# 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, April 6, 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. Morris
Mr. Robertson
Mr. Sherrill

Messrs. Coldwell 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. Partee, Economist
Messrs. Axilrod, Eisenmenger, Garvy, Gramley, Hersey, Reynolds, Scheld, Solomon, and Tow, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Kenyon, Deputy Secretary, Office of the Secretary, Board of Governors
Mr. Leonard, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors

Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Gemmill, 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. Melnicoff, MacDonald, and Strothman, First Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, and Minneapolis, respectively
Mr. Craven, Senior Vice President, Federal Reserve Bank of San Francisco
Messrs. Hocter, Brandt, Andersen, and Green, Vice Presidents, Federal Reserve Banks of Cleveland, Atlanta, St. Louis, and Dallas, respectively
Messrs. Gustus and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively
Messrs. Geng and Wallace, Assistant Vice Presidents, Federal Reserve Banks of New York and Richmond, respectively

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

The memorandum of discussion for the meeting of the Federal Open Market Committee held on March 9, 1971, was accepted.

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 March 9 through March 31, 1971, and a supplemental report covering the period April 1 through 5, 1971. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs noted that at the last meeting of the Committee he had suggested that the foreign exchange markets were on the verge of a speculative crisis. He would now say that such a development was in its early stages.

Chairman Burns said he assumed Mr. Coombs had not meant to imply that such a crisis was inevitable.

Mr. Coombs responded that he hoped it was not. He then noted that since the Committee's last meeting $4.5 billion had moved into foreign central banks and that the pace of such dollar inflows had been accelerating. Last week alone, central bank dollar holdings had risen by $2 billion, including $1 billion on Friday (April 2). Corporation treasurers and other traders were now beginning to hedge against the risk of parity changes over the weekend--the first time that type of speculation had been seen in nearly two years.

Curiously enough, Mr. Coombs continued, the discount rate cuts announced last week by five European central banks had not yet noticeably improved market sentiment. In most instances, the central banks cutting their discount rates had

made it clear that the action was dictated solely by external considerations, thus leaving the impression of an unwilling accommodation to interest rate developments here--and thereby highlighting the credit policy dilemma in which most of the European central banks found themselves. On the other hand, if, as he hoped, it proved possible to weather the present speculative wave, the more fundamental effects of lower European interest rates should begin to show through.

Meanwhile, Mr. Coombs observed, there was the problem of how best to deal with the speculative storm now gathering. Much of the problem was psychological. In recent years the market had been listening to a great deal of official discussion of the virtues of exchange rate flexibility. It was not surprising, therefore, that widespread uncertainty had developed in financial markets both here and abroad as to whether the dollar and other major currencies would in fact be forcefully defended if they came under pressure. It was just that uncertainty that had been driving corporation treasurers and commercial bankers to hedge against the dollar in all of the manifold forms such hedging might take.

Mr. Coombs remarked that he therefore had been most pleased that Under Secretary of the Treasury Volcker, in an interview with the New York Times and Wall Street Journal over the weekend, had clarified U.S. financial policy by asserting

that none of the major European currencies were undervalued at the moment and that the U.S. Government would regard revaluations of those currencies as both unnecessary and undesirable. Mr. Volcker had correctly attributed the current pressure to a temporary movement of short-term funds, and had dismissed the idea that any major policy changes were imminent. The European central banks and governments had welcomed Mr. Volcker's statement and were in the process of making similar strong statements themselves. He thought that the clarification of official attitudes would help a great deal to provide the market with the reassurance it had been lacking.

Mr. Coombs noted that he had been urging the Treasury to stand ready to operate forcefully in the forward market if the dollar should come under pressure. Last Friday the German Federal Bank had initiated such operations in the form of forward sales of marks, and had inquired whether the System would be prepared to join in for its own account in New York after the German market closed. The Treasury had accepted his judgment that such an operation would be worthwhile, and the Account Management therefore began last Friday to sell forward marks for Federal Reserve Account at the ceiling for the spot rate--that is, 3.63 marks to the dollar. As cover for such operations, the System Account had only $26 million of marks on hand, and so he had discussed with officials of the German Federal Bank ways and

means of covering the System's prospective short position in marks in order to guard fully against the eventuality of a revaluation of the mark. The last time the System had operated in forward marks--in 1968--it had covered its short position in forward marks by concurrently drawing marks under the swap line, thereby acquiring the revaluation guarantee under the swap arrangement. Such drawings on the swap line naturally added to the spot dollar position of the German Federal Bank, but in 1968 the dollar holdings of the Federal Bank had been less of a problem than they were now. On this occasion, in order to avoid increasing the dollar holdings of the Federal Bank more or less _pari passu_ with the System's forward operations, that Bank had agreed that the System might cover its short position in forward marks by making contingent drawings on the swap line for value ninety days hence, when the forward contracts would mature. If before the maturity date of the forward contracts the System was able to cover through the market or in direct transactions with the Federal Bank, those contingent drawings on the swap line would be canceled. He thought that was an effective technique of providing the Federal Reserve with the revaluation guarantee that was essential under any such forward operations.

As usual in crisis periods, Mr. Coombs continued, the Swiss franc had come under speculative buying pressure. At the end of March the Swiss National Bank executed a total of nearly

$500 million of dollar swaps with the market so as to inject temporary liquidity into the Swiss money market. Nevertheless, that Bank was forced to take in nearly $400 million more on an outright basis last week. Furthermore, the Swiss officials were concerned about the risk of heavy additional inflows this week, in view of the long Easter weekend coming up. He had been expecting that they might ask the Federal Reserve not only to draw on the swap line to cover their inflows, but also to engage in forward operations in Swiss francs in an effort to reassure the market. For the time being, however, they had tried to deal with the situation themselves by giving their banks a temporary guarantee, valid through next Tuesday, that the Swiss National Bank would take in any dollars offered at the present ceiling of 4.2950. He thought that would help considerably in getting through the immediate difficulties as far as the Swiss franc was concerned. It also would have a useful sympathetic effect on other markets.

Mr. Coombs said he had also been gratified that the U.S. Treasury had gone ahead with a new issue of $1-1/2 billion of certificates of indebtedness to foreign branches of U.S. banks, thus absorbing dollars that might otherwise have flowed back to the Euro-dollar market. The residual Euro-dollar debt of U.S. banks had now been reduced to a level that should impose a much less burdensome charge on the U.S. balance of payments over the months to come.

Despite the avalanche of dollars that had descended upon the European central banks in recent weeks, Mr. Coombs remarked, the Federal Reserve swap debt position remained relatively small, with a total of $450 million outstanding to the Belgians and $170 million to the Dutch. He thought it fairly likely, however, that the Swiss would soon ask the Federal Reserve to make a drawing, possibly on the order of $350 - $400 million. And it was becoming increasingly likely that the Bank of France would also ask the System to take some dollars off its hands through a swap drawing. Such swap drawings might well prove irreversible and eventually require settlement in Treasury reserve assets.

Meanwhile, Mr. Coombs observed, the Treasury's reserve position was holding up well; the German Federal Bank was still refraining from exercising its option to repurchase $500 million of gold from the Treasury. The only major gold order in sight was an order for $282 million from the Bank of France, in connection with a French debt repayment to the International Monetary Fund falling due early in May. As in previous months the United States continued to be favored by the fact that the bulk of the U.S. official payments deficit reflected acquisitions of dollars by the Bank of England, the German Federal Bank, and the Bank of Japan--none of which seemed presently inclined to convert such dollars into other reserve assets or even to ask the System to draw on the swap lines. But the massive reserve

gains by the British, Germans, and Japanese would sooner or later shift into other, and perhaps less cooperative, hands. Meanwhile, the very existence of those large gains continued to generate speculation against the dollar. In the past two days the markets had quieted down considerably, mainly owing to the reassurance provided by the forward mark operation, the Swiss guarantee of the exchange rate, and Mr. Volcker's statement. But so long as major disparities between U.S. and foreign interest rates persisted and continued to magnify the U.S. payments deficit, there was a risk of recurrent crises of increasing intensity.

Chairman Burns then asked Messrs. Solomon and Daane to report on foreign meetings they had recently attended.

Mr. Solomon made the following statement:

> The meeting of Working Party Three during the week before last is worth reporting on because it provided a useful insight into the views of senior officials of the major countries about international monetary problems. Last week's speculative flurry tells us something of the views of market participants. But at WP-3, Treasury and central bank officials, though concerned about the magnitude of short-term capital flows, were, if anything, less uneasy than we expected to find them.
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> The meeting focused on international monetary flows and the discussion began with a fairly full exposition of the economic background for U.S. monetary policy.
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> Let me summarize the major questions that European officials raised about U.S. policy--particularly about the very steep decline in short-term interest rates. While accepting the desirability of promoting recovery of the U.S. economy, they wondered whether

there could not have been more reliance on fiscal policy and less on monetary stimulation. Secondly, given the policy mix, they questioned whether it was necessary for short-term rates to fall as much as they did in order to encourage economic expansion through monetary policy. Thirdly, when they were told that U.S. long-term rates are at levels that are very high by U.S. standards, they pointed out that U.S. experience does not include a recession in which prices were rising at a rate of 3 or 4 per cent a year. They did not accept the proposition that U.S. long-term rates are so high in the circumstances. Finally, there was commendation for the various selective measures taken by the U.S. Treasury and the Federal Reserve to stem the outflow of short-term funds.

The discussion recognized that the flow of short-term capital was a result not only of a push from the United States but also of a pull from Europe, where interest rates were very high and where restrictive fiscal policy had not been relied on enough. The view was expressed that both Germany and the United Kingdom could tolerate somewhat lower short-term interest rates.

Since the meeting, as you know, both the German Federal Bank and the Bank of England have lowered their discount rates by one percentage point, and a number of other central banks have joined in.

There is certainly reason to believe that we are on our way toward a convergence of short-term interest rates between the two sides of the Atlantic. Whether it is now too late--that is, whether speculative flows will now take over in volume--will probably be revealed in the next two days.

As far as U.S. monetary policy is concerned, I can only repeat what I said four weeks ago, but with greater emphasis this time. It seems even more clear to me today that, given the rate at which the aggregates have been growing, the Committee faces no conflict at the moment between domestic and international considerations. From both points of view, there is a good case in my judgment for a firming of short-term interest rates.

Mr. Daane said he might add a postscript to Mr. Solomon's report before commenting briefly on the meeting of the Deputies

of the Group of Ten. At the WP-3 meeting the U.S. representatives were specifically questioned about the concept of "benign neglect" of the balance of payments, and they made it clear that such a concept did not represent official policy. In his press conference following the meeting Mr. Emminger said there was nothing in the attitude of U.S. officials to suggest benign neglect.

Mr. Daane then noted that the G-10 Deputies had met in Paris on March 25. The main purpose of the meeting was to determine just where matters stood with respect to the question of limited exchange rate flexibility. The conclusion was that matters stood just about where they had previously. The countries of the European Economic Community had not yet reached a common position and it was obvious that until they did matters would not move forward on that front. At the same time, Under Secretary Volcker had made it clear that the United States continued to be interested in limited exchange rate flexibility and thought it would be desirable to keep the matter under active consideration. Those comments were not inconsistent with the Treasury's weekend statement, to which Mr. Coombs had referred; they did not suggest that the United States was seeking or expecting any immediate changes in the exchange rates of other countries. At the G-10 meeting Mr. Volcker simply reaffirmed the U.S. view favoring the introduction of somewhat more exchange rate flexibility at a future time, following further study by the Fund

and the Deputies. The Deputies planned to meet again in early July for another stocktaking.

In a concluding observation Mr. Daane said that the so-called Zijlstra group of Deputy Governors--the Steering Committee on the Euro-dollar market--had deferred the meeting originally scheduled to be held in Paris on March 26. The meeting was now scheduled for Saturday morning, April 17--that is, during the weekend of the next Basle meeting.

Chairman Burns asked if the members had any questions concerning the matters reported on by Messrs. Coombs, Solomon, and Daane.

Mr. Coldwell said he was hopeful that the speculative surge Mr. Coombs had described would not get out of hand. At the same time, he wondered whether contingency plans were being prepared for handling dollar inflows to foreign central banks--and, in general, for protecting the dollar--in the event matters developed adversely.

Chairman Burns replied that work on such contingency plans was going forward both at the Board and at the Treasury. Some discussions had already been held between the two agencies and further meetings were planned for this week. He thought there would be little point in discussing those contingency plans today because there were some differences of view that still had to be ironed out.

In response to a question by Mr. Brimmer, Mr. Coombs said that none of the recent forward operations in German marks had been for Treasury account. However, before conducting such operations for System Account he had determined that the Treasury concurred in them.

Mr. Daane remarked that if his understanding was correct it was not inconceivable that the Treasury would engage in similar operations at some point.

