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, May 11, 1971, at 9:30 a.m.

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

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

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

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

Mr. Leonard, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Cardon, Assistant to the Board of Governors
Mr. O'Brien, 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
Messrs. Bryant and Gemmill, Associate Advisers, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Miss Orr, Secretary, Office of the Secretary, Board of Governors

Messrs. MacDonald and Strothman, First Vice Presidents, Federal Reserve Banks of Cleveland and Minneapolis, respectively
Messrs. Link and Craven, Senior Vice Presidents, Federal Reserve Banks of New York and San Francisco, respectively
Messrs. Hocter, Snellings, Andersen, and Green, Vice Presidents, Federal Reserve Banks of Cleveland, Richmond, St. Louis, and Dallas, respectively
Messrs. Gustus and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively
Mr. Sandberg, Securities Trading Officer, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on April 6, 1971, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on April 6, 1971, was accepted.

Chairman Burns noted that, as Mr. Holland had advised the members by wire on April 26, this meeting had been postponed one week in light of possible problems in connection with travel to and from the Board's offices on the originally scheduled date of May 4.

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 April 6 through May 5, 1971, and a supplemental report covering the period May 6 through 10, 1971. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs recalled that at the Committee's previous meeting he had expressed the view that the foreign exchange market was in the early stages of a speculative crisis. That first wave had receded as forward operations had brought the mark under control, but since the fundamentals had remained unchanged another speculative wave was only a matter of time; and the call by Economics Minister Schiller of Germany for floating Common Market rates against the dollar had produced last week the largest movement of funds across the exchanges that had ever been seen--roughly $4 billion in a little over two days' time.

Mr. Coombs observed that the decision last weekend to revalue the Swiss franc and Austrian schilling by 7 and 5 per cent, respectively, represented to some extent a belated adjustment to the German revaluation of October 1969. At that time the Swiss National Bank had recommended a 5 per cent revaluation, but because of legal and other difficulties the Swiss Government had refused to act. The Swiss franc rate emerging yesterday settled down close to the new floor and there might now be some profit-taking outflows that would reduce the $1.7 billion of uncovered dollars in the hands of the Swiss National Bank. However, as a result of the revaluation--the first in twenty years--the prestige of the Swiss franc as a store of value had been much enhanced, and in future crises it would exert an even stronger pull on speculative money.

Mr. Coombs remarked that the Common Market currencies were more important in the present context than the Swiss franc or Austrian schilling. It seemed to be generally agreed by officials in the Common Market countries and by the market that none of those currencies was strong enough on current account to justify revaluation. The officials in all of the Common Market countries except Germany were strongly opposed to floating rates because of the disruptive effects of such rate flexibility on trade in general--and particularly on trade within the Common Market, where the agricultural arrangements were acutely sensitive to any change in exchange rates. Accordingly, they had actively pressed the Germans to introduce special credit controls designed to bar further borrowing abroad by German industry, which now amounted to more than

$6 billion, and to require repayment of such debt at maturity. If such controls had been imposed, the prospect of $6 billion moving across the exchanges in the other direction would have had a tremendous effect on expectations. As a consequence speculation on the mark would have immediately subsided, and with it the pressures on the other Common Market currencies and the Swiss franc. But the German Government, with Minister Schiller taking the lead, refused; and last Sunday the Common Market countries agreed to maintain their parities but to permit a temporary float of individual currencies. Germany immediately chose to float and the Dutch had no alternative but to follow. On the other hand, France and Italy firmly indicated their intention to maintain the present margins--a decision that appeared wise in light of subsequent market developments. Belgium was trying to hold firm but might find it necessary to follow the Germans and the Dutch. Outside the Common Market, Japan had refused to revalue or float the yen.

Those currency adjustments in response to speculative pressures, Mr. Coombs said, had major implications--mostly disruptive--for the dollar and the Bretton Woods system, and for the Common Market in particular. The U.S. Government had played a relatively passive role so far. Secretary of the Treasury Connally had taken the position--rightly, in his judgment--that European parity adjustments were unnecessary, but no specific measures to relieve the speculative flight from the dollar had been adopted or promised. With respect to the dollar, he thought the present situation was the worst of all possible worlds. The revaluation of the Austrian schilling and the Swiss franc, together with the floating of the mark and guilder, would provide only a trivial benefit to the U.S. balance of payments while exposing the dollar to the maximum of bad publicity. The European currency moves were generally regarded as a rejection of the dollar as a reserve currency, with all that that implied for the functioning of the international monetary system. While the European countries could not soon dispense with the dollar as a transactions and reserve currency, they now were likely to begin to move quickly and in concert to seek a substitute—and he would not minimize their chances of finding one.

Mr. Coombs noted that both Federal Reserve swap liabilities and Treasury foreign currency bonds were protected from those currency adjustments by the revaluation clauses in the form of standing orders placed with the foreign central banks concerned. Neither the System nor the Treasury had suffered any losses. So far as Federal Reserve swap debt was concerned, yesterday the Dutch executed the standing order liquidating the System's $250 million guilder debt. The Netherlands Bank was therefore left with $250 million of uncovered dollars which would temporarily be placed in a Treasury special certificate, pending eventual settlement with special drawing rights, proceeds of a Treasury drawing on the International Monetary Fund, or gold.

Mr. Coombs reported that the Federal Reserve also owed $500 million to the Belgians, which similarly would be liquidated if and when the Belgians moved to a new parity. Meanwhile, the Belgians had offered to clear up approaching maturities by taking a $250 million Belgian franc bond from the U.S. Treasury, thereby reducing the need for the Treasury to draw down its holdings of gold or SDR's, or its position in the IMF. Similarly, the System's swap debt of $60 million in marks, which had been converted from contingent to actual drawings last week, would be liquidated if and when a new parity for the mark was established. As for Treasury foreign currency bonds, the Swiss National Bank had honored the revaluation guarantee by liquidating the $940 million Swiss franc bonds outstanding and accepting a new issue at the new rate.

Mr. Coombs remarked that some of the Common Market countries that now had or might later have floating rates could still take in a substantial amount of dollars in an effort to dampen rises in the rates. If that should occur those countries might ask the Federal Reserve to provide cover by drawing on the swap lines. He thought the System could safely do so if it used the authorization, recently approved by the Committee, that permitted purchases of currencies to be used for swap repayments from the foreign bank drawn upon at the same rate as that employed in the drawing.

In conclusion Mr. Coombs commented that, while the foreign exchange market was extremely agitated, there were a number of possible ways of minimizing the damage. The German mark--which was the kingpin in the market--was heavily overbought, mainly with money borrowed in the Euro-dollar market by people seeking to profit from a revaluation. Two things were needed to squeeze the speculators: first, action by the German Government to restrain new borrowing abroad and renewal of outstanding debt by German industry; and second, action by the United States and other countries to keep Euro-dollar rates high enough to penalize those who were borrowing for the purpose of maintaining a speculative position in marks. If through such concerted action speculation on the mark could be broken, the guilder and Belgian franc would be simultaneously relieved of pressure and the dollar might come out of the present situation with a somewhat improved position in the eyes of the world. Action with respect to speculation on the mark was all the more urgent in view of the $400 million reduction of the U.S. gold stock that would be announced on Thursday. There obviously was a risk that many countries, especially smaller ones, would panic and demand gold for their dollars. In general, he thought that a good case could be made for action now, and that there was little to be gained by remaining passive.

The Chairman invited Mr. Daane to comment on the meeting in Basle from which he had just returned.

Mr. Daane observed that the Basle meeting on Sunday was somewhat anticlimactic, since the immediate decisions had already been taken at the Common Market meeting in Brussels. Moreover, the Brussels meeting had continued all through Saturday night--until around 7 a.m. on Sunday--so the participants at Basle who had come from Brussels were extremely tired.

Mr. Daane noted that on Saturday he and Mr. Coombs had attended a meeting of the standing committee on the Euro-dollar market. The report of that committee was discussed at length by the governors at the opening of their Sunday afternoon session, and agreement was reached on two points. First, it was agreed to keep in force the decision that had been reached at the April meeting--in no small part as a result of Chairman Burns' participation--to avoid further placements by the BIS of central bank funds in the Euro-dollar market. Second, it was decided to take a hard look at what Mr. Zijlstra called "a prudent and gradual withdrawal" of earlier placements. The standing committee on the Euro-dollar market was asked to consider that matter. He understood that the Common Market countries also had agreed at Brussels to study the matter, and like the Governors at Basle they too had called for a report by June.

It was clear from the Sunday afternoon governors' discussion, Mr. Daane continued, that the Europeans thought U.S. policy was at the heart of current monetary problems. For the most part that view was expressed more in sorrow than in anger, although one or two speakers made very sharp remarks--even going so far as to characterize U.S. monetary management as "disorderly." Some of the points that emerged in the country-by-country review were similar to those the Special Manager had made today. No one except the Germans had a kind word to say about floating exchange rates, and the governors of the Banks of France and Italy characterized floating rates as a step backward for the international monetary system. Mr. Emminger, who represented Germany, made a lengthy presentation of the external and internal reasons for the German action. He emphasized that their objective was quite dissimilar from that underlying the move to floating rates in 1969. Rather than using the float as a transitional step to a higher parity, the purpose now was to repel speculative funds and then return to the existing parity. The question of the probable date for that return was raised at the Basle meeting, but the Germans did not give any indication more specific than a comment at the Sunday dinner session of governors that it should be before the end of the year. One other point of interest was that the Governor of the Bank of Japan made a firm statement to the effect that the Japanese had no intention whatsoever of changing the parity of the yen.

Chairman Burns then asked Mr. Hersey to comment on recent international developments. Mr. Hersey made the following statement:

> In what I say I shall try to focus on the longer-run implications of the exchange rate actions taken this past weekend. I am quite aware of the disturbing elements in the situation. But the thing I would fear most, a massive revival of faith in gold, has not been in sight--and I continue to hope that constructive changes in exchange rates will diminish the likelihood of such a thing in the future.
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> It is unfortunately true that important changes in exchange rates that in retrospect look both desirable and inevitable are hard for governments to make. In fact, the sterling devaluation of 1967 and the German mark revaluations of 1961 and 1969 did not get made until a crisis had blown up in each case. Important realignments of exchange rates seem frequently to involve pains and problems.
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> In appraising what has happened this past weekend and what may still be ahead in the way of important exchange rate changes, we need to keep in mind that the United States has had a very long string of annual deficits in the balance of payments, that the countries which took some action this weekend have tended to be in basic surplus on average over the years, and that any revaluations by countries in that position are bound to help in the process of restoring reasonable international equilibrium. It is not just a matter of the competitive position and of the trade balance--nor even of the current balance as a whole, including such things as tourist expenditures. Fundamental disequilibria affect the capital account, too. There is plenty of experience to show that capital tends to be drawn to countries with undervalued currencies--not merely for speculation or hedging in a crisis, but year after year because investment opportunities have a way of thriving when exports thrive.

A question of immediate interest to us, and the whole world, is what will happen to the German mark in coming weeks. Influential voices in Paris, in Brussels, in Washington, and perhaps also in Bonn, have urged that efforts be made to get the rate back within its legal range around the old par. The International Monetary Fund, however, has gone no further in the German and Dutch cases than to obtain "assurances with respect to the resumption of the maintenance of the limits around par, in the interest of the smooth functioning of the international monetary system." This carefully worded formulation leaves open the question of whether the future pars will be the old parities or some new and higher values.

The Fund's position in this matter is, I think, in the interests of the international monetary system and also in the long-run interests of the United States. If indeed it proves possible for the mark to be stabilized again at its old parity, that might be a happy sign that markets hope for further progress toward international equilibrium. If, on the other hand, the setting of a new and higher parity proves inevitable, it may be a real help in achieving the needed progress. Particularly will that be so if and when the appreciations and revaluations first accomplished cause pressure to be brought on others--Japan is the outstanding example--who ought to be doing their share in the adjustment process.

In this broader perspective, it seems to me that the events of the past week can be tentatively judged to be turning out in a favorable direction.

Mr. Daane said he might add an observation concerning the attitude of the British at Basle. In past monetary crises the United Kingdom often had been the focal point. On this occasion, however, in the words of the Governor of the Bank of England, Britain was "an oasis of calm in a sea of unease." Quite clearly, the British were thinking that whatever the outcome of the present situation, it would be to their advantage.

Personally, Mr. Daane continued, he was not sure the British were entirely right. Similarly, he did not share the Special Manager's sense of certainty about the implications of recent developments, nor was he wholly persuaded by the comments of Mr. Hersey. In his judgment it was a little early to discern the future shape of the international monetary system--to say whether nations would press on cooperatively or whether events would take a turn for the worse.

Mr. Mayo referred to Mr. Coombs' comment that the Europeans might now move quickly to find a substitute for the dollar as a transactions and reserve currency. He asked whether Mr. Coombs had in mind the development of a Common Market currency.

Mr. Coombs replied that that was one possible route out of a number available. Progress toward a Common Market currency had been set back recently by differences between Germany and the other members. However, the attitude of the Germans toward Common Market cooperation was basically favorable, and if their dollar inflows continued they might find ways of overcoming the present differences in order to move to a protective arrangement. Another possibility was the reestablishment of the old European Payments Union, perhaps broadened to include the United Kingdom, Japan, the sterling area countries, and others. The important point was that it was technically feasible to develop a substitute for the dollar, and the Europeans were well aware of that fact.

Mr. Brimmer noted that at the end of his report Mr. Coombs had talked about the need for prompt action to deal with speculation on the mark. He asked whether Mr. Coombs meant to recommend some particular action by the Federal Reserve. With respect to the forthcoming Treasury announcement of a decrease in the gold stock, Mr. Brimmer asked whether the risks would not be reduced if the Treasury were to explain that the transaction was not connected with the events of the past week.

