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, June 8, 1971, at 9:30 a.m.

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

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. Hexter, Assistant General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Eisenmenger, Hersey, Scheld, Solomon, 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. Coyne, Special Assistant to the Board of Governors

Mr. Wernick, Adviser, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Bryant, Associate Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss 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, Parthemos, and Craven, Senior Vice Presidents, Federal Reserve Banks of New York, Richmond, and San Francisco, respectively
Messrs. Willes, Hocter, Andersen, and Green, Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, St. Louis, and Dallas, respectively
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York
Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on May 11, 1971, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on May 11, 1971, was accepted.

Chairman Burns noted that it was planned to update certain sequences in the System film "Money on the Move," including the simulated scenes of the Open Market Committee in operation, and a question had been raised as to whether the members would be willing to devote some time to that purpose on the day of the next Committee meeting, tentatively scheduled for June 29.

After discussion, it was agreed that a decision on the matter should be left to the Chairman.

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 May 11 through June 2, 1971, and a supplemental report covering the period June 3 through 7, 1971. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said the foreign exchange markets remained in a despondent, apprehensive mood, with many complaints being voiced by exporters and importers affected by exchange rate uncertainties. Worldwide fears that the dollar would weaken further against the major European currencies, as well as the Japanese yen, might be having some very real effects on the U.S. trade balance by encouraging imports before foreign prices increased still further while delaying foreign purchases of U.S. exports which might become cheaper later on. The effect on the U.S. long-term capital balance also was clearly adverse. The Euro-bond market, for example, which had helped to finance U.S. direct investment abroad, had pretty well dried up during the past few months, while net liquidation of foreign investment in the U.S. stock market had reappeared. More generally, the German decision to float the mark was widely interpreted as a direct challenge to the role of the dollar and to the Bretton Woods system. While most European governments took strong exception to the exchange market tactics employed by the German Government, they were joining in a chorus of calls for basic reforms in the system, mainly directed against the reserve role of the dollar.

Mr. Coombs observed that a torrent of confusing official statements about the German mark had kept the market on edge. The initial reaction of the market when the mark was allowed to float was to expect a repetition of the 1969 experience, when the German Federal Bank ratcheted the rate up by selling dollars until it reached the desired point of revaluation. Accordingly, the mark was bid strongly and by May 21 it had moved up to 4 per cent above the previous ceiling. Following official statements in late May reaffirming the intention to maintain the existing parity, the mark began to fall back, and the sharp rise of Euro-dollar rates exerted further downward pressure. If that weakening of the mark had been allowed to continue and, more particularly, if the German authorities had taken action to restrain German industrial borrowing abroad, there might have been a fair chance that the mark rate would have returned to the previous ceiling and brought about a general settling down of other markets as well. Under pressure from the German Government, however, the German Federal Bank intervened to sell dollars on June 2 when the rate reached a level 1.6 per cent above the previous ceiling. The mark rate then recovered strongly and subsequently held around a premium of 3 per cent over the previous ceiling. Since announcing its intention to sell dollars, the Federal Bank had managed to put out roughly $400 million, but so far that was less than the $537 million that would be coming in during June from maturities of forward contracts entered into earlier this year. Where the mark would go from here was by no means clear, but meanwhile the dollar had been on the receiving end of the maximum of bad publicity, with only minimal benefit to the U.S. trade balance through an appreciation of the mark.

Mr. Coombs said the reaction of other European governments to the floating of the mark had been uniformly hostile. The Dutch guilder was dragged in the wake of the mark onto a similarly floating basis and for a certain period of time it had moved upward on almost equal terms with the mark. Since then the guilder had fallen back--perhaps because the market had become better aware of its relatively weak current account position--and it was now trading at a premium of less than 1 per cent above the previous ceiling. Meanwhile, none of the heavy speculative inflow of funds to Amsterdam had been reversed and the Netherlands Bank had been pressing the U.S. Treasury for settlement, one way or another, of its uncovered dollar position of nearly $500 million. As the Committee would recall, the System had had a debt of $250 million outstanding under the swap line at the time, just before the move to a floating rate, that the Netherlands Bank had executed the standing order provided in the revaluation clause. Since then, $150 million had been settled by a U.S. Treasury sale of Special Drawing Rights to the Netherlands Bank, and the Treasury was moving to settle the remaining $100 million by drawing guilders from the International Monetary Fund within the next week or so. There remained another $230 million of uncovered dollars taken in by the Netherlands Bank on the day the mark was allowed to float and that too awaited settlement in one form or another--perhaps, as an interim measure, by a new drawing on the swap line if the guilder were to return to the ceiling under its previous parity.

In the case of the Belgian franc, Mr. Coombs continued, the System still owed $490 million under the swap line while the Treasury owed another $100 million under a special swap drawing it had executed. Initially, the Belgian officials had hoped that $250 million of the System's debt might be settled by a U.S. Treasury issue of a Belgian franc bond but that possibility had been frustrated by subsequent Belgian insistence that the usual revaluation clause be deleted or modified in a way unacceptable to the Treasury. Accordingly, the Treasury might have to take the alternative route of drawing Belgian francs from the IMF along with its prospective drawing of guilders.

In the case of the Swiss franc, Mr. Coombs said, nearly all of the heavy speculative inflow on the day the mark was allowed to float had now been reversed through special operations conducted by the Desk and the Swiss National Bank. A Federal Reserve drawing of $250 million on the swap line provided forward cover for a shift of $250 million into U.S. bank CD's, thereby bypassing the Euro-dollar market. Since then the Swiss National Bank had managed to push out another $400 million by informally guaranteeing the upper limit on the Swiss franc, thereby encouraging outflows of funds on an uncovered basis to the Euro-dollar market. In the absence of those special operations, the forward market would have been unable to accommodate such outflows, even after the 7 per cent revaluation of the Swiss franc. In general, there had been no natural return flows of last month's speculative tides affecting the Swiss franc, the Dutch guilder, and the Belgian franc. Confidence remained badly shaken.

In addition to the prospective drain on the Treasury's reserve assets to settle the debt in Belgian francs and Dutch guilders, Mr. Coombs continued, further losses of reserve assets might arise from a British prepayment of as much as $600 million to the IMF some time this month or early next month. Since the British would not be able to use dollars to pay the Fund they would have to buy other currencies with dollars, which might then be presented by the receiving countries to the Treasury for conversion into reserve assets. The over-all drain on the Treasury's reserve position over the next month or so could thus be fairly sizable, with consequent risk of speculative reactions.

By unanimous vote, the System open market transactions in foreign currencies during the period May 11 through June 7, 1971, were approved, ratified, and confirmed.

Chairman Burns observed that along with Messrs. Mitchell and Daane from the Board he had attended the International Banking Conference of the American Bankers Association, held in Munich near the end of May. He invited Mr. Mitchell to comment on developments at that conference.

Mr. Mitchell noted that the conference had been held in Germany in the midst of the exchange crisis involving the dollar and the mark, and thus had offered an irresistible opportunity for comments on the problem--many of which were made on the basis of limited factual information or analytical insight. The number of central bankers at the meeting--four or five--was smaller than usual, and those present were relatively silent. At the initial formal session Mr. Emminger of the German Federal Bank presented an analysis of the balance of payments position of Germany and the United States, in the course of which he expressed the view that the present difficulties would right themselves in due course. Others at that session disagreed, arguing that controls over short-term flows, or perhaps over the Euro-dollar market, would have to be introduced at some point if the current problem and similar problems in the future were to be solved. The same disagreement was reflected in one way or another at a number of later sessions.

Mr. Mitchell observed that the Euro-dollar market was the subject of considerable discussion at Munich and received some words of endorsement for its role in financing the expansion of world trade. Along with much of the comment, however, there was an undertone of anxiety--a feeling that the problems posed by the Euro-dollar market might be getting out of hand, thus exposing the international monetary system to potentially serious perils. Perhaps the most significant fact about the whole discussion of this topic was that no one present seemed able to set forth a persuasive diagnosis of the problems and to suggest effective remedies.

Another point of interest, Mr. Mitchell said, emerged in a panel discussion of European and American payments systems in which he had participated along with commercial bankers from the United States and Sweden. The panel had concluded that "giro" or credit transfer systems would ultimately drive check (debt) transfer systems out of existence because of their greater adaptability to electronic processing. That conclusion--which he shared--had surprised many of the bankers present, but had not elicited any objections from them.

The Chairman then invited Mr. Daane to add his observations about the Munich conference, and also to comment on the subsequent meeting he had attended of the standing committee on the Euro-dollar market.

Mr. Daane remarked that in his panel remarks at the Munich meeting he personally had tried to indicate some of the questions underlying the unease with respect to the Euro-currency market, although he had not offered any answers. Those questions concerned the impact of developments in that market on the internal economies of affected nations and on the functioning of the international payments system. Perhaps the basic question was whether it was possible for a completely unregulated Euro-currency market of its present size to exist side by side with a system of relatively fixed foreign exchange rates.

Mr. Daane then said that the Committee might find helpful a brief listing of the points made by Gabriel Hauge when he summarized the main developments at the conference. The first point was that there seemed to be widespread agreement that the present disturbance with respect to the mark would take longer to resolve than might be expected on the basis of past experience. Secondly, it seemed to be agreed that the disturbance did not reflect any fundamental disequilibrium in payments positions, so that the expectation was a return to the status quo ante in the area of exchange rates. Third, Mr. Hauge had noted that there had been no mention of gold at the meeting, except for a fleeting reference by Milton Gilbert. Fourth, the comments by almost all participants had reflected concern over inflation in their internal economies. Fifth, there was widespread hope for convergence of interest rates internationally, for the sake of reducing disturbing capital flows. Finally, at least one European central banker had argued in favor of capital controls as the approach to the problem of short-term flows.

Turning to the subsequent meeting of the standing committee on the Euro-dollar market, which he had attended along with Mr. Coombs, Mr. Daane remarked that the session had been concerned with possible mechanisms for withdrawing some of the central bank funds that had been placed in that market. Such withdrawals would involve going a step beyond the earlier agreement at Basle not to place additional funds in the Euro-dollar market. The discussion was inconclusive, but hopefully there would be more progress toward a consensus at the next meeting, which was scheduled for late this week.

Mr. Brimmer asked whether the recent action by the Swiss National Bank to facilitate an outflow of $400 million to the Euro-dollar market, which Mr. Coombs had mentioned, was consistent with the agreement at Basle not to place additional central bank funds in that market.

Mr. Coombs replied that in his judgment the action of the Swiss authorities was not inconsistent with that agreement, since that outflow represented simply the restoration to the

Euro-dollar market of funds that normally were held there. In the absence of that action the funds would have remained on the books of the Swiss National Bank, and it was conceivable that the Swiss authorities would have considered it necessary to ask the System to draw on the swap line, or the Treasury to issue a Swiss-franc bond, in order to absorb them. Personally, he would have preferred to see the funds invested in U.S. bank CD's, but any such judgment probably should be based on a group decision regarding appropriate objectives for Euro-dollar interest rates. He added that, while the general feeling at the Basle meeting of the standing committee was that it would be desirable to withdraw some central bank funds from the Euro-dollar market, at this stage that view was not a precisely reasoned one. It was also worth noting that much of any outflows from Germany that developed probably would move directly into the Euro-dollar market.

