as it should in furnishing liquidity. Indeed, it apparently had furnished more liquidity than businesses and consumers were willing to use, given the present state of confidence. Accordingly, he would not want to continue the recent pattern of progressive easing at this juncture. In particular, he would be quite unhappy for international reasons to see any further decline in short-term rates. Moreover, if some shading up in short rates would be consistent with declines in the long rates--as Messrs. Axilrod and Holmes had indicated might be the case--he would not want to resist such a development.

For those reasons, Mr. Daane observed, he favored alternative A for the directive, with two qualifications on its interpretation. First, as he had indicated he would not want the phrase "maintaining prevailing money market conditions while accommodating any downward movements in long-term rates" to be read as ruling out some back-up in short-term rates. Second, while he would much prefer to delete the proviso clause altogether, if it were retained he would not want it to be implemented unless the aggregates deviated considerably from the expected paths.

Mr. Daane said he thought that a strong case could be made against a further cut in the discount rate at this time. Such an action would be inconsistent with the maintenance of prevailing money market conditions, as called for by alternative A, and it would have significant effects overseas. For example, he had been advised by Japanese officials during the weekend that they were struggling to prevent a large-scale shift of export financing from their domestic market to New York. If they cut their domestic interest rates further to permit financing of the exports in question to be accommodated in Japan they would be encouraging additional exports, and that would increase the difficulties of the dollar's underlying position. He hoped the Committee members would appreciate that such considerations were very important in the thinking of their foreign colleagues. He agreed that U.S. monetary policy could not assume the whole burden of protecting the dollar, but he also believed that it could and should make some marginal contribution to that goal.

Mr. Daane thought there was much to be said for a reduction in reserve requirements at some point, provided it was made clear that the action was not intended as an easing move and that its effect on bank reserves would be fully offset through open market operations. Such a combination of actions could be particularly helpful in reducing downward pressures on short-term interest rates. However, he would not favor any immediate action which might be misinterpreted as further ease.

Mr. Mitchell said he thought the major objective of policy in the immediate future should be to bring about a substantial decline in long-term interest rates. Since A was the only alternative that even mentioned that objective he would support that alternative. In his judgment, however, the task would prove much more difficult than most people realized; many knowledgeable market participants believed that long-term rates had bottomed out, and it was not likely to be easy to turn that psychology around. It would be desirable to use a number of tools, including continued purchases of coupon issues, a reduction in reserve requirements, and purchases of longer-term agency issues. With respect to the last of these, he would suggest that the staff be asked to prepare a new memorandum on operations in agencies as quickly as possible. Perhaps the Committee might then vote by wire on whether to authorize outright operations in the agency market.

Mr. Mitchell observed that he was at somewhat of a loss with respect to the question of the monetary aggregates. While he generally considered himself to be a supporter of the aggregative approach to monetary policy, he had lost much of his faith in the M_1 because of the substantial statistical problems involved in its measurement. Furthermore, he found it difficult to arrive at a useful analytical interpretation of movements in M_2 because of the problem of differentiating between changes in the degree of intermediation on the one hand and monetary expansion on the other. He was not happy about the growth rates in the aggregates associated with alternative A in the blue book, but for the reasons he had mentioned earlier, he was prepared to vote for that alternative.

Mr. Heflin said he thought the Chairman had characterized the present economic situation well when he indicated in his recent Congressional testimony that there was no shortage of money, but rather a shortage of confidence. The discussion today suggested that the Federal Reserve had already used all its available tools in the effort to restore confidence, and that main reliance now had to be placed on fiscal policy.

In terms of instructions to the Manager, Mr. Heflin favored a directive somewhere between alternatives B and C. He preferred the growth rates in the aggregates associated with alternative C, but he was disturbed about the consequences for interest rates which the blue book suggested were implied by that alternative. Accordingly, he would accept alternative B on a temporary basis, with the understanding that prevailing money market conditions would be maintained unless and until the aggregates moved above paths associated with that alternative.

Mr. Heflin said he was opposed to a further reduction in the discount rate at this time for both domestic and international reasons and would recommend against a change at the forthcoming meeting of the Richmond Bank directors. He might report a comment made by one of those directors to the effect that the System was "pulling with both hands"--that is, after market interest rates were reduced by open market policy, the directors were told that discount rates should be lowered to keep them in line with market rates. He (Mr. Heflin) also had some doubts about the desirability of a reduction in reserve requirements, since he thought that would be interpreted as an additional easing action. However, if the choice was between reducing reserve requirements or discount rates, he would prefer the former because it would create less of a problem in the international area. A cut in reserve requirements might also be helpful in stimulating bank purchases of municipal securities.

