MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, May 23, 1972, at 9:30 a.m.

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

Mr. Mayo, Alternate Member of the Federal Open Market Committee

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

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

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. Cardon, Assistant to the Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors

Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer, 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
Mrs. Rehanek, Secretary, Office of the Secretary, Board of Governors

Messrs. Black, Leonard, and Merritt, First Vice Presidents, Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively
Messrs. Eisenmenger, Parthemos, Scheld, Andersen, Tow, and Craven, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Chicago, St. Louis, Kansas City, and San Francisco, respectively
Messrs. Debs and Brandt, Vice Presidents, Federal Reserve Banks of New York and Atlanta, respectively

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee on March 21 and April 17, 1972, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee on March 21 and April 17, 1972, were accepted.

Chairman Burns invited Mr. Daane to report on developments at the several international meetings the latter had attended recently.

Mr. Daane observed that the Standing Committee on the Euro-dollar Market had met in Basle on May 6, but the principal result was the scheduling of subsequent meetings in June and July to consider certain aspects of the Euro-dollar market. The governors' meeting in Basle the next day was uneventful for the most part. However, there was one rather unusual development. At a luncheon session Mr. van Lennep, the Secretary General of the OECD, had put forward a proposal--which he planned to present to the Ministerial Council of the OECD in Paris this week--for utilizing the OECD as a forum for discussions of international monetary reform. In brief, Working Party Three of the OECD would be used for the monetary part of the discussions, and the trade committee would be used for the trade part. A super-group, corresponding more or less to what was called a "committee of council," would be set up within the OECD. That would be a restricted group initially, with members from approximately 12 countries, although perhaps it would be open-ended so as to include more countries as justified over time. Its function, to use Mr. van Lennep's term, would be to "horizontalize" the work of the two other vertical groups--that is, to sort out the various issues and to identify the links between monetary and trade matters. Just how far the responsibilities of that group would extend was not wholly clear, however. Mr. van Lennep's proposal met with unanimous acceptance at Basle except by the U.S. representatives, who suggested--in accordance with the position of the U.S. Treasury--that some alternative types of forums should also be given consideration.

Mr. Daane said the afternoon session of the governors' meeting, involving a "tour d'horizon," was uneventful. However, the evening session was quite interesting. The discussion then focused entirely on the diversification of foreign exchange reserves, mainly into German marks and Swiss francs, now going on in various countries. It was quite clear that Germany and Switzerland, as well as other countries, would prefer not to have their currencies become reserve currencies, and there was considerable discussion of possible rules of behavior that would slow down the flows into marks and Swiss francs.

In the following week, Mr. Daane continued, the ABA's International Monetary Conference was held in Montreal. While a number of sessions had been highly interesting, he would take time today to comment only on a few. In a session on international monetary reform, Mr. Schweitzer of the Fund had led off with comments about the need to de-emphasize the role of the dollar and to increase the role of Special Drawing Rights. The theme that emerged was that the international monetary system would continue to have troubles and that the nations of the world would have to live with them. In a session concerned with the problems of unemployment and inflation, speakers from Britain, France, and Switzerland, and Mr. Stein of the U.S. Council of Economic Advisers were all pessimestic about the ability of national governments to cope with rising prices and wages. The high point of the meeting was the session on the final day at which Chairman Burns discussed the essentials of international monetary reform. His talk was extremely well received, both by the Americans present and by people from other countries. Following the Chairman's remarks, Under Secretary of the Treasury Volcker made concluding comments at a luncheon meeting. Since the Committee members had access to copies of both statements he would not take the time to summarize them.

Chairman Burns noted that the Basle meeting had also been attended by Mr. Coombs and the Montreal Conference by Mr. Hayes. He asked if they had any supplementary observations.

Mr. Coombs said he might add a comment with reference to Mr. Daane's report on the discussion of diversification of foreign exchange reserves. In that discussion President Stopper of the Swiss National Bank had protested rather strongly about the accumulation of Swiss francs in the reserves of certain Western European countries. It was his (Mr. Coombs') impression that that protest had already produced results in at least one country, which was now in process of reducing its holdings of Swiss francs. That, he thought, was a healthy development.