Mr. Mitchell remarked that he had not seen any adequate explanation of the degree to which deposits in the Euro-dollar market were pyramided; in particular, it was not clear to him whether the effects were different for deposits of official and nonofficial funds. He had understood that the agreement to discontinue placements of central bank funds in the Euro-dollar market was based on the view that the market was more vulnerable to such placements than it was to deposits of private funds.

Mr. Coombs said that that was his understanding also. In general, when private funds moved into the Euro-dollar market the flow was a natural response to interest rate differentials. The placement of central bank funds in that market, however, was neither a natural nor a necessary action, and it had the effect of providing additional liquidity to the market.

Chairman Burns then asked Mr. Solomon to comment on recent international developments.

Mr. Solomon said he wanted to put forward very briefly three broad propositions regarding the international financial situation as he saw it. First, the weakness of the dollar reflected the weakness of the U.S. balance of payments. On that basis there were a number of reasons for thinking that any revaluations of European currencies were in the interest of the United States. Second, contrary to a widely held view, a good case could be made in support of the proposition that the German mark was undervalued. Despite an overheated boom, Germany's trade balance had hardly diminished since 1969 and her current account surplus was sizable. When demand conditions in Germany subsided to a more normal rate, the current account surplus would certainly become even larger. From Germany's point of view, therefore, a case could be made for revaluation after the period of float. Third, exchange rate adjustments alone would not fully solve the U.S. problem. Much could be done in the areas of trade policies and military spending abroad to help alleviate the problem. However, it would not make any sense to oppose revaluations of European currencies on the ground that they did not represent an adequate solution. Doctors did not deny medicine to sick patients because it would not bring about a complete cure.

In reply to a question by Mr. Mitchell, Mr. Solomon said he did not think international considerations had a significant role to play in the resolution of the serious domestic policy dilemma the Committee would be considering today.

Mr. Mitchell recalled that Secretary Connally and Chairman Burns in their recent speeches in Munich had said in essence that the United States had made its moves in the monetary policy area. They had not ruled out the possible need for action in other areas and had commented on the need for supporting policies by other countries.

Mr. Daane observed that in his view international considerations were not irrelevant to the Committee's decision today even though primary emphasis had to be placed on domestic considerations.

Mr. Coombs then said that, as he had noted at the previous meeting, the System had been making continuous use of its swap line with the National Bank of Belgium since June 30, 1970; and that it was necessary for the Committee to decide, under paragraph 1D of the authorization for System foreign currency operations, whether to approve continuous use of the line for more than a year. He recommended such approval since a decision at this time to liquidate the full amount outstanding might result in a dangerous strain on the Treasury's reserve position.

By unanimous vote, a delay in the liquidation of outstanding System drawings on the National Bank of Belgium beyond June 30, 1971, was authorized.

Mr. Coombs then noted that a $30 million System drawing on the Belgian Bank would mature for the first time on July 7, 1971. He recommended renewal of that drawing at maturity.

By unanimous vote, renewal for a further period of three months of the System drawing on the National Bank of Belgium maturing on July 7, 1971, was authorized.

Chairman Burns then observed that it would be necessary for the Committee today to give very careful consideration to the outlook for rates of growth in the monetary aggregates and for interest rates. To facilitate the discussion he proposed that at this point the Committee hear the Manager's report on open market operations and the staff reports on current and prospective economic and financial conditions.

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 May 11 through June 2, 1971, and a supplemental report covering the period June 3 through 7, 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:

> During the past four weeks, the capital markets regained a degree of composure that was noticeably absent at the time of the last Committee meeting and for a week or so thereafter. At that time the atmosphere had been dominated by fears that the extremely heavy dollar outflows in early May would force United States interest rates much higher. After mid-May the conviction began to take hold that market rates had already adjusted sufficiently--and perhaps over-adjusted for the time being. The inventory position of dealers had been lightened substantially. Anxious sellers had in some cases accomplished their sales or at least temporarily postponed selling plans in anticipation of better opportunities later. An important factor in the turn-around of sentiment was the report of Chairman Burns' Congressional testimony on May 19, stressing the view that the answer to the international payments problem of the United States did not lie in a sharp rise in domestic interest rates.
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> While the market atmosphere in the last few weeks was much improved from the abject gloom of early May, it remained cautious and vulnerable to renewed pressure. Against this background, System efforts to slow the growth of the aggregates by encouraging somewhat firmer money market conditions had to be cautiously implemented. For the first week--or nine days to be more precise--after the May 11 meeting, the Desk continued to aim for the somewhat firmer money market conditions, characterized by a Federal funds rate around 4-1/2 per cent, that had prevailed toward the end of the period before the last Committee meeting. This

stance was maintained even though the data on money and credit aggregates available on May 14--just a few days after the meeting--already suggested greater than desired strength. In holding conditions unchanged for the time being, the Account Management had in mind the weak condition of the capital markets, which had deteriorated further in the days since the May 11 meeting, and the fact that the upward revisions in the aggregates had been based to a considerable extent on preliminary data for the early May weeks.

In meeting reserve needs during the May 19 statement week, the Desk bought $128 million of coupon issues, by placing orders with one or two dealers each day for modest amounts of specified issues at market prices. This technique for purchasing securities was chosen in preference to the usual "go-around" procedure, in which all dealers are asked simultaneously to make offerings to the Desk. In our opinion a general go-around would have confronted the Desk with a very heavy volume of offerings--thus obliging the Desk either to buy much more than it intended in light of reserve needs, or else producing widespread disappointment among unsuccessful would-be sellers. Prices continued to decline during the interval of System coupon buying, but I believe the System purchases were helpful in preventing a vacuum from developing as insistent sellers pressed supplies on the market at times when no other buyers were apparent.

By May 21 the information on money and credit aggregates indicated even greater strength than before, and the atmosphere in capital markets was much improved, although still highly sensitive. The Desk began aiming for slightly firmer money market conditions, with Federal funds expected to be around 4-1/2 to 4-3/4 per cent. A week later, with evidence on the aggregates little changed and a few days of net improvement in the capital markets behind us, sights were reset to aim for a Federal funds rate centering on 4-3/4 per cent. Finally, in the current week, confronted by still greater exuberance in the aggregates, we have been aiming for money market conditions that would produce a Federal funds rate around 4-7/8 per cent.

While money market conditions were firming quite gradually over the interval since the last meeting, the course of rates on most market instruments did not run so smoothly. Rates on three-month Treasury bills, for example, fluctuated substantially over the period. In yesterday's auction the average rate on three-month bills was set at 4.51 per cent, up 65 basis points from the rate established in the auction just preceding the last meeting of the Committee. Incidentally, yesterday's average rate will call for a new rate of 4-5/8 per cent on System repurchase agreements.

In the longer-term markets, on the other hand, there have been some net declines in yields over the interval. Short- and intermediate-term Treasury coupon issues rose in yield over the full interval, although the yields at the close were not as high as in mid-May. And at the long end of the maturity spectrum some Treasury issues registered modest net yield declines over the period. Even more strikingly, rates on new Aa-rated corporate utility offerings rose from 8 per cent just before the last meeting to a high of 8.45 per cent by mid-May, but then came down to 7.73 per cent on an offering last Thursday; that last issue is still in syndicate and the reception has been only fair.

As the blue book[1/] notes, the Committee may wish to move money market conditions further in a firming direction in view of the continued strength in money growth. Market observers are also aware of the strong growth, particularly in the narrowly defined money supply, and some further firming in money market conditions would cause no great surprise. Still, the impact of a move to 5 per cent or above in the Federal funds rate is hard to predict, because a move into territory above the discount rate could bring other factors into play, notably including market discussion of increases in the discount and prime rates and a possibly substantial increase in the use of the discount window. On the other hand, if the process of working toward firmer money market conditions is gradual, it is possible that the shift could be accomplished without much upset to the longer-term markets--which to some degree have already anticipated greater firmness in the money market.

In the last few days, the Treasury's balance at the Federal Reserve Banks, which is normally maintained around the $1 billion level, has been somewhat

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

below that level despite the fact that the Treasury has been making 100 per cent calls against available tax and loan account deposits. In the next few days projections indicate that the balance will drop sharply further, probably requiring some short-term Treasury borrowing from the Federal Reserve until mid-June tax receipts come in. On our latest projection, the level of such borrowing might exceed $1 billion--especially if Germany were to redeem special issues in the course of supplying dollars to the foreign exchange market. To be on the safe side, I recommend that the Committee amend the continuing authority directive by increasing the limit for direct Treasury borrowing from the System from $1 billion to $2 billion, in the expectation that the $1 billion limit will be restored at the next meeting of the Committee.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period May 11 through June 7, 1971, were approved, ratified, and confirmed.

By unanimous vote, the dollar limit specified in paragraph 2 of the continuing authority directive, on Federal Reserve Bank holdings of short-term certificates of indebtedness purchased directly from the Treasury, was increased from $1 billion to $2 billion. As amended, paragraph 2 read as follows:

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

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

Mr. Partee made the following statement:

The official estimates of the first-quarter expansion in GNP, as you know, have been revised appreciably higher since the last meeting of the Committee, to $30.8 billion. Much of the larger increase is in durable goods consumption, but small upward adjustments were also made in several other sectors. Despite this stronger first-quarter showing, the Board staff has not been led to raise our sights for the year as a whole. Our current dollar GNP estimate for 1971 is up a bit, to slightly over $1,050 billion, but our projection of real growth for the year, at 2.4 per cent, is just where we have had it for the past six months. The first-quarter performance, abstracting from autos and trucks, showed very little over-all vigor. Essentially, the one-quarter surge simply reestablished automotive output and sales at reasonably normal levels, so that not much carryover impetus is implied for subsequent quarters.

We do believe that economic recovery is now well in process, and that it is unlikely to be reversed any time soon. The leading indicators have been positive, though not particularly robust for a cyclical recovery phase, during the past six months. Retail sales are increasing in real as well as dollar terms, even abstracting from the recovery in car buying; May sales, based on the weekly data, appear to have been unchanged from

April but to have shown a healthy 1 per cent gain in the non-automotive lines. Industrial production rose moderately in March and April, and an appreciable increase of around 1 point more now seems indicated for May. In addition, the employment trend appears finally to be strengthening; the May increase in nonfarm employment, at 130,000, was the largest in a good while--aside from strike effects--and it included the first small increase in manufacturing nonproduction worker employment of the past 15 months.

The real question, as for some time past, is not whether we are in a recovery but how vigorous it will prove to be. On this score, the recent evidence does not seem to me encouraging. Recent consumer surveys show at best only modest improvement in attitudes; spending is rising moderately, but as yet there are no indications of a real resurgence in consumer demands. Business capital spending appears likely to remain flat for some time to come; the past month brought news not only of a downward revision in spending plans for the year, concentrated in the second half, but also a sizable decline in new orders for capital equipment in April and the NICB report of reduced capital appropriations by manufacturers in the first quarter. Business inventory accumulation remains very low--negative in real terms if steel hedge buying is excluded--but there is little indication as yet of any desire to rebuild stocks. Although inventory ratios in manufacturing generally have been declining over recent months, inventory positions do not seem uncomfortably low relative to current shipments, and they continue quite high relative to order backlogs.