In response to Mr. Brimmer's second question, Mr. Coombs said he was sure the Treasury would explain that the gold sale had been arranged some time ago. Unfortunately, however, market participants had a tendency to brush such explanations aside. In the present case they might well interpret the transaction as indicating that the French had resumed their earlier practice of buying gold, and conclude that additional purchases would follow.

Turning to Mr. Brimmer's first question, Mr. Coombs said he was thinking of actions by the Treasury, rather than the Federal Reserve. The purpose would be to keep upward pressure on Euro-dollar interest rates. One possibility would be for the Treasury to offer a large security issue in the Euro-dollar market, either directly or through New York banks. Such an issue could drive Euro-dollar rates to unduly high levels. Moreover, he was doubtful that the Treasury would be willing to follow that course. An alternative would be to issue securities through the BIS, with a take-out by the Treasury.

Such securities might have a maturity of, say, two years, and carry an interest rate of about 4-3/4 per cent. The BIS was the largest single operator in the Euro-dollar market, and it was wholly under the control of the governments of the member countries. In his judgment that alternative offered the best hope of pulling funds out of the Euro-dollar market in an efficient and inexpensive manner.

Mr. Mitchell said it appeared from Mr. Daane's comments that the governors at Basle had felt somewhat hesitant about pulling central bank funds out of the Euro-dollar market. He asked whether the desirability of a Treasury issue in that market might not also be questioned.

Mr. Coombs said he understood some of the governors were a bit worried that a sudden withdrawal of central bank funds from the Euro-dollar market might have adverse effects on the credit situation. It was his impression, however, that they were all agreed on the desirability of keeping Euro-dollar rates up. It was only a short step from a decision to invest no more money to a decision to withdraw some funds, and he suspected that if some specific proposal was made the governors would agree to it. Perhaps Mr. Daane would have some views on that question.

In response to further questions by Mr. Mitchell, Mr. Coombs said he was thinking of an issue of about $1 billion, offered in tranches of $100 million--with the timing subject to the judgment of the BIS management, under the general supervision of the European central banks as well as U.S. monetary officials. Such an issue might have some multiplier effect in reducing the volume of funds in the Euro-dollar market, although no one was sure just what the multiplier was. The most important effect, however, would be to put pressure on those who were borrowing Euro-dollars to finance speculative positions in marks--particularly those who had made forward commitments that would be coming due this week. He was not sure that a $1 billion issue would be sufficient for the purpose, but additional securities could be offered if that appeared desirable.

Mr. Daane said he thought Mr. Coombs had correctly interpreted the attitude of the governors. As he had indicated earlier, the standing committee on the Euro-dollar market, as well as the Common Market group, were planning to consider whether and how funds might best be moved out of the Euro-dollar market--and, more generally, how to control that market. He understood that the standing committee might meet again around the end of May. As far as the U.S. Treasury was concerned, it was giving consideration to an operation along the lines Mr. Coombs had described as well as to the possibility of issuing securities directly to foreign central banks rather than to the market through the BIS. The Treasury was not entirely sure the BIS was the most desirable agent for the operation. It also had some question about the proposed take-out provision, which would make the securities liquid but would leave the Treasury vulnerable to shifts in market conditions. As he had noted, however, the proposal was being actively considered.

Chairman Burns said he personally favored the approach Mr. Coombs had described and had supported it in discussions with the Treasury.

In response to a question by Mr. Brimmer, Mr. Daane said the two approaches the Treasury was considering were not mutually exclusive, and it was possible that both would be followed. Of the two, the operation through the BIS would have a more direct impact on market conditions. The possibility of a Treasury issue of securities directly to foreign central banks had been raised by others during the Sunday afternoon session at Basle. It was evident in the discussion that some central banks were prepared to engage in such an operation immediately and others were willing to give it consideration.

Mr. Coombs added that the German Federal Bank was willing to acquire $5 billion of longer-term Treasury securities immediately, and no doubt similar arrangements could be made with certain other central banks. However, he thought it would be simpler administratively to deal with the generality of central banks through one agency, such as the BIS, rather than to enter into many negotiations with individual central banks.

Mr. Mayo suggested that the best approach for the Treasury might be to combine a security sale to the German Federal Bank with the operation through the BIS. He suspected that once the Germans had agreed to purchase such a security other central banks would readily do the same.

Mr. Coombs commented that the central banks of Germany and Japan were obvious candidates for such securities, since their dollar accumulations had been large. He doubted that other central banks held enough dollars, considering their liquidity needs, for them to want to fund some of their holdings. As he had indicated, he thought the simplest and most effective approach was to work with them through the BIS.

Mr. Daane remarked that one advantage to a BIS operation that had been noted in the discussions at Basle was that it would provide a channel for intercepting Euro-dollar placements through the BIS from central banks other than those in the Group of Ten.

Mr. Sherrill asked whether there were grounds for concern about the consequences for U.S. capital outflows of policies designed to maintain upward pressure on Euro-dollar interest rates.

Mr. Coombs replied that the exposure to capital outflows would, of course, be increased by higher Euro-dollar rates. In that connection he thought it would be desirable to consider an extension of the interest equalization tax to short-term securities.

Mr. Brimmer noted that under recent legislation the President could apply the IET in the short-term area by Executive Order. Accordingly, action could be taken quickly and could be scaled to the needs of the moment. Some thought was being given at the Board to recommending application of the IET to bank credits.

Mr. Coldwell said he gathered that Mr. Coombs was not expecting a major reflow of funds from Germany to develop soon.

Mr. Coombs replied that there had been no evidence thus far of a reflow from either Germany or Switzerland. Market participants no doubt were assuming that the governments involved would take some kind of action and were waiting to learn the nature of that action before acting themselves. In such a situation it should not be difficult for the authorities to precipitate the kinds of flows they desired by taking appropriate measures.

In reply to another question by Mr. Coldwell, Mr. Holmes said that in recent days the Germans had purchased a large volume of special Treasury certificates which they would redeem if reflows occurred. Such speculative reflows could create a cash management problem for the Treasury, but there should be no great difficulty in coping with it in light of the Treasury's strong cash position.

> By unanimous vote, the System open market transactions in foreign currencies during the period April 6 through May 10, 1971, were approved, ratified, and confirmed.

Mr. Coombs noted that on May 4, 1971, there had been distributed to the Committee copies of a letter from Mr. Fritz Leutwiler, General Manager of the Swiss National Bank, concerning the interpretation of the revaluation clause in System swap contracts; and certain related materials, including a draft of a proposed reply for Committee review. As the members had been advised in a memorandum from Mr. Broida dated May 10, following the dramatic turn of events in international financial markets last week it had been decided to defer a response to Mr. Leutwiler.1/ In view of the complexity of the issue raised, he would recommend that the Committee delegate authority to act on its behalf in connection with any response to the Swiss National Bank, or to other central banks in the swap network raising similar questions, to the subcommittee designated in paragraph 6 of the authorization for System foreign currency operations--namely, Chairman Burns, Vice Chairman Hayes, and Mr. Robertson, or their alternates.

> It was agreed that a subcommittee, consisting of the Chairman and Vice Chairman of the Committee and the Vice Chairman of the Board of Governors, or designated alternates, should be authorized to act on behalf of the Committee with respect to any response that might be made to central banks in the System's swap network raising questions similar to that raised recently by one such central bank concerning the appropriate interpretation of certain language in the swap contracts.

Mr. Coombs then noted that his memorandum concerning System drawings on the swap line with the National Bank of Belgium

1/ Copies of the materials referred to have been placed in the Committee's files.

had been distributed to the Committee on May 4, 1971.[1] Two drawings by the System, of $35 million each, would mature for the first time on May 24 and June 10, respectively; and two drawings, of $40 million and $35 million, would mature for the second time on May 24 and June 9, respectively. As indicated in his memorandum, the Belgians had taken the position that individual three-month drawings should not be renewed more than once. In subsequent conversations, however, they had adopted a more flexible stance and now were prepared to have drawings. run on for more than the six months involved under a one-renewal approach. Of course, all four of the drawings in question could be cleared up if the Belgians bought the $250 million franc-denominated Treasury bond he had mentioned earlier.

Mr. Coombs went on to say that the System had been making continuous use of the Belgian swap line since June 30, 1970, and it would still have a substantial volume of drawings outstanding even if the proceeds of a Treasury bond issue were applied to repayment of maturing drawings. It was possible that a large reversal of international flows would permit clearing up the whole swap line by midyear, but that was not very likely. Accordingly, the point

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

was probably approaching at which the Committee would have to decide, under paragraph 1D of the foreign currency authorization, whether to approve continuous use of the Belgian line for more than one year. The Committee might either make that decision today or defer it until June.

Mr. Coldwell recalled that some doubts about the advisability of having a swap line in active use for more than one year had been expressed in the past, when the question was whether such use should be authorized in connection with British drawings. He would be reluctant to see the System's own drawings stay on the books for such a period.

In reply to a question by Mr. Mitchell, Mr. Coombs said an affirmative decision in the present instance would not represent a precedent. He did not think any damage would be done to the principle underlying the one-year limitation in view of the emergency now existing; indeed, the language of paragraph 1D took specific account of the possibility that exceptional circumstances might warrant a delay.

Mr. Brimmer noted that the text of the Belgian message to the Federal Reserve--cited in Mr. Coombs' memorandum--referred to the rule within the Common Market that there should be no second renewals of drawings by one Common Market country upon another.

He asked whether the Belgians had meant to imply that an internal rule of the Common Market should now govern their swap transactions with the Federal Reserve.

Mr. Coombs said he did not think any such implication was intended. In the past the System itself had taken a fairly firm view that swap drawings preferably should be cleared up within six months. Although the foreign currency authorization did not require formal action until the one-year limit had been reached, the Committee's general posture had been that continuous drawings for more than six months were a matter of concern, and that efforts should be made to find means of repayment when drawings had extended for such a period. In effect, that was an informal rule based on actual practice.

Chairman Burns asked Mr. Coombs what the consequences would be if the Committee decided not to let its Belgian line remain in active use for more than one year.

Mr. Coombs replied that full repayment of the remaining drawings by the System at midyear would increase Belgian holdings of uncovered dollars by a corresponding amount. Since the Belgians were likely to ask the Treasury to exchange those dollars for gold, SDR's, or the proceeds of a Fund drawing, the System's action would in effect be at the expense of the Treasury's holdings of reserve assets. He thought the Committee would want to consider carefully the desirability of creating an additional and perhaps unnecessary drain on U.S. reserves at this point.

The Chairman indicated that he shared Mr. Coombs' view.

Mr. Hayes said he hoped the Belgian swap line could be cleared up by June 30, but if that did not prove possible he would favor authorizing its continuous use for more than a year. While he did not feel strongly, he thought the Committee might best vote on the matter today, since it seemed that little would be gained by postponing action until June.

Mr. Mitchell said he would prefer to wait until the next meeting. He believed it would be the sentiment of the Committee that the swap line should be cleared up as soon as possible, and the members would be in a better position to assess the dimensions of the problem four weeks from now.

Mr. Coombs said he did not think any problems would be created by such a postponement. In the interim, he suggested that the Committee take note of the proposed renewal of the four swap drawings he had mentioned earlier. Also, it might be desirable to indicate to Treasury officials that the Committee did not intend to place the Treasury under additional pressure.

Mr. Mitchell observed that he would have no objection to such a course.

Chairman Burns said he thought the Committee should not take action on the matter without consulting with the Treasury, and accordingly he also would favor deferring the decision. It seemed likely to him that the Treasury would favor an exception by the Committee to its one-year rule. He asked whether there would be any objection to postponing action, and none was heard.

Possible renewal of the four swap drawings on the National Bank of Belgium was noted without objection.

Chairman Burns then noted that Mr. Robertson had just returned from a meeting of the Central Bank Governors of the American Continent that had been held in Quito, Ecuador. He invited the latter to comment.

Mr. Robertson said he would limit himself to two observations. First there had been a great deal of concern evident at the meeting about recent developments in foreign exchange markets. It was fortunate that U.S. representatives to the conference happened to be in Latin America at the time, since they had found it possible to allay much of that concern. Secondly, he had found that exposure to the very serious problems faced by some other countries on the continent was valuable in helping him to gain perspective about the problems of this country.

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:

> There has been nothing on the domestic economic scene over recent weeks to rival the dramatic events in the foreign exchange markets. Nor has the non-financial news included surprises such as those in the financial sector, where the prime bank loan rate has been lifted and new issue yields on Aaa corporates have risen 70 basis points, to new highs for the year, since the last meeting of the Committee. Nevertheless, recent developments in the business situation have been important and encouraging. Evidence that the economic recovery has begun, which I reported to you five weeks ago, has strengthened considerably in the interim. The current red book[1/] is full of comments pointing to somewhat better orders and sales, and businessmen are widely quoted as being moderately more bullish. Preliminary indications are that the production index will be up a half point or so in April. If so, and excluding the temporary effects of autos and steel, this would be the first real increase in a long while.
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> Housing and State-local government construction expenditures, of course, are adding substantially to the current strengthening in economic tempo, as has been the case for some months past. But the new element in the picture is an apparent pickup in consumer buying. First quarter retail sales--which have just been revised upwards--were 4 per cent (16 per cent, annual rate) above the fourth quarter of last year. Much of this gain was due to the abnormally low level of car sales during the strike and to the pickup in building materials sales accompanying the surge in housing starts. Excluding these categories, the residual of retail sales in the first quarter was only a little higher than in the fourth. Within the quarter, however, there was a strengthening trend.