Mr. Hayes said he agreed that the Chairman's remarks in Montreal had been well received and he wanted to compliment him on them. Although there had been some reflow into the dollar and exchange markets were calm at the moment, the stress the Chairman had placed on the urgency of moving toward longer-run reforms was very timely and useful.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period April 18 through May 17, 1972, and a supplemental report covering the period May 18 through 22, 1972. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said the steep rise of the London gold price over the past few weeks to nearly $58.00 had attracted more attention than it probably deserved. The basic cause of the rising gold price was quite simple. As the South African balance of payments position had improved in recent months, the South African Reserve Bank had found it possible to divert part of current gold production to rebuilding its gold reserves, and thus the residual supply reaching the London gold market had been curtailed. As the gold supply had fallen and the price had reacted upward, the Russians--who had also been selling in moderate amounts--had, at least, temporarily pulled out of the market; and that move had tended to push the price up still more. Finally, as the price had risen, there had been a widespread revival in Europe of rumors to the general effect that a continuing impasse in negotiations for reform of the international financial system would sooner or later lead to a major increase in the official price of gold as the only way out.

So far, Mr. Coombs reported, the rise in the price of gold had had only a limited effect on the exchange markets. Rates on the dollar had been marked down somewhat; and it was possible, as claimed by some London gold dealers, that the new wave of speculation on gold had delayed decisions to move back into dollars. But, by and large, the dollar had shown a fairly high degree of resiliency during this period of potentially disturbing developments in Vietnam and on a number of other fronts.

To his mind, Mr. Coombs continued, that resiliency encouraged the hope that the stage might be getting pretty well set for sizable return flows and rising dollar rates as soon as a few favorable developments occurred in the international area. For example, a decided improvement in the U.S. trade figures for April or May might lead quickly to a spreading belief that the worst of the dollar crisis was over and that the time had now come to sell out holdings of European currencies while the rates were still favorable. In Switzerland, where a billion dollars or so of hot money was currently earning only negligible rates of return, the beginnings of such a shift in expectations were already evident. Swiss demands for Euro-dollar bonds had strengthened markedly in recent weeks and the Swiss franc rate had remained more than one-half per cent below par, despite recent developments in Vietnam and other disturbing news of the kind which ordinarily put upward pressure on the Swiss franc. Against that background, the Swiss National Bank had agreed last week to System purchases of Swiss francs in the market in moderate amounts--that is, not much more than about $5 million a day. So far, the Desk had accumulated $20 million equivalent of Swiss francs without having any effect on the rate.

In those circumstances of strengthening confidence in the dollar, Mr. Coombs continued, any tendency for U.S. short-term interest rates to rise in relation to European rates would probably stimulate even larger return flows. In that connection, he had the impression that European rates had now just about touched bottom, so that there probably would not be any further help from that source. He also would like to stress the beneficial effect on market attitudes that had been produced by the Chairman's speech in Montreal. More generally, he thought the situation was now at a stage where a reasonably cooperative and conciliatory approach toward the Europeans could yield major dividends in the form of a strengthening of the dollar.

Finally, Mr. Coombs said, the members would recall that at its March 21 meeting the Committee had referred to a subcommittee, consisting of Messrs. Burns, Hayes, and Robertson, a Belgian proposal regarding the revaluation guarantee on the System's Belgian franc swap debt. The subcommittee agreed to accept the Belgian proposal on the understandings that the new swap would have a six-month maturity and that everything possible would be done to pay down the swap debt at a rate of at least $50 million equivalent per month. Also, the U.S. Treasury had requested that, if any swap debt remained outstanding at the end of the six-month term, the National Bank of Belgium should give "serious consideration" to allowing the Federal Reserve to acquire the needed Belgian francs in the market or by direct sale of dollars to the National Bank on a definite amortization schedule. The formal revaluation of the Belgian franc was now being awaited, but meanwhile arrangements had been made with the National Bank for the System to buy roughly $20 million of Belgian francs directly from that Bank. That purchase was made possible by a need for dollars on the part of the Belgian Government. While the National Bank might itself have provided the dollars out of its uncovered holdings, it had instead allowed the Federal Reserve to supply dollars against Belgian francs in order to permit progress to be made on repayment of the swap debt. He thought the Belgian officials were showing a cooperative attitude.

Mr. Daane remarked that it was his impression from discussions with officials of the National Bank of Belgium that they felt a real sense of responsibility for working with the System in developing means for liquidating the outstanding swap debt.