Mr. Heflin said he would support continued probing in the coupon market. As for the purchase of agencies, he shared the concerns others had expressed, particularly those relating to the fragmented nature of the market. He would not favor operations in agency issues at this time.

Mr. Clay remarked that the path of recovery in the national economy was still rather unclear. Its basic strength was obscured by the after-effects of the auto strike and the preparations for a steel strike, and the intensity of the upswing in the months ahead remained uncertain.

Despite the drop in the unemployment rate, Mr. Clay observed, the demand for labor continued weak. To him that underscored the incompatibility of the goals of encouraging employment and of restraining price inflation. Recent developments in the domestic financial area had revealed the extreme sensitivity on the upside of long-term interest rates, especially corporate rates.

Mr. Clay said he had been pleased to hear the Chairman's comments today regarding the limited nature of the System's responsibilities with respect to the balance of payments. In his judgment a solution to the payments problem would require changes of a fundamental character which the Federal Reserve itself could not bring about, and it made sense for the System to focus primarily on the objectives toward which it could make a fundamental contribution. At the same time, it would not be desirable for Federal Reserve policy to worsen the balance of payments situation, and he was concerned over the possibility that that constraint might hamstring the System at some point in its attempt to achieve domestic goals. Accordingly, it would be useful for the Committee to have an evaluation of the international implications of various steps it might take for domestic purposes.

As to the directive for the period ahead, Mr. Clay observed that alternative C appeared more suitable to him than the other alternatives in terms of the expected paths of the financial aggregates. In his judgment the others--particularly A and D--involved greater risk of accelerating price inflationary forces down the road. He thought that there need be no particular concern about the possibility that the implementation of alternative C might lead to some upward movement of money market rates, as long as those developments proved compatible with the rates of growth desired in the financial aggregates. After all, earlier the Committee had pushed money market rates lower than it desired on other grounds in order to encourage money supply growth. Moreover, if the aggregates were deviating from targets, the Manager would have instructions and authority to modify open market operations accordingly.

Mr. Clay noted that alternative D, the most expansionary of the four draft directives, had been designed with a view to bringing downward pressure on long-term interest rates. While that was a desirable goal, there was no assurance that adoption of D would lead to lower long-term corporate and municipal rates. Market interpretation of such monetary policy action might well set in motion forces leading to more rather than less upward pressure on such interest rates. At the same time, D would involve very high rates of growth in the financial aggregates.

With respect to the discount rate, Mr. Clay said he wanted to think a little more about the considerations Mr. Daane had raised. Apart from those considerations, he definitely would be inclined to make another quarter-point reduction to bring the discount rate into closer alignment with market rates. Such action also would be useful in helping to moderate any tendency for market rates to rise as a result of System efforts to slow growth in the financial aggregates.

Mr. Clay observed that he would be very much in favor of a reduction in reserve requirements at any point at which such action was consistent with the existing stance of monetary policy. He thought a cut in requirements would be useful in connection with the System's membership problem, which was an important problem at this time. He had consistently favored operations in coupon issues when circumstances suggested that they would serve a useful purpose, and he would favor continuing them now within the limitations the Manager had described.

Mr. Clay said he had mixed feelings about operations in agency issues. On the one hand, such operations were likely to be an exercise in frustration and futility. Once begun, they probably would have to be continued indefinitely. Moreover, the market for agency issues was so thin that the System was likely to find itself making the market and operating in a way that was not necessarily best for a central bank. On the other hand, the Federal Reserve was an instrumentality of Congress; and Congress had, in effect, told the System to undertake some experimentation in that area. Also, as the Manager had indicated, operations in agencies could be helpful with respect to the Committee's market objectives at this time. On balance, he thought that if the System was ever to undertake such operations, this would be the appropriate occasion.

Mr. Mayo expressed the view that the Committee had made a significant improvement in its directive at the February meeting when it placed primary emphasis on money market conditions while retaining a caveat with respect to the monetary aggregates in the form of a proviso clause. While he agreed that the Committee had to keep the aggregates in mind he thought there had been an undesirable tendency recently to measure System policy in terms of the single variable M_1. By decreasing the emphasis on the aggregates in its directive, the Committee would be creating a better atmosphere both at home and abroad for the evaluation of monetary policy.