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

Thus, non-auto sales declined in January but then rose 0.6 per cent in February and another 1 per cent in March. According to the advance monthly report just received, April has held these gains.

The pickup in retail trade has led the staff to increase our second-quarter GNP projection by $2 billion--to a $19 billion increase overall--and it accounts also for much of the more favorable tone of business comment included in the red book. But we are restrained in our enthusiasm, at least for the present. Consumer surveys still indicate a cautious attitude, reflecting continuing concern about unemployment, inflation, and income prospects. And new car sales, which might ordinarily be expected to serve as a bellwether of an improvement in buying attitudes, have not been particularly strong in recent months. Indeed, sales of domestic models declined a little in April, to a 7.9 million annual rate. Thus, it may be a while yet before consumer spending rises appreciably faster than income; we are expecting this to happen, and the saving rate to decline, in the summer months.

Another development that potentially could add to the strength of economic recovery is the recent behavior of inventories. During the first quarter business inventories on a book value basis rose at a $4-1/2 billion annual rate, about the same as in the fourth quarter--when the auto strike sharply cut dealer stocks--but much less than in the third. Excluding autos and steel, moreover, there was a reduction in the book value of inventories in the first quarter, which implies a considerably larger liquidation in real terms. The reduction was especially marked in manufacturing, with declines in each of the last four months if steel stockpiling is excluded, and it served to reduce inventory-sales ratios appreciably. There is no way to tell with any precision when inventory accumulation on a substantial scale may resume. But the liquidation we have been seeing must certainly hasten that day and, in conjunction with strengthening final sales, could set the stage for a sizable upward adjustment in industrial output. The staff is projecting moderate inventory accumulation on a GNP basis in the second quarter due in part to a faster rate of steel stockpiling; the turnaround could well prove to be larger than we are predicting.

Despite the apparent improvement in the behavior of the consumer price index in the first quarter, we have again lifted our estimates as to the probable rate of inflation this year. Much of the reduction in the rate of rise in the CPI was due to the declines in mortgage rates, which do not carry through to the GNP deflator. In turn, much of the improvement in the private GNP deflator, the rise in which slowed from a 5.9 per cent rate in the fourth quarter to 4.2 per cent in the first, resulted from a shift in mix as auto purchases declined and then recovered in the post-strike period. On a fixed-weight basis, the private GNP deflator rose at a 4.9 per cent rate in the first quarter, a little less than in the fourth quarter but about the same as the average increases experienced in both 1969 and 1970. Thus, there has not really been an appreciable moderation in price inflation to date, and in some lines--including building materials and sensitive industrial materials--price quotations recently have been moving up again.

We continue to expect some slowing in the rate of inflation as the year progresses, as production facilities remain generally underutilized and as productivity continues to improve. But the effect of the latter on unit labor costs may be largely behind us, since the productivity gain in the private nonfarm economy over the past year recovered to 3.2 per cent, not far from the long-range average. Meanwhile, however, average rates of compensation have continued to rise rapidly, with first-quarter compensation per manhour in the private nonfarm economy 7.3 per cent higher than a year earlier. And wage increases continued undiminished; in the first quarter, average collective bargaining settlements in manufacturing amounted to 8.1 per cent for the first year and 6 per cent over the life of the contract (not counting cost of living escalators), the same as in both 1969 and 1970.

Because of the resumed uptrend in productivity, unit labor cost increases have narrowed to 4 per cent over the past year from 7-1/2 per cent in the preceding year. But so long as recent rates of wage increase persist, this would seem to establish something like a 4 per cent floor on the rate of inflation, allowing for variations due to changes in prices of foodstuffs, minerals, and imported materials. Profit margins, despite a little recovery in the first quarter, remain very low historically--too low to permit any appreciable absorption of higher costs. Indeed, I would expect businessmen to take every opportunity to restore margins whenever market conditions permit.

The question is whether monetary policy could or should do anything to combat a persisting residual rate of inflation such as this. The answer, I think, is negative. Product markets generally are in a comfortable--if not sloppy--supply-demand condition, resources are substantially underutilized, and labor appears to be readily available across most of the range of skills and in virtually all sections of the country. In fact, it is difficult to see how even a marked increase in economic activity and in employment could add appreciably to price pressures, given the slack that exists, although admittedly some opportunities for large price markups might thereby be created. It seems to me that we should regard continuing cost increases as a structural problem not amenable to macro-economic measures, just as reducing the unemployment rate below 4 per cent or thereabouts has long been viewed as an objective requiring structural rather than macro solutions.

The economic outlook as we see it provides no cause for alarm concerning the reemergence of demand-oriented price pressures over the next year or so. The indications of cyclical improvement that I have noted today help to confirm the economic projections that we have regularly presented to the Committee since last fall, but so far they do not warrant any appreciable increase in our estimates of the probable pace of recovery. These projections, as you know, are for a moderate rate of real growth during the remainder of the year, but not enough to prevent some further updrift in the unemployment rate. Even a substantially greater acceleration in the economy than we have projected, however, would leave substantial unutilized resources at year-end and very probably well into 1972.

In these circumstances, I believe that monetary policy can afford to remain quite accommodative to increased credit use and to public desires for liquidity for some time to come. This does not preclude some firming up of money market conditions, if that should appear necessary in order to put some restraint on a continuance of the recent rapid growth in money supply. But I would urge that any such firming be most cautious at this point.

> Investor nervousness, rather than underlying economic and financial conditions, appears to me to have caused the recent runup in long-term interest rates. There seems to be a good chance now of a reversal, provided that investors are not frightened by policy actions or other unexpected events over the weeks to come.

Chairman Burns then called for a general discussion of the economic and financial outlook.

Mr. Hayes said he agreed almost completely with Mr. Partee's comments on the current and prospective economic situation. Perhaps he was a little more optimistic than Mr. Partee with respect to the outlook for unemployment; projections made at his Bank suggested that the unemployment rate might be reduced a little by the end of the year. He would not want to dwell on that difference, however, because it did not have significant policy implications and because the projections inevitably reflected a large element of guesswork.

Mr. Hayes observed that he would be reluctant to accept Mr. Partee's negative answer to the question of whether there was a role for monetary policy in combating the persisting residual inflation. At the same time, he was pleased to note that Mr. Partee allowed for the possibility of some firming of money market conditions to restrain growth in the money supply. In his (Mr. Hayes') judgment the most effective role that monetary policy could play in combating the continuing inflationary psychology was to prevent excessive rates of growth in the monetary aggregates.

Mr. Francis said he continued to believe that the "corrective" adjustment of the economy from the excesses of 1965 through

1968 had proceeded satisfactorily. Last year the rate of growth of total demand for goods and services was restricted to about 5 per cent, near the long-run optimum rate. Such a slowing of demand growth necessitated a slowing in real product, given the momentum of inflation which had been allowed to develop earlier.

Current data indicated that the economic adjustment was proceeding with progressively less total cost, Mr. Francis remarked. While total spending was expanding at a slightly faster pace, the rate of price increase was gradually receding. As a result, growth in production had been slowly accelerating in contrast to the earlier deceleration. The crucial problem, as he saw it now, was the development of a program for continuing the progress under way in reducing inflation, making some real progress on the balance of payments problems, and providing a healthy, viable economy for the future. The alternative of fostering a very rapid economic recovery from the slowdown would seriously impede the achievement of those goals.

Mr. Mayo observed that he joined Mr. Partee in his restrained optimism and agreed that there had been a little more evidence of the solidity of the expansion in the last few weeks than there had been earlier. His Bank's GNP projections for 1971 continued to be a little higher than those of the Board's staff. Recently the Chicago Bank's continuing study of price change announcements had revealed fewer increases and more reductions for manufactured products than had been the case for a long time. Any resulting optimism about the price outlook should be tempered, however, by the indication that prices of meats, building materials, and services were, if anything, rising faster than a year ago. On the whole, he thought the economic situation had improved enough to permit the Committee to be a little firmer in its monetary policy.

Mr. Coldwell said he thoroughly agreed with Mr. Partee's analysis except that he would make one change of emphasis. It appeared from his observations in the Eleventh District and elsewhere that lenders were awash with funds; they were searching for appropriate investments and pushing loans aggressively. At the same time, consumer spending was beginning to improve. He asked whether Mr. Partee thought the very large base of liquidity might not lead to a sharp increase in consumer spending.

Mr. Partee said he would agree that the personal saving rate had been running high for several years and that over the past 12 or 18 months the forms of saving had shifted away from securities and toward deposits, which were more liquid. Consequently, there was now a large pool of liquid savings that could be tapped. That was one of the considerations that had led the Board staff to project faster growth in consumption than in income as the year went on.

However, Mr. Partee continued, such expectations were highly uncertain. For example, recent staff estimates had suggested that retail sales increased by about 1-1/4 per cent further in April, both in total and less automobiles and certain nonconsumption items, such as building materials. However, the Census Bureau's advance report for April, which became available yesterday, indicated that sales had risen by one-half per cent in total and by only one-tenth per cent after the indicated exclusions. Of course, the advance reports had been highly unreliable, and in any case it was not unreasonable to expect some flattening of sales growth in April following the sizable increases of February and March. He cited the new data only to illustrate the uncertainty about the strength of consumer spending in the period ahead.

Mr. Coldwell suggested that the current international financial situation might be having an adverse influence on consumer spending. It was his impression that people reacted to increases in uncertainty--even in areas they did not fully understand--by holding back on spending.

Mr. Mayo expressed the view that in the present instance such behavior was more likely to be characteristic of businessmen than consumers.

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 April 6 through May 5, 1971, and a supplemental report covering the period May 6 through 10, 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, open market operations established somewhat firmer conditions in the money market and interest rates rose generally by 1/4 to 3/4 of a percentage point. The foreign exchange crisis, coming in the midst of the Treasury's May refunding, created new uncertainties in domestic financial markets. While the Government securities market has regained some of its confidence, the international situation continues to cast a cloud over the money and capital markets.
>
> Treasury bill rates rose sharply early in the period--with the three-month bill moving above 4 per cent--as the market, with heavy bill positions, speculated on the extent to which the System had changed its money market objectives. It was generally believed that the shift towards firmer money market conditions was linked to the System's concern about the international situation and to the rapid growth of the monetary aggregates. As the period progressed, however, the three-month bill rate declined as dealer positions were worked down under the impetus of demand arising from seasonal factors, from foreign bill buying, and from a cautionary desire for liquidity on the part of banks and others. In yesterday's auction average rates of 3.86 and 4.18 per cent were established on three- and six-month bills, respectively, up 16 and 43 basis points from the auction just preceding the last meeting. A substantial spread developed between short- and longer-dated bills over the period, reflecting the market's change in expectations about interest rates and the demand for liquidity.
>
> Both the corporate and municipal bond markets were under considerable pressure throughout most

of the period as new offerings continued high and as banks generally became extremely cautious in their investment policies.

The Treasury's refunding came at a time when prices of intermediate-term Treasury notes and bonds had already undergone a substantial readjustment. In light of international uncertainties, the refunding package was deliberately designed to be as unobtrusive as possible. The initial market reaction to the offering of the two short-dated notes was favorable and both issues soon moved to a substantial premium. However, bank and other holders of longer-dated Government securities--many acquired on a speculative basis earlier in the year--tried to take advantage of the absence of a longer-dated security in the refunding to lighten their positions. The deterioration in the foreign exchange markets, coming on top of this selling pressure, led to a very poor situation in the Government securities market last Tuesday and Wednesday. Both new issues were selling below issue price at the close of business on Wednesday, the day the books closed on the refunding. In order to prevent disorderly conditions from developing in the Government market, the Desk undertook rather extensive support operations on behalf of the Treasury, buying about $520 million Treasury coupon issues and $65 million long-term Treasury bills. We considered the possibility of purchasing coupon issues for System Account, but given even-keel considerations and the fact that the Treasury had ample resources to cushion the market, such purchases were not necessary. By Thursday, the market began to function more normally and on Friday--after the results of the refunding turned out to be better than the market's most gloomy expectations--a rally developed, continuing on Monday as the securities markets reacted calmly to the weekend developments in the foreign exchange markets.

Given the recent sell-off in the securities markets, there is some hope that the slide in intermediate- and longer-term rates could come to an end. There are, however, bank and other holders of Governments who would like to reduce portfolios further and who might try to take advantage of any better market atmosphere to liquidate. Thus, the market might well be subject to testing with the results uncertain, depending to a large extent on unfolding developments in the exchange markets and market expectations about the future course of monetary policy.

The Treasury's cash position, while currently quite strong, is subject to a great deal of uncertainty. The Treasury has issued a large volume of special certificates to foreign central banks--about $3 billion on last Friday and yesterday--but it is not clear how long they will be able to keep the money. Attrition in the refunding, at $1.8 billion, is higher than had been anticipated earlier (although much less than many had expected last Wednesday) and a heavy cash drain is expected in June. It is likely, therefore, that the Treasury will be coming forth with a cash offering--presumably Treasury bills--in the near future. The Treasury would probably be well advised to run its cash balance on the high side in light of the international situation.

As far as open market operations are concerned, the Desk moved immediately after the last meeting of the Committee to firm up money market conditions, bringing the Federal funds rate up to the upper part of the 3-3/4 to 4-1/4 per cent range specified by the Committee. New data, available shortly after the meeting, indicated that the aggregates--particularly M_1--were performing strongly, and we then aimed at a Federal funds rate of 4-1/4 per cent. Indeed, the strength of the aggregates might have suggested a need for a further firming of money market conditions, but the closeness of the Treasury refunding and the growing sensitivity of the capital markets argued strongly against any further change.