Housing has performed exceptionally well in helping to fuel the economic recovery, with starts fully 50 per cent higher than they were at the cyclical low a little more than a year ago. Housing starts and residential construction have been running somewhat above our earlier estimates, and we have increased our projections for the remainder of the year in view of the high level of outstanding mortgage commitments and the continuing large flow of funds to savings institutions. State and local capital expenditures have been strong also, though estimates of the rise in public construction expenditures over recent months have been revised downward from the exceptional rates shown earlier. The continuing very large volume of

State-local financing, combined with the obvious backlog of public facility needs, promises further increases in public capital outlays in the months ahead.

It will take more than continued strength in housing and State-local capital spending, however, to propel us to a vigorous recovery. The best near-term possibilities, assuming no additional stimulative fiscal actions, would seem to be a sizable pickup in consumer buying and an associated increase in business inventory needs. We are projecting some acceleration in consumer buying, a decline in the personal saving rate, and the first beginnings of renewed inventory accumulation--abstracting from steel--in the remaining months of the year. Perhaps our expectations are too moderate. Consumer financial wealth has increased greatly with recovery in the stock market; holdings of liquid assets--including money balances--have risen sharply this year; and confidence in future income prospects may be improving now that the incidence of layoffs has waned along with the pace-setting example of continuing large union wage settlements. Even if our projections for the second half are too conservative, however, it would take a great deal of excess spending to make a sizable dent in the manufacturing capacity utilization rate, currently running at 73 per cent, or in the unemployment rate, which threatens to go above its present 6.2 per cent rate if there is substantial growth in the civilian labor force this summer.

We plan to review our projections, and to extend them through the first half of 1972, for the next meeting of the Committee. It seems evident, however, that there is not sufficient strength in the picture to promise the utilization of most or all of the nation's idle resources, or to threaten a re-emergence of demand-induced inflation, over this time span. The total labor force, despite a large gain in May, is still running only one million above a year ago, well below the expected normal rate of growth. The civilian labor force promises to increase even more rapidly in the months ahead, as the size of the armed forces continues to be reduced. Employment opportunities, despite the first signs of a strengthening trend, may well continue to be limited by the high sensitivity of almost all businesses to their cost projections and by the financial bind in which most State and local governments find themselves. The current unreceptivity of the labor market to new job seekers is well illustrated, I believe, by the unemployment rates for young adults in the 20-24 age group, which in May averaged 10.8 per cent for men and 11.5 per cent for women.

Given this economic background, the dilemma facing the Committee today seems to me an extraordinarily difficult one. On the one hand, the economy over the short run--by which I mean the next year or so--needs all of the support that can be mustered. Most economic projections (including our own) show no signs of a takeoff, and in any event there is a great deal of room for improvement in job markets, in the potential expansion of real demands, and in profits prospects and investment incentives. On the other hand, recent rates of growth in the money supply--and the rates of growth projected by the staff over the next few months--are clearly excessive by almost anybody's standard. Such rates of growth, if continued for long, would threaten to fuel new inflationary forces in the economy over the longer term--by which I mean by late 1972 and 1973. Perhaps, at the higher interest rate levels that have now developed, monetary expansion would slow of its own accord later in the summer. But the demand deposit expansion that has occurred has been very widely distributed, and we know little about its causes. I, for one, cannot say with confidence that a marked slowing is assured.

If the Committee should decide today to move decisively in the direction of curbing the recent monetary growth rates, long-term credit markets would almost certainly react adversely. Interest rates--already very high by historical standards--would rise further as an initial reaction, and demand/supply conditions could well tighten as investors held back and borrowers attempted to speed up their financings. There is little justification for higher interest rates beyond such expectional influences, however, if our economic projection is anywhere close to being on the mark. Hence, interest rates and market tensions could well subside later on, in which case housing and the financing of State-local capital spending projects would be unlikely to suffer any lasting harm. Nevertheless, there are risks in either course of action. I am glad that I don't have to make the decision facing you today.

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

Over the past two months growth in the money supply has continued rapid. The rate of increase in M_2 slowed in April-May from its exceptional first-quarter rate, but still remains historically very high. Meanwhile M_1 appears to be growing even more rapidly than in the first quarter, when the growth rate had been permitted to accelerate to make up for previous shortfalls. The continued very rapid growth in money supply--particularly M_1--over the past two months naturally raises the questions of whether the supply of reserves by the Federal Reserve has been excessively generous for the needs of the economy and of how money should be fitted into the policy approach in the period ahead. Mr. Partee has already discussed economic prospects. I would like to focus more closely on reserve, money, and interest rate relationships in evaluating policy alternatives currently before the Committee.

In the first quarter, both total and nonborrowed reserves rose at annual rates of about 11 per cent. Over the past two months--from March to May--reserve growth continued rapid, with nonborrowed reserves rising at about an 11 per cent annual rate and total reserves at around 10 per cent. A continued rapid expansion in total reserves is now in prospect in June, given the lagged effect on reserves of the sharp rise in deposits in the course of May.

Thus, the supply of reserves provided by the Federal Reserve has not slowed down after the first-quarter make-up period, even though the rate of growth in total time and savings deposits at commercial banks has been at about half its exceptional 27 per cent first-quarter growth rate, requiring less reserves on that account. Clearly, the Federal Reserve has accommodated the supply of reserves to an expansion in the public's demand for private demand deposits and for M_1. Some of the additional M_1 was supplied by the Treasury since there was a moderate drop on balance in U.S. Government deposits from March to May, but as compared with the availability of reserves, this was a minor factor contributing on the supply side to M_1 growth.

The System was, however, a reluctant supplier of reserves and did let the large expansion in demand for money exert an upward impact on interest rates. The average Federal funds and 3-month bill rates in May were about 80-90 basis points higher than they were on average in March, while most other short-term market rates rose by even more. The averages of yields on new high-grade corporate and municipal bonds rose about 50 basis points over the period.

In part the enhanced demand for money seems to reflect a lagged reaction to earlier lower interest rates. In part it represents the need to finance current economic activity, which in money terms grew at a 13 per cent annual rate in the first quarter and appears to be growing at around a 7-1/2 per cent annual rate in the second. And in part there may have been growing precautionary attitudes on the part of many small holders of cash balances in the current period of economic uncertainty. These are, of course, all explanations after the fact; before the fact, neither our best judgment, nor the money market model which was contributory to our judgment, predicted a rise in M_1 of the size that has actually developed over the past two months, given the intervening rise in short-term interest rates.

To attempt to see if some special factor has been at work we looked through the disaggregated data that we have at hand on demand deposits by Reserve district, class of bank, and ownership groupings. From the first of the year through the third week in May, there was no evidence of concentration of money growth in any particular geographic area or class of bank. On the basis of year-ago comparisons with seasonally unadjusted data, it would appear that the increase in demand deposits has been fairly well distributed across Reserve districts and took place at both country and city banks. Our ownership data are so new as not to permit even year-ago comparisons, but what we do have is, again, suggestive of a wide distribution of holdings. In the first quarter, the great bulk of the increase appears to have been in holdings of households, and this is also where it showed up, seasonally adjusted, in our flow-of-funds accounts. The monthly ownership data from large banks for April does show about two-fifths of that month's increase in nonfinancial business holdings, but we have no idea what the monthly seasonal might be.

On balance, I would say that we do not have evidence to contradict the view that there has been a rather widespread rise in the demand for money over the past few months. But what this means for the future is not extremely clear. We have not pushed this money on unwilling holders; if we had, interest rates would have declined, but as pointed out, they have risen. However, the danger cannot be overlooked that enlarged cash balances could lay a basis for an undesirably large increase in spending if and when business and consumer confidence in the economy is more restored.

The appropriate growth path in M_1 and the appropriate level of interest rates obviously depend on the economic outlook, and in that respect I would like to add one point to Mr. Partee's excellent statement. It seems to me that in a period when price rises are stemming essentially from cost-push pressures, and when demand is lagging, a money supply growth rate above historical standards is not likely to lead to inflationary pressures in the future. Rather, the higher growth rate would mainly reflect the cost-push pressures that exist and the need to provide more money than usual in order to maintain the growth in real cash balances necessary to permit a reasonable level of interest rates and a reasonable pace of economic recovery. The danger of an eventual future inflation would be greater with growth rates as rapid as the past few months, but rates of growth for M_1 in a 6-8 per cent range as summer progresses do not seem out of line to me, given the structural problems in the labor market and the need to maintain profit margins for economic recovery purposes. Once cost-push pressures abate, I would expect the need for M_1 growth to move back toward historical norms.

Moving in the direction of alternative B[1/] could represent a reasonable compromise for the Committee in its efforts to resolve the various dilemmas before it. But if that were done, I would like to suggest that it be considered as a move toward gradually reducing the rate of reserve growth and that later money market rates be permitted to ease back, after the initial

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

> tightening that is evidently required, should that be consistent with more moderate reserve and M_1 growth, as might well be the case if the economic outlook does not strengthen. Such a policy probably would not forestall the near-term upward adjustment in longer-term rates and the prime rate likely to result from a clear immediate further tightening of the money market. But on the assumption that the economic outlook is no stronger than projected, a more flexible policy with regard to money market conditions, keyed in part to developments in monetary aggregates, might over time blunt the extent of market reaction, or possibly hasten a reversal in temporary rate increases, as the market is encouraged to appraise the longer-run outlook for credit demand and supply.

The Chairman then called for a general discussion of economic and financial conditions and prospects. He added that the members no doubt had questions they would like to put to the staff.

Mr. Eastburn asked if Mr. Axilrod would elaborate on the staff's projections of interest rates and monetary aggregates over coming months. Specifically, he wondered how the staff thought the transactions demand for money might be affected by the expansion in business activity expected in the third and fourth quarters, and whether allowance had been made for lagged effects. He also asked whether the projections in question were based on the staff's econometric model.

Mr. Axilrod responded that while the model was used in making the projections, staff judgments also were introduced. However, the model did support the view that the demand for money reacted with some lag to changes in interest rates, and the staff projections allowed for some reduction in the demand for money over the next few months as a consequence of recent increases in interest rates. But, since GNP was expected to rise at an annual rate of about 7 per cent in the third quarter and somewhat faster in the fourth quarter, the transactions demand for money was expected to increase considerably. If that expansion in demand were accommodated reluctantly--in the sense that short-term interest rates were forced up or permitted to rise--long-term rates probably would rise in some degree. If market participants were to conclude tomorrow that the target for the Federal funds rate had been moved up to, say, 5 per cent, it was likely that yields on long-term Governments would rise immediately and that the reaction would subsequently spread to the markets for corporate and municipal bonds. It was probable that after a time long-term rates would decline somewhat and the spread between long and short rates would narrow if, as he expected, actual credit demands did not prove to be very strong. The tighter that money market conditions became, the larger the immediate reaction would be; and while rates might decline over the longer run, their rise in the short run would involve a cost.