Mr. Coombs agreed that the Treasury might well find it desirable to do so. If they did, however, in order to get a revaluation guarantee it would be necessary to make special arrangements similar to those that had been made on earlier occasions when the Treasury had operated in the forward markets for Belgian francs and Dutch guilders. On this occasion a special meeting of the Council of the German Federal Bank would have been required to approve such arrangements, and since time was short it was simpler to operate for System Account.

Mr. Daane referred to the Special Manager's observation that the System's holdings of marks would provide cover for only a limited volume of forward mark operations. He (Mr. Daane) thought the Committee should give careful consideration to any proposals to activate the swap line to obtain cover for operations beyond that point. However, he did not consider it necessary to pursue the matter today.

Mr. Coombs noted that such use of the swap line would be consistent with the procedure that had been followed in the past for the purpose of providing the System with a revaluation guarantee. The only novel aspect of the current proposal was that the drawings would be contingent, rather than actual.

Chairman Burns asked why Mr. Daane thought the proposal needed fresh study if it called for essentially the same procedures as had been followed under similar circumstances in the past.

Mr. Daane said that present circumstances differed from those of the past in some respects, including the German authorities' possible attitude following the use of the swap line by the System to obtain cover for its forward operations; the Germans could raise a question of the System's covering their holdings of dollars in the same way. He thought the resulting problem could be important, but that it was not one which the Committee could resolve at this time. The approach Mr. Coombs had suggested might well prove to be appropriate but he personally would like to reserve judgment until a decision was necessary. It was his understanding that Treasury officials also had some reservations about the proposal.

Mr. Brimmer expressed the view that the Committee should be brought up to date on the matter in light of Mr. Daane's reservations, and also in light of the technical difference from similar

operations in the past and the fact that such operations had not been employed for several years.

Mr. Robertson remarked that he could not see any substantive difference between a contingent drawing for value three months hence and a drawing made today.

Mr. Coombs said that was his view also. The only difference was that a contingent drawing on the German Federal Bank would not result in an immediate increase in the dollar holdings reflected in the accounts of that Bank.

Mr. Heflin recalled that Mr. Coombs had described exchange markets as being in the early stages of a crisis, but then had agreed that a crisis was not necessarily inevitable. He asked whether Mr. Coombs had meant to imply that a crisis might erupt at any moment.

Mr. Coombs responded that he could not predict how the situation would develop. There had been some very strong pressures which, if not checked, could have represented the beginning of a serious crisis. As he had indicated, the situation had become calmer in the last two days mainly as a result of the operations in forward marks, the action of Swiss National Bank, and Mr. Volcker's statement. However, he did not know how long the present situation would last. It was prudent, in his judgment, to recognize that some event--a political development, an incautious statement by a public official, or whatever--might start the wheels of speculation

moving again. To an important extent, the exchange markets were at the mercy of events.

Mr. Mayo observed that the recent speculation might have reflected an emotional wave associated with the unwinding of the Euro-dollar problem and the large disparity between interest rates in the United States and abroad. If, as Mr. Solomon had suggested, those rate spreads were beginning to narrow--or at least did not widen further--and if policy makers acted prudently, there might well be grounds for hoping that conditions would now be relatively calm.

Mr. Coombs said he thought that at best 1971 would prove to be a difficult year. The problem was one of confidence, and confidence had been badly shaken. So far this year the United States had incurred an official settlements deficit of $6.6 billion--a figure that represented a tremendous annual rate. He would hope that the rate of deficit would decline as the year progressed, but it was still going to be very large for the year as a whole; and that meant that U.S. reserve assets would be reduced significantly. One major risk was that the Treasury's reports over the course of the year showing those reductions could intensify the speculative fever, and could lead to the kind of speculation that fed on itself. Under present circumstances he would not want to count on good luck or on the hope that the market had passed through an emotional period which was now over.

Chairman Burns said it was still true that a convergence of interest rates here and abroad would do a great deal to clear the atmosphere. He suspected that that process was just getting under way.

Mr. Coombs agreed that a narrowing of interest rate spreads would be of tremendous help.

> By unanimous vote, the System open market transactions in foreign currencies during the period March 9 through April 5, 1971, were approved, ratified, and confirmed.

Mr. Coombs then noted that six System drawings on the National Bank of Belgium, totaling $280 million, would mature in the period from April 19 through May 10, 1971. Five of those drawings would be maturing for the first time and one--a $15 million drawing coming due on May 10--would be maturing for the second time. Unless there was a substantial change in market conditions the drawings would have to be rolled over, and he would recommend such a course.

Mr. Robertson said he did not see how the Committee could object if in fact that were the only course open to it.

Mr. Coombs commented that renewal of the drawings seemed to him to be the only practicable alternative. In principle, the Committee could ask the Treasury to provide a take-out, but in light of the present strained circumstances in the markets he did not think that would be desirable.

Renewal of the six swap drawings on the National Bank of Belgium was noted without objection.

The Chairman then called for the staff report on domestic economic 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. Partee made the following statement:

The business situation during March remained generally dull. This is indicated both by the statistics for the month available to date and by the qualitative comments from most of the District summaries contained in the red book.[1] Aside from the continuing effects of the catch-up in auto output (a considerable part of which has been going into inventory), the fast pace of steel production as stocks are built up as a hedge against a strike this summer, and increased activity in the construction and building materials sectors, there still isn't anything much that can be pointed to as solid evidence of an upturn. Retail sales seem to have picked up a bit in March, with pre-Easter sales of general merchandise relatively good lately. But industrial production apparently changed little in March, despite higher steel output and maintenance of auto assemblies at a 9 million rate. Unemployment moved back to the 6 per cent level, with employment stable and the labor force up only slightly following the unusual February decline.

Indeed, if appropriate allowance is made for the effects of the auto strike, I believe that the first quarter would probably rank as the cyclical low. We still estimate that the first-quarter rebound in GNP was very large--on the order of $27.5 billion--but more than $20 billion of the advance was due to the resumption of output at General Motors. The residual increase is more than offset by the probable rise in the GNP

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

deflator, implying an appreciable decline in non-automotive real GNP. Industrial production declined further in the first quarter, after subtracting out autos and trucks, as did manufacturing employment adjusted for workers on strike. Total nonfarm employment in the first quarter averaged less than 100,000 above the third quarter of 1970, before the auto strike commenced. Retail sales, exclusive of autos, were no higher in the first quarter than in the fourth, which implies some decline in real terms. And inventory investment in the first quarter appears to have turned negative, if allowance is made for the buildups in steel and auto stocks.

The significance of viewing the first quarter as the cyclical low, rather than some earlier period, is that this casts first-quarter developments in an entirely different light relative to expectations for the future. There has been a tendency to regard the disappointing first-quarter results as raising doubts about the course of economic recovery in the months ahead. But this is because most observers thought that we were already in an upturn and that the emerging signs of recovery, in that context, were unusually weak. If, instead, the cyclical recovery still lies ahead, then there is little basis as yet for saying that the economy lacks the customary vigor of a recovery period. It may well do so, particularly since the recovery is apt to be interrupted at a very tender stage by a steel strike, but the evidence is not yet in hand.

If the economy is viewed as being at the very beginning of a cyclical recovery, some of the incoming evidence can be regarded as at least moderately encouraging. Construction outlays are rising strongly, both for residential building and for State and local projects. Residential outlays for the first quarter are estimated to be $3.6 billion higher, at an annual rate, than in the fourth quarter of 1970, while recently revised estimates for State and local construction indicate a quarter-to-quarter rise of $3-1/2 billion that is relatively even more impressive. Gains of this size cannot be expected to persist, since they in part reflect a catch-up in expenditures from depressed levels, but continuing sizable increases seem clearly in prospect in both sectors. The possibility of a pickup later this year in manufacturers' capital outlays, as projected by the recent Commerce-SEC survey,

also seems more reasonable when viewed in the context of a developing business recovery. And the inventory liquidation in manufacturing reported over recent months, making allowance for autos and steel, is a traditional precursor to renewed accumulation of stocks once sales pick up and prospects brighten.

The situation with regard to consumer spending admittedly remains ambiguous. There are a few faint stirrings of increased buying interest at the retail level. General merchandise sales, related to past years with Easter as a reference date, are up more than in either 1970 or 1969 on a year-to-year basis. Distributor sales of color TV sets have strengthened markedly over the past several months, and furniture and appliance sales generally rose appreciably in the first quarter. Domestic new car deliveries increased considerably in the last 10 days of March, to a rate above 8.5 million units--though the 10-day sales reports are notoriously volatile. Retail sales generally must still be regarded as sluggish relative to incomes, however, and consumer surveys have not yet shown an appreciable improvement in attitudes. The index of consumer sentiment compiled by the Michigan Survey Research Center improved somewhat in the February survey, but the weekly Sindlinger survey has shown slight deterioration again over the past month or so, following moderate earlier improvement.

In the past, however, consumer surveys have repeatedly shown marked improvement following a firming up in income and job prospects. If the economy is at the point of recovery, therefore, future surveys may well show a strengthening trend. Incomes should be moving up more rapidly in the spring and summer if industrial output and final sales do begin to strengthen. In addition, we are now expecting substantial additions to income flows stemming from the retroactive increase in social security benefits, which will be paid out in late June, and from a military pay bill which seems an increasingly likely prospect for passage by around mid-year. Altogether, I am inclined to feel that consumer spending is likely to show a noticeable improvement during the spring and summer, although a continuing weak job market--and the probability of still higher unemployment among new labor force entrants--are likely to be retarding forces.

The prospect of a strengthening business situation along the lines I have described is in no way inconsistent with staff GNP projections for the remainder of the year. The second-quarter projection is for an increase of $17 billion, which is considerably more than in the first quarter after making allowance for the one-time effects of the resumption of output at General Motors. Staff projections for the third and fourth quarters strengthen further, with increases, on average, at annual rates of 8-1/2 per cent in current dollar GNP and 4.3 per cent in real output. The point of my discussion is to present some alternative reasoning that also leads to expectations of a brightening business picture in the months ahead, despite a bleak winter. In addition, however, I would like to emphasize the difficulty of gauging with any great accuracy the extent and rapidity of an economic recovery before it is even convincingly in progress.

At present, it does not appear likely that the recovery will develop unusual--or perhaps even average--momentum in its first year. Unfavorable factors are too numerous, and the scars of a deeper and considerably longer recession than had been anticipated too fresh, to suggest a sharp cyclical movement, at least initially. Productive resources will remain underutilized for some time to come, in any event, and I believe that there is room for some additional fiscal stimulus of a temporary nature. But I am now inclined to agree with those who believe that monetary policy has provided about as much stimulus to the economy as prudently can be injected from the standpoint of a longer-term strategy. Credit flows in the first quarter were very substantial, as discussed in the green book,[1/] and credit is now abundantly available for all uses judged creditworthy at this point by lenders. Long-term market interest rates have dropped back close to the February lows, and should continue to drift lower in the months ahead if the staff economic forecast is approximately correct. And the monetary aggregates have responded very well to our efforts this past quarter toward achieving a temporarily faster rate of growth.

In sum, I would not advise the Committee to seek to stimulate a flow of credit in the second quarter

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

> greater than that achieved in the first, which was accompanied by expansion in the narrowly defined money supply at an 8 per cent annual rate. Our projections of the financial relationships, based importantly on expected GNP growth, suggest that expansion in the money supply is likely to be somewhat more than that if current money market targets are retained. I think that such a development should be resisted, and therefore that the Committee will need to consider today whether the time has come for a cautious probing toward somewhat firmer money market conditions.

Chairman Burns then called for a general discussion of the economic and financial situation and outlook. He suggested that the members note any points at which their judgments differed from those of the staff, and that they bring to the Committee's attention any additions to the staff's analysis that might be useful and any new information that had come their way.

Mr. Daane observed that there had been a good deal of discussion in the press recently about possible fiscal actions to stimulate the economy. He asked whether there was reason to believe that such actions would be taken in the near future.

Chairman Burns said it was now recognized within the Administration to a much greater degree than earlier that the monetary authorities had done their job well, and that if any further stimulation was needed it would have to be provided by fiscal policy. The question of whether fiscal stimulation was needed was currently under active discussion, but no decision had been made as yet and none was likely in the next few weeks.

Personally, he thought the Administration was wise in waiting a bit before deciding.

Mr. Mayo noted that some fiscal stimulus not contemplated in the budget would result when the recently enacted increase in social security benefits was implemented.

Mr. Partee observed that the staff's GNP projections already allowed for the stimulative effects of the social security legislation. Although the specifics of the actual legislation differed in some respects from those assumed in the projections, in terms of the amount of stimulus the differences about canceled out. He might mention that in the latest projections allowance had been introduced for another source of fiscal stimulus not fully allowed for in the budget--namely, a military pay increase amounting to about $2.5 billion, at an annual rate, beginning July 1, 1971. The House of Representatives had already passed a bill providing for such an increase, and it had been assumed that legislation finally enacted would be similar to the House bill.