In reply to a question by Chairman Burns, Mr. Coombs said there were no official statistics on the volume of transactions in the London gold market, although the Bank of England did try to make informal estimates. The market was quite a thin one; the volume on an average day might be only about $4 million or $5 million.

> By unanimous vote, the System open market transactions in foreign currencies during the period April 18 through May 22, 1972, were approved, ratified, and confirmed.

Mr. Coombs then said he had certain recommendations to lay before the Committee, the first of which related to the System's swap debt of $715 million equivalent to the Bank of England. Earlier the Bank of England had been unwilling to approve purchases of sterling by the Federal Reserve, either in the market or in direct transactions with the Bank. More recently the outlook for sterling had deteriorated as inflation in Britain had continued at the highest rate in Europe and the British trade balance had slipped into heavy deficit. A favorable trend in the U.S. situation would probably put heavy pressure on sterling. In those circumstances, while the Bank of England remained opposed to System purchases of sterling in the market, he thought that they might now be willing to sell sterling directly to the Federal Reserve for dollars. As the Committee knew, the U.S. Treasury had on hand $200 million equivalent of sterling arising out of the British debt repayment to the Fund. He believed the Treasury would be prepared to sell that sterling to the Federal Reserve on the condition that the System was able to make arrangements with the Bank of England to buy the remaining $515 million of sterling needed to clean up its swap debt.

In his judgment, Mr. Coombs continued, the problem was essentially one of timing. If, for example, the System were to make a direct deal with the Bank of England tomorrow, it would be paying a rate on sterling 1/4 per cent above par. However, there was a very real possibility that by August 15, when the swap reached its next maturity, the rate on sterling might have fallen by 2-1/2 per cent to its floor. Paying off the swap now, therefore, might cost the System roughly $13 million more than if it were to wait for the sterling rate to decline. He was not sure how firm the Treasury's position was, but it was his impression that the Treasury placed greater weight on the objective of clearing up the sterling debt than on that of avoiding additional cost, and that it would be prepared to have the Federal Reserve buy all the sterling needed at current rates. An alternative approach would be to work out an amortization schedule providing for weekly purchases of, say, $40 million to $50 million of sterling between now and August 15. He recommended that the Committee delegate to the subcommittee he had mentioned earlier the authority to act on its behalf in connection with the matter.

Mr. Mitchell asked why Mr. Coombs thought a subcommittee would be in a better position than the full Committee to deal with the matter.

Mr. Coombs replied that that recommendation reflected his uncertainty about the firmness of the Treasury position. While he had the general impression that the Treasury would prefer to have the swap debt paid off sooner rather than later, that attitude might change if, for example, sterling should slump in the next few weeks. In view of the size of the potential loss to the Federal Reserve, he thought there would be advantages to the kind of flexibility on the System's part that would be facilitated by delegation of responsibility to a subcommittee.

Mr. Coombs added that he was reasonably confident that the sterling debt could be paid off within a few months' time. The choice appeared to be between repaying the debt quickly or holding back a bit in the expectation that the cost would be significantly lower. He personally was inclined toward the latter course and would plan to recommend it to the subcommittee.

Mr. Brimmer noted that the Committee had always taken the Treasury's attitude into account in such negotiations, and that he would be reluctant to oppose the Treasury in the present instance. In the past the Committee had thought of operations under the swap network in terms of protecting the nation's reserve assets rather than in terms of profit and loss.

Mr. Daane said that, while he shared Mr. Brimmer's views, he believed the flexibility Mr. Coombs had mentioned would be particularly important now, considering the management situation at the Treasury. As the members knew, Mr. Connally was being succeeded by Mr. Shultz as Secretary, and Under Secretary Volcker was out of the country. Under such circumstances, he thought it would be desirable for the Committee to delegate the matter to the subcommittee, providing the latter with whatever guidance it thought proper.

Mr. Mitchell said the guidance he favored was to the effect that, unless the Treasury had some overriding reasons to the contrary, the System should not pay off its sterling debt until after the expected decline in the sterling rate had occurred.