For the coming period Mr. Mayo favored alternative A of the draft directives. He did not think that alternative involved some of the risks others had seen in it. While he agreed that the second-quarter growth rate in M_1 associated with A in the blue book--9 per cent--was too high, he noted that the Committee would have several opportunities to make adjustments, beginning at its early-April meeting, if it appeared that such a growth rate was actually developing.

Mr. Mayo noted that in connection with alternative A the blue book suggested interpreting "prevailing money market conditions" as involving a Federal funds rate of about 3-1/2 per cent. He would prefer to interpret prevailing conditions as involving a funds rate in the range of 3-1/4 to 4 per cent. As to the low end of the proposed range, he noted that the funds rate was at 3-1/4 per cent today. As to the high end, he would not object to some modest firming in money market conditions over the next four weeks, so long as it was done in a low-key manner and did not involve pushing the funds rate above 4 per cent. He would not favor any further easing at this time, essentially for balance of payments reasons.

Mr. Mayo said he would commend the Manager for his recent operations in coupon issues and would encourage him to continue such operations. He was opposed to outright operations in agency issues because of the many problems he thought they would raise. He believed a strong case could be made for a further quarter-point reduction in the discount rate, since such a cut would ratify only in part the declines in short-term market rates that had occurred since the last meeting of the Committee. He appreciated the problems Mr. Daane had mentioned concerning the probable interpretations abroad of such a move. Of equal significance, however, were the probable interpretations at home of a failure by the System to continue reducing the discount rate in line with market rates. He would prefer to delay any reduction in reserve requirements.

In a concluding observation, Mr. Mayo said he was a little concerned about how the Treasury might react if Congress removed the 4-1/4 per cent interest rate ceiling on a certain amount of long-term Treasury bonds. In particular, he was worried that the Treasury might feel that it had to offer a long-term bond this spring. Such an offering would, of course, make the Committee's task more difficult.

Mr. Strothman said there seemed to be little question about the fragility of the recovery and the importance of both the unemployment and balance of payments problems. Weighing all those considerations, he favored alternative A for the directive. He also favored continued purchases of coupon issues and a reduction in reserve requirements; those two actions combined would give the Desk the opportunity to sell a substantial volume of Treasury bills.

Finally, he would like to see the discount rate reduced to bring it into closer alignment with market rates. One advantage of keeping the discount rate in line with the market was that it would then be feasible to raise the rate when the System desired to take such action as a signal to the public.

Mr. Swan commented that a revision of the statement regarding interest rates in the first paragraph of the draft directive would be desirable in the interest of precision. He suggested that the statement be revised to read "Short-term interest rates and mortgage rates have fallen further in recent weeks but yields on new issues of corporate and municipal bonds have risen considerably...."

After discussion it was agreed that the change suggested by Mr. Swan should be adopted.

With regard to the second paragraph of the directive, Mr. Swan said he agreed with the objectives expressed by some of those favoring alternative A. However, he preferred the wording of alternative B or C, with the addition in either case of a reference to the intention of accommodating downward movements in long-term interest rates. Despite the recent fluctuations in the narrowly defined money supply, he would be reluctant to have the Committee imply that it was no longer as concerned as earlier with the objective of promoting moderate growth in the monetary and credit aggregates. At the same time, he would not want to see the Federal funds or bill rates rise to the levels shown in the blue book in connection with C. He hoped the blue book overstated the degree of firming that would be associated with the aggregative growth rates given under C. In any case, he would find acceptable only a modest firming of money market conditions, with the funds rate not exceeding 4 per cent. More generally, he would want the funds rate to remain in a range of 3-1/4 to 4 per cent.

Mr. Swan thought the Desk should continue its operations in coupon issues and that the Committee should give serious consideration to authorizing outright operations in agency issues. In his judgment some of the comments on the agency market that had been made in the go-around applied better to the conditions of ten years ago than to those of today. He would admit, however, that he was not overly optimistic about the benefits to be derived from operations in agency issues.

Mr. Swan noted that the directors of his Bank had voted to reduce the discount rate by a quarter-point at their last meeting. In his judgment such an action was clearly in order, since the rate was at least as far out of line now as it had been at the time of the previous reduction. He thought another cut in the discount rate, by itself, would not be interpreted as signifying a change in the stance of monetary policy and would not put any further downward pressure on short-term market rates. While he was sympathetic to the international problem, he thought foreign monetary authorities recognized clearly that what mattered from their point of view was not the discount rate in the United States but market rates. On the other hand, to depart now from recent practice by delaying discount rate action would risk having a great deal of policy significance attached to a cut if one eventually was made.