Mr. Coldwell remarked that business conditions still appeared to be very sluggish. Many businessmen with whom he had talked were concerned about such matters as wage-push inflation, the capital costs of pollution control, heavy Federal deficits, and the prospects for rising interest costs. Bankers saw little change in the level of loan demand or in the local business

scene. In general, people seemed not only somewhat pessimistic but also confused and uncertain. He shared their concern and much of their confusion.

Mr. Coldwell then referred to Mr. Partee's observation that the trough of the cycle might best be considered to have occurred in the first quarter of 1971 rather than in some earlier quarter. He asked whether such a change in the interpretation of the past should not result in some change in the projections of the future.

Chairman Burns noted that the proposed change in dating of the trough involved a shift of only one quarter--from the fourth to the first. Moreover, as he understood it, Mr. Partee was referring to the trough in an analytical rather than an absolute sense.

Mr. Partee added that Administration analysts were tending to use November 1970 as the low point of the cycle on a monthly basis. In his judgment that was not a good analytic choice, partly because the General Motors strike was still under way in that month; looking at more general output and sales data, he would be inclined to choose a month in the first quarter--perhaps February. If in fact the cyclical improvement in the economy was still to come, one should not be expecting businessmen to be talking about recovery as yet and the discouraging news of the past few months should not be regarded as surprising.

Mr. Coldwell then asked if Mr. Partee would still expect long-term interest rates to drift lower in the months ahead if short-term rates were to rise further, or if corporations planning capital issues were to accelerate their offerings.

In reply, Mr. Partee said he thought the present situation in financial markets was quite delicate. Participants in the long-term market were watching money market conditions very closely, and any upward movement in short rates at this point no doubt would produce a sympathetic reaction in long rates for a brief period. However, if the improvement in the economy over the course of 1971 was no greater than the projections indicated, it seemed reasonable to expect long rates to drift downward on balance--much as they had in 1961-62, which was also a period of a rather weak recovery. An increase in short rates could lead to capital market problems in the near term if it induced many corporations to accelerate their bond offerings; it seemed quite possible that as many as fifteen or twenty corporations planning sizable capital issues might do so. However, he thought such a development would simply postpone the downdrift in long rates until summer or early fall.

Mr. Maisel asked whether the demands on capital markets were likely to be more closely related to the growth rate in real or nominal GNP. He noted that the staff's projections suggested that real GNP would grow at only about one-third the rate typical

of other recent recoveries, but that dollar GNP would expand nearly as rapidly as in the past.

Mr. Partee observed that the mix of cash versus credit expenditures would probably be affected if real GNP was growing slowly; for example, business fixed investment was unlikely to be very strong. As a general rule, however, demands on credit markets were likely to be more closely related to the change in current dollar GNP than to the change in real GNP, since it was dollar outlays that had to be financed.

Mr. Morris commented that the staff's economic projections appeared to be essentially unchanged from a month ago. That led him to wonder about the basis on which Mr. Partee had changed his recommendation for policy.

In reply, Mr. Partee said he might first note that while the projections for aggregate GNP had not been changed much, there was a sense in which they could be said to suggest a little more strength than earlier. What he had in mind was the fact that the projected growth rates had been reduced for the first half of 1971 and increased by a roughly corresponding amount for the second half. Those revisions implied a greater step-up in the rate of recovery as the year progressed--an implication that was significant for monetary policy because, in light of the probable lags, it would be reasonable to formulate policy today mainly with an eye to the business situation expected around the end of the year.

A second consideration underlying his policy recommendation, Mr. Partee continued, was the very large volume of credit flows recently, as reflected in the preliminary flow-of-funds data for the first quarter. Obviously, credit was now readily available in all long-term markets and in short-term markets as well; and the monetary aggregates, after lagging over the winter, recently had strengthened greatly. In effect, monetary policy had already become highly stimulative, and in his judgment no further liberalization was needed.

Finally, Mr. Partee said, the prospective growth in GNP was fairly substantial in dollar terms, and seemed likely to be associated with a growing demand for money. That suggested the need for somewhat higher short-term interest rates in order to keep the monetary aggregates from growing at a faster rate than the Committee had previously desired. He was suggesting a slight firming of policy in terms of money market conditions, but not in terms of the aggregates.

Mr. Morris observed that the staff seemed to be laying heavy stress on the sharp rise in $M_1$ that had occurred in the past three weeks. In his judgment that increase was clearly related to an unusual decline in Treasury balances. He wondered whether the staff might be thinking in terms of "instant equilibrium," and misinterpreting a temporary disequilibrium situation as reflecting a sudden increase in the demand for money.

Mr. Axilrod agreed that the decline in Treasury balances during the past week or two had had some effect on the level of $M_1$. He should note, however, that the decline in such balances had exceeded projections mainly because of the postponement of a Treasury security issue which banks would have been permitted to pay for by credits to tax and loan accounts; the patterns of Treasury receipts and expenditures had differed only a little from staff expectations. In his judgment, if the financing had been conducted on schedule and tax and loan accounts therefore credited earlier, the money supply would not have been significantly lower; the main effect on the money supply from the Treasury financing itself would come later, when the banks sold off the new securities to the public.

Mr. Axilrod went on to say that he did not think the staff projections were based on an assumption of "instant equilibrium." For example, it had been expected that the upward effects on the aggregates of the sharp first-quarter drop in interest rates would take time to work out and would continue into the second quarter, as reflected in the substantial growth rates in the aggregates projected for that quarter under current money market conditions. He might add--since occasions for this sort of statement did not arise often--that the staff's model had projected growth in $M_1$ in February and March with a remarkable degree of accuracy.

Chairman Burns commented that any satisfaction that might be derived from the precision of particular projections should be tempered by the uncertainties associated with others. As a case in point, he had been advised last Thursday morning that $M_1$ was projected to grow in April at an annual rate of 5.5 per cent, but within another day he had been told that the projection had been revised upward to 10 per cent.

Mr. Solomon said he might note in further response to Mr. Morris that his own analysis had been based not on the behavior of $M_1$ in recent weeks but on the behavior of all of the aggregates in recent months.

Mr. Francis said it seemed to him that the economy was at a critical stage in a transition from the aftermath of the excesses of the period from 1965 through 1968. At present inflation was still strong, and for some time unemployment had remained above levels that would be desirable for the long run. He thought such conditions would continue for some months regardless of the stabilization policies followed now.

Transition to a viable economic stability was a long and arduous process involving costs in lost production and jobs, Mr. Francis remarked. However, the costs in terms of lost employment had been kept relatively low, as evidenced by the fact that a larger percentage of the population of working force age was employed today than in any year from 1952 through 1965. Because

of the persistence of higher rates of inflation, the period of correction was likely to be longer and to require continued patience.

Mr. Francis noted that unemployment currently was about 6 per cent of the labor force. Many analysts considered 4 per cent as practical "full" employment, but perhaps 4-1/2 or 5 per cent accompanied by price stability was more nearly the long-run attainable level under present labor market arrangements. In the last decade whenever the unemployment rate had been below 5 per cent inflation had accelerated, largely because of labor market imperfections. Consequently, the current marginal transitional cost in terms of unemployment of reducing the inflation was possibly 1 or 2 per cent of the labor force, and involving unemployment for a period averaging 10-1/2 weeks. Part of that marginal unemployment had been caused by inevitable dislocations resulting from cutbacks in the nation's defense program.

Mr. Francis commented that the inflation burden, on the other hand, was borne not only by the 94 per cent who were employed but also by those retired and others not in the labor force as well as the 6 per cent who were presently unemployed, but living off savings, unemployment benefits, or welfare. The loss of economic well-being from a continuous erosion of purchasing power of pensions, holdings of savings, or losses on contracts was no less real than the loss from unemployment.

The classical quick solution of the price-unemployment problems had been delayed, Mr. Francis said, by a lack of flexibility in wages, other monopolistic or regulatory interferences in markets, and inadequate labor market information. Nevertheless, necessary economic adjustments had been proceeding, and the outlook was now brighter. Most projections of future developments indicated a gradual decline in the rate of inflation, an acceleration in the growth of real output, and a gain in employment.

Mr. Heflin reported that his staff agreed with the general thrust of the projections shown in the green book, but they expected a somewhat smoother rise in GNP over the first half of the year. They thought growth in the first quarter would prove to have been somewhat smaller than shown in the green book, chiefly because their estimates of consumer spending on durable goods were lower than those of the Board's staff. For the second quarter they expected growth to be a little faster than the green book projection--partly because most of the recent statistical revisions had been in an upward direction, and partly because they thought that the recent substantial strengthening of money growth would stimulate consumer spending.

With respect to the second half of the year, Mr. Heflin noted that the green book projections were based on the assumption of a 60-day steel strike in the third quarter. If the strike was shorter--or did not occur at all--a smoother

pattern of growth could be expected in the second half as well. He doubted that the unemployment rate would rise to the 6-1/2 per cent level projected in the green book, but at the same time he saw little reason to hope that it would fall very far below the current level of 6 per cent by year-end. While the recovery projected was substantial, it seemed rather clear that it was not strong enough to make major inroads into the large pool of idle resources that had developed over the last year.

Mr. Heflin remarked that under those circumstances, and in light of the problems in the international arena, the Committee probably should be thinking today in terms of policy for the period until the next meeting rather than for the entire second quarter; and it should focus primarily on interest rate relationships and only secondarily on the near-term behavior of the monetary aggregates. As he interpreted the comments of Messrs. Daane and Coombs, at this point the performance of short-term interest rates in the United States could have highly important implications for the international financial situation. That situation probably ruled out any reductions in the discount rate or in reserve requirements for the time being.

Mr. Kimbrel said he found much to agree with in the staff's latest GNP projections. In previous economic recoveries prices had usually held while monetary policy was trying to stimulate demand. In the present recovery period, however, there still was an

unacceptable rate of inflation. Typically, productivity increased in recoveries, and in that respect the current recovery was unlikely to be an exception. There was a real question, however, whether the beneficiary of those productivity gains would be business, labor, or the consumer. The Federal Reserve should be encouraging businessmen to pass those lower costs on to the consumer. If the System showed by its actions that it sought gradual rather than overly rapid recovery, it would strengthen the fundamentals that were working toward less inflationary conditions. But if it now turned to an even more stimulative policy, businessmen might be drawn to the conclusion that the System was no longer striving to have business hold down price increases and to encourage expansion at a noninflationary rate. Regardless of the slack in the economy, business and labor set prices and wages in an environment that the System influenced to some extent. Therefore, if the Committee lost its "cool" much of its recent success in slowing the inflation could well evaporate--with the resulting risk of seeing the economy develop severe strains in the future when full employment returned, or earlier.

Finally, Mr. Kimbrel said, he considered the international economic news to underscore the need for maintaining confidence. For monetary policy to become more stimulative could seriously undermine that confidence.

Mr. Mayo said he basically agreed with Mr. Partee's analysis. He would add only two observations, the first of which related to the auto industry. Like others, he had been aware that small cars were of great importance in the present market. Just how important they were was brought home to him this morning by the publication of figures indicating that during the first quarter about 350,000 imported cars had been sold. That compared with sales a year earlier of 260,000 imports--itself a record at the time. Moreover, Detroit was finding that sales of the new small American models were being made primarily at the expense not of imports but of larger American cars. In effect, U.S. manufacturers were suffering not only from the increased competition of imports but also from lower average selling prices for their cars.

His second point, Mr. Mayo continued, was related to the fact that Mr. Partee's analysis seemed to be more cheerful today even though the quantitative GNP projections had been changed very little. He hoped that Mr. Partee's increased optimism was not predicated on the assumption that the proposed shift in the date of the trough from the fourth to the first quarter would be widely accepted, because he did not think it would be. For practical purposes, and particularly in light of the margins of error in the data, he thought the most meaningful interpretation was that economic activity had been essentially flat for five quarters.

Mr. Hayes commented that the assessment of the economic outlook by the New York Bank was relatively close to that of the Board's staff, as had been the case for some time. He had no convictions about the proper timing of the trough, but in general he agreed that moderate expansion was the most likely prospect even though the economy at present was admittedly quite sluggish. He shared Mr. Francis' view that patience would be required with respect to unemployment. While he did not expect the unemployment rate to rise further, he did not think it would decline significantly before early 1972; and he was not certain that it would fall then as much as some present projections suggested. In his judgment a gradual recovery was desirable, since rapid expansion would involve a great danger of creating a new wave of inflation. He took some comfort from recent statistics suggesting that the price advance was slowing, but he recalled other recent occasions when similar indications had proved illusory. Certainly the outlook for wage settlements remained grim. There seemed to be a good deal of pessimism in the business community regarding the probable effectiveness of the Administration's recent actions in the construction industry. Personally he hoped that those actions represented a first step toward an incomes policy, which was badly needed.