As the Committee knows, Federal funds have most recently been trading at a rate well in excess of the 4-1/4 per cent objective. This phenomenon appears to be related to a super-cautious approach to reserve management by the major money market banks arising from uncertainty about the exchange crisis, rather than to any shortage of reserves. In fact, the System vigorously resisted the high funds rate, mainly through the aggressive use of RP's, although there were also outright purchases of about $1 billion of Treasury bills and, early in the period, of nearly $200 million of coupon issues. In the statement week ending last Wednesday the banking system had free reserves of over $200 million--a statistic not consistent for long with a Federal funds rate averaging 4.41 per cent.

I should note in passing that while we have had a higher Federal funds rate in the most recent period, member bank borrowing has actually declined from the level prevailing between the March and April meetings. This rather unusual situation is related to a decline in special borrowing from the System and to the fact that our Federal funds objective has still been well below the discount rate.

As we look to the period ahead, it seems fairly clear that domestic open market operations will have to be conditioned by unpredictable developments in the foreign exchange market that will have an impact on money flows and on market psychology. On balance, there should be a need to supply reserves in the period ahead, which could provide a useful cushion if one is needed to help keep the markets calm. It would be most helpful in interpreting whatever directive the Committee decides on to have an indication of the relative weights the Committee wants to place on the monetary aggregates as compared with credit market conditions. Should the Committee decide to firm money market conditions, a modest upward movement in the funds rate from the current objective is not apt to have a major effect on longer-term markets. It is hard to tell in advance the precise point at which a reaction would set in or how strong the reaction would be. It is also not clear how much the purchase of coupon issues would help stabilize the longer-term markets. If the markets again become very sensitive, the knowledge that the System is a buyer could lead to massive selling by reluctant holders of Governments in a volume that could not be handled without giving up on reserve objectives.

So far the domestic market reaction to weekend developments has been calm. But in light of all the uncertainties, domestic open market operations in the period ahead will undoubtedly have to be approached in as flexible a manner as possible.

Chairman Burns said he thought the Manager deserved special commendation for the manner in which he had conducted open market operations during this extraordinarily difficult period. At least part of the credit for the orderly behavior of the Government securities market should be given to Mr. Holmes.

In reply to questions by Mr. Mitchell, Mr. Holmes said the volume of foreign official holdings of Treasury securities would depend on the nature of international flows of funds. If foreign central banks were to lose reserves they would reduce their holdings of special certificates and Treasury bills. The Treasury's cash position was strong at the moment because it had just sold $3 billion of special certificates, but at some point it probably would have to raise additional funds in the market.

Mr. Mitchell then asked Mr. Holmes to elaborate on his statement that System purchases of coupon issues could lead to massive selling by reluctant holders.

Mr. Holmes said he had not meant to suggest that the Desk should not buy coupon issues in the period ahead, but rather that it should approach such operations with caution and perhaps modify its techniques. The kind of situation he was concerned about could be illustrated by developments at times in the past, when the Desk had entered the market to buy securities and found itself faced with a flood of offerings from people who wanted to get out. The would-be sellers had been intelligent enough not to try to press their securities onto the market; rather, they had hoped to deal directly with the Federal Reserve, which they considered to be the only major buyer available. But when the Federal Reserve entered the market overtly and then failed to buy their securities, they lost hope and began to press their holdings on an unreceptive market. That kind of situation was a dangerous one from the System's point of view. It meant that the Desk either had to give up its efforts to stabilize prices or provide such a large volume of reserves that it would subsequently prove very difficult to regain control of the monetary aggregates.

Mr. Morris said he was concerned about the sharp increases in long-term bond rates that had occurred since the last meeting of the Committee, and he was sure other members were also. If those increases were sustained there was little doubt that mortgage rates would back up.

Chairman Burns commented that mortgage rates had already moved up somewhat, and Mr. Morris agreed. The latter went on to say that continued rises in mortgage rates at this stage of a very sluggish economic recovery would be a highly disturbing development. The Manager had suggested that a modest upward movement in short-term rates might not have much of an impact on the long-term market. He would like to have further comment from the Manager on that point.

Chairman Burns remarked that the question Mr. Morris had raised was a critical one at this juncture. He hoped the Committee would discuss it after having the benefit of the staff's views.

Mr. Axilrod said he had planned to comment on the matter in his statement later in the meeting. Mr. Morris suggested that the discussion be postponed until after Mr. Axilrod had made his statement.

Mr. Brimmer said he would like to have Mr. Holmes' views on the domestic implications of one of Mr. Coombs' proposals. As he understood Mr. Coombs' suggestion, it was that the U.S. authorities should now try to raise Euro-dollar interest rates. Currently the Euro-dollar rate on overnight money was in the neighborhood of 11 or 12 per cent, and the 90-day rate was 7-1/2 to 7-3/4 per cent. One might ordinarily expect the rates to decline somewhat from those high levels, and he wondered about the domestic consequences if they were to go up instead.

Mr. Holmes replied that one possible consequence would be to encourage the flow of domestic short-term capital to the Euro-dollar market. However, a check by the New York Bank with major commercial banks revealed that the latter had not been able to identify any such flows in transactions they had handled recently. In general, it seemed to him that while it was difficult to determine the right Euro-dollar rate, the objective of penalizing speculators was a useful one to pursue. It would be desirable to proceed cautiously, but it also was important to get an early start.

In response to the Chairman's request for comment, Mr. Coombs observed that while the spread between Euro-dollar and domestic rates had increased considerably recently, he thought there might be some sympathetic reaction in domestic markets to changes in Euro-dollar rates. He added that in suggesting that Euro-dollar rates be kept under upward pressure he had not meant to imply that they should necessarily be raised from their present levels. What he had in mind was keeping those rates from falling significantly. He did not think there were any real risks in the kind of operation he had proposed, since it could be carried out in a delicate manner and kept under close control by the U.S. authorities and the BIS management.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period April 6 through May 10, 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 Committee in my view has some particularly hard choices before it today. Attainment of a moderate rate of growth in the monetary aggregates, especially M_1, over the near-term may still be in conflict with any desires to keep long-term interest rates from rising further, much less declining from the highs for the year recently reached. In this context, questions naturally arise as to whether or to what extent the level of long-term interest rates should be a constraint on FOMC action at this juncture. And questions arise as to what growth rates might be construed as appropriate for the aggregates in light of the diverse behavior of money supply and bank credit.
>
> Expectations of inflation are still an important influence on long-term rates, but I doubt that a significant worsening of these expectations occurred over the last few weeks. Thus, I doubt that such expectations are an explanation of the 60 to 70 basis point rise in long-term market rates

since the last Committee meeting. The chief explanation for that rise is, I believe, market fears of a future rise in interest rates induced by a tightening monetary policy; such fears changed investor attitudes, including those of banks. The fears were generated by the policy-induced tightening of the funds market shortly after the last Committee meeting, by the rapid growth in the money supply of the past three months, and by the foreign exchange crisis. Among other results, this led to an attempt to unwind speculative bond positions. In the process, long-term rates moved to levels which seem to me to be out of line with what still appear to be relatively moderate growth prospects for the economy. Given the lack of ebullience in anticipated plant and equipment spending and the important role of increased housing and public construction outlays in the prospective economic recovery, it would seem safer for long-term rates to be below what are probably artificially high levels induced by unwinding of speculative positions.

If such a theory of the recent long-term rate rise is correct, these rates should begin coming down on their own fairly soon, although that could be delayed if there are yet more bonds or Treasury coupon issues to be sold by, say, trading banks or dealers anxious to minimize capital losses or to protect whatever gain is left to them. But there is always the chance that the staff has misconstrued the situation. It might just be that current long-rate levels do appropriately reflect the future return from investment at near full employment, with due allowance for the rate of inflation. In that case, rates will not come down on their own.

Under the circumstances, it might be advisable to go light on coupon purchases for the time being, although some purchases might still be useful if they can help smooth an unwinding of speculative positions. If the money market is kept reasonably steady, and if it is correct that the recent long-term rate rise just reflects short-term protective moves by near-speculators, long-term rates will come down. If rates do not come down, it may be that they have attained something like an equilibrium level, and coupon purchases would do little to change rate levels and could have the perverse effect of encouraging investor selling if they were taken by the market as indicating lack of confidence by the System in the sustainability of current rate levels.

The key to long-term markets at the moment is the money market--assuming the volume of new corporate bond flotations in the future does not burgeon from around current levels. A money market stabilized around a 4-1/4 per cent Federal funds rate would contribute to tranquility in bond markets. At such a funds rate, however, M_1 growth may well slow down only modestly over the next few months from the almost 11 per cent pace of April and would likely remain high by historical standards. On the other hand, bank credit, as measured by the proxy, grew quite moderately in April on average and may show little net change on average in May.

With bank liquidity quite high, I do not find this limited expansion in bank credit over a two-month period worrisome. It is associated, in April, with a sharp decline in liabilities to branches; in May, with an expected sharp drop on average in U.S. Government deposits; and over the course of both months with an expectation of no net expansion in large CD's. Basically, of course, the sluggishness in bank credit reflects a weakness in loan demands on banks and an expectation on the part of banks that long-term interest rates will rise. Once loan demand picks up, net Treasury cash borrowing demands expand as we move into the summer months, and/or banks return to a more positive attitude toward security investments, bank credit expansion is likely to resume at a more rapid pace.

Nevertheless, the current weakness in bank credit expansion, together with the sensitivity of long-term markets, may be taken as reasons for moving quite cautiously in slowing the growth rate of M_1. (M_2 already appears to have slowed from its extravagant February-March rate, and its growth seems, if staff projections are correct, to be moving into a range similar to that of the last three quarters of 1970.) If under the circumstances the Committee wished to move toward slower growth in M_1 than presumed under directive alternative A,[1] it would probably be best to move one very small step at a time. One strategy would be to establish a Federal funds rate around 4-3/8 per cent in market thinking and adjust it upwards in small steps if M_1 appears to be rising more rapidly than desired. As the funds rate moves persistently to 4-1/2 per cent and above, it seems to me that chances of an adverse bond market reaction increase significantly.

Chairman Burns remarked that Mr. Axilrod's view of the risks for the bond market of some firming of money market conditions seemed to be somewhat different from the Manager's view. He asked Mr. Holmes if that was his impression also.

Mr. Holmes said he did not think the difference was great. In his judgment a Federal funds rate of 4-1/2 per cent would not have very much effect on the bond market, but the risks of a reaction would increase if the funds rate was raised above 4-1/2 per cent--say, to 4-3/4 per cent. He should note that it was not possible to be completely confident about such judgments. For example, if the exchange market crisis was resolved in a manner favorable to the United States, or if the growth in the aggregates began to slow, the market reaction might be quite different from what it would be if everything seemed to be going wrong.

1/ The alternative draft directives submitted by the staff for Committee consideration are appended to this memorandum as Attachment A. Growth rates for M_1 for the first and second quarters specified in connection with directive alternative A in the blue book (the report, "Monetary Aggregates and Money Market Conditions," prepared for the Committee by the Board's staff) were 9.0 and 8.5 per cent, respectively.

Mr. Morris said he found the Manager's clarification of his views to be helpful. He then expressed the hope that the dramatic events in the international area in recent days would not divert the Committee's attention from the fact that, while the domestic economy was in an expansive phase, the expansion was extremely sluggish at the moment. Thus, a monetary policy that generated a more or less permanent upward thrust in long-term rates could be quite costly domestically. A small increase in the Federal funds rate--say, to 4-3/4 per cent--could have a significant impact on expectations in the bond market. At the same time, he doubted that it would have much effect on international flows of funds. The international situation had passed the point at which interest rate differentials were the critical consideration; now the main problem was posed by speculation on currency revaluations.

Mr. Daane said he was not sure the Committee could ignore international rate relationships at this juncture. The attitudes of foreign monetary officials were much more likely to be favorable if there was some tangible evidence that U.S. monetary policy had been shifted a bit to the tighter side. While those officials were viewing U.S. policy from the standpoint of their own problems, the effect on their attitudes of a somewhat less relaxed policy stance--which they had been hoping for all along--would be of some advantage to the United States. For that reason, he would like to ask the

Manager what difference there might be in his operations during the coming period under two alternative approaches--that of placing main emphasis on slowing of the growth in the aggregates, and that of probing toward somewhat higher short-term interest rates, bearing in mind the movements that were occurring in the aggregates.

Mr. Holmes replied that either approach might well lead to about the same operations in the coming period, since an instruction to achieve slower growth in the aggregates than was now expected presumably would call for pushing toward a higher funds rate and a firmer money market. How much firming was sought would depend in part on the extent to which the Committee wanted operations to be constrained by developments in the bond markets. In any case, although there was a difference in emphasis the outcome could be the same as under a primary instruction to seek firmer money market conditions.

Mr. Heflin expressed the view that timing was a very important consideration at this particular moment, in view of the uncertainties that were likely to be permeating both the domestic and international arenas over the next two or three weeks. Although he was much concerned about the growth rates in the aggregates, he thought the Committee should be careful not to rock the boat at the moment in an effort to slow their growth.

Mr. Mitchell said he wanted to raise a question about the growth rate of money. He recalled that last autumn, when M_1 growth was falling short of the Committee's desires, the staff had commented that to some extent changes in economic activity led to changes in money; that the line of causation was not wholly in the opposite direction. He now noted that from the fourth to the first quarter the money supply had grown less than GNP, so that velocity had risen. If it was true that the money supply responded, at least in part, to changes in GNP it would appear that the Committee had not been following a very stimulative policy.