Mr. Partee added that the transactions demand for money was projected to rise more in the third quarter than might be expected solely on the basis of the expected increase in GNP. That was because transactions demands appeared to be more closely associated with retail sales than with total GNP; and while the projections suggested that growth in total GNP would slow a bit from the second quarter to the third, they also suggested that the rate of expansion of consumer spending would step up a little. The main reason for the difference between those projected growth rates was the assumption of a 60-day steel strike in the third quarter--an assumption which, incidentally, now appeared less likely to be realized than it had a month ago. In any case, while a steel strike would affect total GNP, it would have relatively little impact in the short run on the availability of goods at retail. Also, consumer spending was expected to be stimulated in the third quarter by the payment this month of the retroactive increases in social security benefits.

Mr. Morris asked whether the third-quarter GNP projections allowed for the sharp, if temporary, increase in long-term interest rates which Mr. Axilrod had indicated might develop.

Mr. Partee replied that no specific allowance had been made in the GNP projections for a further increase in long-term rates. Presumably the main impact of higher long-term rates would be on housing and State and local government expenditures. However, mortgage funds were already committed for the great bulk of housing starts that would be made in the summer months, and a significant increase in mortgage interest rates now would have relatively little impact on starts until late 1971 or early 1972. Moreover, the effect on housing activity of higher interest rates was likely to be rather marginal, at least relative to the effects that would flow from curtailed availability of funds; and there should be no significant problems of availability so long as flows of funds to savings and loan associations continued substantial, although such problems might well develop over time if market interest rates rose further. Similarly with respect to spending by State and local governments; although increased long-term interest rates no doubt would lead to some cutback in municipal bond issues from the very high recent and prospective volume, such a development would affect spending only with a lag. In sum, further increases in long-term rates were not likely to have a significant impact on GNP growth within the period through the end of the year covered by the staff's present projections.

Mr. Morris then noted that, according to the blue book, M_1 would increase at an annual rate of about 10.5 per cent over the third quarter if money market conditions were unchanged. However, the New York Bank's projection suggested growth at only about half that rate--5.0 per cent. He asked Messrs. Axilrod and Holmes to comment on the difference.

Mr. Axilrod replied that while he was not familiar with the details of the New York Bank's projection, he might be able to throw some light on the matter by commenting on the figure given in the blue book. Over the past four months the staff's econometric model had consistently underestimated the rise in the level of M_1 from the previous month, by roughly $350 million on average. The errors in the blue book projections were even larger--averaging something over $700 million--because the staff had reduced the estimates yielded by the model on judgmental grounds. Such a record of consistent understatement suggested that some systematic factor was being overlooked; for example, there might have been a basic change in the public's attitudes towards holding cash balances. That lent some weight to the view that money growth would remain relatively strong over the next few months. In any case, the model was so constructed that, under what might be called an "error learning process," an underestimate in a particular month led to higher estimates of levels in the ensuing months. It might turn out, of course, that the four successive months of understatement were only the consequence of chance. In that case the latest projections might prove to be overstatements; and, incidentally, the level of interest rates associated with any rate of growth in M_1 would be lower than the blue book implied.

Mr. Holmes added that the staffs at the New York Bank and the Board were looking into possible reasons for the disparity between their projections of M_1. He also had found the difference to be puzzling, particularly since both projections were based on the same information and assumptions. Perhaps the most significant implication one could draw at this point was that projecting was a hazardous business.

Mr. Mayo said that his staff had done some independent work on the consequences of a modest further increase in long-term interest rates for housing and State and local government expenditures, and had reached essentially the same conclusion as Mr. Partee--namely, that such a rise would not have an abortive effect on the recovery in those two sectors during calendar 1971. However, they reserved judgment about 1972.

Mr. Mayo then referred to Mr. Axilrod's comment that he would expect needed growth in M_1 to fall back toward historical norms once cost-push pressures abated, and asked whether the staff thought there were grounds for expecting any moderation in such pressures soon.

Mr. Partee replied that he was aware of nothing in the latest available information that suggested any moderation of cost-push pressures in 1971. The settlement just reached in the aluminum industry provided for very large increases in wages and fringe benefits, and that settlement no doubt would serve as a precedent for the steel negotiations now getting under way. Similarly, the current negotiations in the telephone industry were likely to result in large increases.

Mr. Partee added that the staff planned to review the outlook for cost pressures over the coming year at the next meeting. At the moment, he thought there were grounds for some small measure of hope that such pressures would moderate in 1972. For one thing, far fewer wage agreements would be subject to renewal in 1972 than in 1971, and most of the agreements reached this year provided for considerably smaller increases in compensation in the second and third years of the contract than in the first year, assuming that increases under cost-of-living escalators would remain within reasonable bounds. Secondly, if the economic recovery were to gather strength this year and next, there should be greater gains in productivity which would serve to moderate the rise in unit labor costs.

In reply to a further question by Mr. Mayo, Mr. Axilrod said that the large increases shown in the blue book projections in the average levels of M_1 and M_2 from June to July were attributable mainly to an expected sharp decline in average Government deposits between those two months. He added that the close inverse relationship between changes in Government and private deposits appeared to be a short-run phenomenon, limited to a few weeks. That, at least, was the conclusion of most staff members who had looked into the question.

Mr. Coldwell said it seemed to him that the economic recovery was still proceeding slowly, and that it was hampered by the attitudes of businessmen and consumers which reflected fears of continued inflation and uncertainties born of wage pressures, high unemployment, rising prices, international monetary crises, and so on. The future seemed to hold the hope of further growth but there were a number of disturbing question marks. There were potentially sharp inflationary pressures as fiscal stimulants came to fruition along with lagged effects of present monetary growth. The recovery was fragile largely because of inflationary fears. Unfortunately, the Federal Reserve itself had educated the public to follow developments in M_1; many people were now doing so, and they were concluding that the System was laying the basis for inflation later on. Consumers were hoarding funds to meet the rising cost of living and businessmen were unprepared to expand their capital base for similar reasons.

Thus, Mr. Coldwell observed, he concluded that the primary task at present was to stop inflation, even if doing so required greater unemployment for a short period. Economic recovery with inflation would only mean more severe restraint later, and further reserve creation now would amplify the foundation already laid for a new inflationary surge.

Mr. Mitchell said that like others he was worried about the longer-run effects on the economic recovery of a Committee policy designed to slow the growth in the monetary aggregates. Mr. Partee had suggested that housing and State and local government spending in 1971 probably would not be affected much by further increases in long-term interest rates. However, if the Committee were to adopt alternative C for the directive today one possible consequence would be a sharp fall in prices of common stocks, which could have a wealth effect on spending. He asked how Mr. Partee would assess that possibility.

In reply Mr. Partee said that predicting the stock market was a very hazardous undertaking. Concurrently with the increase in interest rates there might be some positive developments--such as a strengthening of profit expectations with rising business volume--so that a stock price decline could not be predicted with certainty. Of course, the effects on the market of higher interest rates taken alone would be negative, and so the effects on the change in consumption would also be negative. On the basis of the Board's econometric model, he would guess that the effect on spending of a decline in stock prices on the order of, for example, 5 per cent would be perceptible but not large enough to bring the economic recovery to a halt.

Mr. Daane asked whether the Manager thought it might be possible to move to a less liberal posture with respect to the provision of reserves, hopefully achieving some slowing of growth in the aggregates in the process, without pushing the Federal funds rate up to 5-1/4 or 5-1/2 per cent. Specifically, he wondered whether it was likely that the aggregative growth rates associated in the blue book with alternatives B or C could be achieved with the money market conditions associated with alternative A, including a 4-3/4 per cent funds rate. If the answer was no, he would be interested in having the Manager's judgment about the likely response in long-term markets to a sharp run-up in the funds rate, and about possible means for minimizing the reaction. His basic question was whether it might be feasible to reeducate the market to accept larger variations in money market rates without jumping to conclusions about changes in the Committee's policy stance.

Mr. Holmes said he thought it was highly unlikely that the slower aggregative growth rates of alternatives B or C could be achieved without raising the funds rate above 4-3/4 per cent. In general, he agreed with Mr. Axilrod that the immediate reaction to a higher funds rate would be a rise in long-term rates, but that over the longer run there might be some reversal--particularly if the rates of growth in the aggregates slowed. With respect to the immediate response, conditions in the capital markets were always subject to the effects of sudden changes in expectations; and while such changes might result from many developments apart from conclusions about Federal Reserve policy, market participants were constantly seeking clues to System objectives. At the moment the market might be particularly sensitive to further increases in the funds rate since recent advances had brought it up to the level of the discount rate. Nevertheless, it was quite possible that a rise in the funds rate would have only a modest effect on capital markets.

Mr. Maisel remarked that in his judgment the key question concerned the rates at which the System supplied reserves and permitted the monetary aggregates to expand; obviously, the consequences would be different if M_1 were permitted to grow at the same pace as GNP or, say, at two-thirds of that pace. He hoped the Committee would focus on that question at its next meeting. He added that he was interested in Mr. Axilrod's suggestion that the Committee might view adoption of alternative B as a move toward gradually reducing the rate of reserve growth. He wondered whether Mr. Axilrod had in mind some new operating procedure based on reserves.

Mr. Axilrod replied that, while it would not be impossible to work out such an operating procedure, he had not meant to imply that he had one in hand. His point was that if the Committee wanted to slow the rate of growth in the monetary aggregates it would be better to use the achievement of a slower growth rate of reserves as a guide to operations rather than the attainment of any particular level of money market rates. To aim for tighter money market conditions <u>per se</u> would be simply to ratchet rates up. If the focus were on reserves, however, and it turned out that the demand for money were not as strong as assumed in the staff projections, then interest rates could be permitted to move down again.

Chairman Burns said he would be sympathetic with the suggestion that, instead of setting some higher level of interest rates as the objective and moving gradually toward it, the Committee should set its target in terms of some slower rate of growth in reserves and accept whatever interest rate levels proved to be consistent with that growth rate. He asked whether that was the essence of Mr. Axilrod's proposal.

Mr. Axilrod replied affirmatively, noting that the Committee might want to attach a proviso with respect to the acceptable range of fluctuations in interest rates.

Mr. Maisel remarked that the specific form of any such proviso would be a critical matter.

In response to the Chairman's request for comment, Mr. Holmes said that one implication of Mr. Axilrod's suggestion was that the market could be conditioned to expect a wider range of fluctuation in interest rates, so that it would not react sharply to changes of one-half percentage point or so. He thought that view was probably correct, although he suspected that the conditioning period might be relatively long. Obviously, the Desk could operate in terms of reserves, since they were its stock in trade. However, problems would be posed by the erratic nature of the short-run relationships between changes in reserves on the one hand and in the other monetary aggregates and interest rates on the other hand, and questions of the trade-offs desired would be important.

Mr. Partee said he thought it was necessary to recognize that if the demand for money was strong an effort to slow the growth in the aggregates would mean a rise in interest rates, whether operations were keyed to reserves or to money market conditions. As he understood it, Mr. Axilrod was suggesting that the Committee instruct the Desk not simply to seek higher money market rates, but rather to keep an eye on the aggregates and stand ready to let market rates decline if their growth appeared to be slowing.

Mr. Axilrod concurred in Mr. Partee's observation. He added that if reserves were used as the guide to operations and the demand for deposits should weaken, interest rates would decline in the normal course of events as the Manager supplied additional reserves to maintain the target rate of reserve growth. In his judgment it was important to allow for that possibility. As Mr. Partee had noted, however, in the converse case interest rates would rise.