In a final observation Mr. Swan said he would like to see a modest reduction in reserve requirements, but he was still not sure about the appropriate timing of such a move.

Mr. Coldwell remarked that he favored alternative A of the draft directives, although he would suggest replacing the two-way proviso clause with a one-way clause guarding against excessive growth in the aggregates but not against shortfalls. Because the projections of the aggregates were so uncertain he thought it would be desirable to focus on maintaining fairly stable money market conditions and hope that such stability would be associated with some decline in long-term interest rates. The additional easing called for by alternative D struck him as undesirable since he believed that monetary policy had already gone as far as feasible in promoting an economic recovery. At this point monetary policy could make its greatest contribution by fostering a stable environment.

While he favored stable money market conditions, Mr. Coldwell continued, he was concerned about the Committee's recent tendency to set a specific Federal funds rate as a target for the Manager. In his judgment it would be preferable to indicate an acceptable range for the funds rate. He would not be disturbed by some backing and filling in that rate at present. He would, however, be disturbed by a pronounced reversal in short-term rates and he would view a 4 or 4-1/2 per cent funds rate as too high.

Mr. Coldwell said he was opposed to a further reduction in the discount rate at this time, both on international grounds and because he thought such a move would have the unfortunate effect of stimulating expectations of further declines in short-term market rates. He did not think discount rate changes should be made automatically as market rates moved up or down, and he believed there was nothing in the System's recent practice or in its discussions of discount rate policy to suggest that changes were intended to be automatic.

With regard to reserve requirements, Mr. Coldwell thought the approach Mr. Daane had suggested--combining a reduction in requirements with offsetting open market operations--was worth consideration. If the Board did reduce reserve requirements he hoped it would give careful consideration to the desirability of making changes in time compared to demand deposits. He also hoped the Manager would continue to probe in the coupon market. He would prefer not to undertake outright operations in agency issues, since he thought that once the System bought issues of one agency it would be obliged to acquire those of others.

Mr. Morris reported that the directors of the Boston Reserve Bank had voted a 1/4 point reduction in the discount rate more than two weeks ago. He supported that reduction essentially for the reasons advanced by Messrs. Mayo and Swan. For good or ill, the System had conveyed the impression to the public that its policy was to move the discount rate gradually in order to keep it in line with short-term market rates. At present the gap was large; at 4-3/4 per cent the discount rate was far above the 3-1/2 per cent bill rate. A failure by the System to reduce that gap by discount rate action would be interpreted by the market as indicating that the System expected short-term rates to rise. That was not the kind of psychology the System should be generating if it hoped to foster declines in long-term rates.

Mr. Morris remarked that a reduction in reserve requirements would be particularly useful under circumstances in which it appeared impossible to attain the objectives for the aggregates without depressing short-term rates further. He would favor withholding a cut in requirements for use in that eventuality, even though he did not think it was very likely to arise in the near future. His position with respect to operations in coupon and agency issues had not changed. Modest operations in both types of securities might create the illusion that the System was accomplishing something. In his judgment, however, it would be a mistake to expect such operations to help reduce rates on other long-term securities; their effect would mainly be to widen spreads. That view was supported by developments in recent weeks, during which yields on corporates had risen sharply and those on municipals moderately, despite substantial purchases of longer-term Treasury issues by the Desk. The only effective way of influencing long-term rates at this point was to convince investors and corporate treasurers that they would in fact decline.

Mr. Morris remarked that if he were thinking only in terms of desirable growth rates in the monetary aggregates he would favor alternative B or C of the draft directives. However, he doubted that the Federal funds rates associated with those alternatives were properly specified. Assuming that the staff's GNP projections were correct, he believed that appropriate growth rates in the aggregates could be achieved without putting substantial upward pressure on short-term rates. To put it another way, he thought it was necessary to maintain prevailing money market conditions, as called for by A, to achieve growth rates in the aggregates in the neighborhood of those associated with B and C. Accordingly, he favored alternative A for the directive.

Mr. Robertson said he found himself very much more optimistic than anyone around the table. It seemed to him that the groundwork had been laid for an upswing in economic activity, and that such an upswing would soon become evident. He agreed that the recovery thus far was fragile, but he believed that spring, which was almost here, would loosen the purse strings of the consumer. He suspected that observers would be surprised at the rate at which the recovery would proceed.