Mr. Axilrod commented that he would qualify any statement about the influence of GNP on money by adding "at any given level of interest rates." As had been expected, the money supply had increased more in the first quarter than it might otherwise have because of the post-strike surge in activity. Looking ahead, the staff was projecting expansion in GNP at about a 7.5 per cent annual rate in the second and third quarters. Such growth would have to be accompanied by a substantial rise in the money supply unless there was to be a further rise in interest rates. He would expect the effect on the economy of such a rise in money, and the associated credit conditions, to be felt several quarters later;

in his judgment the change in GNP in a particular quarter did not depend to any important extent on the change in money in that quarter.

Mr. Maisel said he had two comments. First, the Manager's statement today that a modest increase in the funds rate probably would not have much of an impact on long-term rates was quite similar to a statement the Manager had made at the previous meeting. It was worth noting, however, that in the interim long-term rates had risen by 70 to 80 basis points. That fact suggested the depth of the uncertainties facing the Committee. Secondly, as he interpreted the numbers, from the beginning to the end of the five-week period since the last meeting M_1 had grown less than had been expected, and M_2 far less--contrary to the view generally held, which was based on the fact that those aggregates were above expectations in the intervening period. He asked Mr. Axilrod if that represented a correct interpretation of the data.

Mr. Axilrod replied that Mr. Maisel's interpretation was correct in terms of the relationship between the weeks comprising the end points of the period. The weekly pattern of M_1 had differed from staff expectations, but on a monthly-average basis M_1 and M_2 had grown faster than expected.

In response to another comment by Mr. Maisel, Mr. Axilrod agreed that there might be problems with the seasonal adjustment factors, and it was possible that the sharp increase in M_1 in early April and the subsequent rundown were related to international money flows connected with the foreign credit restraint program of the Department of Commerce and had no permanent implications. He might note that the staff's projections for the aggregates in May and June, shown in the blue book, reflected an upward adjustment in the M_1 growth rate expected to be associated with particular money market conditions. Thus, some of these questions would be put to the test over the next two months.

Mr. Brimmer remarked that he was not sure whether the Manager and Mr. Axilrod had come to any agreement on the question raised by Mr. Morris. Under alternative B the blue book specified a Federal funds rate of 4-3/4 per cent. The Manager had suggested that such a rate might produce a reaction in long-term markets, but that a 4-1/2 per cent funds rate probably would not. However, Mr. Axilrod apparently believed that even a 4-1/2 per cent rate might represent dangerous ground.

Mr. Axilrod commented that to the extent there was any disagreement on the matter between himself and Mr. Holmes it was small. He had expressed some concern about a 4-1/2 per cent funds rate because of the possibility that the market thought recent rates at around that level were a temporary aberration related to the international situation. If that were the case, then a judgment by the market that the Committee had deliberately raised its target to 4-1/2 per cent might create a reaction much like that experienced right after the Committee's preceding meeting. As

Mr. Holmes had indicated, however, no one could be certain about such judgments. He did feel reasonably certain that a 4-3/8 per cent funds rate would not prevent a rally from developing in the bond market, and that the higher the rate the smaller the chances of such a rally. At funds rates over 4-1/2 per cent questions would begin to be raised about the viability of the present discount rate, and there might be a wave of speculative selling in longer-term markets. In light of such considerations he would counsel extreme caution, including the avoidance of any dramatic actions and beginning the coming period with a funds rate below the level to which it had recently risen.

Mr. Hayes said he could understand the solicitude for long-term rates implied in the discussion this morning. At the same time, he thought the members should keep certain facts in mind in deciding what bearing that concern should have on the Committee's policy decision. The volume of long-term credit flows had been--and continued to be--enormous despite relatively high interest rates, and those flows undoubtedly had contributed importantly to the improvement of the economy's liquidity. With respect to the mortgage market, the flows of funds to thrift institutions had been sensationally large, and even if they were somewhat lower in coming months they would seem to provide a major support to residential construction.

In reply to a question by Chairman Burns, Mr. Hayes said he thought such support should be available for a number of months but he could not say whether it would continue beyond the end of the year.

The Chairman then commented that the question of how long that support would last was a matter of considerable concern. He went on to say that while an economic recovery was definitely under way it was still quite fragile. Long-term rates had risen quite sharply recently; yields on new corporate issues had gone up about 70 basis points in the past four or five weeks, and they now were about 1-1/8 percentage points above their late-January lows. If such increases continued he would be fearful about the prospects for the recovery. Accordingly, he thought the level of long-term rates was a matter of great importance--and also one of great uncertainty. Personally, he had been surprised by the rise that had taken place since the previous meeting, and he wondered if the Manager also had been.

Mr. Holmes responded affirmatively. He noted that the volume of new bond issues had not slackened to the degree expected; the May calendar of public offerings by corporations was now estimated at $3 billion--a very large volume, even though well below the record March level--and the flow of announcements of sizable offerings seemed to continue without abatement. The behavior of capital markets would improve if corporate treasurers began to exercise a little more restraint with respect to bond flotations.

Chairman Burns observed that corporations had little reason to exercise such restraint if they expected a firming of monetary policy.

The Chairman then said he would like to report on a recent action by the Board about which the Reserve Bank Presidents had not yet been informed. Toward the end of last week one Reserve Bank had proposed a discount rate increase of one-half point. The Board had voted to disapprove the increase for the following reasons. First, it was concerned about the effects a rise in the discount rate would have on debt markets, which at present were in a highly sensitive condition. Secondly, the Board feared that, with the economic recovery still fragile, a discount rate increase could damage confidence. Finally, the Board feared that a rise in the discount rate might have a significant impact on long-term interest rates and thereby adversely affect the flow of funds into markets for mortgages and issues of State and local governments--not necessarily immediately, but perhaps in six months.

Chairman Burns added that information about this action should be held in strict confidence by everyone present today. It would be particularly unfortunate if the information became public and was interpreted, as it probably would be, as a sign of disunity within the Federal Reserve.

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

Mr. Hayes said that in the interest of saving time he would summarize the statement he had prepared and submit the full statement for inclusion in the record. He then summarized the following statement:

> We are meeting today in the midst of an international monetary crisis which could turn out to be the most serious since World War II. A vote of no confidence in the dollar has been taken by several major central banks, and while the exchange markets so far have been relatively calm after the events of the weekend, the underpinnings of the whole postwar international financial structure are being questioned. While some major decisions have already been taken in Europe, the final resolution of the crisis remains in doubt. And, although the German government played a major role in precipitating the crisis at this time, we cannot overlook our share of responsibility.
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> In my judgment, policy decisions in this country should reflect some awareness of this responsibility and can still have a real bearing on the final outcome. In our own monetary field, it is obvious that the wide spread between short-term rates here and abroad has been a major factor causing an enormous flow of dollars into European central banks, and from an international point of view further firming of rates in this country could hardly fail to be helpful. Moreover, the potential seriousness of the international situation would justify us in giving somewhat greater weight to international factors in our policy determination than we have in the recent past.
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> Fortunately, however, our present position vis-a-vis our domestic goals does not conflict with this international objective. It seems clear to me that the monetary and credit aggregates, taken as a whole, have been growing much more rapidly than they should for any extended period if they are to be consistent with noninflationary economic expansion. For example, I would like to see the narrowly defined money supply return to

about a 6 per cent growth rate instead of the 10 per cent or more we have experienced in April and in the last three months. Likewise, gains in M_2 have been too high, even after giving due weight to substantial reintermediation. Of the three usual measures, only the credit proxy seems to have shown a growth that can be characterized as moderate.

Attainment of more reasonable growth rates calls for some additional firming in money market conditions. I would like to see the Federal funds rate in a range of 4-1/2 to 5 per cent, probably starting at the lower end of the range and probing toward the higher end of the range in the light of market reactions. These firmer conditions might be consistent with a bill rate of 4 to 4-1/2 per cent and a slightly negative or zero net borrowed reserve position. I recognize that the books have just closed on a none-too-successful Treasury refunding and that under normal circumstances we would refrain from any deliberate change in money market conditions for perhaps another week. However, the importance, from an international point of view, of our showing some willingness to move toward greater firmness is so great that we would be justified this time, I believe, in departing from an even keel policy.

Admittedly, the policy I am advocating entails a risk of some upward movement in long-term interest rates. I can understand the reluctance of some members of the Committee to adopt a policy which may involve such a rise in rates at a time when rates are already high and when the recovery of the economy is still tentative and uncertain. However, I do not believe that long-term rates can be the controlling, or even a principal, factor in our deliberations at this time for the reasons I mentioned earlier.

As to the directive, I would suggest that a modified version of alternative B would be appropriate. I would favor the following language, which might be labeled "alternative D":

> To implement this policy, the Committee seeks to moderate growth in monetary and credit aggregates over the months ahead. To this end, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some firming of money market conditions, while taking account of developments in the capital markets and uncertainties in foreign exchange markets.

This language retains the key idea that the Committee "seeks to moderate growth" in the aggregates. It further specifies that to this end, a "firming in money market conditions" is wanted, with account being taken of both capital market developments and foreign exchange market uncertainties. Seeking "to moderate growth in the aggregates" would mean something of the order of 6 per cent for M_1, while recognizing that this may not be possible. By "firming" money market conditions I would have in mind a funds rate of about 4-1/2 to 5 per cent. This latter goal might have to be modified if capital markets turned very sour, or if foreign exchange market conditions deteriorated. I do not believe that the clause on coupon issue purchases should be retained. Purchases of coupons in moderate amounts should be considered as more or less routine, and in the present context it is hard to maintain that they can promote accommodative conditions in long-term credit markets.

Last Thursday our directors voted unanimously to increase the discount rate by 1/2 of a percentage point to 5-1/4 per cent. They recognized that under ordinary circumstances such a move would not be desirable, coming just after the books closed on a Treasury refunding operation. They also recognized that the usual sequence in working toward a firmer monetary policy would be to start with open market operations and to use the discount rate as a confirming action. Finally, they were quite aware that a one-half point discount rate rise could have substantial temporary unsettling effects on the delicately poised bond market, and might require some System intervention.

Nevertheless, the directors felt that in this major international crisis there was nothing the System could do that could be more useful and more timely than to give an overt signal of our concern and our willingness to move quickly toward narrowing the interest rate spread which was a major cause of the difficulty. They felt that the sooner this action was taken the better, and that we clearly needed an increase larger than the downward moves of one-quarter point that were made during the winter months as adjustments to market conditions. They felt that prompt action on the discount rate could serve as an important signal both to authorities in Germany and other countries that were in the process of making crucial decisions, and to the unsettled foreign exchange markets, that the United States intends to defend the value of the dollar. While recognizing the risks involved in a general increase in domestic interest rates, they felt that those risks were outweighed by international considerations, more particularly against the background of rapid growth in the money and credit aggregates in recent months. I believe their reasoning was sound. I regret that the Board was unwilling to approve the increase last week. But it is still not too late to move, and a discount rate increase might well play an important role in the eventual resolution of the exchange market problem.

Chairman Burns asked whether Mr. Hayes thought the open market policy he advocated would be accompanied by an increase in long-term interest rates. Mr. Hayes replied that he could not be sure that would happen, but he was willing to take the risk.

The Chairman then remarked that he would be interested in knowing whether Messrs. Daane or Coombs had heard any suggestions as to the desirability of a U.S. discount rate increase during the Basle meetings. He personally had talked with a number of foreign central bankers in recent days and, while a wide variety of questions had been discussed in the course of those conversations, that possibility had not been mentioned.

Mr. Daane commented that, as at other recent Basle meetings, the participants had expressed concern about the rate of growth in the monetary aggregates that the Federal Reserve had permitted. However, he had not heard any reference to a possible U.S. discount rate increase.

Mr. Coombs said his experience was similar to Mr. Daane's. Although the foreign officials at Basle were disturbed by the large international rate spreads, they had not suggested any specific action in the area of domestic U.S. monetary policy.

The go-around then resumed with comments by Mr. Francis, who expressed concern about the inflationary implications of a target for money growth at an annual rate of 6 per cent or more. Although the present target had been adopted only a few meetings ago, it represented a continuation of a trend which had extended for about the past four and one-half years. Money had grown at a 6.3 per cent average annual rate since January 1967.

In evaluating the implications of continuing such a high target rate of monetary expansion, Mr. Francis thought the Committee should consider the history of the last two decades. During the ten-year period ending in late 1962, money grew at an average annual rate of 1.5 per cent. Given the changes that occurred in velocity and in the economy's productive potential, over-all prices rose at a relatively slow 1.5 per cent annual rate.

With the economic sluggishness of the early 1960's, Mr. Francis said, monetary stimulation was increased, and money rose at a 3.5 per cent average annual rate from late 1962 to the end of 1966. With velocity continuing to rise at its earlier pace and potential real output growing a little faster, that rate of monetary expansion resulted in a gradual increase in inflation to a 3 per cent rate. Following the credit crunch of 1966 money growth was again accelerated, producing a 6.3 per cent average annual rate from early 1967 to the present. Although the rate of increase in velocity had declined and a further small rise in the rate of potential output growth had occurred, a 6 per cent trend rate of monetary expansion implied a sustained 4 per cent rate of inflation.

In each case, Mr. Francis continued, the rate of growth in money was accelerated in order to overcome weakness in the economy. Despite those progressively more stimulative monetary actions, the rate of unemployment had averaged about the same whether the trend growth of money was 6 per cent, 3.5 per cent, or 1.5 per cent. The trend growth had had its chief impact on prices, whereas fluctuations around the trend had had the greatest impact on production and employment.

Mr. Francis believed it was imperative that the Committee not accelerate further the trend growth of money if inflation was ever to be curbed. In his opinion, the 10 per cent rate of monetary expansion since December, and the implied rapid growth rates until next fall under alternatives A and B, were cause for alarm. If acceleration to a higher trend was adopted, the Committee would find itself once again facing temporary economic dislocations accompanying future attempts to slow the rate of money growth. Moreover, such dislocations would become progressively more severe when restraint was applied at successively higher rates of monetary expansion and inflation. Such developments in the recent past had resulted in great pressure to accelerate monetary growth.