Mr. Solomon remarked that the Treasury's attitude toward the System's sterling swap debt was consistent with the attitude it had taken earlier with respect to the Belgian franc debt; in both cases it had recommended repayment as soon as possible. In his view those recommendations reflected not an indifference to profit and loss considerations but rather a general view that debt repayments would strengthen the position of the United States in the coming international monetary negotiations.

Chairman Burns observed that he had no reason to question Mr. Coombs' forecast of a decline in the sterling rate, but he recognized that it was a forecast. The key consideration, in his opinion, was the one noted by Mr. Daane concerning the current transition in leadership at the Treasury. Since it would not be easy to determine the Treasury's position in the days immediately ahead, he thought Mr. Coombs' recommendation was a good one.

Mr. MacLaury said he concurred in the Chairman's observation, and also in the earlier comment by Mr. Mitchell. He thought circumstances with respect to the sterling debt differed somewhat from those in the Belgian case, in that there was a greater prospect of a decline in the exchange rate for sterling than for Belgian francs. In any event, the advantages for the U.S. bargaining position of repayment of those swap debts were not as great as might appear at first glance, since the Treasury itself had a large volume of debt outstanding--in the form of Roosa bonds denominated in Swiss francs and German marks--which was not likely to be repaid soon.

Chairman Burns suggested that the Committee vote on Mr. Coombs' recommendation on the understanding that if it was approved any Committee members with definite views on the matter would forward them to the subcommittee.

> It was agreed that a subcommittee, consisting of the Chairman and Vice Chairman of the Committee and the Vice Chairman of the Board of Governors, or designated alternates, should be authorized to act on behalf of the Committee with respect to the repayment of the System's swap debt to the Bank of England.

Mr. Coombs said his second recommendation related to repayment of the System's swap debt of $1.6 billion in Swiss francs. Like the Bank of England, the Swiss National Bank had until recently been opposed to Federal Reserve purchases of Swiss francs either in the market or by direct deals with the Swiss National Bank. Since last summer, however, the Swiss National Bank had managed to reduce considerably its holdings of uncovered dollars, which now stood at somewhat less than $400 million. As he had mentioned, the Swiss franc had been quoted well below par on the exchange markets, and the Swiss National Bank had concurred in moderate market purchases of Swiss francs by the System. He had also asked the Swiss authorities whether they would be interested in direct sales of Swiss francs against dollars. They had recently replied that they would be prepared to do as much as $300 million equivalent on the condition that the exchange be made at the central rate of 3.84 Swiss francs to the dollar, a rate about one-half per cent above recently prevailing market rates. He had replied that any transaction at rates other than market rates would require prior approval by the Committee, but he had left a standing order with them to do $300 million if the market rate should rise to the level of the central rate.

As the members would recall, Mr. Coombs continued, on several occasions in the past the Committee had authorized direct purchases of guilders from the Netherlands Bank at rates above the market rate, in response to the suggestion of the Bank that System efforts to acquire a similar amount of guilders in the market would probably raise the market rate by at least a corresponding amount. If the Committee was strongly interested in making a sizable repayment on the System's Swiss franc debt, he thought the proposal of the Swiss National Bank was not unreasonable. Furthermore, in view of the magnitude of that debt he thought it was unlikely that the System would be able to pay off the entire amount through market purchases, so that a special deal of the type proposed by the Swiss National Bank would eventually prove necessary in any case. He might also add that at the moment the Treasury was averse to seeing the Federal Reserve engage in transactions at rates above the market. On the other hand, the chances were probably good that sometime in the next few months the market rate for the Swiss franc would rise to the central rate and give the System an opportunity to pay off the $300 million. He would recommend that this problem also be referred to the subcommittee.

> It was agreed that the subcommittee indicated above should be authorized to act on behalf of the Committee with respect to repayments on the System's Swiss franc swap debt.

Mr. Coombs said it was worth noting, in connection with the matters just discussed, that the possibility was now in sight of repaying more than $1 billion of the System's outstanding swap debt within the next three months. As to his final recommendation, the Committee would recall that last December, when all of the System's swap lines had reached the end of their annual terms, most of the foreign central banks in the network had agreed to their renewal for another full year. Those doing so included the National Bank of Belgium. However, the central banks of four other members of the Common Market--France, Germany, Italy, and the Netherlands--had requested that the renewal be limited to six months. Thus, the $1 billion swap lines with the German Federal Bank and the Bank of France would reach the end of their terms on June 15 and 28, respectively, and the lines of $1-1/4 billion with the Bank of Italy and $300 million with the Netherlands Bank would expire on June 30. He recommended that routine telexes be sent out suggesting the renewal of those swap lines for another six months. He understood that the U.S. Treasury would be in agreement with such a procedure.