Mr. Mitchell asked about the extent to which the growth in reserves during the first half of 1971 represented the accommodation of reintermediation, as investors shifted out of market securities.

In reply, Mr. Axilrod observed that time and savings deposits other than large CD's had expanded at an annual rate of about 27 per cent in the first quarter--no doubt reflecting to a large extent a shift out of Government securities on the part of investors. A very large volume of reserves had been required to accommodate that rise. In April and May, however, growth in such time deposits had slowed considerably--to annual rates of less than 15 per cent. However, there had not been any significant slowing in the average growth rate of reserves from the 11 per cent pace recorded in the first quarter.

Mr. Mitchell remarked that growth rates in time and savings deposits in April and May suggested that reintermediation was continuing, if on a smaller scale than in the first quarter. He thought it would be desirable to accommodate that process, since it represented only a shift in preferences among desired assets.

In response to a comment by Mr. Partee, Mr. Mitchell remarked that he did not think the same could be said about the recent rise in demand deposits, since money holdings served a purpose different from that of near-money holdings.

Chairman Burns said he concurred in Mr. Mitchell's view that account should be taken of the reintermediation under way in interpreting the recent rates of growth in the monetary aggregates and reserves.

Mr. Axilrod observed that he personally had not been disturbed by the 11 per cent growth rate of reserves in the first quarter, partly because so large a volume of additional reserves had been required to support the shift of consumer funds from marketable securities to time and savings deposits. However, he thought questions were raised for the Committee by the continuation of the same growth rate for reserves on the average in April and May, when expansion in time deposits had slowed markedly.

Mr. Swan said he had a few observations on financial developments in the Twelfth District. It appeared that inflows to California savings and loan associations had again set a new record in the month of May. It was interesting to note, however, that in the first four months of the year virtually all of the net increase in the deposits at those associations had been in certificate accounts, and that consequently there had been some increase in the average cost of money to them. It was also interesting to note that the Bank of America had announced yesterday that, while it was not changing the rate it offered on passbook savings, it was raising its rates on certificate accounts back to the earlier levels of 5-1/2 per cent on one-year accounts and 5-3/4 per cent on two-year accounts. At the same time it was increasing the rates it charged on mortgage loans. In general, the large banks in the District were moving toward a 7-1/2 per cent rate on mortgage loans. Savings and loan associations also were raising mortgage rates from the earlier 7 to 7-1/4 per cent range up to 7-1/2 per cent.

With respect to the national aggregates, Mr. Swan asked whether Mr. Axilrod could explain why the adjusted credit proxy had increased much less than M_1 and M_2 in April and May.

Mr. Axilrod replied that such an explanation might be offered either in terms of the arithmetic of the components of the various aggregates or in terms of economics. Speaking of the economic factors at work, he noted that bank loan demand--while picking up--had not been unusually strong recently. Secondly, banks had become less willing buyers of securities as a result of a shift in their expectations for interest rates. As a result, banks had not aggressively sought deposits of the types they could control most closely--particularly large-denomination CD's; indeed, they had offered rates on CD's only high enough to roll over their outstandings. They also had permitted their nondeposit funds to decline further. Those developments, along with some net decline in Treasury deposits from March to May, explained the smaller growth in the bank credit proxy over that period.

Chairman Burns said he thought it would be helpful also to have the arithmetic explanation Mr. Axilrod had mentioned. He noted that over April and May the adjusted bank credit proxy had increased at an annual rate of 6.9 per cent, and the end-of-month bank credit series at a rate of 5.2 per cent. Those were not explosive rates of growth, and it would be useful to have clearly in mind the relationships between such figures and the higher growth rates of M_1 and M_2.

Mr. Axilrod noted that M_1 and M_2 had increased at annual rates of 13.4 and 13.8 per cent, respectively, on average from March to May. In response to the Chairman's request, he would undertake to explain the arithmetic relationship between the 13.8 per cent rise in M_2 and the 6.9 per cent rise in the adjusted bank credit proxy over those two months. The proxy included three principal components not included in M_2: funds from nondeposit sources, which declined about \$3 billion from March to May; large-denomination CD's, which were substantially unchanged over that period; and U.S. Government deposits, which declined $700 million. In total, those components declined by about $3.7 billion over the two months, or at an annual rate of about $22.2 billion. That figure represented about 6-1/2 per cent of the adjusted credit proxy. The difference between the annual rates of increase in M_2 and in the adjusted proxy was a little less than 7 percentage points, so the figures virtually reconciled on this crude basis. A more refined analysis would allow also for the behavior of other items making for a difference between M_2 and the proxy series--such as net interbank deposits, included in the proxy; and nonmember bank deposits and currency in circulation, included in M_2.

Chairman Burns asked whether it would be feasible to include a table showing detailed reconciliations in future blue books, and Mr. Axilrod replied affirmatively.

Mr. Mitchell commented that the reconciliation offered some reassurance if one were willing to live with the bank credit proxy as a guide to policy. However, it was not addressed to the questions of why M_1 had been rising so rapidly and how significant reintermediation had been. Answers to such questions probably would require an analysis of the total flows of funds.

Mr. Axilrod remarked that in his judgment even that kind of analysis would not answer the basic question of whether it was desirable to slow the growth in M_1 from its recent rapid rate or whether continued growth at that rate was acceptable because the credit proxy was growing more slowly. One could argue that the current rate of bank credit growth was more closely related to the current condition of the economy than to the System policy stance at the moment. On that basis, if M_1 were now growing at a rate that would create inflationary pressures at a later point in time--and he was not sure that it was--one might expect a surge in bank credit demand when that time arrived.

Mr. Partee expressed the view that the key economic question at issue was whether banks were acting as if the resources available to them were expanding at the 7 per cent rate of growth reflected in the adjusted proxy series or at the 13 or 14 per cent rate of growth reflected in the money stock series. It seemed clear to him that in their willingness to make loans banks were behaving as if they had plenty of funds available; the proxy series was growing at only a 7 per cent rate because of the discretionary actions by banks based on their expectations of further interest rate increases. In other words, the current growth rate of the proxy series understated the availability of bank funds; although loan demands had not yet materialized in large volume, banks were prepared to accommodate such demands when they did appear. A related point was that the recent large increases in demand deposits had improved the liquidity positions of the deposit holders, and that fact might have consequences for their future behavior.

Mr. Maisel remarked that banks had the option of staying liquid on the one hand, or bidding for CD funds and investing the proceeds in securities on the other hand. As he understood Mr. Axilrod's comments, the credit proxy was growing at a relatively low rate because banks preferred to stay liquid at the moment. It seemed to him that the rapid rise in M_1 could be explained in terms of a similar behavior pattern on the part of firms and individuals; they had sought to increase their demand deposit holdings because of a desire for liquidity and a disinclination to invest.

Mr. Mitchell said he was inclined to agree with Mr. Maisel's observation, although it was not clear to him why firms were not acquiring commercial paper rather than holding large demand deposits. In general, however, he thought the behavior of M_1 and M_2 had been more appropriate in the first quarter, when GNP was expanding rapidly, than in the past two months, when GNP growth apparently had slowed.

Mr. Axilrod noted that bank attitudes toward securities had changed between the first and second quarters. In the first quarter banks had acquired securities at a rapid pace in the expectation of interest rate declines; as a consequence, the credit proxy had expanded at an annual rate of nearly 11 per cent. As he had noted earlier, when banks subsequently became less interested in securities, growth in the credit proxy had slowed.

Mr. Robertson observed that the volume of bank loan commitments had risen sharply in the three-month period ending April 30, according to the survey results reported in the supplement to the green book.[1/] He asked about the relationship between that development and the rather moderate recent rate of growth in bank loans.

Mr. Partee replied that the rapid increase in commitments no doubt reflected the desire of banks to expand their loan volume. However, he did not think there would be a close relation between the volume of commitments in any relatively short period and the volume of loans actually placed on the books in that period, since commitments were taken down with varying lags and some not at all.

In reply to a further question by Mr. Robertson, Mr. Partee said no data on commitments were available for the period since the end of April. However, he was not aware of any evidence suggesting that banks had become less interested in expanding loans.

Chairman Burns noted as a point of fact that while bank loans had been stagnant in April they had risen rapidly in May; according to the green book, total loans had increased at a 12 per cent annual rate in that month and business loans at a 17 per cent rate.

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

Mr. Francis observed that economic activity appeared to be responding to the stimulative monetary actions of 1970 and to the even more aggressively expansive actions since January. According to the St. Louis Bank's projections, total spending might be increasing at about a 10 per cent annual rate in the second quarter and total real production might be rising at a 4 to 5 per cent rate. Progress was being made in reducing the economic slack, and the upward thrust of the expansion appeared to be steadily strengthening. At the same time, there had been little abatement in the rate of inflation.

Mr. Francis noted that recently interest rates had risen, retracing part of the decline of last fall and winter. Some had commented that such a rise, particularly in long-term rates, might well choke off the business recovery. He thought interest rates had been a very poor guide to the thrust of monetary actions. There was no simple, direct relationship between monetary actions and interest rates. An increase in the stock of money and bank credit added directly to the supply of loanable funds, tending to cause interest rates in the short-run to be lower than they otherwise would be. However, a rise in money and bank credit also had expansionary effects on the total demand for goods and services and, in time, placed upward pressure on prices. With expectations of greater sales and a higher rate of inflation, demands for credit might be expanded at a faster rate than the supply of credit created, and net upward pressure on interest rates would result.

Mr. Francis observed that in most periods of economic recovery and rapid expansion interest rates had risen, and monetary aggregates had increased rapidly at the same time. Unless a rise in interest rates occurred at a time of marked slowing in the growth of monetary aggregates, he preferred to interpret a rise in rates just as he would a rise in price of commodities--that is, as one indicator of rapid expansion. Better guides than interest rates to the influence of the Federal Reserve's actions on economic activity included the growth rates in Federal Reserve credit, the monetary base, total member bank reserves, and money. Increases in money plus time deposits and total bank credit--if adjusted for Regulation Q effects--also provided better measures of monetary influence than did interest rates. All of those monetary aggregates had been rising very rapidly in recent months. That gave him great concern over the probability of further escalation of the inflation.

Mr. Kimbrel noted that, according to the green book, in view of the substantial underutilization of labor and industrial capacity there should be some slowing of the advance in the GNP deflator--even though wage increases would no doubt continue to be quite substantial. He asked why a lessening of price pressures should be expected now, when the economy was bordering on recovery, if recent levels of excess capacity and unemployment had not produced that result already.

Mr. Partee said it seemed reasonable to expect that persistence of high unemployment would in time lead to some diminution of wage pressures, in nonunion if not unionized sectors of the economy. Secondly, in the initial stages of recovery excess capacity and unemployment would remain high, and it seemed likely that increasing rates of gain in productivity would moderate the rise in unit labor costs. Therefore businesses would be under less pressure to raise prices, while factory utilization rates would remain too low to permit them to initiate price increases in a strong marketing environment. It was true that that process had been much slower in unfolding in the course of the present cycle than in the past, but he saw no reason to think that it would not develop at all.