Mr. Francis believed the Committee should seek to reduce gradually the trend growth of money below the 6 per cent rate called for under directive alternative C. It was his opinion that a trend rate of monetary growth of 4 per cent would be desirable. If velocity and potential output should grow at about their recent trends, a gradual slowing of the rate of inflation would occur while output expanded toward capacity levels. If velocity should resume its higher trend growth of 1952 to 1966, the period of adjustment would be longer and the ultimate appropriate rate of monetary expansion might be about 3 per cent.

Mr. Francis noted that some might object to such a policy, anticipating the temporary financial market dislocations and the less rapid recovery of output which might result. In his opinion, however, that policy was the only one which would utimately reestablish a relatively stable price level. While output growth would remain moderate for a few months longer than otherwise, the Committee could look forward in the natural course of events to growth of output at the economy's potential. Monetary actions which attempted to foster a rapid expansion of output in the short run would most likely produce higher, or even accelerating, inflation for many years to come with accompanying stop-and-go stabilization efforts.

Mr. Kimbrel observed that if he interpreted the comment in the blue book correctly, the recent advance in market rates could be explained to a considerable extent by expectations that the System was turning toward a firmer policy. When the M_1 figures for April were thoroughly digested by the financial community, however, it would find little to confirm the view that policy firming had taken place in terms of monetary aggregates. The current estimates of M_1 for April showed a rate of growth above what he believed the Committee had desired, and that rate in turn was higher than the rate he believed was consistent with moderate expansion.

Of course, Mr. Kimbrel continued, policy execution in the last four weeks had been seriously complicated by a number of factors, including international developments and Treasury refinancing. Nevertheless, it seemed to him that the experience illustrated the practical difficulty--if not the impossibility--of following a consistent long-range growth path in the aggregates without permitting some fluctuations in market rates. Otherwise, the Committee found itself locked into a position of merely confirming conditions that might not be at all what it desired.

Mr. Kimbrel said he had not been especially enthusiastic about the "catching up" rationalization for stepping up growth rates for monetary aggregates in order to correct for previous shortfalls. Neither did he consider a mopping-up process, whereby attempts were made to suddenly correct previous overshoots, to be desirable. The result was likely to be a situation such as the Committee was confronted with in alternative C.1/ A more practical approach, it seemed to him, was to admit past mistakes, take the situation as it was, and go on from there in the hope of doing better.

Mr. Kimbrel believed that the rates of growth in M_1 in March and April had been excessive and inconsistent with a policy of moderate growth and an orderly reduction in the rate of inflation. However, that past performance could not be corrected by a sudden tightening in order to achieve some kind of an arithmetic average. He believed that a gradual probing operation aimed at getting back to an acceptable growth in the aggregates would be preferable.

Mr. Kimbrel noted that alternative B did move in the direction of reducing the rate of expansion in the monetary

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1/ Specifications given in the blue book for alternative C included a Federal funds rate in the range of 6 to 8 per cent. The blue book text read in part as follows: "Should money market conditions tighten as much as indicated for this alternative between now and the next meeting of the Committee, both short- and long-term rates would likely rise very dramatically, and questions would be raised about the prospects for continued growth in consumer-type time and savings deposits under current interest rate ceilings. The current discount rate would obviously be far out of line with the market conditions associated with this policy alternative."

aggregates. The figures specified might be about as far as the Committee could safely go between now and the next meeting.[1/] However, he would be happier if the target growth rate for M_1 were specified at 7-1/2 to 8-1/2 per cent, and he would be willing to see the Federal funds rate push up to just below 5 per cent if necessary to dampen the rate of growth in M_1. Moreover, he would hope it would be possible to supply a modest volume of reserves through coupon operations in the next period. He would regard that as a probing move toward a further dampening in the growth of M_1.

Mr. Eastburn said he would favor alternative B for the directive. The growth rates for the aggregates associated with alternative A were too high, and he would eliminate alternative C on the ground that efforts to make up for overshoots--as well as shortfalls--within short periods were likely to lead to difficulties. He thought it would be desirable to add to the language of alternative B the one-way proviso clause included in A, which read: "provided that somewhat firmer money market conditions shall be sought if it appears that the monetary and credit aggregates are significantly exceeding the growth paths expected." He would interpret that proviso language to mean that the Federal funds rate might approach 5 per cent, and member bank borrowings might rise into the

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1/ Specifications for alternative B in the blue book included a Federal funds rate of 4-3/4 per cent and an annual rate of growth in M_1 of 8.5 per cent for May as well as for the second quarter as a whole.

$400 million to $450 million range, if necessary to keep the aggregates from growing at rates above those associated with alternative B--which in his view were already too high. However, he agreed with Mr. Axilrod that any firming should be implemented very cautiously.

Mr. Eastburn said he had been highly interested in the comments earlier today on the relationship between interest rates and growth rates in the monetary aggregates. While it was hard to determine what really was influencing the aggregates, he found himself wondering whether their recent rapid growth did not reflect a basic change in the relationship. He suspected also that the recent increases in interest rates reflected not only the market's assessment of the outlook for monetary policy but also expectations of renewed inflation. It was important that the System avoid acting in a manner that tended to confirm such expectations.

Mr. Eastburn added that if there had been a basic shift in the underlying relationship it might be impossible to keep long-term rates from rising further without tolerating increases in the aggregates large enough to do considerable damage to the economy nine months hence. Moreover, the problem of controlling the aggregates would be complicated later in the year by frequent periods of even keel. Accordingly, the sooner it was possible to bring about a lower rate of growth in the aggregates the better it would be.

Mr. MacDonald observed that, although the economy had expanded at a rapid rate in the first quarter, unemployment remained at an unacceptably high level. In addition, inflation continued to be a serious problem. The situation was further complicated by the persistent and sizable balance of payments deficits that this country had experienced, and the Committee's deliberations today had been brought into sharper focus by the recent crisis in foreign exchange markets. It was necessary for the Committee to pay attention to the goal of improving the nation's international position, but reductions in unemployment and in the rate of inflation should continue to be given high priority.

Mr. MacDonald remarked that monetary policy from February to May had been more than adequately expansionary to stimulate economic recovery. He thought it was now appropriate to return to a growth path for the aggregates over the months ahead that was consistent with the Committee's basic objective--to foster conditions of full employment with noninflationary growth.

That would seem to call for alternative C, Mr. MacDonald said. However, he found the associated money market conditions to be unacceptable. Alternative B was more desirable in terms of money market specifications, but the rates of growth indicated for the aggregates were somewhat excessive. Thus, he would prefer a directive today cast in terms of the money market specifications of alternative B, but which would envision moving toward growth paths of the aggregates over the months ahead that were consistent with alternative C. As others had suggested, he would want to proceed cautiously in raising the Federal funds rate.

Mr. Sherrill said he thought the Committee members were generally agreed that the recovery was still in a very delicate stage and that the outlook was highly dependent on developments in long-term markets. In his judgment the Committee's immediate objective should be to avoid changes in short-term rates that were likely to generate upward pressures on long-term rates. However, the long-term goal of fostering a noninflationary prosperity called for slowing the growth in the monetary aggregates, particularly M_1.

Mr. Sherrill noted that he was not as alarmed about the recent and prospective growth rates in M_1 as he would have been under other circumstances because M_2 and the bank credit proxy did not appear to be growing at excessive rates. On the other hand, it was possible that the rapid growth in M_1 was an indirect cause of the recent increase in long-term rates, since market participants might be anticipating firming actions by the System in an effort to slow the expansion in money.

Mr. Sherrill went on to say that the Committee's immediate and longer-run objectives clearly were in conflict at the moment. He thought alternative B represented the best means of resolving that conflict. He would interpret B to call for raising the target for the Federal funds rate to 4-1/2 per cent, and then moving gingerly toward 4-3/4 per cent, keeping a careful eye on the reaction in bond markets. He noted that the growth rate of M_1 had declined a little in both March and April, and that further slowing was projected for May and June. If that slowing eventuated it should help calm conditions in the market.

Mr. Sherrill added that he recognized the risks involved at present in System operations in coupon issues. Nevertheless, there might still be opportunities to engage in such operations in a useful manner, and he would want the Desk to take advantage of any such opportunities.

Mr. Brimmer remarked that he agreed in general with Mr. Partee's analysis of the economic situation. He favored alternative B for the directive. In his judgment, 4-1/4 per cent was too low a target for the Federal funds rate; like Mr. Sherrill he thought the Manager should start with a 4-1/2 per cent target and try to work upward from there. He recognized that both the Manager and Mr. Axilrod thought there was some danger that a 4-3/4 per cent funds rate would bring long-term rates under upward pressure, but he believed it would be desirable to put the matter to the test. Accordingly, he would favor having the Manager probe toward a 4-3/4 per cent rate, standing ready to back off if necessary.

Mr. Brimmer said he concurred in Mr. Eastburn's view that expectations of renewed inflation accounted for part of the recent increase in long-term interest rates. He was impressed by the fact that market participants appeared to be coming increasingly to the view that long-term rates had already gone as low as they were likely to. Just yesterday, the Chairman of the Home Loan Bank Board had made a statement advising prospective home owners to buy a home now, on the grounds that mortgage interest rates had leveled out and were not likely to drop further. The Committee had to take such expectations into account. As to the corporate and municipal markets, he noted that the volume of new offerings was still very high, even though it was down somewhat from recent peaks.

Mr. Maisel observed that for some time--perhaps four or five months--the Committee had not had a detailed discussion of the appropriate growth rates for the monetary aggregates. At first glance the growth rates projected for M_1 under alternative A--9.0 and 8.5 per cent in the second and third quarters, respectively--seemed rather high. However, he thought such rates would not be out of line with past experience. The staff was projecting that GNP would rise at a 9.3 per cent annual rate from the fourth quarter of 1970 to the fourth quarter of 1971, so that continued growth in M_1 at about a 9 per cent rate would imply an increase in velocity over the year. Moreover, the alternative A growth rates for M_2 and the bank credit proxy seemed to him to be low relative to what would be needed to achieve expansion in GNP at the projected rates. As he had indicated, however, the Committee had not given adequate consideration recently to such questions. He hoped that could be done at a forthcoming meeting on the basis of a staff analysis of the relation between growth rates in the various aggregates and goals for production, employment, and prices.

As he suggested earlier today, Mr. Maisel continued, he did not think the recent behavior of the aggregates offered grounds for concern since they had risen less than expected from the two weeks before the preceding meeting to the last two weeks. He was concerned, however, by the sharp increase in long-term interest rates that had occurred since the preceding meeting.

In light of such considerations, Mr. Maisel remarked, he thought it would be desirable to maintain prevailing money market conditions at present. In his judgment the Desk should probe toward a higher Federal funds rate if it turned out during the period that the aggregates were running above the alternative A or B paths--which were almost identical for the next four weeks--but not otherwise. He favored alternative A for the directive language.

Mr. Daane said he liked the spirit of alternative B and the specifications associated with it, but he did not like the format with its central focus on the monetary aggregates. While the Committee should be concerned about excessive growth in the aggregates, it should also be concerned about the risk of adverse developments in the long-term markets that could damage the economic recovery; and to focus on the aggregates would be to increase the risk of such developments. In the current environment--including the unsettled conditions in international markets--he thought the Manager should be given a good deal of flexibility with respect to operations.

For those reasons, Mr. Daane continued, he would favor couching the directive primarily in terms of money market conditions. While he was not sure what specific language might be best, he thought the Manager should be instructed to probe toward a higher Federal funds rate while remaining alert to the need for avoiding disruption in the long-term markets. He would hope that the minor firming of money market conditions he advocated would have some dampening effect on the aggregates, but he would not want to aim for any precise aggregative targets.

Mr. Hayes noted that the language of alternative D he had proposed earlier did not have the narrow focus on targets for the aggregates of the staff's alternative B, since it called specifically in the second sentence for some firming of money market conditions.

Mr. Daane agreed, but added that he would still prefer to formulate the primary instruction in terms of money market conditions. Although the Manager had indicated earlier that the outcome might be the same whether the emphasis was placed on market conditions or aggregates, he (Mr. Daane) thought the risks would be smaller with a money market emphasis.

Mr. Mitchell commented that like others today he agreed with Mr. Partee's analysis. Unlike others, however, he thought that analysis led to a preference for alternative A. He, too, was unhappy with the behavior of M_1 but he would not want to attach too much importance to that measure; M_1 had a number of statistical shortcomings, and it was not available on the dis-aggregated basis that would be needed to understand its movements fully. He thought the Committee should not be unduly disturbed by its high rate of growth, and should be prepared to live with that growth for a while longer in the hope that it would slacken.

Mr. Mitchell added that a further advantage of alternative A was that it would provide less risk than the other alternatives of doing damage in the long-term area. As had been suggested, the long-term markets were delicately poised at the moment.

Mr. Daane asked whether Mr. Mitchell would favor holding the Federal funds rate at its present level.

Mr. Mitchell replied affirmatively, adding that he gathered from Mr. Axilrod's remarks that long-term markets might begin to perform in the manner desired so long as they were not given a signal that higher rates were in prospect. He favored alternative A not because he preferred the aggregate growth rates associated with it--as Mr. Maisel had pointed out, for the next four weeks they were virtually identical with those given under alternative B--but because he was concerned about the psychological effects of the higher funds rate called for under B.