Chairman Burns said it was his impression that the Treasury would mildly prefer to have the requests for renewal originate with the foreign central banks involved. If that were the case, there might be some advantage in postponing the telexes until just before the swap lines expired.

Mr. Coombs recalled that that procedure had been considered last December, but it had been decided then that the best course was to follow the usual procedure, treating the renewals as a routine technical matter. In the past the System had customarily taken the initiative with respect to renewals of the lines, and for it to hold back now would be to raise questions in the minds of officials of foreign central banks and finance ministries regarding its objectives and motives. The basic reason for renewing the lines was to minimize the chances of market disturbances; and a rash of market rumors or press reports that the Federal Reserve was pulling away from the swap network would be particularly unfortunate at present, when conditions in foreign exchange markets were developing favorably. In sum, he thought there was nothing to be gained by delaying the telexes until the last moment rather than by sending them out at the customary time, a week or so before the maturity dates.

Mr. Daane expressed the view that there was something to be said on both sides of the question. On balance, he would be inclined to treat the renewals routinely, avoiding any suggestion of a sense of urgency but not waiting until the eleventh hour to send the telexes. While a few days' delay might have some advantages, any longer wait would involve disproportionate risks.

Mr. MacLaury remarked that, against the background of the Chairman's comments in Montreal on the need for moving ahead in international monetary reform, it might well be counter-productive for the Federal Reserve to wait for other countries to take the initiative in an area where it had always taken the first step. He also would favor proceeding to send out the telexes in the customary routine fashion.

Mr. Brimmer expressed the view that this was not the time to change the procedure with respect to renewals of the swap line.

Mr. Solomon said he assumed the Treasury was simply interested in avoiding a situation in which the Federal Reserve appeared to be asking other central banks for a concession.

Chairman Burns commented that the risk of such an interpretation would seem quite small if the procedure followed was the same as that which had been employed repeatedly in the past.

By unanimous vote, the Committee approved the renewal for further periods of six months of the following swap arrangements, having the indicated amounts and maturity dates:

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Maturity date
Bank of France	1,000	June 28, 1972
German Federal Bank	1,000	June 15, 1972
Bank of Italy	1,250	June 30, 1972
Netherlands Bank	300	June 30, 1972

The Chairman then called for the staff report on the domestic economic and financial stiuation, 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:

All indications are that the economic recovery is continuing to gather strength, with expansion proceeding now along a broad front. The most noteworthy news of the past month, in my view, was the indicated rise in the industrial production index by a full percentage point in April, to within 1 per cent of its 1969 cyclical high. Since the turn of the year, industrial output has increased at a 9 per cent annual rate, with all major components of the index participating in the recovery and the rise in output of business equipment particularly strong. An expanding flow of orders in manufacturing has fully supported this increase in activity; new orders for durable goods were up 1 per cent further in April and order backlogs advanced for the sixth month in a row.

Also very impressive has been the sustained rise in nonfarm employment, which has grown by 1 million in the first four months of the year, and in the length of the average workweek in manufacturing. Sizable employment gains over recent months have occurred in manufacturing as well as nonmanufacturing industries, and have involved both production and nonproduction workers. The unemployment rate thus far has remained close to 6 per cent, as you know, with an unusually sharp increase in the civilian labor force matching the increase in jobs. But continued growth in employment at anything like the recent pace would probably bring a gradual decline in unemployment, which is what we are predicting over the balance of the year.

Not all of the incoming statistics have shown further strength since the last meeting of the Committee, but the declines that have occurred have been more or less expected. Thus, retail sales dropped back somewhat in April following the large March upsurge. For the two months combined, however, sales were at a substantially higher level than during the winter, and the weekly data thus far in May seem to be pointing toward another increase. Housing starts also dropped again in April, to a 2.1 million annual rate, which goes beyond the decline anticipated in our second-quarter projection. Building permits have remained at around a 2 million rate, however, and it may well be that the low April starts number reflects a seasonal adjustment problem. The failure of business inventories to rise appreciably as yet is also surprising. Book value figures over the first quarter showed only a $4-1/2 billion rate of increase, including the effect of higher prices. With inventory/sales ratios relatively low and declining, however, we are inclined to view this past weakness in inventory investment as a source of future business strength. The sharp April gain in industrial output, along with the sustained advance in bank loans to business, suggests that a larger inventory accumulation may already be in process.