Mr. Hayes said he had little to add to the comments already made regarding the international financial situation except to note

that the problems in that area obviously should be given a high priority in the Committee's policy deliberations. He welcomed the Chairman's comments on fiscal policy, since he concurred in the view that if further stimulus was needed--as it well might be--it should come from the fiscal side.

With respect to the outlook in capital markets, Mr. Hayes agreed that there was a large backlog of new corporate bond issues that might be brought to market in the near future. At the same time, he thought there was a widespread conviction among knowledgeable observers that offerings would taper off substantially over the course of the year from their recent tremendous volume. The implication was that long-term interest rates were likely to be moving down, even though at the moment conditions in bond markets were highly sensitive.

Mr. Swan remarked that he agreed in general with Mr. Partee's assessment of the current economic situation. However, he had some difficulty with the staff's analysis in the blue book.[1/] In particular, he found it hard to believe that money market conditions would have to be firmed to the extent that the blue book suggested in order to slow the rate of monetary expansion. He hoped Mr. Axilrod would comment on that analysis in his statement later in today's meeting.

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

Mr. Daane said he was not only uneasy about the international situation but he also was less cheerful than Mr. Partee about the domestic outlook. While he hoped Mr. Partee's view was the correct one, he personally was disturbed by the indications of a malaise both here and abroad that seemed to extend beyond economic matters. He was not sure that economic prospects were that much brighter for the second half of the year, and he was not aware of any developments during the past four weeks that had tended to brighten those prospects.

Like Mr. Hayes, Mr. Daane continued, he welcomed the Chairman's comments on fiscal policy. He was particularly pleased that there was now a greater awareness within the Administration of the degree of monetary stimulus the System had provided, and that prospects for a better mix of stabilization policies had improved. He would not be at all surprised if it was found necessary to provide additional stimulus through fiscal policy.

Mr. Daane added that he agreed with Mr. Heflin that the Committee should focus mainly on interest rates at this time.

Chairman Burns then noted that at its previous meeting the Committee had briefly discussed the possibility of undertaking outright operations in agency issues, and that two memoranda on the subject had recently been distributed.[1/] After considering

[1/] One of the memoranda referred to, prepared by the staff, was dated March 23, 1971, and entitled "Federal Reserve Open Market Operations in Federal Agency Issues." The other, from the Committee's General Counsel, was dated March 24, 1971, and entitled "Exchange of maturing Federal agency issues for new issues." Copies of these memoranda have been placed in the Committee's files.

the question at some length he personally had concluded that it probably would be desirable for the System to undertake such operations. For one thing, they would constitute an additional policy tool that could prove useful under certain conditions. For another, there was sentiment in Congress for the System to take steps that would be helpful for housing. He was inclined to doubt that System operations in agency issues would accomplish much in that connection, but he could well be wrong and it would be worthwhile to put the matter to the test. Also, if the System declined to use the tools Congress had provided, other less desirable legislation might be enacted in the hope of benefiting housing.

However, the Chairman continued, he thought the Committee should postpone action on the matter. The Treasury was about to propose legislation that would permit the consolidation of the issues of various Federal agencies, and in the Treasury's judgment a System decision to undertake outright operations in such issues at this time would damage the chances that that legislation would be enacted. While he thought those chances were not very good in any case, the Treasury's position was understandable. Moreover, the need for the additional policy tool was not very strong at the moment.

The Chairman asked whether there would be any objection to deferring the matter. He added that he probably would recommend

outright operations in agency issues at a later point, assuming his thinking did not change in the interim.

Mr. Brimmer observed that there was some question as to whether it was appropriate for the System to operate in issues of those Federally sponsored agencies that were wholly under private ownership. He hoped the staff would look into that question and make definitive recommendations.

Chairman Burns said he understood from Mr. Holland that a staff study of the question was already in process.

Mr. Robertson remarked that since the matter of operations in agency issues had been held in abeyance for a long time he thought there would be little harm in some further delay.

Mr. Hayes said he was agreeable to holding the matter over. He added that he felt strongly that it would be undesirable to undertake outright operations in agency issues.

Chairman Burns remarked that it would be helpful if Mr. Hayes would indicate his reasons for that feeling.

Mr. Hayes said he would briefly note his main reasons. First, he had grave doubts about the desirability of the System's operating in particular markets for the purpose of providing assistance to a specific sector of the economy. To do so was likely to expose the Federal Reserve to strong pressures to provide similar assistance to other sectors. Secondly, the fact that the agency market was highly fragmented, with frequent and rather

haphazard new offerings, would pose serious problems for System operations. Those problems would, of course, be reduced if agency issues were consolidated, as under the legislation the Treasury planned to recommend.

Chairman Burns commented that both of Mr. Hayes' points made very good sense to him, and he thought the first offered a particularly strong argument against outright operations in agency issues. Nevertheless, in his judgment such arguments were outweighed by those on the other side, and as he had indicated he was presently inclined to favor agency operations.

The Chairman then noted that at the preceding meeting he had suggested that Committee members think about the possibility of having an independent accounting firm participate along with the Board's examining force in the annual audit of the System Open Market Account. Since that time a memorandum on the subject had been distributed to the Committee.[1/] He asked Mr. Holland to comment.

Mr. Holland noted that on the basis of a preliminary analysis it appeared that it would be quite feasible to work out arrangements for an outside accounting firm to participate in the annual audit of the System Account at a cost that probably would

1/ The memorandum referred to, from Mr. McIntosh, Director of the Board's Division of Federal Reserve Bank Operations, was dated March 30, 1971, and entitled "Audit of System Open Market Account." A copy has been placed in the Committee's files.

not be substantial. He might emphasize that the proposal was for joint audits by the outside firm and the Board's examination force, and not for a substitution of the former for the latter. If the members were inclined to favor the proposal in principle the staff could proceed to work out detailed procedures and firm estimates of costs for Committee consideration.

In response to a question by Mr. Coldwell, Mr. Holland said that the matter had been discussed with Lybrand, Ross Bros. and Montgomery because that was the firm that currently audited the Board's accounts. It was contemplated that the audit of the System Account would be rotated among leading accounting firms, in parallel with the rotation used by the Board.

Mr. Swan said he thought the Committee should carefully consider some of the implications of the proposal before approving it. He knew of no reason for dissatisfaction with the quality of the examination made by the Board's staff, but if outside auditors were nevertheless brought in observers might infer that the present type of examination was considered inadequate. Such a development was likely to lend support to those who thought the System's accounts should be audited by the General Accounting Office.

In reply to a question by Mr. Clay, Mr. Holland noted that the purpose of the proposal was to enable the outside firm to issue an independent certified report of audit of the System Account each year. Thus, the role of the outside firm would extend beyond a

review of the procedures employed by the Board's examiners; as noted in Mr. McIntosh's memorandum, such a procedural review was now made regularly in connection with the Board staff's examination of Federal Reserve Banks and Branches, and three such reviews had been made of procedures for examining the System Account in the course of the last fifteen years or so. The reasoning behind the proposal was that differences in circumstances warranted a different approach to the examinations of the Reserve Banks and of the System Account. The Board's examination force was entirely independent of the Reserve Banks. However, it was not wholly independent of the Open Market Committee, since it was employed and paid by the Board, whose members also served on the Committee.

Chairman Burns remarked that there was no question in his mind about the adequacy of the current auditing procedures. However, while he had not studied the matter closely or pondered it long, it was his feeling that there probably was some advantage in having an independent accounting organization make the certification, since it would then be clear to Congress and the public that an objective examination had been conducted. Unlike Mr. Swan, he thought such a procedure might well reduce any pressure for an audit by the GAO.

Mr. Brimmer expressed the view that if the Committee were to decide to have an outside auditor examine the System Account an excellent case could be made for using the GAO rather than

a private firm. For that reason he would want to weigh the matter carefully.

Chairman Burns said he would have no objection to an audit by the GAO if it were confined to an examination of the accounting records themselves. He would object, however, to an audit that extended to policy matters, such as had been suggested at times in the past.

Mr. Robertson observed that he would go along with the proposal if it was considered helpful in terms of providing needed assurances to Congress and the public about the objectivity of the examinations of the System Account. However, he saw no advantage to the proposal from any other viewpoint; he was satisfied that the current examination and review procedures were about as good as any that could be devised.

Mr. Kimbrel said he also considered current procedures to be adequate, and he would be hesitant about making the proposed change. Mr. Mayo expressed similar sentiments.

Mr. Daane commented that he would be agreeable to the proposal for the sake of the advantages the Chairman had mentioned. He noted, however, that the statement of the "Objectives of the Examination" attached to Mr. McIntosh's memorandum included as one objective the determination that System transactions were "within the limitations imposed by directives of the Federal Open Market Committee." Since that language could be read as calling for a

consideration of policy questions, he thought it should be clarified if an outside accounting firm were to be brought in.

After some further discussion Chairman Burns remarked that the Committee probably had pursued the subject about as far as was useful today. He suggested that the staff be asked to work out some more clear-cut and concrete proposals for Committee consideration later, and that the members continue to give thought to the matter.

There were no objections to the Chairman's suggestion.

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 March 9 through March 31, 1971, and a supplemental report covering the period April 1 through 5, 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:

> Over the period since the Committee last met the monetary aggregates turned in a stronger performance than had been anticipated and, as a result, the Desk sought to achieve money market conditions a shade less easy than had earlier prevailed. Long-term interest rates, which had risen sharply in the interval before the last meeting, retraced a good part of that rise, despite a record volume of new corporate offerings. As the new issue rate on top-graded securities began to reapproach the 7 per cent level, however, investor interest slackened and longer rates have moved part of the way back in a cautious market, with considerable uncertainty about the international financial situation rising to the surface in the past few days.

Treasury bill rates rose substantially during the period, reflecting the Treasury's sale of $5 billion of bills to raise cash and a growing suspicion among market participants that the System might be moving to a somewhat less accommodative position in the light of the rapid growth of the monetary aggregates and the balance of payments situation. In yesterday's auction an average rate of 3.70 per cent was established on the three-month Treasury bill, up 39 basis points from the rate established in the auction just prior to the last meeting.

As noted earlier, the unexpected strength of the aggregates--amply described in the written reports--led the Desk to seek money market conditions a shade less easy than had prevailed. Early in the period, we sought to move the Federal funds rate from the 3-1/2 per cent level to somewhere between 3-1/2 and 3-3/4 per cent, and when the apparent strength was confirmed by data available last week, to 3-3/4 per cent in keeping with the Committee's instructions. As is sometimes the case, we were not altogether successful in achieving that aim. In the last statement week--a week ending on the quarterly statement date--the Federal funds rate averaged a touch over 4 per cent, despite massive injections of reserves and an apparently ample over-all reserve supply, as the high free reserve number for the week testifies. In combating the somewhat firmer money market conditions we made heavy use of the repurchase agreement--dealer financing needs were high in the wake of the Treasury's cash financing--making over $8 billion of such agreements over the period.

The Desk continued to buy Treasury coupon issues, acquiring just over $400 million over the period. Despite these purchases--and an additional $200 million bought for Treasury trust accounts--dealer positions in issues maturing in more than one year rose by about $175 million to over $1 billion, and yields in the intermediate area rose by 20 to 30 basis points last week. The weakness in the Government bond market last week was in part a reflection of the congestion in the corporate market, but there was also rather vigorous profit-taking by banks and others who had acquired securities at lower prices earlier in the year. Our own operations, too, may have induced dealers to take on more securities than they now feel comfortable

with in light of domestic and foreign uncertainties, particularly with a major Treasury refunding not far off. It would appear that further coupon purchases could be effected in the period ahead, but a cautious approach appears called for. There is the risk that an over-aggressive buying program could distort yields and cause problems for the Treasury in its refunding. A number of market participants already feel that the System has done too much.

Looking ahead, developments in the foreign exchange market could cast a pall over our domestic financial markets. With the economy continuing to appear weak and some respite from the record flow of new corporate issues likely in the second quarter--although the calendar could build up--a further decline in long-term rates would appear to be a good possibility under normal circumstances. Seasonal demand for Treasury bills should also be strong. But dealer positions in Governments are very heavy--at over $6 billion last Friday they were only a few hundred million below their all-time high--and a wave of speculation against the dollar could have untold consequences for our markets and for interest rates. As you know, foreign central banks took in over $1 billion in exchange market operations last Friday, and we will have to invest most of it for them tomorrow. The Treasury is prepared to issue more special certificates to foreign central banks to avoid putting undue downward pressure on short-term rates. But, with dealer bill positions over $4.5 billion, it would appear possible to follow a flexible approach and effect a sizable volume of purchases in the market. As for System operations, the outlook is for a need to supply a substantial volume of reserves in the second half of April.