Mr. Heflin said he concurred for the most part in Mr. Partee's assessment of the economic situation, but he was not sure that he was quite as optimistic as Mr. Partee was. It seemed to him that activity had not picked up more mainly because of uncertainties with respect to wage costs and inflation. He had come to the reluctant conclusion that while monetary policy might help a little it could not solve the problem; and it could worsen it. That led him to ask for the Chairman's appraisal of the distance which the Administration was likely to move in developing an incomes policy.

Chairman Burns said he wished he could give an encouraging response to that question but he could not. He thought the Administration had been much too slow to recognize the need for an effective incomes policy. He had urged that action be taken in that area and intended to continue doing so. However, he had found that the facts were not fully understood in Government circles; there was a tendency to put an optimistic interpretation on wage and price developments which was not supportable on close examination of the evidence.

The Chairman went on to say that he could not agree with Mr. Partee's analysis of the wage-cost outlook. In his judgment the old rules were no longer working. Since the last recession in 1960 there had been vast changes in the economy, and while the business cycle was still very much alive the pattern of cyclical developments had changed. An evolution in that pattern had been under way much earlier. Years ago, when business activity turned down, prices would respond--with some lag--not by rising more slowly but by declining; and wages would follow. That kind of response had become progressively weaker after World War I, and of late one found that at a time when unemployment was increasing prices continued to advance at an undiminished pace and wages rose at an increasing pace. In a sentence, that had been the experience recently in the United States and for a longer period in Canada and Great Britain. Time and again economists had hoped that the old business cycle would reassert itself in the sphere of prices and wages; he personally had so hoped in 1969. However, he had now come to the conclusion that the response had changed. The forces of which Mr. Partee had spoken still existed, but their effects were being nullified by stronger forces of more recent origin.

Chairman Burns said he could not take the time to discuss those forces in detail today, and in any case he was not sure he understood them as well as he would like to. He might note, however, that one element in the situation was the expansion of trade unionism in the public sector over the past decade. There had been numerous strikes of public service employees--strikes against the Government--and most of them had been successful in the sense that the wage demands had been met. That, he thought, had had a profound influence on the entire labor movement; in light of the evidence, it was judged that the Government lacked the power or the will to curb abuses in the market place. Hence, the trade unions have become bolder.

In addition, the Chairman continued, welfare was on a much greater scale now than it had been a number of years ago. Because the Government now subsidized strikers to an important extent, employers were less willing to take a strike. Also, with inflation proceeding at its recent rate there was a moral force on the side of the unions' demands for cost-of-living adjustments. And the unions could say that workers were entitled to share in the increased productivity of the economy even though, apart from the past year, in recent years increases in productivity had been more a myth than an actuality. His discouragement about the situation was increased by the fact that in his view monetary policy could do very little to arrest an inflation that rested so heavily on wage-cost pressures. In his judgment a much higher rate of unemployment produced by monetary policy would not moderate such pressures appreciably. As he had indicated, he intended to continue to press hard for an effective incomes policy.

The Chairman then called for the go-around of comments on monetary policy and the directive, beginning with Mr. Treiber who made the following statement:

> As regards economic and financial developments, I would underline (1) the discouraging price situation, (2) the unrelenting cost pressures from rising wage rates, (3) the grave international position of the dollar, and (4) the rapid growth of the monetary aggregates, which in the last couple of months has been at excessive rates.
>
> With regard to monetary policy, some further firming of money market conditions is called for to slow monetary growth and to contribute to a better international position of the dollar. It seems to me that the Federal funds rate should move up to about 5-1/4 per cent within the next couple of weeks. Indeed, a further move to 5-1/2 per cent would seem indicated if the aggregates continue to grow rapidly.
>
> Of course, it is important to avoid unsettlement and congestion in the capital markets which could happen if market sentiment were to be significantly affected by some further firming of money market conditions. At the same time, it is important to bear in mind that clearly excessive rates of growth of the monetary aggregates and inflationary expectations also tend to affect market anxieties. A return to moderate monetary growth could help allay market apprehensions and thus contribute to market stability. Inflationary expectations play an important role in the level of interest rates. Over the long run, lower interest rates can be maintained only if inflation is brought under control.
>
> Among the three alternative directives suggested in the blue book, I would favor alternative B. I believe we should seek to slow the rate of growth of the monetary aggregates, and in doing so we should be mindful of developments in capital markets. We should be concerned to avoid congestion and disturbance in long-term markets, while letting long-term interest rates find their own level.
>
> As for the discount rate, an overt act of an increase in the rate does not seem to be called for at this time. The move toward firmer money market conditions should be gradual, retaining flexibility to temper

> the change and to avoid a severely disturbing effect on the long-term capital market. As firmer money market conditions develop, consideration of an increase in the discount rate may become appropriate.
>
> As inflationary pressures persist in an environment in which demand is not pressing on supply--in which there is much slack in the use of potential resources--I feel more and more that there is a need for an affirmative Government policy directed at tempering cost pressures in the economy. Such a policy should not be considered as a substitute for proper monetary policy, but as a supplement and complement.

Mr. Morris said he wanted to compliment the staff on the accuracy of its economic projections over the past five or six months. Those projections had served the Committee well. The monetary projections had also been useful to the Committee even though the staff had underestimated the actual rates of growth in the aggregates. At a time when some members of the Committee, himself included, had expected the growth rates to moderate to acceptable levels, the staff had been saying correctly that higher short-term rates would be needed to bring such moderation about.

Mr. Morris observed that until the last two or three weeks he had not been unduly concerned about the relatively rapid rates of growth in the aggregates. There had been shortfalls earlier, and growth rates averaged over the past nine to twelve months had not appeared to be excessive. Moreover, he had expected the bulge in the aggregates to be temporary. His attitude also had been affected by the relatively weak pace of the economic recovery; through April the recovery appeared to be on a course comparable to that of 1961 which, as the members would recall, had been quite shallow.

However, Mr. Morris continued, during the past few weeks a wide divergence had developed between events in the financial and the real worlds. That divergence offered a signal to the Committee that it should pause to reexamine the situation. In the meantime, he thought the Committee had to act, at least temporarily, to moderate the growth in the aggregates, since they were expanding at a pace much faster than could be tolerated for a sustained period. Accordingly, he favored alternative B for the directive today. However, he would suggest that such action be considered highly tentative, and that the Committee should be prepared to reverse course at its next meeting if that appeared desirable then.

Mr. Coldwell said the Committee's task was clear in one respect: it had to recapture control over credit creation. He would suggest that it do so by modest but steady moves. He would favor a Federal funds rate in the 5 to 5-1/2 per cent range, and would hope that the aggregates would grow at rates between those associated with alternatives B and C. Even such growth rates would be unduly high, but he thought it would be undesirable to wrench money market conditions as sharply as the blue book suggested would be necessary to bring growth down to the alternative C rates. For directive language he would suggest the following, which might be labeled "alternative D": "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to gradually firming money market conditions and reducing the rate of advance in monetary and credit aggregates while, to the extent feasible, directing such operations in a manner conducive to improved capital market conditions."

Mr. Coldwell added that the Committee could not be certain of the amount of firming that would be necessary to reduce growth in the aggregates to acceptable rates. It was partly for that reason that he favored only a modest move at this time.

Mr. Swan said he also thought the Committee had to act to slow the growth of the aggregates. Accordingly, he would be willing at this point to accept alternative B for the second paragraph of the directive.

Mr. Swan added that he had two comments on the draft of the first paragraph. One concerned the statement reading "Thus far in 1971 the consumer price index has increased at a slower pace than earlier...." Because at present the index was available only through April, he thought it would be better to say "In the first four months of 1971 the consumer price index increased at a slower pace than earlier...." The second suggestion related to the statement on interest rates. He noted that since distributing the original draft directive the staff had proposed a revision in that statement to take account of the increases in short-term rates of the last two business days. The staff's proposal, which essentially was to limit the reference to recent rate declines to long-term securities, seemed appropriate to him. However, he thought it would be desirable also to add a clause indicating that mortgage rates had risen.

After discussion it was agreed that the proposed changes in the draft of the first paragraph would be appropriate.

Mr. Strothman commented that the Committee was again faced with a difficult choice. Alternative A had great appeal because it would place no additional upward pressure on long-term rates, thus helping to prolong the expansion in outlays for housing and State and local projects. However, the staff's third-quarter projections for the money supply suggested that alternative A might build too much immediate liquidity into the economy and might possibly strengthen expectations of future price rises. Accordingly, he thought consideration should be given to alternatives B and C.

Mr. Strothman observed that the authors of the blue book argued that considerable whipsawing of short-term rates would be called for under alternative C in the process of achieving a fairly steady rate of growth in M_1 over the third and fourth quarters. Such whipsawing of short rates would presumably have a similar effect on long rates and on the types of plans which they influenced. Because of that, and also because the money supply projections were less than certain, he would rule out C. That left alternative B, which Mr. Strothman thought might be a fair compromise. There was, of course, the possibility that the increase in the funds rate called for under B would trigger a jump in the prime rate. But CD rates had already risen significantly; thus, if loan demand continued strong a rise in the prime rate might be only a little more likely under B than A.

Although he had some intuitive feeling for alternative A, Mr. Strothman observed, the projections led him to favor alternative B. If B was adopted, however, he would prefer to see the Manager move as slowly as possible toward a Federal funds rate of 5-1/4 per cent.

Mr. Mayo said that, like Mr. Morris, he had been patiently waiting for the development of circumstances under which it would be possible to attain lower growth rates in the aggregates with little or no advance in interest rates. But he had found himself growing increasingly restive with that stance, and now he also would favor alternative B in order to put some modest restraint on the monetary aggregates. Looking down the road, he hoped that the suggestion in the blue book that there might be some lessening of financial market pressures in the fall would prove to be accurate.

With respect to money market objectives, Mr. Mayo said he would prefer to specify the target for the Federal funds rate in terms of a range from 5 to 5-1/2 per cent, rather than as the single figure of 5-1/4 per cent, in order to give the Manager more flexibility. He also would want any increase in the funds rate to be implemented gradually.

Mr. Mayo added that when the funds rate rose above 5 per cent--and certainly when it exceeded 5-1/4 per cent--the System would have to face the question of a possible increase in the discount rate. Such an increase would be consistent with the System's stated position that the discount rate should bear a fairly logical relationship to short-term interest rates. He advanced the suggestion with some hesitancy, because there obviously would be strong reactions to a discount rate increase in some quarters. On balance, however, he thought that if the Committee adopted a directive allowing the Manager to raise the funds rate as high as 5-1/2 per cent, the Federal Reserve should be prepared to give serious consideration to a change in the discount rate.

Mr. Clay remarked that the combination of developments in the money and capital markets and in the financial aggregates represented a disturbing and difficult situation. Committee members had expressed considerable concern over the circumstances that existed at the time of the last meeting, and the Committee had devised an approach to monetary policy that it hoped would lead to constructive results. Despite those intentions and efforts, the formulation of a successful monetary policy program was more difficult today than it had been then.

The domestic economy continued a rather uninspiring recovery with a high and growing level of unemployment, Mr. Clay observed. At the same time, the price inflation problem remained essentially intractable. While the atmosphere of crisis was not so apparent on the international financial front as it had been a few weeks ago, the basic problem in the international balance of payments with its various ramifications continued to confront this country in a serious way.