Mr. Maisel remarked that it was particularly important to avoid an increase in the funds rate immediately after the Committee meeting, as had happened following the preceding meeting. He noted that operations would remain under an even keel constraint for another week or so. It might be desirable under the proviso clause of alternative A to seek a higher funds rate after the end of the even keel period, but if so he would favor proceeding cautiously.

Chairman Burns asked whether the Manager would interpret alternative B as calling for an immediate increase in the funds rate.

Mr. Holmes replied that, as the members knew, the funds rate recently had been above the 4-1/4 per cent objective, at 4-1/2 per cent or higher, despite the fact that the Desk had supplied a large volume of reserves. It probably would have been feasible yesterday to bring the rate down to 4-1/4 per cent, but he had not thought it advisable to do so in light of the possibility that the Committee might decide today to seek a higher rate. The blue book specified a 4-3/4 per cent funds rate in connection with alternative B, and a Committee decision in favor of that alternative presumably would be based on the conclusion that such a rate was needed to slow the growth in the aggregates over time. There would still be a question of whether the Committee would want the Desk to move to 4-3/4 per cent immediately, or to start out with the present 4-1/2 per cent rate and probe up towards 4-3/4 per cent. He noted that a number of members favoring B had advocated probing gently toward rates above 4-1/2 per cent, and backing off if there was an undesirable reaction in the bond market.

Mr. Brimmer asked how the Desk's operations might differ if the Committee adopted alternative A.

Mr. Holmes replied that a decision in favor of A presumably would imply a Committee desire to have the funds rate brought back down to the previous target level of 4-1/4 per cent, whereas under B the Desk would, at the minimum, try to hold the rate at the 4-1/2 per cent level actually prevailing. He added, incidentally, that he would not expect a 4-1/2 per cent funds rate to upset the bond market because the rate had already been at that level for a number of days.

The Chairman then suggested that one possible course would be to adopt the language of alternative A but associate with it the specifications shown in the blue book under alternative B, and instruct the Manager to keep a close eye on the performance of the aggregates. The Manager might also be given more than the usual degree of flexibility in light of the prevailing uncertainties

Mr. Hayes noted that alternative A called for maintaining "prevailing" money market conditions, whereas the 4-3/4 per cent funds rate associated with B in the blue book was higher than the rate now prevailing.

Mr. Maisel said the Manager might be instructed to start out the period by maintaining the current 4-1/2 per cent funds rate. The critical question for the Committee to decide would then concern the circumstances under which he should probe towards a 4-3/4 per cent rate.

Chairman Burns observed that he would interpret the type of instructions he had mentioned as calling for a higher funds rate only if the aggregates were expanding excessively.

Mr. Hayes said he would question the desirability of accepting the projected growth rates in the aggregates without probing toward firmer money market conditions, assuming conditions in the capital markets made such probing feasible.

The Chairman remarked that the difference between Mr. Hayes' position and his own seemed to reflect a difference in their views of the economy. Personally, he considered higher interest rates not as an objective but as a cost that might have to be incurred, depending on developments. Lower interest rates were needed to foster the kind of prosperity that had been eluding policymakers; at the same time, the money supply could not continue to grow at the pace of the past three months if inflation were to be brought under control. The staff's analysis suggested that the aggregates would grow rapidly further at current interest rates, and that growth at a moderate pace would be associated with sharply higher interest rates. Faced with that dilemma, most Committee members seemed to be leaning toward some version of alternative B as a middle ground. Speaking for himself, he would like to see interest rates kept where they were--or, preferably, reduced--unless the aggregates were growing at excessive rates.

In response to a question by Mr. Hayes, Chairman Burns said he would consider as excessive the 9 per cent growth rate for M_1 shown in the blue book for the second quarter under alternative A. As he had noted earlier, he would want the Manager to watch the behavior of the aggregates closely. He thought the funds rate should be raised from its present level of 4-1/2 per cent if that appeared necessary to prevent excessive growth. However, he would not want the rate raised immediately, before incoming data on the aggregates indicated the need.

Mr. Holland remarked that if the target for the funds rate were to be raised from 4-1/4 per cent to the 4-1/2 per cent level actually prevailing, it might be desirable to revise the language of alternative A to call for maintaining "currently" prevailing conditions in the money market.

Mr. Hayes said the Committee might specify the target for the funds rate in terms of a range from 4-1/2 to 4-3/4 per cent on the understanding that, after starting out with a 4-1/2 per cent rate, the Manager would probe toward 4-3/4 per cent if the reaction in capital markets was not extreme.

In reply to a question by the Chairman, Mr. Hayes said he would not favor making the probe toward a higher funds rate conditional on developments with respect to the aggregates partly because he thought not much could be learned about the trend of the aggregates from data for very short periods.

At this point the meeting recessed. It reconvened at 2:25 p.m., with the same attendance as at the morning session.

Mr. Heflin recalled that in February and March, given the shortfalls in the aggregates during the preceding four months and the obvious desirability of working for lower long-term yields, he was prepared--as a temporary expedient--to accept growth rates in the aggregates of the order of 10 per cent or more. Now that the shortfalls had been made up, he thought there was a new ball game. He was disturbed over the prospect, on top of the rapid expansion of the first quarter, of growth rates in M_1 and M_2 of 8 to 10 per cent or more in the current and third quarters. Growth rates of that order persisting over a period that long were clearly excessive. He was all the more convinced of that in view of what he took to be a growing climate of inflationary fears. In such a climate, excessive expansion in M_1 and M_2 could defeat, rather than contribute to, the Committee's objectives with respect to long-term interest rates.

Nevertheless, Mr. Heflin continued, he would be reluctant to take any dramatic or overt tightening move until there was some evidence of significant improvement in the unusually nervous atmosphere that had dominated financial markets over the past few weeks. He would definitely rule out alternative C and, given the state of market psychology, he would have some hesitation about moving to alternative B at this time. The language of alternative A was acceptable to him although he was not happy with the specified growth path of the aggregates. He would prefer to have the proviso refer to "the growth path desired" rather than to "the growth path expected." He would like to have such a proviso interpreted to mean that, to the extent that it could be done without serious risk of disrupting the markets, the Desk should move in the direction of the market conditions specified under alternative B if it appeared that M_1 in May was growing at an annual rate much over 7 per cent. Until the proviso became operative he thought the Desk should try to keep the funds rate around its present level of 4-1/2 per cent.

Mr. Clay remarked that the monetary policy adopted at the last meeting of the Committee would still be appropriate for the domestic economy today and the period ahead. Unfortunately, developments since the last meeting, largely in response to the international financial situation, had drastically altered the position of both interest rates and the financial aggregates. Accordingly, it would be very difficult to bring monetary policy back into that intended posture very quickly.

Nevertheless, Mr. Clay observed, it was important to move back toward those goals for the financial aggregates so far as feasible. The impact on money and capital markets of alternative C, as discussed in the blue book, would be too severe. The changing international currency relationships might lead to improvement in the credit markets, as a reflow of funds dropped domestic short-term rates and as the atmosphere in the domestic money and capital markets improved. Accordingly, it might be possible to bring about money market conditions more acceptable than those associated with alternative C in the blue book, while at the same time achieving growth rates in the aggregates in line with alternative C. In any case, the thrust of policy should be in that direction, and in the interest of bringing the growth rates in the aggregates under control, the Committee would need to stand ready to accept somewhat higher money market rates than it had viewed as acceptable a month ago.

Mr. Clay said he could accept alternative D with Mr. Hayes' specifications provided sufficient recognition was given to the need for flexibility in light of the international financial situation. On balance, however, he would prefer alternative B. He would urge a cautious, flexible probing toward lower rates of growth in the aggregates to the extent that was possible while remaining highly sensitive to the risk of undue increases in long-term rates. He thought the Committee had to pay attention to the money supply if only because the market and the public were paying it a great deal of attention; under such circumstances, its behavior could have significant effects on market psychology.

Mr. Mayo said he was quite impressed with the logic of the proposal made earlier that the Committee adopt language along the lines of alternative A and the specifications of alternative B. As Mr. Maisel had noted, the blue book paths for the aggregates under the two alternatives were almost the same for the period until the next meeting; for M_1 the largest difference in any week was $100 million, out of a total of $222 billion. But the specified money market conditions for the two alternatives were significantly different. To his mind that pointed up the difficulties associated with too precise a specification of the relationships between the aggregates and money market conditions.

Although he liked the specifications of alternative B better than those of A, Mr. Mayo continued, he preferred the emphasis on money market conditions of A. He would modify the staff's draft to call for maintaining "currently prevailing" money market conditions, which he would define as a range around 4-1/2 per cent, perhaps 4-3/8 to 4-5/8, or even 4-3/4, per cent. He would not be concerned if the funds rate exceeded 4-3/4 per cent on occasional days, but it should not be above that rate for any protracted period. He stressed that point because he thought a funds rate persistently above the discount rate would lead to speculation about an increase in the discount rate. He would consider a discount rate increase undesirable under present circumstances.

Mr. Mayo expressed the view that the three-month Treasury bill rate was not likely to reach 4-1/2 per cent if the Federal funds rate were around that level. He would not want to push short-term rates up too much because of his concern about long-term rates. At the same time, he thought the Manager had made a good case for reducing the emphasis on operations in coupon issues.

In that connection, Mr. Mayo observed that his enthusiasm for coupon operations had diminished somewhat now that the objective had begun to resemble the goal of the original "operation twist"--that of pushing down long-term rates while letting short-term rates move up a little. When he had advocated coupon operations a few months ago, he had understood the objective to be simply that of fostering declines in long-term rates.

Mr. Strothman said his preference was for alternative B, but with a two-way proviso. That seemed to him to be a reasonable compromise. The Board's staff was a shade more bullish than it had been earlier, but even so, the economy was sufficiently far from attaining a satisfactory unemployment rate that a relatively high rate of increase for M_1 seemed justified. He did not consider an 8 to 8-1/2 per cent rate of increase as regrettable, or as acceptable only because the Committee was unwilling to force market interest rates sharply higher; given the staff's economic outlook, 8 to 8-1/2 per cent was an appropriate rate of increase for M_1 for the months immediately ahead. The higher rates which alternative B would produce might be judged desirable, taking into account the unsettlement in foreign exchange markets. He welcomed the emphasis on purchases of coupon issues in alternative B, however, and would like to see such operations pursued somewhat more vigorously.

Mr. Swan remarked that the directors of the San Francisco Reserve Bank had concluded at their meeting last Thursday that the discount rate should not be increased at present. However, they had expressed more strongly than for some time their concern about the rates of growth in the monetary aggregates and about generally increased fears of a renewal of inflationary pressures. Personally, he thought liquidity had been provided in recent weeks at a considerably faster rate than had been anticipated at the last meeting, and that the Committee should now try to get the growth rates of the monetary aggregates back within reasonable limits.

Mr. Swan observed that the recent slowing of growth in M_2 was attributable in large part to slackened inflows of consumer-type time and savings deposits. It was worth noting that there did not appear to be any comparable slackening in the inflows to savings and loan associations. The San Francisco Bank's sample check of California associations indicated that inflows were extremely large in April--probably larger than in any other April on record--and that they continued heavy in the first few days of May.

With respect to long-term rates, Mr. Swan agreed with Mr. Eastburn that renewed expectations of inflation might have been a significant factor in the recent increases. In his judgment insufficient attention had been given to that possibility.

Mr. Swan said he could accept either alternative D or alternative B for the directive, and he was in substantial agreement with Mr. Brimmer with respect to the specifics of operations. He did not agree with the suggestion that because of the similarity in growth paths for the aggregates the Committee could use the language of alternative A and associate with it the specifications given under B. In his judgment, no matter how the Committee spelled out the specifications, the outcome was not likely to be the same if it adopted the language of A rather than that of B or D. Under the latter alternatives, the "color, tone, and feel" of the market probably would be different, and the chances of controlling excessive growth in the aggregates would be better.

Mr. Coldwell commented that he still had four primary desires with regard to policy. First, he would like to see reserve availability sufficient to support and facilitate economic recovery, but not so great as to overliquefy the economy and generate or reinforce expectations of inflation. He thought System operations recently had done some of the latter. Second, he would like to see short-term yields high enough to be competitive with such yields abroad, and long-term rates low enough to stimulate housing and facilitate capital issues. Third, he would like to see sufficient balance to contribute to international equilibrium. Finally, he would like to see sufficient stability in market conditions to engender optimism and permit long-range planning.

In his judgment, Mr. Coldwell continued, the first priority should be given to the international problem, the second priority to stabilizing money market conditions, and the third to slowing the overly rapid growth in the aggregates. He did not like the idea of higher long-term rates, but in assigning priorities the Committee had to be prepared to take some risks.

As to the directive, Mr. Coldwell was willing to accept Mr. Hayes' alternative D. If he were writing a directive on his own, however, he would call for operations with a view to "stabilizing money market conditions at levels conducive to lower rates of growth in monetary aggregates and improved balance in international yields."

In a concluding observation, Mr. Coldwell said he was especially concerned about the international problem. To some extent the immediate problem reflected fiscal deficits and imbalances in interest rates. However, he was highly disturbed by the longer-run weakening in the nation's competitive position and deterioration in the value of the dollar, and by the apparent lack of policies designed to correct the fundamental balance of payments problem. He deeply resented the embarrassment the United States had suffered in the latest currency crisis, and he hoped that some action would be taken to forestall future crises of that kind.