As far as the aggregates are concerned, the blue book analysis suggests that we would have to bring about a very substantial tightening of the money market to stay on a 6 per cent growth path for $M_1$. There can be little doubt that a Federal funds rate in the 4-3/4 to 5-1/2 per cent range--as called for under alternative C--would have a disruptive effect on financial markets, particularly if brought about promptly, as it would almost have to be in light of the Treasury refunding. One can only hope that the relationship between the funds rate and monetary growth--as has often been the case--will turn out to be different from that the blue book suggests. It is also rather puzzling to note

that under all three directive alternatives the second-quarter growth rate projected for the credit proxy is lower than the rate projected for $M_1$. This is certainly not the historical relationship and it is hard to sort out the significance of such a pattern for the economy or for financial markets.

As you know, the Treasury raised $5 billion through the sale of Treasury bills since the Committee last met, and it will be raising an additional $1.5 billion through the sale of a special 5-3/8 per cent three-month Euro-dollar note scheduled for today. It will still have to raise additional cash by the end of the quarter, but some part of this might conceivably be raised through the sale of special certificates to foreign central banks. Late this month the Treasury will be announcing its plans to refund $8.4 billion in notes maturing on May 15, of which $5.8 billion are held by the public. The System holds about $1.7 billion of the maturing securities, and following recent practice, I would plan to roll them over into whatever new issues the Treasury offers in proportion to expected public subscriptions. Even keel considerations would suggest that, if the Committee contemplates a change in money market conditions, the change should be effected promptly so that the market will have a chance to adjust before the Treasury has to set the refunding terms on April 28. The market remembers vividly the near-disaster in last year's May cash financing, and any intensification of present uncertainties could make this a difficult refunding.

Mr. Daane noted that the Manager had suggested that in light of the forthcoming Treasury financing any desired change in money market conditions should be effected promptly. He asked the Manager to indicate just how soon even keel considerations would begin to offer a significant constraint.

Mr. Holmes replied that in his judgment any such change in money market conditions should be accomplished by the end of the next week.

In response to another question, Mr. Holmes said there would be no problems in the period ahead with respect to the

availability of coupon issues for purchase by the System; indeed, such purchases would serve a useful purpose in reducing dealer inventories. Nevertheless, he thought they should be approached with caution, because the effect on market yields could make it difficult for the Treasury to set terms in the refunding.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period March 9 through April 5, 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:

> The flow of funds data newly available for the first quarter and detailed in the green book can be used to help evaluate policy alternatives against the over-all credit and liquidity demands of the economy. In the first quarter a record amount of funds was raised by nonfinancial sectors of the economy in absolute terms, and relative to GNP the amount of funds raised was very nearly a record--all this in a period of declining interest rates. Banks supplied about 50 per cent of the credit, which was well above normal, but the record total of funds raised suggests that something more than mere reintermediation was in process.
>
> Credit flows during the past quarter were, as you know, centered on long-term markets, as they had been to a great extent in the fourth quarter of last year. The net external financing requirements of both businesses and State and local governments were very sizable, but some of the long-term credit raised appears to have reflected, particularly for businesses, a persisting desire to restructure debt and a continuing effort to improve liquidity positions. In addition, the extent of long-term financing might also anticipate a somewhat greater rate of spending later in the year by State and local governments and also businesses.

Accommodation of the very large long-term credit demands has also involved, indirectly, the reliquefication of other sectors of the economy. Commercial banks have been the principal buyers of State and local government securities, but their willingness to do so has been enhanced by large net inflows of deposits and a rebuilding of their own liquidity positions. For example, liquid assets of weekly reporting banks, including short-term municipals, are currently running over 12-1/2 per cent of total liabilities, almost 4 percentage points above late-1969 lows and also well above the peaks of late 1967 and late 1968.

Other financial institutions, too, have improved their liquidity noticeably over the past year. With this first order of business out of the way, savings and loan associations have greatly increased mortgage acquisitions. Mutual savings banks, on the other hand, turned actively toward the corporate bond market and acquired over 20 per cent of net new corporate bond issues in the first quarter, a very much higher percentage than normal for them.

Ultimately, so much credit could not have been financed in the first quarter at declining interest rates without the sizable expansion in monetary aggregates that occurred--an 8 per cent annual rate of expansion in $M_1$, a 17-1/2 per cent rate for $M_2$, and probably about an equally high rate for $M_3$. Such an increase in narrowly defined money and its close substitutes contributed to improving the liquidity position of the public generally. It should be pointed out, though, that there was some offset from an apparent large net decline last quarter in holdings of Treasury and Federal agency securities by households, as net new issues of these securities dropped to near zero and as net acquisitions by commercial banks rose sharply and purchases by foreigners continued relatively large.

The combination of continued strong demands for liquidity, relatively small net new issues of Treasury and Federal agency debt, and strong long-term credit demands from private nonfinancial sectors led to declines in short-term interest rates last quarter that were on balance greater than the declines in long-term market rates. Over the next few months, as the improved liquidity position of most sectors of the economy leads to an abatement of liquidity demands, it

would seem likely that the spread of long over short rates will narrow from its current very wide margin.

With the strength of economic recovery still quite conjectural, but with the balance of payments position difficult, an optimum method of narrowing yield differentials would appear to involve some further firming of short-term rates and also some decline in long-term rates. If staff estimates of interrelationships among monetary aggregates and money market conditions are correct, and if economic recovery proceeds more or less on schedule, an effort by the Committee to slow down the growth in aggregates as a group, including $M_1$, from the rapid recent pace will in fact involve some firming of short-term market rates. Such a slowing of aggregates would be consistent with the view that the crest of liquidity demands has been reached.

In such a context, it would appear reasonable for the Committee to permit some firming of money market conditions. However, the firming might best be kept within quite modest bounds for now--say, no more than would be indicated by a Federal funds rate of around 4 per cent, give or take a little. A principal reason for keeping the firming modest is to avoid galvanizing upward pressures on long-term rates in the still tender early stages of economic recovery and to permit, to the extent possible, such rates to decline further. There may, however, be limited, if any, scope for long-term rate declines when the money market is showing signs of further firmness, since the calendar of bond offerings over the near term is still high by historical standards and the volume of unsold corporate bond issues in syndicate has built up over the past couple of weeks. Under the circumstances, the use of coupon purchases to supply reserves would need to be continued in size to attempt to convince investors and borrowers that the direction of long-term rates is not necessarily upwards.

Such a general approach to policy would be consistent with a directive framed in terms of money market conditions and with a proviso clause, like the directive adopted at the last meeting but which may seek somewhat firmer money market conditions.[1] It

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1/ Three alternative draft directives prepared by the staff for Committee consideration are appended to this memorandum as Attachment A. A fourth alternative also distributed is shown in Attachment B.

> would also appear consistent with the phrasing of alternative B which from some points of view yields a better long-run stance for policy by emphasizing a somewhat more moderate growth in the aggregates and not necessarily prejudging the course of interest rates. Operationally, either method of stipulating the instructions is workable, of course. However phrased, the Committee may wish to consider providing leeway on the easing side of money market conditions in case the aggregates, and the economy, do not perform as well as expected.

Mr. Swan said he agreed that any firming of money market conditions should be held to modest dimensions. As he had suggested earlier, however, he doubted that firming to the various degrees discussed in the blue book in connection with the several alternatives for the directive would be associated with rates of growth in the aggregates as high as indicated. But that, of course, was a matter of judgment.

Mr. Brimmer observed that if long-term market interest rates were to decline more slowly, or even to rise a little, some corporations now contemplating bond issues might be induced to borrow at banks--thus relieving pressures in the bond market. He asked whether Mr. Axilrod thought that such a development would create any problems.

Mr. Axilrod responded that many companies--rationally or not--apparently wanted to borrow at long term in order to restructure their debt positions, and accordingly might be unwilling to switch to bank financing. In his judgment the economic outlook was

still sufficiently uncertain, and inflationary pressures still sufficiently strong, to make it undesirable for such companies to be locked into long-term debt carrying high interest rates. For one thing, a relatively high-cost burden of long-term debt would intensify in some degree the cost-push aspects of inflation. But more importantly, with profits low at the same time, high long-term corporate borrowing costs would work to discourage the real spending needed to spur economic activity. Furthermore, it was his feeling that additional declines in mortgage rates were needed and that they would be encouraged only if long-term market rates in general moved lower. In his judgment the whole recovery process had been delayed by the stickiness of long-term rates last year.

Chairman Burns added that long-term rates were far out of line with the rate of business profits. He thought that situation posed dangers for the future of the economy.

Mr. Heflin remarked that for the past two or three weeks policy makers had been enjoying the better parts of two worlds, with rates on new issues of long-term securities falling substantially while short-term rates were backing up. He thought, however, that that might have been due to a rather lucky conjuncture of circumstances which could not be expected to continue much longer. In any case, he would like to have the judgments of Messrs. Axilrod

and Holmes as to how much further short-term rates could rise without putting upward pressure on long-term rates.

Mr. Axilrod said he thought the chances were about even that the Federal funds rate could rise another ten to fifteen basis points and the Treasury bill rate perhaps twenty basis points without affecting long-term rates. Larger short-term rate increases--such as those associated in the blue book with directive alternatives B and C--were likely to lead to sharp advances in long-term rates, unless the economy were suddenly to weaken substantially.

Mr. Holmes observed that the recent rise in the funds rate to 4 per cent had had some effect on long-term markets, but not much. There still was a good deal of money available for long-term investment, and he suspected that--assuming everything went well--the funds rate could be moved up to 4-1/4 per cent without producing too great a reaction in bond markets. However, to raise the rate above 4-1/4 per cent probably would be treading on dangerous ground. He should add that one could never be sure of such judgments, and that the best course might be to probe cautiously, remaining ready to back away if initial actions had undesirable repercussions.

Mr. Melnicoff commented that over the past six to eight months the yield curve had inclined more and more sharply upward. The excess of long- over short-term rates had been caused in part by the continuing heavy demands on capital markets, but in part it undoubtedly also reflected investor fears of further inflation.

He agreed that long-term rates were dangerously high, given the state of the economy. However, he suspected they would remain high until policy makers demonstrated that they were willing to take the actions necessary to slow inflation.

Chairman Burns said that before calling for the go-around on policy he would make a few comments on the economy. He found himself moderately optimistic about the course of events. For one thing, the pace of productivity improvement was quickening; the increase in the first quarter had been at an annual rate of at least 4 per cent and probably more. Secondly, there were some signs of a slowing of inflation--the first such signs that he was prepared to take seriously. Also, the Government was now definitely moving toward an incomes policy. That movement had been slow and had not gone as far as might have been wished, but it had covered a great distance since a year ago.

As he had noted earlier, the Chairman continued, there was now much better recognition within the Administration of what the Federal Reserve had accomplished and of the fact that any further stimulus that might be needed would have to come from the fiscal side. In the international area, he found it most encouraging that short-term interest rates in the United States and abroad were finally beginning to converge. That tendency had been delayed in part, perhaps, because U.S. officials had been too lenient with their European counterparts in recent months. The Europeans had

been highly critical of the United States--with some justification--for relying too heavily on monetary policy for purposes of stimulation. But the European authorities also were open to criticism for not placing more stress on fiscal policy in their own efforts to control inflation. If nations were to live in a world of convertible currencies they had a common interest in greater coordination of interest rate policies.

The Chairman observed that the dollar had come under speculative pressures that had begun to reach dangerous proportions last week. However, the foreign exchange markets had been fairly quiet during the last two days. No doubt the discount rate reductions in Europe had helped to calm the situation. The U.S. Treasury also had made a significant contribution by its offer of $1.5 billion of special securities to foreign branches of U.S. banks. That action had taken a good deal of courage on the part of the Secretary of the Treasury, since it was necessary to offer an interest rate well above the rates at which the Treasury could borrow domestically; the nation was fortunate in having a Secretary with such courage. Mr. Holmes had advised him that the issue was likely to be fully subscribed, and he understood that the Treasury was prepared to offer additional securities of the same type if that should prove necessary.