Mr. Robertson then made the following statement:

It is obvious that we do not yet have inflation under control, although once again there are a few encouraging signs in the area of industrial prices and in the consumer price index. However, there are indications that an economic recovery is under way although it is hard to say how strong it may be and what may be its effects on unemployment, inflation, and the balance of payments.

Despite the seeming turnaround in economic activity, there are still some uncertainties as to the strength of demands for goods and services. Residential construction is a plus, and the first quarter is seeing the beneficial effects of a rebound in auto production and some advance buying and ordering to hedge against a steel strike. But sales of domestic autos are on the disappointing side. And retail sales in general, while rising, are not rising by much. Needless to say, the balance of payments is something of a problem, but thus far other countries seem to be remaining relatively calm in the face of the sizable flow of dollars to them.

While the economic evidence is not clear, on balance it suggests an economic outlook little different from what we saw four weeks ago. Thus, I see little reason to change our general policy course, but at the same time I do not want it to become any easier. In fact, I think we may already have become too expansive and hence I would not like to see a repetition of February's rate of growth in the key aggregates--M_1, M_2, or the bank credit proxy.

The growth of both M_1 and M_2 in February was immoderate, in my view, even though the M_1 growth did no more than make up for past shortfalls. The February M_2 growth was particularly worrisome to me, since it brought the growth in this measure over the past five months to a rate so high as to risk refueling inflationary fires. The staff expects the growth rate in M_2 to slow in the future, which is encouraging if it works out, but I would hope for an even less rapid growth.

I would be happy if money market conditions should remain, until the next meeting of this Committee, about as now prevailing, if that would result in monetary aggregates growing moderately.

I would not want to see money market rates below current levels, even if the rate of growth in the aggregates for March weakened a bit. Given the demonstrated range of error in our projection capabilities, I am more inclined to trust my subjective judgment on this point, and it tells me that we probably have gone as far as we ought to in easing money market rates. My feeling is that at these rate levels, the System will be providing ample liquidity for both banks and the public. Indeed, it could even be too much.

If the maintenance of current money market conditions should yield too rapid a growth in the aggregates (giving weight to M_1, M_2 and the bank credit proxy, rather than to any single one of them), I think the Manager should take some modest firming counteraction.

It would be possible, I recognize, for market participants to react in exaggerated fashion to this kind of tightening action by the Desk, should it take place. If that should happen, one useful way to moderate such reactions might be through a further one-quarter point drop in the discount rate. This could be one of those occasions when the "timing" of a discount rate action is more important than the action itself.

These views lead me to favor a directive in terms of alternative A, as drafted by the staff, but targeted more nearly to the growth paths for the aggregates specified for alternative C, or possibly B, for March and early April.

As for operating in agency issues, I can see no basis for refraining from doing so as long as we operate in coupon issues--and the time is now appropriate.

Mr. Robertson added that the agency market was quite different now from what it was five or ten years ago, and he thought that System operations in that market would not involve difficulties significantly greater than operations in the market for Treasury coupon issues. He had never been enthusiastic about coupon operations, but if they were undertaken to foster declines in long-term rates--an objective that he, like other Committee members, favored--he did not think there were good grounds for opposing operations in agencies.

Chairman Burns remarked that while the members were divided regarding the desirability of outright operations in agency issues, it appeared from the go-around that at present a majority favored such operations. He thought the Committee should not make a decision on the matter today; he wanted to give it more study, and he assumed that others were in the same position. However, he believed that a decision should be made quite soon, since it was unlikely that the Committee would be in a better position to act in, say, three or six months than it would be shortly. Accordingly, he favored proceeding along the lines Mr. Mitchell had suggested. Specifically, he proposed that the staff be asked to prepare a memorandum setting forth the pros and cons of outright operations in agencies within the next week or so; and that the Committee plan on reaching a decision, either by telegraph vote or in the course of a telephone conference meeting, before the Committee's meeting in Washington on April 6.

There were no objections to the Chairman's proposal.

Turning to current policy, Chairman Burns said he would like to clarify one matter relating to M_1 growth rates. Over the first nine months of 1970 M_1 had expanded at an annual rate of about

6 per cent. If the same growth rate were to be attained over the following six months--and accepting the present preliminary estimates for February--M_1 would have to expand at an annual rate of about 10.5 per cent in March. While that point was an arithmetical one, it was worth keeping in mind.