It appeared to Mr. Clay that the System had no happy choices at the present time. It had to curb the tremendous pace of growth in the monetary aggregates in order to avoid a later acceleration of the already high rate of price inflation and its accompanying consequences. However, interest rates already had risen sharply and the important long-term rates appeared to be highly sensitive to further upward movement. That potentiality had to be weighed in terms of a modest recovery whose principal strength, apart from the temporary automobile post-strike turnaround, had been in the housing and State and local government areas--both of which could be seriously retarded by higher interest rates.

Mr. Clay thought that to deliberately accept growth rates of financial aggregates such as were associated with policy alternative A would be a serious mistake. In one sense, alternative C came closest to facing up to the situation, although even the growth rates of the aggregates associated with it were too high. At the same time, the repercussions in the credit markets and the impact on the economy from such a policy program under present circumstances would involve risks that could hardly be taken. Yet the Committee had to move strongly in the direction of bringing the aggregates under control, and that seemed to require as a beginning today a decision that involved something more than the specifications of alternative B. Perhaps the best course would be the alternative D approach Mr. Coldwell had suggested.

Mr. Clay remarked that a decision to institute a strong incomes policy could not be made by the Federal Reserve System. While most Committee members did not like such an approach, the situation that had developed really left no satisfactory way to avoid it over a relatively short-term period. In fact, if such action was not taken fairly soon, there presently might be no way to avoid the even less palatable approach of a complete harness of direct price and wage controls. Such a program would not remove the need for a more appropriate monetary policy, however.

For the longer run, Mr. Clay observed, this country had to make some basic statutory changes to permit better responses to market forces. The experience of recent years growing out of the long inflationary boom had underscored that need and had produced substantial evidence as to the general type of program that should be adopted. Federal Reserve officials should be thinking about how the System could contribute to that goal and still do its own job properly.

Mr. Heflin said it seemed to him that today's policy decision involved something more than the simple dilemma of a choice between continued excessive growth in the aggregates and an undesirable run-up in long rates. In particular, he was not at all sure that acquiescing in the prospective rapid growth in the aggregates would provide any insurance against further increases in long-term yields. He was disturbed over the evidence of a resurgence of inflationary psychology and over the prospect of a corresponding increase in the inflation premium in interest rates. Also, the publicity given to the current rapid growth in the aggregates was clearly generating expectations that the policy brakes would have to be applied harder later on. Under the circumstances it seemed to him that continued excessive expansion in the aggregates might well entail greater intermediate-term risks to financial markets than action to reduce that growth to more moderate dimensions.

Mr. Heflin said he was not prepared to recommend any crash program to get M_1 back to the 5 to 6 per cent growth path that he would consider to be moderate. But he thought that time was running out in that connection, and that the Committee should move in that direction as conditions in the bond market allowed. He would support alternative B, although he believed the Manager should be given leeway to move to its market specifications gradually and opportunistically, with as little risk as possible to the market. That course of action might well lead to upward pressure on the discount rate. Personally, he would be inclined to hold back on a discount rate increase until it became fairly clear that the market had discounted such action.

Mr. Mitchell said it was necessary at this time for the Committee to tranquilize M_1, and to make clear in its directive that it was doing so. Tranquilization might come about in three ways: by statistical revision, for which one could hope; by better understanding of the numbers, which was a rather pious hope; and by a change in the growth rate of the money supply. Once tranquilization had occurred the Committee could get back onto a sounder course. As much as he disliked doing so, he came out for the alternative C policy course. However, he would modify the language of the staff's draft directive to call for operations with a view to "achieving substantially more moderate growth in the narrowly defined money stock."

Mr. Daane said he thought the Committee had placed itself "between the rock and the hard place" by its preoccupation with the monetary aggregates and its unduly narrow focus on the Federal funds rate. Unlike Mr. Morris, he would not give the staff very high marks for the precision of its projections.

In his judgment, Mr. Daane continued, the Committee now had to pull back on monetary expansion. However, he would favor doing so in a manner that would give the Manager a good deal of leeway to minimize the shock to capital markets. That intention could be made clear by substituting for the staff's alternative B the following language, which might be labeled "alternative E": "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining bank reserve and money market conditions that will lead to moderation of growth in monetary aggregates over the months ahead." Such language would give the Manager the necessary leeway, and it might help to bring the market and the public back to the view that the System dealt in bank reserves and was willing to accept fluctuations in interest rates and in rates of growth of the aggregates. If the Committee was going to try to wean the public away from the notion that it was locked into particular Federal funds rates and aggregative growth rates, this was the time to start the process.

Mr. Maisel observed that while he agreed with most of what had been said by earlier speakers, he did not agree with the comments just made by Messrs. Mitchell and Daane. He thought the great advantage of alternative B as formulated by the staff was that it focused on the monetary aggregates, and he would not favor revising it as Mr. Daane had suggested.

In his judgment, Mr. Maisel continued, the critical questions at this juncture concerned the operating conditions to be sought and the speed with which the Desk was to move toward them. He thought the Committee should set its goals in terms of growth rates in reserves and monetary aggregates rather than in terms of some specific Federal funds rate; and that it should call for a cautious approach to changes in the funds rate, taking account of the possibility that the aggregates might turn out to be weaker than the blue book projections indicated. Specifically, he would favor starting out in the coming period by tightening somewhat, moving the funds rate into the 4-7/8 to 5 per cent range. He would keep the funds rate in that range later if incoming data suggested that the aggregates were significantly below the paths associated with alternative B. If, however, the aggregates appeared to be rising at least as strongly as the paths projected under B, the target for the funds rate should be raised gradually to 5-1/4 per cent.

Mr. Brimmer said he favored alternative B for the directive, but he would propose two changes in language. The previous directive had indicated that "the Committee seeks to moderate growth in monetary and credit aggregates over the months ahead." Contrary to the staff's suggestion that the words "and credit" be deleted, he thought the previous language should be retained. It was true that the bank credit proxy recently had been rising less rapidly than M_1 and M_2, but it was also true that the proxy series had been stronger in May than the Committee had expected at the time of the last meeting. Moreover, in light of the recent large increase in bank loan commitments, it was quite likely that bank credit would expand substantially over the summer months. Secondly, in the final sentence of alternative B he thought it would be better to indicate that operations were to be conducted with a view to "achieving," rather than "maintaining," the bank reserve and money market conditions consistent with the objectives cited in the first sentence.

With respect to operating targets, Mr. Brimmer said he believed it would be undesirable for the Committee to give the Manager specific instructions with regard to the speed at which he should seek to firm money market conditions. As Mr. Partee had indicated, some increase in interest rates probably had to be expected if the objective of slowing the growth of the aggregates was to be achieved. Hopefully any rise in interest rates could be kept to moderate proportions, and the Manager no doubt understood that the Committee would want him to proceed cautiously. However, particularly in view of the fact that the interval until the next meeting would be only three weeks, it would be desirable to give the Manager a good deal of discretion with respect to the target for the Federal funds rate. Personally, he expected that it would be necessary to raise the funds rate to the 5-1/4 per cent level indicated in the blue book if growth in the aggregates was to be held down to the rates associated with alternative B.

Mr. Sherrill remarked that he shared the concern of other Committee members over the recent rapid growth of the monetary aggregates, particularly M_1. In reacting to that development, however, it was important not to lose sight of the condition of the economy. He thought the members agreed generally that the future course of the recovery depended heavily on continued advances in housing and State and local government expenditures. In his judgment, any substantial increase in long-term rates at this point might produce a more marked reaction, particularly in housing, than might be expected at first glance. He had come to that conclusion because he suspected that an inventory problem might be developing in the supply of new houses as construction costs advanced. In that situation, a rise in mortgage interest rates might well lead to a sudden slowing of sales--and that, in turn, could cause a major setback to the over-all recovery.

Nevertheless, Mr. Sherrill said, like others he would be distressed if M_1 were to advance at an annual rate of 10 per cent in the third quarter, and on balance he would be willing to run some risk with respect to long-term interest rates to achieve slower growth. Accordingly, he favored alternative B for the directive. However, he would like to have firming actions implemented quite gradually. Specifically, he would instruct the Manager to raise the target for the funds rate to 5-1/4 per cent, but at a pace designed to minimize the disturbance to the capital markets. He would prefer to continue formulating instructions to the Manager in terms of the Federal funds rate; he was not sure he understood all of the implications of operating in terms of reserves and he thought such a procedure would be even more puzzling to market participants.

Mr. MacDonald commented that he shared the concerns that others had stressed this morning. He had been in agreement with the Committee's recent objectives for monetary policy, which implied gradually reducing the growth rates of the aggregates even though that involved some increase in short-term interest rates. Thus, he had found it disappointing that the growth rates for May and the projections for the second quarter were excessively high despite the net increase in money market rates. In his view, the Committee should seek more moderate rates of growth during the third quarter. Substantial increases in interest rates were undesirable at this early phase of the recovery, but he would accept further incremental moves, in the manner suggested by Messrs. Maisel and Sherrill, to tighten money market conditions in the range indicated in the blue book in connection with alternative B. Hopefully, such actions would slow the rates of growth of the monetary aggregates toward the target paths associated with alternative C.

Mr. Eastburn said he agreed that the Committee had to get the monetary aggregates under better control, but he also thought that something more than a modest step was required to do that. Accordingly, he favored alternative C.

There were several reasons for that preference, Mr. Eastburn continued. First, as noted in the blue book, changes in short-term interest rates had a lagged effect on the aggregates. Thus, prompt action was desirable if the aggregates were to be slowed later in the year. Secondly, while he agreed that monetary policy could not deal directly with an inflation of the cost-push variety, it certainly could avoid aggravating it. From that point of view even under alternative C the third-quarter growth rate in M_1--8 per cent--was too high. Third, in a period of uncertainty like the present fewer mistakes were likely to be made if monetary policy was focused on the aggregates rather than on interest rates. He believed that that point had been made in the report last year of the committee on the directive that Mr. Maisel had chaired. Fourth, the record with respect to the staff's past projections was not such as to produce much confidence in the accuracy of the latest projections; as had been noted, in recent months growth in M_1 had been consistently underestimated. Finally, he did not agree with the suggestion in the blue book that the M_1 growth rate for September projected under alternative C--3 to 4 per cent--could be "considerably less than might be desired." In his judgment it was time to have any errors fall on the side of restraint rather than ease.

If the Committee were to adopt the alternative C policy course the Manager would have to be given the discretion necessary to avoid disorderly markets, Mr. Eastburn observed. Perhaps that might best be accomplished by using the directive language Mr. Coldwell had proposed. The actual path of the aggregates might turn out to be closer to that associated with alternative B than C, but he thought it would be desirable to push as far as feasible in the direction of C.

Mr. Eastburn added that the rise in market interest rates that no doubt would follow from the adoption of the alternative C policy probably would mean that the discount rate should be increased. The directors of the Philadelphia Reserve Bank were becoming quite restive about the current discount rate; they were inclined to raise the rate for signal purposes as well as for market reasons.

Mr. Kimbrel noted that in the past he had indicated that neither a catching-up nor a mopping-up policy, in an attempt to correct past shortfalls or overshoots, appealed to him. It seemed to him that a preferable course of action was to admit past mistakes and from that point on to try to do better in light of past experience.