Returning to the domestic economy, Chairman Burns said he did not attach much importance to the question of whether the cyclical

trough had been reached in November or February. What was important was that, as Mr. Partee had suggested, a recovery now appeared to be under way. However, the recovery was quite fragile, and economic conditions in general were at a delicate stage. He had a vivid recollection of developments in 1931, when the Federal Reserve had raised its discount rate and acted to stiffen short-term rates because of a balance of payments problem, and an incipient recovery had been cut off. During the past month the System had permitted short-term rates to rise a little. He thought the action had been wise, and that it was consistent with the Committee's decision at its March meeting; indeed, in his judgment the Manager had carried out the spirit of the Committee's instructions with great skill. He also concurred in the suggestion that short-term rates should now be permitted to move up a little further. It was important, however, that the System act with the greatest caution. If long-term interest rates, which were far out of line with the profit rate, were to rise, the recovery could be cut off and the nation might then enter on a long period of economic stagnation. The Federal Reserve could not permit such a development, not only for domestic reasons but for balance of payments reasons as well.

The Chairman then called for the go-around of comments on monetary policy and the directive, beginning with Mr. Hayes.

Mr. Hayes made the following statement:

I continue to feel that we have gone as far as we should go, in terms of monetary ease, from a domestic viewpoint. We have brought about a vast improvement in the nation's liquidity, setting the stage for a resumption of sound economic growth. Not only did the first quarter apparently make up for all of the shortfall in the narrow money supply in fourth quarter, but the current outlook for growth of the money and credit aggregates as a whole suggests that we may be facing an excessive expansion of money. Meanwhile, on the international side we seem to be moving into the kind of major crisis that has long loomed as a probability in the light of our huge payments deficit, especially on the official settlements basis, and the sharp contrast between interest rates here and abroad. Under these circumstances I think we should promote a firming of short-term rates to the extent this can be accomplished without causing major repercussions on the bond market. I have in mind trying to bring the Treasury bill rate somewhat above 4 per cent.

As to the directive, alternative D for the second paragraph seems to give appropriate emphasis to the primary need to achieve firmer short-term rates. However, I would want to seek money market conditions more like those specified in the blue book in connection with alternative B. The Manager would have to be cautious in moving the funds rate into the upper part of the indicated 4 to 4-3/4 per cent range, being mindful of possible serious repercussions in the capital markets as well as the imminent Treasury refunding; but I would hope he could move fairly promptly in this direction so that reasonably stable conditions might be achieved in advance of the Treasury financing.

I would also favor a number of modifications of the wording of alternative D. First, I would drop the word "somewhat" from the phrase "with a view to attaining somewhat firmer money market conditions." Secondly, to reflect our concern with disturbances in the capital market, after that phrase I would add the words "while continuing to meet some part of reserve needs through purchases of coupon issues in the hope of mitigating the impact on long-term credit markets, and taking account of the Treasury financing the terms of which are to be announced late in the period." I would omit the proviso dealing with the

aggregates. Finally, the first sentence of the paragraph might begin "To implement this policy, in the light of the recent strength in the aggregates and the severe worsening in the balance of payments situation, System open market operations..." To summarize, I would suggest the following language for the second paragraph, which might be labeled "alternative E":

> To implement this policy, in the light of the recent strength in the aggregates and the severe worsening in the balance of payments situation, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining firmer money market conditions while continuing to meet some part of reserve needs through purchases of coupon issues in the hope of mitigating the impact on long-term credit markets, and taking account of the Treasury financing the terms of which are to be announced late in the period.

It seems to me that the Board's decision to hold the discount rate at 4-3/4 per cent has been entirely appropriate and clearly useful in the international situation we face. I would hope this stance would continue to prevail. There continues to be a pretty good case for reducing reserve requirements to take care of the next bulge in reserve needs, but only if it can be made quite clear in the announcement that this is not a measure of additional ease but is, rather, directed at the objective of sustaining short-term interest rates. If the announcement were to coincide with other remedial balance of payments measures, this would be all to the good.

Chairman Burns said he might add a word about the discount rate. The Board had received proposals for a further reduction in the rate from six Reserve Banks, but had not acted on them--for one reason, because of concern about the possible effects abroad. To his mind, that was sufficient reason for not reducing the discount rate at this time; and while he did not want to prejudge future

action by the Board, he thought that several members, at least, would continue to oppose a discount rate reduction so long as the present delicate situation persisted. Each of the Reserve Bank Presidents would have to reach his own decision regarding his recommendations on discount rates to the directors of his Bank.

Mr. Morris remarked that he found it a little difficult to discuss policy in terms of the alternatives presented because, like Mr. Swan, he was skeptical about the staff's specifications. In particular, he found it difficult to reconcile the analyses of the green book and the blue book. The green book depicted a sluggish second quarter with GNP growing less than productive capacity; that meant there would be more slack in the economy at the end of the quarter than there was now. Yet the blue book suggested that the demand for money was so strong that to hold growth in $M_1$ to a 6 per cent annual rate it would be necessary to raise the Federal funds rate into a 4-3/4 to 5-1/2 per cent range--a degree of tightening which he thought would have disastrous effects on expectations in long-term markets.

In view of his skepticism about the blue book analysis, Mr. Morris continued, he found it necessary to formulate his own prescription. For directive language he would favor alternative A, which was substantially the same as that of the outstanding directive. He would interpret the "prevailing" money market conditions to be maintained as involving a Federal funds rate in a range between

3-3/4 and 4 per cent. In light of the near-term economic outlook, he would be very surprised if a funds rate in that neighborhood proved to be associated with a 9 per cent growth rate in $M_1$ in the second quarter, as suggested by the blue book. However, if it appeared at the time of the next meeting that the staff's analysis was correct, he would want to revise his thinking.

In general, Mr. Morris said, he thought the economic recovery was at so delicate a point that the Committee should be careful to take no actions that would engender a change in the expectations of investors in the longer-term markets. In his judgment a small increase in the funds rate--say from 4 to 4-1/4 per cent--might very well have an adverse impact on expectations domestically without accomplishing much with respect to the balance of payments.

In response to a question by Mr. Hayes, Mr. Coombs said he thought some firming in the domestic money market would have a helpful effect on the atmosphere in the foreign exchange markets, by strengthening the prospects for a convergence of interest rates.

Mr. Coldwell said that, as he viewed it, banks had been reliquefied so rapidly and reserves increased so sharply that, with the resulting marked interest rate declines, the corrective influences inherent in the business slowdown had been outpaced. At the same time the U.S. balance of payments deficits had been accentuated and the possibilities of severe unrest in international financial markets had been recreated. Furthermore, there may again have

been generated the perverse reaction that additional credit creation meant a confirmation that more inflation was certain--and, with the resulting defensive business decisions, there now was the possibility that long-term interest rates might go up not down.

Mr. Coldwell thought the Committee faced a serious problem of conflict in policy objectives. Business slack and high unemployment called for monetary ease with further rate reductions, especially in long-term markets. But continued inflation and the foreign problem called for a restraining policy with higher interest rates, especially in short-term markets. Moreover, the monetary aggregates had been rising too rapidly, generating further concern of future inflation. However, too large a retrenchment in rates would merely confirm businessmen's expectations of a policy reversal and accelerate their protective actions.

In his judgment, Mr. Coldwell continued, it was necessary to defuse the developing international problems and then hold to a course of constancy and stability until the imbalances in the economy were corrected or adjustments completed. To accomplish the defusing one was tempted to search immediately for new regulations, and perhaps they would eventually be needed. If so, consideration might be given to further limitations on capital outflows, income tax rebates, and subsidies in the shipping, credit, and insurance costs of exports. Serious consideration could be given to a large Fund drawing to tide the country over

the economic transition period, and to renewed negotiations to cut military costs in NATO countries and Japan.

While most of those possible actions were outside the scope of the Federal Open Market Committee, Mr. Coldwell observed, he hoped that other elements of Government were prepared to take fundamental corrective action, rather than attempting to alleviate symptoms. There was, however, a question in his mind regarding contingency planning by the Federal Reserve--particularly with respect to what might be done to satisfy the forward commitments the System would be assuming if the speculative surge continued. He hoped the Committee would not get too far out on a limb without a guarantee from the Treasury that a take-out would be available.

With respect to domestic monetary policy, Mr. Coldwell said he would like to see short-term rates move back up to the vicinity of 4 per cent; a reduced rate of expansion in the monetary aggregates; and concentration on the objective of market stability. It seemed to him that with certain modifications alternative D would meet his preferences. He would revise the staff's language to call for "minor firming" in money market conditions rather than for "somewhat firmer" conditions. Also, in view of the exceptionally rapid recent growth of the aggregates, he would favor a one-way proviso clause, calling for

even firmer conditions if the aggregates expanded more rapidly than expected. Earlier this year the Committee had talked about making up for the shortfall in $M_1$ that had occurred in December; perhaps now it should be thinking in terms of making up the too-rapid growth of the past two months. Laying that aside, however, at this time he would favor concentrating on policy for the short run and focusing on interest rates, particularly in light of the forthcoming Treasury financing.

Mr. Swan said it was clear from information on the liquidity positions of financial institutions and the economy in general and from data on recent flows of funds that there was sufficient liquidity at the moment. Accordingly, for the longer run the Committee should be considering a cut-back in the rate of growth of the monetary aggregates. As he had indicated at other recent meetings, he thought changes in $M_2$ were more significant than those in $M_1$. However, now that the fourth-quarter shortfall in $M_1$ had been made up, he would not be happy to see $M_1$ continue to grow at an annual rate of 8 or 9 per cent through the second quarter. In his judgment the appropriate growth rates for $M_1$ and $M_2$ over the second quarter were about 6 and 10 per cent, respectively.

Nevertheless, Mr. Swan continued, he believed the Committee should place more emphasis on money market conditions in the short run, and he agreed that any firming of such conditions in the

period ahead be kept to very modest proportions. As he had noted earlier, he questioned the accuracy of the blue book specifications; he doubted that it would be necessary to raise the Federal funds rate to the neighborhood of 5 per cent in order to hold second-quarter growth in the aggregates down to the rates he considered appropriate. He would favor maintaining the money market conditions associated with alternative D, including a Federal funds rate in the range of 3-3/4 to 4-1/4 per cent. He also favored the language of D, except that he had some difficulty with the proviso clause. On one side, he would not want to have money market conditions eased if--as he expected-- growth of $M_1$ and $M_2$ in the second quarter appeared to be falling short of the 8 and 11 per cent rates the staff had indicated would develop under that alternative. On the other side, if it turned out that the staff was right and such growth rates were emerging, he would not want to have the Federal funds rate pushed up to around 5 per cent.

Chairman Burns asked whether Mr. Swan's problem might be met by referring in the proviso clause to deviations from the growth paths "desired" rather than those "expected," and interpreting the desired growth rate for $M_1$ over the second quarter as 6 rather than 8 per cent.

Mr. Swan replied that such a modification would be helpful, but he still would not want to instruct the Manager to raise the funds rate as high as 5 per cent if that appeared

necessary to attain the "desired" growth rate in $M_1$. On balance, he would be inclined to delete the proviso clause entirely from today's directive.

Mr. Maisel observed that he had formulated a revised version of alternative D that was intended to meet some of the problems with which Mr. Swan was concerned. His proposed language read as follows:

> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining money market conditions consistent with the Committee's objectives for the growth of monetary and credit aggregates, while continuing to meet some part of reserve needs through purchases of coupon issues in the interest of promoting accommodative conditions in long-term credit markets, and taking account of the Treasury financing the terms of which are to be announced late in the period.

Mr. Axilrod noted that, according to the blue book path for $M_1$ shown under alternative C, expansion in the month of April at an annual rate of 8 per cent would be consistent with a 6 per cent growth rate over the second quarter as a whole. Thus, if the Committee favored a longer-run target of 6 per cent it might want to have the proviso clause interpreted in terms of a desired growth rate for April of 8 per cent.

Mr. Swan said that such a course would be agreeable to him, so long as it did not imply that 8 per cent was the target growth rate for the longer run.

Mr. Strothman observed that the Board staff's projections seemed generally reasonable to him. He believed, however, that a

gradual return to an unemployment rate in the 4-1/2 to 5 per cent range was desirable, and that to achieve that objective $M_1$ would have to increase at a relatively high rate through 1971. Therefore, he favored the specifications associated with alternative A. Although he found the language of alternative A acceptable as drafted, he would prefer to see it rewritten along the lines of B, and to include the reference the latter contained to continuing to meet some part of reserve needs through purchases of coupon issues. He could also accept the language proposed by Mr. Maisel if it were associated with the specifications of A.

Mr. Strothman went on to say that there was no question as to the seriousness of the international financial situation. In the light of that situation, it might be well to give top priority to maintaining unchanged money market conditions rather than to achieving the 9 per cent growth rate for $M_1$ in the second quarter that was associated with alternative A. There was a question, however, as to the need at this time for somewhat tighter money market conditions, particularly now that several European central banks had decreased their official lending rates. Even under alternative A, no action was contemplated that would worsen the international situation and one wondered how much good a slight tightening of money market conditions would do. Not enough, it would seem, to compensate for the marginally greater domestic unemployment that would likely result.