Mr. Morris said he was more concerned than most people around the table seemed to be with the weakness of the economic expansion. Thus far, the current recovery undoubtedly would rank as one of the weakest cyclical revivals in the nation's history. Whether the expansion would accelerate was highly dependent on continued large flows of funds into mortgages and bonds of State and local governments. That was why the recent sharp increase in long-term yields was so disturbing; unless reversed, it was bound to result into a slowing of flows of funds into those rate-sensitive markets. He agreed with Mr. Axilrod that the primary cause of the rise in long-term rates was a change in market expectations, induced to a large extent by the belief that the Federal Reserve had changed its policy. For that reason he thought it would be unwise at this juncture to give the market another signal that would be interpreted as reflecting a change in policy.

Mr. Morris observed that like others he was concerned about the sharp rise in M_1 during the past few months. However, he still thought a great deal of the increase was due to nonrecurring causes that were the counterpart of earlier shortfalls. Even if M_1 were to grow in the second quarter at the 9 per cent rate projected under alternative A--and he was a little skeptical of that projection--its growth over the three quarters ending then would average out at a 7.1 per cent rate. In his judgment that was not an excessive growth rate for a period of economic slack.

Given the hazards for sustainable economic expansion posed by the sharp rise in long-term rates, Mr. Morris continued, he thought the Committee should seek to stabilize the markets over the next four weeks. Such a course would help create expectations consistent with the decline in long-term rates that he considered essential if the goals for the domestic economy were to be met. He favored alternative A with the blue book specifications, including a Federal funds rate nudged back down to 4-1/4 per cent. He would find a 4-1/2 per cent funds rate acceptable if he were sure that the market had fully discounted such a rate. However, since the 4-1/2 per cent rate had been in effect only for about a week, in a period marked by highly unusual circumstances, the market might well interpret its persistence as signifying another discrete step toward a less expansionary policy.

Mr. Robertson made the following statement:

> The available evidence seems to indicate that the economy has become a little stronger over the past month. Probably the most important development has been the increase in consumer spending, as evidenced by the higher retail sales figures. For some time I

have expected that the very large potential backlog of consumer spending would eventually be released. We are now seeing the beginnings of it. As for prices, progress is being made, by some standards, toward slowing the rate of increase, but figures such as the April rise in the wholesale price index emphasize that we still have a hard battle ahead if we are to control inflation in a meaningful way.

The statistics on monetary aggregates are still too strong. As you know, I view these numbers with a certain degree of skepticism, and I do not think we should base our decisions on a movement of one or a few weeks' duration. But from my point of view, the figures have now been running well above desirable levels for too long. M_1 growth is still very high. There has been more slowing in the rate of expansion of M_2, but this was from an extraordinarily high level and still has not brought it down to a rate I would consider desirable. The third aggregate, the bank credit proxy, is, of course, growing quite slowly and is not a source of concern at the moment.

We must also give international financial considerations due weight in our policy decisions. The dramatic developments of this past week attracted attention even in far-away Ecuador, as can be attested by those of us who attended the Central Bank meeting in Quito last week. But we must be careful not to overreact to these events, or to try to undertake more in the way of remedial action by means of open market policy than is its proper responsibility.

As I see it, both our domestic and international concerns call for an open market policy prescription today that seeks to moderate the aggregate flows, even though it results in some modest firming of money market conditions, but preferably, of course, without any such firming. In all events, any tightening should not be so abrupt as to result in a whipsawing of short-term rates. (That would be neither wise nor necessary.) Interpreted in this manner, alternative B of the draft directives would, I believe, be in the best interests of achieving our longer-term objectives. However, I would eliminate the reference to the purchase of coupon issues, because I think it is an ineffective way of bringing down rates in the long-term issues, and in addition because continuation of this practice on any large scale runs the risk of driving

> participants out of the coupon issue market and leaving the Federal Reserve as the only buyer therein. Also, I would prefer to incorporate into alternative B the first part of the proviso clause in alternative A, reading approximately as follows: "provided that somewhat firmer money market conditions shall be sought if it appears that the monetary and credit aggregates are significantly exceeding the growth paths desired."

Mr. Robertson added that incorporating the proviso clause should help make clear that the Committee was interested in slowing down the growth in the aggregates if and as it could. He thought it would be undesirable at the moment to give evidence of an overt firming of policy, and that any firming should be quite modest. In general, however, he believed that the Committee should keep its eye on the aggregates rather than on money market conditions.

Chairman Burns observed that a sizable majority of the Committee favored a second paragraph for the directive along the lines of alternative B, although there were some questions to be resolved. One such question concerned the desirable scale of operations in coupon issues and the nature of the reference, if any, to such operations in the directive. He asked the Manager whether the System's recent operations had been interpreted as an effort to dominate the market for longer-term Government securities.

Mr. Holmes replied that while market participants were not unanimous on the matter, there seemed to have been more of that sentiment in connection with the System's coupon purchases shortly after the April meeting than there had been earlier.

The Chairman then asked what advice Mr. Holmes would give the Committee.

Mr. Holmes said he would suggest de-emphasizing coupon operations to minimize the risk that the System would become the only major buyer, although the Desk might continue to engage in such operations whenever it appeared that they would serve a useful purpose. If the Committee decided on such a change in emphasis it might be well to reflect it by modifying the directive language.

Messrs. Robertson and Hayes concurred in the Manager's suggestion.

Mr. Daane remarked that the Committee might modify the draft directive along the lines Mr. Hayes had suggested earlier, replacing the clause relating to coupon operations with a clause reading, "while taking account of developments in the capital markets." Alternatively, some such language as "while continuing to evidence concern about conditions in long-term credit markets" might be used.

Mr. Mitchell commented that those clauses struck him as rather cryptic.

Chairman Burns suggested that the Committee consider two possible courses. The first would be to retain the concluding clause of alternative B, which read "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." The second would be to delete that language and to expand the final clause of the first sentence to indicate that account should be taken not only of the current Treasury financing and foreign exchange market uncertainties but also of "developments in capital markets."

In reply to questions, Mr. Holmes said he would interpret a Committee decision in favor of the first course as calling for continuing operations in coupon issues on about the recent scale, making allowance for the fact that such operations had been constrained most recently by even keel considerations. Adoption of the second course would indicate that the Committee wanted to de-emphasize such operations in the manner he had suggested. He thought that if the Committee followed the second course it would be desirable to spell out its intent in the policy record. The choice between the two courses would seem to him to have little bearing on the extent to which developments in capital markets affected the target for the Federal funds rate; the issue was one of operating techniques rather than targets.

In response to the Chairman's request for an indication of their preferences, a majority of the members signified that they would prefer the second course.

Chairman Burns observed that, in accordance with the sentiment of the majority, the first sentence of alternative B should be considered as revised to read as follows: "To implement this policy, the Committee seeks to moderate growth in monetary and credit aggregates over the months ahead, taking account of the current Treasury financing, developments in capital markets, and uncertainties in foreign exchange markets." Turning to the second sentence, he asked whether the members thought the following modification of the draft language would accurately reflect the Committee's intent: "System open market operations until the next meeting of the Committee shall be aimed initially at maintaining currently prevailing money market conditions, and thereafter conducted with a view to maintaining bank reserves and money market conditions consistent with the above-cited objectives."

Mr. Maisel said he would like to pursue the question of how such language would be interpreted. One issue, to which he had referred earlier, concerned the circumstances under which the Desk would probe toward a funds rate above 4-1/2 per cent. Another was whether the Manager would plan to raise the rate at which the Desk made repurchase agreements from its present 4-1/8 per cent level. That question was important because the market was likely to interpret a higher RP rate as a signal that policy had been tightened.

Mr. Holmes agreed that the market was highly sensitive to the rate on RP's, and indicated that unless the Committee instructed him otherwise he would plan to hold the rate at 4-1/8 per cent during the coming period. Of course, he might be required to increase the RP rate if the average rate in the Treasury bill auction should rise; as the members knew, paragraph 1C of the continuing authority directive specified that the RP rate should not be below the lower of the discount rate or the average issuing rate on the most recent issue of three-month Treasury bills. However, the market was familiar with that provision of the continuing directive and was not likely to misinterpret an increase in the RP rate required under it.

Mr. Maisel then observed that his view on the first issue was that the target for the Federal funds rate should be increased above 4-1/2 per cent only if the aggregates were growing at a pace in excess of the alternative A and B paths and it was clear that a higher funds rate would not be at the expense of stable or declining long-term interest rates.

In response to questions by Messrs. Mitchell and Sherrill, Mr. Holmes said he would interpret the proposed second sentence to call for holding the target for the funds rate at 4-1/2 per cent at least until new data on the aggregates became available late in the week. If long-term rates were under upward pressure and the aggregates were weak, he assumed the Committee would want him to ease money market conditions a bit.

In reply to a question by Mr. Brimmer, Mr. Holmes said he was not sure the Committee had reached a consensus about the course to be followed if the aggregates were expanding at roughly the pace associated with alternative B.

Mr. Brimmer expressed the view that the Manager should be free to probe toward funds rates above 4-1/2 per cent if the aggregates were growing at such a pace.

Mr. Daane remarked that in his judgment the members were placing too much emphasis on specific growth rates for the monetary aggregates and on specific targets for the Federal funds rate, given the large measure of uncertainty attached to any estimates of the relationships between the two.

Mr. Hayes said his position was similar to Mr. Brimmer's. He noted that he would be prepared to accept some increase in long-term interest rates in an effort to achieve more moderate growth in the aggregates than specified under alternative B. He would favor instructing the Manager to probe toward higher funds rates if that could be done without damage to the capital markets.

Mr. Robertson said he had had that thought in mind in proposing that the proviso clause of alternative A be added to B.

Mr. Maisel remarked that much depended on how one defined "damage." In his judgment damage would have been done to the capital markets if long-term rates did not reverse their recent runup and decline by, say, 50 or 60 basis points over the next four weeks.

Chairman Burns observed that the directive under discussion was a version of alternative B; unless the aggregates appeared to be exceeding the growth paths associated with that alternative, he thought the target for the Federal funds rate should not be raised above 4-1/2 per cent. As he had noted earlier, the Manager needed more than the customary degree of leeway in making operating decisions, in view of the types of problems that were likely to arise over the coming weeks. Personally, he believed the Manager should be free to raise the target for the funds rate even somewhat above 4-3/4 per cent if it appeared that the aggregates were still growing excessively at such a funds rate.

Mr. Mitchell expressed the view that the Manager should also be free to seek funds rates below 4-1/2 per cent if the aggregates were weak.

The Chairman agreed. In general, he thought operations should be biased in the direction of lower long-term interest rates, in accordance with the needs of the economy.

Mr. Robertson said he would add one comment--namely, that the primary objective of operations should be to moderate the rate of increase in the aggregates.

Chairman Burns agreed that that should be the Committee's first instruction to the Manager at this point. The second instruction, which the Manager also had to keep in mind, was that higher interest rates were considered not as an objective of policy but rather as a cost that might have to be incurred.

The Chairman then called for a vote on a directive consisting of the first paragraph as drafted by the staff and a second paragraph with the two sentences he had read earlier.

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

The information reviewed at this meeting suggests that real output of goods and services rose substantially in the first quarter primarily because of the resumption of higher automobile production, and more moderate growth appears to be in prospect for the current quarter. The unemployment rate remained high in April. 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 moderated in the first quarter, but the rise in industrial prices stepped up again in April. The money stock both narrowly and broadly defined expanded substantially further in April but growth in bank credit slowed. Inflows of consumer-type time and savings funds to banks moderated, partly as a result of reductions in the interest rates offered by banks, but flows to nonbank thrift institutions continued heavy. Interest rates on most types of short- and long-term market securities rose sharply in April and early May, reflecting uncertainties about domestic, and more recently international, financial prospects. The over-all balance of payments deficit in the first four months of 1971 was exceptionally large, in great part reflecting short-term capital outflows. Recently, after further large international flows of funds, several European central banks suspended sales of their currencies for dollars; subsequently, announcements were made that the German mark and Dutch guilder would be permitted to float for the time being, and that the Swiss franc and Austrian schilling were being revalued. 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, the Committee seeks to moderate growth in monetary and credit aggregates over the months ahead, taking account of the current Treasury financing, developments in capital markets, and uncertainties in foreign exchange markets. System open market operations until the next meeting of the Committee shall be aimed initially at maintaining currently prevailing money market conditions, and thereafter conducted with a view to maintaining bank reserves and money market conditions consistent with the above-cited objectives.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, June 8, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

May 10, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on May 11, 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, and more moderate growth appears to be in prospect for the current quarter. The unemployment rate remained high in April. 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 moderated in the first quarter, but the rise in industrial prices stepped up again in April. The money stock both narrowly and broadly defined expanded substantially further in April but growth in bank credit slowed. Inflows of consumer-type time and savings funds to banks moderated, partly as a result of reductions in the interest rates offered by banks, but flows to nonbank thrift institutions continued heavy. Interest rates on most types of short- and long-term market securities rose sharply in April and early May, reflecting uncertainties about domestic, and more recently international, financial prospects. The over-all balance of payments deficit in the first four months of 1971 was exceptionally large, in great part reflecting short-term capital outflows. Recently, after further large international flows of funds, several European central banks suspended sales of their currencies for dollars; subsequently, announcements were made that the German mark and Dutch guilder would be permitted to float for the time being, and that the Swiss franc and Austrian schilling were being revalued. 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.

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 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 somewhat firmer money market conditions shall be sought if it appears that the monetary and credit aggregates are significantly exceeding the growth paths expected, taking account of the current Treasury financing and uncertainties in foreign exchange markets.

Alternative B

To implement this policy, the Committee seeks to moderate growth in monetary and credit aggregates over the months ahead, taking account of the current Treasury financing and uncertainties in foreign exchange 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, 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.

Alternative C

To implement this policy, the Committee seeks to promote moderate growth in monetary and credit aggregates, taking account of the current Treasury financing and uncertainties in foreign exchange 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, 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.