Altogether, the evidence seems to me fully supportive of earlier staff projections of an accelerating economic expansion. Indeed, we have increased our estimates of the projected gain in real GNP to a 7 per cent annual rate this quarter and close to an 8 per cent rate in the second half of the year. The upward revision reflects mainly three major sources of additional strength. First, we have raised our sights for business capital spending to a year-over-year increase of 14 per cent; this is in line with the latest McGraw-Hill survey of business plans and also seems consistent with the sustained strength in orders and increasing output of capital equipment. Second, we have raised our projections of personal income to reflect somewhat larger increases in average rates of compensation than previously assumed, an increase in social security benefits of 12-1/2 per cent rather than 5 per cent as of mid-year, and an increase this fall in the Federal minimum wage to $1.80, as provided for in the House-passed bill. And third, we have allowed for an increment to defense spending amounting to $1-1/2 billion in this calendar year. This reflects our very rough and unofficial estimate of the out-of-pocket costs of the recent escalation of military activities in Vietnam, and it is concentrated in the second half of the year as depleted inventories of munitions, fuel, and the like are rebuilt. The extent and duration of the increase in U.S. military activity is highly conjectural at this point, of course, but I believe that we are warranted in making some provision now for the budgetary consequences of the action.

Our new projection also incorporates revised estimates as to the course of inflation for the balance of the year. As stated, we have raised the estimated increase in compensation per manhour in the private nonfarm economy to the 6-1/2 to 7 per cent range during the second half of this year, from an annual rate of increase of around 6 per cent assumed earlier. This seems consistent with the deferred increases provided for in existing labor contracts, the size of wage increase requests that are currently before the Pay Board, and the probability that wage rates will strengthen along with improved job market conditions in the nonunion--and largely uncontrolled--areas of the economy.

Such an increase in average compensation would be likely to involve rising unit labor costs at around a 3 per cent rate, even with a relatively favorable rate of gain in productivity. And business firms historically have increased profit margins during periods of sharp cyclical recovery, when rising volume has permitted greater efficiencies and a spreading of overhead costs. Conceivably, the rise in wage rates or profit margins or both could be retarded by a substantially tougher controls program, but a tightening of the degree that appears required seems unlikely. Therefore, we have raised our projected increase in the private fixed-weight GNP deflator to around a 3-1/2 per cent annual rate in the second half of the year, roughly 1/2 point higher than had been estimated previously.

On balance, the new higher GNP projection, if realized, would have favorable short-term connotations for the economy. The larger increase in real output would cut more deeply into our unutilized resources; we have reduced the projected unemployment rate for the fourth quarter of the year to 5.2 per cent and have increased the manufacturing capacity utilization rate to close to 80 per cent. The increasing pace of activity, moreover, would be more in the character of previous cyclical recoveries, and hence would be more likely to engender the business optimism and spending plans that would extend and broaden further the economic expansion in 1973. And the increase in the projected rate of inflation later this year still cannot be said to reflect importantly the influence of strengthening market demands; rather, it results from our judgment that the wage-price program will fall a little short of its stated goals in reducing cost-push pressures in the economy.

Nevertheless, the prospect of an appreciably faster expansion than previously projected has its disquieting aspects. Clearly, an 8 per cent rate of real growth cannot be long sustained. Clearly, the projected strengthening exposes the economy to the hazard of unwanted increases in demand, such as might be fueled by massive tax refunds next spring. And clearly, continued economic expansion at the pace envisioned would gradually generate demand pressures on the structure of wages and prices and could encourage the kind of expectations that would intensify our longer-run inflationary problems. I still do not think that the

> time has come for an overt move in the direction of monetary restraint. But the risks are growing, and it is becoming increasingly important to avoid any lasting speedup in monetary expansion. For the time being, I would recommend that the Committee follow a middle course, permitting continued monetary expansion as reflected by growth in the narrow money supply at around a 6 to 7 per cent rate. In my judgment this will require holding back on the provision of bank reserves relative to demands, so that tighter money market conditions are likely to develop as the summer progresses.