Mr. Strothman added that he would suggest a revision in the first paragraph of the proposed directive, relating to the sentence reading "Wage rates in most sectors are continuing to rise at a rapid pace." To avoid any implication of a forecast, it might be better to use the past tense of the verb, stating that wage rates "rose" at a rapid pace.

Following discussion, in which it was noted that the original form of the statement appeared to be warranted by the terms of some very recent wage settlements, the Committee agreed that the wording should not be changed.

Mr. Mayo said that while he would not necessarily want to delete the proviso clause from the directive, he thought it would be desirable at this point to emphasize money market conditions. He would have no objections to edging the Federal funds rate up into the 3-3/4 to 4-1/4 per cent range specified under alternative D. Indeed, he thought there would be some benefit to a funds rate in that range or even a little higher--perhaps up to 4-1/2 per cent, if market conditions permitted. In his judgment, however, such an objective could be encompassed under the term "prevailing money market conditions" used in alternative A, and need not be described as "somewhat firmer" conditions, as in alternative D. He thought a significant firming would not be desirable in light of the domestic economic

situation, and that a directive calling explicitly for firming could be seriously misinterpreted when the policy record was published in 90 days. The forthcoming Treasury financing also argued against any significant firming at this time.

Accordingly, Mr. Mayo continued, he favored the directive language shown under alternative A, although he agreed with the suggestion that the proviso clause should refer to "desired" rather than to "expected" growth paths in the aggregates. He took some comfort from the fact that under all four alternatives the staff estimates suggested that $M_2$ would grow less rapidly in the second quarter than it had in the first. He was not particularly concerned about the differences in the growth rates for $M_1$ shown under the various alternatives because, like others, he found it hard to believe that growth in that variable would be as strong as the staff suggested under the different sets of money market conditions described. In any case, the Committee would be reviewing the situation at its meeting in early May, and it would have an opportunity to modify its policy stance then if that appeared desirable.

Chairman Burns said he understood Mr. Mayo's reluctance to adopt a directive at this time which called for "somewhat firmer money market conditions." He asked whether Mr. Mayo would be unhappy about a directive calling for operations with a view to

"attaining temporarily some minor firming" in money market conditions.

Mr. Mayo replied that such a modification would be an improvement from the staff's draft, but he would still prefer his earlier suggestion. He was quite comfortable with the notion that a funds rate in the range of 3-3/4 to 4-1/4 per cent would represent a continuation of "prevailing" conditions, since the effective rate at the moment was about 4 per cent. Insofar as such a range would imply firming, the amount would be less than had occurred in the interval since the previous meeting.

Mr. Hayes noted that in recent days the actual funds rate had exceeded the Desk's target, which currently was 3-3/4 per cent.

Chairman Burns said he thought the language Mr. Mayo had proposed would not accurately reflect the Committee's intent if it were to adopt the specifications associated with alternative D. He would be inclined to describe the adoption of such specifications as "some minor firming," and he thought it would be useful to add the word "temporarily."

Mr. Mayo said he would prefer "maintaining somewhat firmer money market conditions" to "attaining temporarily some minor firming." As the record indicated, money market conditions had firmed during the last few weeks.

Mr. Maisel remarked that if the Committee set its goal in terms of some particular growth rates for the aggregates, it

would not be necessary to indicate in the directive whether the associated money market conditions were likely to be firmer or easier; as the members would note, such terms did not appear in the directive language he had suggested. To include the word "firming" would imply that the Committee wanted firmer conditions for other reasons.

Mr. Clay commented that economic developments and prospects were not particularly encouraging. However, it did not appear that what was lacking was availability of funds and liquidity of commercial banks and other lending institutions. In fact, the System would need to guard against pushing monetary expansion too far lest serious problems be created on the inflationary side when economic activity accelerated.

It would be helpful to have lower long-term interest rates, Mr. Clay continued. The Federal Reserve was rather limited as to how much it could do in bringing that about, particularly in the financial sectors where it was most needed, such as the corporate, municipal, and mortgage markets. Apart from what impact might be derived from focusing operations on longer-term Governments, open market operations to lower rates had to be considered relative to the resulting growth in the monetary aggregates.

Mr. Clay observed that selection of a policy directive for the period ahead was very difficult because there was a real conflict between the appropriate targets for the aggregates and for

money market conditions. Among the draft directives, alternative C would be the most satisfactory in terms of the aggregates but it was associated with too much firming of money market conditions. Money market specifications for either A or D would be acceptable, but both--and particularly A--involved much too high growth rates in the aggregates. There was no way to solve the conflict of targets. Alternative B probably could serve as a sort of middle ground or compromise.

Mr. Heflin said he thought the Committee's objective at this point should be to firm short-term interest rates to the extent feasible--in order to help in the balance of payments area--without incurring a serious risk of arresting, or reversing, the recent downtrend in long-term rates. It had been demonstrated that a sizable miss of the Committee's targets for the aggregates could be made up subsequently, and so he would not be particularly concerned about excessive growth rates for a short period. He favored the money market conditions associated with alternative D, which, he noted, were intermediate to those of alternatives A and B. With respect to the language of D, he would prefer to include the word "temporary" in describing the firming sought.

Mr. Daane remarked that, despite his general uneasiness about the current malaise and its possible impact on the domestic economy, he thought the Federal Reserve had gone about as far as

it should, and perhaps a bit too far, in easing monetary policy. In his judgment any further stimulus should come from the fiscal side, and should be accompanied by an incomes policy. As to monetary policy, he thought a slight uptick in short-term interest rates would be marginally helpful in encouraging the convergence of short-term rates internationally. However, any such rise should be accomplished before the Desk's operations came under even keel constraints.

Mr. Daane said he favored a directive along the lines of alternative D. However, he would revise the language to call for "probing cautiously toward somewhat firmer money market conditions..." He thought such a revision would meet some of the problems others had seen in the staff's draft, and it would give the Manager the leeway necessary to avoid the kind of disruption of long-term markets about which he, as well as other Committee members, were concerned. He would also suggest moving the reference to the Treasury financing up to near the beginning of the second paragraph from its position in the draft following the reference to purchases of coupon issues.

After discussion the Committee agreed that the reference to the Treasury financing should be placed immediately after the words, "To implement this policy." It also agreed that for the sake of clarity the wording of the reference should be revised to indicate

that the terms of the financing would be announced "late in the month" rather than "late in the period."

Mr. Maisel said he thought the specifications of alternative D, which most members seemed to favor, were the proper objectives for the coming period. He was concerned, however, about the possible impact of a reference to "firming" on expectations in long-term markets when the directive was published in three months; an indication that the Committee sought firmer conditions at this early stage in the recovery, at a time when the unemployment rate was rising, could have a major impact on long-term interest rates. He had suggested a revision of D partly for that reason, but also because he thought the staff's draft did not properly convey the essence of the policy implied by the specifications given under D. Such problems might also be met by adopting the language shown under alternative A.

Mr. Brimmer said he would favor a directive along the lines of Mr. Hayes' alternative E, but with certain revisions. It seemed to him that the international situation offered the main grounds for seeking some increase in short-term rates at this point, and he thought it would be desirable to refer to that fact in the second paragraph of the directive. Indeed, he would strengthen Mr. Hayes' proposed reference by adding the word "especially," making the additional clause read "in the light of the recent strength in the aggregates and especially the severe worsening in the balance

of payments." That clause might be followed by the reference to the Treasury financing. He would specify the objective of open market operations as that of "attaining some minor firming in money market conditions." Finally, he also favored dropping the proviso clause. He was unhappy about the prospect of an 8 per cent growth rate in $M_1$, but he thought it would be desirable to move gradually in slowing money growth to 6 per cent.

Chairman Burns asked whether Mr. Brimmer thought an indication in the directive that the minor firming was to be attained "temporarily" would be adequate in implying a balance of payments motivation for such a policy course.

Mr. Brimmer said that would be helpful, but he would prefer a specific reference to the balance of payments.

Mr. Maisel said he could not recall a case in which the Committee had referred to a specific problem sector such as the balance of payments in the second paragraph of the directive. He thought it would be a mistake to do so now, since that would be likely to raise more questions than it answered about the Committee's policy intent.

Mr. Sherrill observed that he would focus on the objectives of policy and not comment on the problems of wording the directive. He favored the objectives associated with alternative D, primarily because a target range for the Federal funds rate of 3-3/4 to 4-1/4 per cent was consistent with his view that a small uptick in short-

term interest rates would be desirable at this point. In his judgment the economy was still quite weak and in need of further stimulation. However, he was concerned about the long-term effects of excessive growth in $M_1$, and he thought that modestly higher short-term rates would help to slow growth in $M_1$ to a pace that could be sustained over the longer run without inflationary consequences. The international problem also was a consideration, although by itself he would not view it as justifying higher short-term rates. In sum, he thought maintaining a Federal funds rate centering on 4 per cent was the best way of balancing the various relevant considerations.

Mr. MacDonald commented that in his opinion monetary policy should not be too expansionary in the present environment. Like others today, he had mixed feelings about the draft directives. He preferred alternative C for its 6 per cent growth rate in $M_1$ over the second quarter, and the associated increases in $M_2$ and the adjusted credit proxy. Permitting the monetary aggregates to continue to expand at rates much above the averages of the last 15 months would seem to involve a risk of providing too much liquidity to an already highly liquid banking system. However, the Federal funds rates specified under alternative C were higher than he would like; he preferred the 3-3/4 to 4-1/4 per cent range for the funds rate associated with alternative D. Those views placed him in the same difficult position as others. On balance, he thought he would

find acceptable a modified version of alternative D, like that which appeared to be taking form as the discussion proceeded.

Mr. Melnicoff said he also believed that the monetary aggregates had been growing too rapidly, and he favored operations aimed at slowing their growth somewhat. For that purpose he would permit money market conditions to firm as far as they could without creating problems in longer-term securities markets. He could support either alternative B or D for the directive, provided it was understood that the objective was an orderly transition to the money market conditions that would be consistent with growth in $M_1$ over the longer run at an annual rate of 6 per cent.

Mr. Kimbrel commented that the rise in short-term interest rates contemplated under alternative C might come too quickly and might be just a trifle large. A smaller and more gradual increase in short-term rates might be less upsetting to the downward trend in long-term rates discussed in the green book. No great disaster had taken place when short-term rates rose in the period since the last meeting, and he doubted that there would be a great disaster if they went up a little more.

Mr. Kimbrel said his own preference, therefore, lay somewhere between the blue book alternatives B and C, but with the objective of promoting the "moderate growth" in the aggregates--including expansion in $M_1$ at a 6 per cent annual rate--envisaged under C rather than the "somewhat more moderate growth", with 7 per cent

expansion in $M_1$, called for under B. However, if the Committee should decide again to move away from aggregates and couch its directive largely in terms of money market conditions, he would favor the money market specifications under alternative B, but with the aggregates very closely bound by those given in alternative C.

If growth in $M_1$ in fact stayed in the 6 per cent range rather than 8 per cent or more, Mr. Kimbrel thought the Committee would be giving reassurance to the markets that it had not set aside its objective of controlling inflation. The members should not forget that some portion of the still high long-term interest rates was compensation for inflation. Reassurance that the Committee was still trying to slow the inflation, therefore, might help push long-term interest rates down further, along with the fundamental demand and supply factors that apparently were working in that direction.

Mr. Francis said it seemed important to him that the Committee get on a steady monetary course at rates of expansion in the aggregates below those recently prevailing. In the short run, a rapid monetary injection might stimulate spending, production, and employment without serious consequences for prices. However, in the longer run prices would again accelerate, intensifying the nation's economic problems. It seemed that only by eliminating the stop-go stabilization actions and reducing barriers to efficient operations in labor and other markets could policy makers permanently

improve the total social welfare and avoid acting as the architects of successive waves of intensifying inflation and recession.

In Mr. Francis' opinion, the 5 per cent rate of growth of money recorded in the period from December 1969 to January 1971 had been appropriate. Total spending accelerated slowly, and a basis had been laid for rising production and employment while providing for a gradual reduction in inflationary pressures. He recommended pursuing a 5 per cent trend rate from the present time. Total economic welfare in the long run would be served better, in his judgment, if monetary actions continued to place some downward pressure on prices.

Mr. Francis urged once again that much less emphasis be given to money market conditions in implementing policy. Interest rates had to be free to fluctuate in response to changing demands and supplies of credit if they were to perform their allocative functions efficiently. Interference by the System in those markets reduced their efficiency, and it should be kept to the minimum consistent with the Committee's views as to the proper volume of central bank credit to be injected.