The Chairman then remarked that a majority of Committee members had expressed a preference for alternative A of the directive drafts, but there had been a substantial body of sentiment for the growth rates in the aggregates associated with alternatives B and C. He proposed that the Committee vote on the language of alternative A, on the understanding that it would be interpreted in a particular fashion. First, the "prevailing money market conditions" to be maintained unless the proviso clause became operative would be typified by a Federal funds rate centering on 3-1/2 per cent. Secondly, the "growth paths expected" for the monetary and credit aggregates, referred to in the proviso clause, would be taken as the paths for March and April associated in the blue book with alternative B. Third, the aggregates would be deemed to be "deviating significantly" from the expected paths, and thus to cause the proviso clause to become operative, if their deviations exceeded three or four percentage points.

For illustrative purposes, the Chairman continued, he might use M_1, the most important of the aggregates. Under alternative B, the March growth rate in M_1 was shown at 5.5 per cent. Under his proposal, prevailing money market conditions would be maintained even if the rate of growth in M_1 in March was estimated to be as high as 8.5 or 9 per cent. In the event of a greater upward deviation, however, the target for the funds rate would be moved up by one-quarter point, to 3-3/4 per cent. On the other side, if growth in M_1 in March was estimated to be at a rate as low as 1-1/2 or 2 per cent, the funds rate target would be lowered by one-eighth, or at most, one-quarter of a point.

Mr. Hayes asked whether it was the Chairman's intention that some fluctuation in the funds rate around 3-1/2 per cent would be acceptable even if the proviso clause did not become operative.

Chairman Burns replied affirmatively, noting that some fluctuation would have to be expected.

Mr. Hayes then said he found it difficult to decide whether he could vote for such a directive, since any further decline in money market rates would be a highly disturbing development.

After further discussion, it was agreed that the target for the funds rate should be reduced by only one-eighth of a point in the event of shortfalls in the aggregates of the magnitude the Chairman had described.

Mr. Hayes then indicated that he would find it possible to vote affirmatively, in light of the proposed asymmetry in the response to upward and downward deviations in the aggregates.

Mr. Brimmer expressed similar sentiments.

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

The information reviewed at this meeting suggests that real output of goods and services, which declined in the fourth quarter of 1970, is rising in the current quarter primarily because of the resumption of higher automobile production. Although the unemployment rate has edged down recently, it remains high. Wage rates in most sectors are continuing to rise at a rapid pace. Movements in major price measures have been diverse; most recently, the rate of advance moderated for consumer prices and wholesale prices of industrial commodities, but wholesale prices of farm products and foods rose sharply. Bank credit increased considerably further in February, as business loans strengthened substantially and banks again made sizable additions to their holdings of securities. The money stock both narrowly and broadly defined expanded sharply in February. Short-term interest rates and mortgage rates have fallen further in recent weeks but yields on new issues of corporate and municipal bonds have risen considerably, in part as a result of the very heavy calendar of offerings. The over-all balance of payments deficit in January and February was exceptionally large. Imports increased more rapidly than exports in January, and capital outflows have been stimulated by widened short-term interest rate differentials. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining prevailing money market conditions while accommodating any downward movements in long-term rates; provided that money market conditions shall be modified if it appears that the monetary and credit aggregates are deviating significantly from the growth paths expected.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, April 6, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

March 8, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on March 9, 1971

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services, which declined in the fourth quarter of 1970, is rising in the current quarter primarily because of the resumption of higher automobile production. Although the unemployment rate has edged down recently, it remains high. Wage rates in most sectors are continuing to rise at a rapid pace. Movements in major price measures have been diverse; most recently, the rate of advance moderated for consumer prices and wholesale prices of industrial commodities, but wholesale prices of farm products and foods rose sharply. Bank credit increased considerably further in February, as business loans strengthened substantially and banks again made sizable additions to their holdings of securities. The money stock both narrowly and broadly defined expanded sharply in February. Short-term interest rates have fallen further in recent weeks but yields on corporate and municipal bonds have risen considerably, in part as a result of the very heavy calendar of offerings. The over-all balance of payments deficit in January and February was exceptionally large. Imports increased more rapidly than exports in January, and capital outflows have been stimulated by widened short-term interest rate differentials. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation and the attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining prevailing money market conditions while accommodating any downward movements in long-term rates; provided that money market conditions shall be modified if it appears that the monetary and credit aggregates are deviating significantly from the growth paths expected.

Alternative B

To implement this policy, the Committee seeks to promote sustained growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective.

Alternative C

To implement this policy, the Committee seeks to promote moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective.

Alternative D

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in money and credit markets; provided that operations shall be modified if it appears that the monetary and credit aggregates are deviating significantly from the growth paths expected.