Therefore, Mr. Kimbrel continued, at present he would prefer to cast the directive in terms of monetary aggregates, as was done in alternative B. At the same time, he would allow the Manager a generous amount of flexibility in carrying out the directive. The projected rates of growth in the aggregates associated in the blue book with alternative B were higher than those consistent with what the Committee had called "moderate" growth rates. However, considering present conditions, the 9 per cent rate of growth in M_1 projected for June under B might be all that could be hoped for without drastically disrupting money and capital markets. Nevertheless, he would want to press just as far as possible.

Mr. Kimbrel said that if it was necessary to allow money market rates to rise in order to slow the rate of monetary expansion, that step had to be taken; and it was his feeling that nothing was to be gained by postponing it. Should it turn out that once again the growth rate was exceeding that projected, he would favor pushing toward an even higher Federal funds rate unless capital markets came under excessive pressure.

Mr. Kimbrel observed that several suggestions for rewording the directive had been made. However, he was not especially concerned about the exact wording so long as the sense of the Committee's instructions was conveyed. He could even accept the wording of alternative C, as interpreted by Mr. Eastburn.

Mr. Francis remarked that from January to May the money stock had increased faster than in any other consecutive four-month period since World War II. The St. Louis Bank's studies indicated that unless the growth rate was slowed markedly, very soon virtually all anti-inflationary benefits from the slowdown in 1969 and 1970 could be lost. For the past two years, just as in the late 1966-early 1967 period, growth in total spending had been held to an optimum long-run rate. Just as in the earlier period, the continued effects of previous excesses on prices had caused cutbacks in production, and by now a major portion of the transition cost to economic stability had again been paid. But now, as in 1967, it appeared that there was an overwhelming desire for a quick recovery of production and employment. If such desires resulted in the Committee's delaying a return to a reduced rate of monetary expansion, the 1969-71 period, just like the 1966-67 episode, would be merely a costly pause in a trend of accelerating inflation.

Mr. Francis suggested that money growth be held to a moderate 4 per cent rate from the May level. He did not accept the conclusion of the blue book that such a rate was practically impossible to achieve. There was little doubt that reducing the growth of money to a 4 per cent rate from now through the end of the year would imply a rise in the Federal funds rate and in other market interest rates in the next few months. However, it was also very clear from past experiences that interest rates would rise much longer and much further if a very rapid rate of monetary injection was continued. Even though a 4 per cent rate of money growth might now appear difficult to attain, the Committee should be mindful of the fact that it could become even more difficult the longer a high rate of monetary stimulus was maintained.

Mr. Francis said that such a slower growth in money would probably mean a less rapid recovery of production and employment, but one which was more likely to be sustained. Production and employment had risen at relatively rapid rates from 1962 to 1964 with a moderate 3.4 per cent average annual rate of growth of money. One might also observe that average unemployment since early 1967, when the growth rate of money had averaged more than 6 per cent, had been about the same as in the 1953-62 period when money had grown at an average 1.7 per cent rate. Production and employment benefits gained by accelerating money upward from a previous trend had always been temporary.

A continuation of the trend of money growth in recent months would accelerate the upward trend of prices, Mr. Francis observed. Furthermore, as inflationary expectations became more firmly entrenched in contracts, regulations, and the thinking of the public, the ultimate correction would become more costly either in severity or duration.

Mr. Robertson made the following statement:

> As I see it, the time for some determined decision-making by this Committee is at hand. While there are a number of significant considerations to be taken into account in shaping our policy directive today, none matches the overriding importance of the need to slow down the growth rate of the monetary aggregates.
>
> To put it simply, both M_1 and M_2 have been running too high for too long. We have waited in vain for this spring's excessive strength in these aggregates to fade, as presumably technical or transitory influences waned and as the considerable firming already introduced in money market conditions had a chance to work its way through the financial

> system. But all this has proved insufficient to stem the growth of the aggregates. Accordingly, it is up to the Committee to act with greater determination to moderate the injection of reserves into the banking system.
>
> I recognize that such a course of action can lead to higher interest rates immediately ahead. I do not want to see higher rates per se, but I am prepared to see them rise if necessary in order to retard the aggregate expansion. I would only caution the Manager to conduct his operations in an orderly and responsible manner, guarding against undue whipsaw effects on the market. Our goal should not be "firm" money market rates; rather that should be considered a possible though an unfortunate result of an effort to slow down the rate of injections of reserves. But move we must, if we are not to pile up new inflationary tinder which will plague us in the future.
>
> This implies to me that we need to vote for directive language something like alternative B as suggested by the staff. I would favor such an instruction to the Manager.

Mr. Robertson added that he could also accept the directive language proposed by Mr. Coldwell if the reference to "firming money market conditions" was deleted.

Chairman Burns commented that like other members he had struggled with the problem facing the Committee at this time. It was entirely clear to him that the recent rate of growth in the monetary aggregates was excessive and that it had to be slowed down. He was willing to accept some rise in interest rates if need be, but he thought that was an area the Committee would have to watch with great care. The present recovery was not vigorous or robust, and it rested preponderantly on improvement in home building and State and local expenditures--activities that were peculiarly sensitive to advances in interest rates. Nevertheless, he thought the Committee would have to tolerate some rise in interest rates at this time. Higher interest rates should not be considered the objective; the objective was to slow the rate at which bank reserves were supplied. But that probably--although not necessarily--would entail a rise in interest rates.

As far as the directive was concerned, the Chairman continued, he shared the preference of the majority for alternative B. He would not favor having the 5-1/4 per cent level considered as a ceiling for the Federal funds rate in the coming period; it would be better, in his judgment, to give the Manager discretion to raise the rate a little above 5-1/4 per cent if that appeared necessary to achieve the objectives for the aggregates. At the same time, he thought the Manager should wait several days before taking firming actions, since a move promptly after today's meeting was likely to have an undesirably sharp effect on expectations.

Chairman Burns added that he personally was not satisfied with the form of the directive and with the kind of supplementary instructions, emphasizing the Federal funds rate, that the Committee had been giving to the Desk. At the moment he was inclined to think it would be better to emphasize the quantity the Desk could control directly--bank reserves--and to let interest rates find their own levels. He was not sure about that judgment, however, and he believed the question urgently needed reexamination.

Accordingly, he would ask Mr. Maisel and the other members of the directive committee to work with the staff on such a reexamination.

The Chairman then noted that during the go-around several Reserve Bank Presidents had commented on the possibility of a near-term increase in the discount rate. In his opinion such an action would be most unfortunate. Late last winter the System had not followed market rates all the way down, and at this juncture it did not have to rush to follow them up. Action might become necessary eventually, if market rates continued to rise. However, action now would be likely to precipitate an increase in the prime rate, and it would have an unfortunate impact on expectations. It was important to recognize that the economy was still weak; the unemployment rate was at its recent maximum, a little over 6 per cent, and the staff projections--which had been very good over the past year--suggested that the rate would be moving to still higher levels in the second half of the year. For the Federal Reserve to raise the discount rate at a time when unemployment was so high would lead many observers to wonder about the nature and purposes of the System and would produce strongly negative reactions in the Congress and the Administration. He did not know how other members of the Board would react to any Reserve Bank proposal for a discount rate increase that might be received in the coming weeks, and it was possible that his own thinking would change as a result of developments in the interim. However, at present he would expect to oppose such an action.

Turning back to the directive, Chairman Burns noted that the Committee had concurred in certain changes in the draft of the first paragraph suggested by Mr. Swan and incorporating a revision the staff had proposed. As he had indicated, for the second paragraph the sentiment of the Committee was clearly in favor of alternative B. However, Mr. Brimmer had suggested two changes in the draft of that alternative--to retain the words "and credit" in the statement that the Committee sought to moderate growth in "monetary and credit aggregates over the months ahead," and to replace "maintaining" with "achieving" before "bank reserve and money market conditions consistent with those objectives." He asked about the views of the members regarding those proposed revisions.

There was general agreement that the second of the two proposed changes would be appropriate.

Mr. Mitchell said he was opposed to the first proposed change. In his judgment recent bank credit growth had not been excessive; the Committee's concern today was with the behavior of the money stock series. Accordingly, he thought it would be inappropriate to indicate a desire to moderate growth in bank credit.

After discussion, the Chairman called for a poll of the members' preferences on the matter. The results indicated that by a small majority the members preferred to omit the words "and credit," as proposed in the staff's draft.

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 is expanding moderately in the current quarter, following the first-quarter surge that primarily reflected the resumption of higher automobile production. The unemployment rate remained high in May. Wage rates in most sectors are continuing to rise at a rapid pace. In the first four months of 1971 the consumer price index increased at a slower pace than earlier, in considerable part because of a decline in mortgage interest rates; the rate of advance in wholesale prices of industrial commodities, which had moderated in the first quarter, stepped up again in April and May. The money stock both narrowly and broadly defined expanded even more rapidly in May than in April but growth in the bank credit proxy remained moderate. Interest rates on most types of market securities rose sharply further during much of May, reflecting continuing uncertainties about domestic and international financial prospects; more recently rates on long-term securities have declined on balance, but mortgage rates have risen. The U.S. merchandise trade balance, which was in small surplus in the first quarter, worsened in April. The deficit in the over-all balance of payments has diminished since early May, when capital outflows were swollen by expectations of changes in foreign exchange rates, but it remains large. Differentials between short-term interest rates in the United States and in major foreign countries narrowed on balance in April and May, but differentials between rates in the United States and in the Euro-dollar market recently have widened as rates in that market moved up sharply in early May. 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 aggregates over the months ahead, taking account of developments in capital markets. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with those objectives.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, June 29, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

June 7, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 8, 1971

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services is expanding moderately in the current quarter, following the first-quarter surge that primarily reflected the resumption of higher automobile production. The unemployment rate remained high in May. Wage rates in most sectors are continuing to rise at a rapid pace. Thus far in 1971 the consumer price index has increased at a slower pace than earlier, in considerable part because of a decline in mortgage interest rates; the rate of advance in wholesale prices of industrial commodities, which had moderated in the first quarter, stepped up again in April and May. The money stock both narrowly and broadly defined expanded even more rapidly in May than in April but growth in the bank credit proxy remained moderate. Interest rates on most types of market securities rose sharply further during much of May, reflecting continuing uncertainties about domestic and international financial prospects, but more recently both short- and long-term rates have declined. The U.S merchandise trade balance, which was in small surplus in the first quarter, worsened in April. The deficit in the over-all balance of payments has diminished since early May, when capital outflows were swollen by expectations of changes in foreign exchange rates, but it remains large. Differentials between short-term interest rates in the United States and in major foreign countries narrowed on balance in April and May, but differentials between rates in the United States and in the Euro-dollar market recently have widened as rates in that market moved up sharply in early May. 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; provided that somewhat firmer conditions shall be sought if it appears that the monetary and credit aggregates are significantly exceeding the growth paths expected and if capital markets are not under excessive pressure.

Alternative B

To implement this policy, the Committee seeks to moderate growth in monetary aggregates over the months ahead, taking account of developments in capital 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.

Alternative C

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to moving actively to bank reserve and money market conditions that will lead to substantial moderation of growth in monetary aggregates over the months ahead.