Mr. Robertson made the following statement:

> As I see the economic situation, there continue to be some encouraging signs of a slowdown in inflationary price increases and a pick-up in economic activity, although in neither case does the evidence appear to be conclusive. Consequently, although I think we are headed in the right direction, we are

going to continue to face difficult adjustment problems in the months ahead. One particularly encouraging development is the Administration's action with regard to wages in the construction industry. The President deserves commendation for this move, and I hope that it will prove to be only the precursor of other efforts in the general category of incomes policies designed to enlist the cooperation of business and labor in the battle against inflation. On the other hand, the balance of payments remains a source of serious potential difficulties, and most recent evidence suggests the possibility of troublesome developments ahead.

The performance of the monetary aggregates--except, perhaps, the bank credit proxy--over the past month or so must be described as overly robust. The apparent growth rates have been high enough to lead me to the conclusion that it would be wise to aim our policy now toward bringing about some prudent slowdown. Monetary growth more moderate than that of the past month and that which appears to be in prospect over the current quarter is, I believe, a necessary long-run target if we are to avoid rekindling inflationary fires--which I regard as the greatest of all the economic dangers we face.

Policy directed toward achieving such a moderation could involve some firming of money market conditions, and I would be prepared to accept such a development. It should not, however, be permitted to go so far as to have a serious adverse impact on market attitudes or to cause undesirable whipsawing in short-term rates generally. But a modest firming, if it develops as a concomitant to a move to a more moderate growth in the aggregates, would, in my opinion, be appropriate. In addition, such firming might bring as a welcome by-product some marginal alleviation of our balance of payments problem.

In terms of instructions to the Manager, these views lead me to favor either alternative B or alternative C of the draft directives. While I prefer the near-term growth rates of monetary and credit aggregates contemplated under alternative C, I believe the Federal funds and Treasury bill rates contemplated under alternative B would represent more orderly change in policy direction and would be less likely to throw market attitudes out of kilter. If I am precluded from having my cake and eating it, too, I would choose to vote for alternative B. If alternative D is interpreted to mean

> the same thing, I could vote for it even though I cringe a bit at placing emphasis on money market conditions.

Mr. Robertson added that the many comments today regarding appropriate directive language seemed to be concerned primarily with the best means of capturing the sense of certain objectives favored by most members. It appeared from the discussion that the majority wanted to avoid unduly rapid growth in the aggregates and to foster some increase in short-term interest rates--not a very large increase, but large enough to make some marginal contribution towards closing the gap between rates here and abroad.

Chairman Burns remarked that, like most members, he favored some version of alternative D for the second paragraph of the directive. He was inclined to concur in the view that the language of the staff draft calling for "somewhat firmer money market conditions" might be misinterpreted when the directive was published in three months. In his judgment, the major reason for a slight increase in the target for the Federal funds rate at this time was the state of the balance of payments. He did not think a firming of policy was warranted by the economic situation. As to the monetary aggregates, he would remind the Committee that the recent high growth rates in $M_1$ had merely made up for earlier deficiencies; even with the rapid expansion in February and March, the annual rate of growth over the six-month period ending with March was only 5-3/4 per cent. Accordingly, while he would not

want the recent rapid growth to continue for long, he thought the expansion in $M_1$ in February and March, in itself, did not warrant firmer money market conditions.

The Chairman observed that none of the various formulations of the objective of open market operations that had been suggested during the go-around was likely to be considered ideal by the whole Committee, and the problem was to find language that the largest number would consider acceptable. He proposed that the members be polled regarding the acceptability of each of the following three formulations: "attaining temporarily some minor firming in money market conditions"; "probing cautiously toward somewhat firmer money market conditions"; and "maintaining temporarily somewhat less easy money market conditions."

The poll revealed that the first of these formulations was acceptable to more members than the second or third.

Chairman Burns then asked the members to indicate whether they would want to omit the proviso clause from the directive, as some had suggested. Four members responded affirmatively.

The Chairman commented that while a majority preferred to retain the proviso clause, he thought it was the sense of the Committee that in the event of significant upward deviations in the aggregates from the desired growth paths the target for the Federal funds rate should be raised above 4-1/4 per cent only grudgingly, if

at all. He asked whether there were any objections to such an interpretation, and none was heard.

Mr. Robertson referred to the Chairman's comment regarding the importance of the balance of payments for today's policy decision and asked whether it might not be desirable to include a reference in the second paragraph to the worsening of the balance, as Mr. Hayes had suggested.

Mr. Melnicoff said he shared the view Mr. Maisel had expressed earlier that it would be undesirable to include such a reference in the second paragraph, and some others concurred. Mr. Holland suggested that the best course might be to reformulate the language concerning the balance of payments in the statement of the Committee's broad policy objectives contained in the final sentence of the first paragraph.

Mr. Maisel said he thought the course Mr. Holland had suggested was appropriate. He questioned, however, whether it was correct to describe the problem confronting monetary policy at the moment in terms of the underlying balance of payments; he thought it would be better to refer to short-term capital outflows.

Mr. Brimmer concurred in Mr. Maisel's observation.

The Chairman then asked whether there would be any objection to an understanding that the reference would be incorporated in the final sentence of the first paragraph but that the specific wording

would be left to the staff, subject to the approval of a group consisting of Messrs. Maisel, Brimmer, Hayes, and himself.

There were no objections to the Chairman's proposal.

Mr. Holmes said he would like some clarification of the Committee's intent, assuming the directive language under discussion would be approved. He then raised a number of specific questions.

After discussion it was agreed that the minor firming sought, which was to be attained in the period before even keel considerations became important, involved a shading of the funds rate up to the upper end of a 3-3/4 to 4-1/4 per cent range; that for purposes of the proviso clause the "desired" growth rates for the aggregates were those consistent with growth in $M_1$ in April at an annual rate of 8 per cent; and that the proviso clause should not be implemented in the direction of easier money market conditions if the aggregates were expanding at rates only moderately below those desired.

Mr. Hayes said he would find it necessary to dissent from the proposed directive, which he thought gave inadequate recognition to the need for moving toward somewhat higher short-term interest rates in light of the international financial situation. He considered a target range of 3-3/4 to 4-1/4 per cent for the Federal funds rate to represent virtually no change from the range actually prevailing recently, and he preferred a funds rate in the neighborhood of 4-1/2 per cent, assuming that could be achieved

without upsetting the bond market. He would not object to a little stiffening in long-term rates.

Mr. Kimbrel said he also planned to dissent from the directive. He favored a target for the funds rate of at least 4-1/2 per cent and preferably 4-3/4 per cent.

With Messrs. Hayes and Kimbrel dissenting, 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 rose substantially in the first quarter primarily because of the resumption of higher automobile production, but that the unemployment rate remained high. More moderate growth in real GNP appears to be in prospect for the current quarter. Wage rates in most sectors are continuing to rise at a rapid pace. The rate of advance in consumer prices and in wholesale prices of industrial commodities appears to have moderated recently. In March bank credit and the money stock both narrowly and broadly defined again expanded substantially, although the increases were less sharp than in February. Inflows of consumer-type time and savings funds to banks and nonbank thrift institutions reached unusually high levels in the first quarter as interest rates on competitive short-term market instruments declined considerably further. In recent weeks, however, key short-term interest rates have moved up somewhat on balance. Yields on new issues of corporate and municipal bonds declined during much of March despite a continuing heavy calendar of offerings, but most recently long-term market yields have also risen somewhat. The over-all balance of payments deficit in the first quarter was exceptionally large. The trade surplus for the first two months was very small, and capital outflows have been stimulated by wide short-term interest rate differentials. Despite recent

reductions in the discount rates of several European central banks, these differentials remain wide. 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, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of the Treasury financing the terms of which are to be announced late in the month, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining temporarily some minor firming in money market conditions, while continuing to meet some part of reserve needs through purchases of coupon issues in the interest of promoting accommodative conditions in long-term credit markets; provided that money market conditions shall be modified if it appears that the monetary and credit aggregates are deviating significantly from the growth paths desired.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, May 4, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

April 6, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on April 6, 1971

## FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services rose substantially in the first quarter primarily because of the resumption of higher automobile production, but that the unemployment rate remained high. More moderate growth in real GNP appears to be in prospect for the current quarter. Wage rates in most sectors are continuing to rise at a rapid pace. The rate of advance in consumer prices and in wholesale prices of industrial commodities appears to have moderated recently. In March bank credit and the money stock both narrowly and broadly defined again expanded substantially, although the increases were less sharp than in February. Inflows of consumer-type time and savings funds to banks and nonbank thrift institutions reached unusually high levels in the first quarter as interest rates on competitive short-term market instruments declined considerably further. In recent weeks, however, key short-term interest rates have moved up somewhat on balance. Yields on new issues of corporate and municipal bonds declined during much of March despite a continuing heavy calendar of offerings, but most recently long-term market yields have also risen somewhat. The over-all balance of payments deficit in the first quarter was exceptionally large. The trade surplus for the first two months was very small, and capital outflows have been stimulated by wide short-term interest rate differentials. Despite recent reductions in the discount rates of several European central banks, these differentials remain wide. 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,

taking account of the Treasury financing the terms of which are to be announced late in the period.

Alternative B

To implement this policy, the Committee seeks to promote somewhat more moderate growth in monetary and credit aggregates over the months ahead, while continuing to meet some part of reserve needs through purchases of coupon issues in the interest of promoting accommodative conditions in long-term credit markets. 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 those objectives, taking account of the Treasury financing the terms of which are to be announced late in the period.

Alternative C

To implement this policy, the Committee seeks to promote moderate growth in monetary and credit aggregates over the months ahead, while continuing to meet some part of reserve needs through purchases of coupon issues in the interest of promoting accommodative conditions in long-term credit markets. 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 those objectives, taking account of the Treasury financing the terms of which are to be announced late in the period.

ATTACHMENT B

To: Federal Open Market Committee April 6, 1971

From: The Staff

The language shown below, labeled "alternative D," represents an endeavor to offer the Committee another choice for the second paragraph of the directive which would call for some firming action by the Desk, but would constrain the degree of firming in order to limit the amount of upward pressure that would be placed on interest rates--particularly long-term rates. The associated specifications for money market conditions and monetary and credit aggregates (given on the attached page) are intermediate to those shown in the blue book for alternatives A and B.

Alternative D.

"To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to ~~maintaining-prevailing~~ ATTAINING SOMEWHAT FIRMER money market conditions, while ~~accommodating-any-down-ward-movements-in-long-term-rates~~ CONTINUING TO MEET SOME PART OF RESERVE NEEDS THROUGH PURCHASES OF COUPON ISSUES IN THE INTEREST OF PROMOTING ACCOMMODATIVE CONDITIONS IN LONG-TERM CREDIT MARKETS, AND TAKING ACCOUNT OF THE TREASURY FINANCING THE TERMS OF WHICH ARE TO BE ANNOUNCED LATE IN THE PERIOD; 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."

Attachment

## DIRECTIVE ALTERNATIVE D

Paths of Key Monetary Aggregates Monthly and Quarterly
(Seasonally Adjusted in Billions of Dollars)

| | Concepts of Money | | Adj. Credit | Total |
|---|---|---|---|---|
| | M1 | M2 | Proxy | Reserves |
| 1971 | | | | |
| February | 217.3 | 430.8 | 337.7 | 30.5 |
| March | 219.0 | 437.2 | 340.1 | 30.7 |
| April | 220.7 | 442.1 | 343.5 | 30.8 |
| May | 222.7 | 446.6 | 344.6 | 31.2 |
| June | 223.4 | 449.3 | 346.1 | 31.1 |
| | Per Cent Annual Rates of Growth | | | |
| March | 9.4 | 17.8 | 8.5 | 8.5 |
| April | 9.5 | 13.8 | 12.0 | 3.5 |
| May | 11.0 | 12.0 | 4.0 | 16.0 |
| June | 4.0 | 7.5 | 5.5 | - 3.5 |
| 1st Q. 1971 | 8.2 | 17.4 | 10.7 | 11.0 |
| 2nd Q. 1971 | 8.0 | 11.0 | 7.0 | 5.5 |
| | Paths of Key Monetary Aggregates--Weekly (Alternative D) | | | |
| March 24p | 219.3 | 438.5 | 338.9 | 30.5 |
| 31e | 220.5 | 440.4 | 340.2 | 31.0 |
| April 7 | 220.6 | 441.0 | 342.4 | 30.6 |
| 14 | 221.6 | 442.6 | 343.4 | 30.6 |
| 21 | 219.6 | 441.3 | 343.9 | 31.0 |
| 28 | 221.1 | 443.4 | 343.9 | 31.0 |
| May 5 | 221.0 | 444.2 | 344.7 | 31.2 |

Money Market Specifications for Alternative D

| | |
|---|---|
| Federal funds rate | 3-3/4--4-1/4 |
| Member bank borrowing | 300--400 |
| Net reserves | -50 to -250 |

p -- Preliminary.
e -- Estimate.

April 5, 1971.