Chairman Burns noted that the normal pattern during an upswing in production was for inventories of finished goods to fall in the early stages and for total inventories to rise subsequently. He asked Mr. Partee to comment on recent changes in finished goods inventories.

In reply, Mr. Partee said inventories of finished goods held in manufacturing industries declined at an annual rate of about $1 billion in March after having increased in February. Over the first quarter as a whole they declined at a rate of $400 million, which was not a large change. Inventories of purchased materials also fell, but stocks of goods in process rose in association with the expansion in production. The book value of total business inventories--in trade as well as manufacturing--increased at a rate of only $4.7 billion over the quarter, including the effects of higher prices.

Mr. MacLaury observed that Mr. Partee had commented in qualitative terms on the undesirable consequences if growth in real output were to be sustained at an 8 per cent rate for too long, but the staff had not presented to the Committee a set of figures indicating those consequences in detail. Moreover, the period for which the staff projected the course of economic activity had shortened as the year progressed; early this year the projections had covered the whole of 1972 and, although it was almost midyear, they had not been extended any further. In his view, the projections should always cover a period at least four quarters ahead even though that might be difficult at times.

In the circumstances, Mr. MacLaury continued, the staff at the Minneapolis Bank had attempted to use the Board's econometric model to project the course of economic activity through the second quarter of next year. On the basis of an assumption of growth in M_1 at an annual rate of 7 per cent throughout the remainder of this year and 5 per cent thereafter, the model indicated that the unemployment rate would fall to about 4 per cent by the middle of 1973 and would continue downward thereafter. The rate of increase in the GNP deflator was projected to slow through the second quarter of next year but then to speed up again.

Mr. MacLaury emphasized the highly uncertain character of those results, noting that he would rather have projections into 1973 made by the Board's staff. However, the results were in accord with his feeling that a rate of expansion was being generated that would carry the economy not only to but through the full employment level.

Chairman Burns said he believed the staff was not yet prepared to set forth projections into 1973 but would do so in a chart presentation at the Committee's June meeting. In that connection, he had planned to suggest today that the Committee schedule a special meeting for the Monday afternoon preceding the regular meeting tentatively scheduled for Tuesday, June 20, in order to provide more time for the presentation and Committee discussion of the projections. He asked whether there would be any objection to holding a special meeting for that purpose beginning in mid-afternoon on June 19, 1972, following the meeting of the Presidents' Conference planned for that day.

There was general agreement with the Chairman's suggestion.

Mr. Partee remarked that the econometric model could be used to project ahead for any desired number of quarters, and projections had in fact been run at the Board through the first quarter of 1974. However, he would hesitate to make use of such unrefined numbers. The staff's customary practice was to give the Committee judgmental projections, for which the econometric model was only one of several inputs.

For what it was worth, Mr. Partee continued, the longer-run econometric projections he had mentioned were similar in broad outline to those Mr. MacLaury had described. However, a particular problem was created by the large refund of Federal income taxes--amounting to as much as $10 billion--that would be made next spring because of overwithholding of taxes this year. The only postwar precedent for the resulting temporary bulge in disposable income was in early 1950, when large National Service Life Insurance dividends were paid to veterans of World War II; the total of such dividends was of roughly the same magnitude in relation to personal income as the tax refund expected next year. The staff was studying the 1950 experience to help in estimating the probable effects of the expected tax refunds. The econometric model had translated those refunds, without any special adjustment, into a very rapid expansion in real output, which would carry the unemployment rate down to 4.2 per cent in the second quarter of next year and to a still lower level later in 1973.

Mr. Coldwell said he agreed in general with Mr. Partee's assessment of the economic situation. Production and consumption had strengthened and business and consumer confidence had improved. Nevertheless, there were uncertainties that should be considered. Inflation was still a source of concern, and the wage and price controls still posed problems to be solved. There were monetary imbalances associated with the efforts to create a new international financial system, and those efforts might produce new uncertainties in the autumn. He was not too troubled that the decline in the rate of unemployment had been slow, since that was a consequence of rapid expansion in the labor force and growth in employment had been satisfactory. Looking ahead, he anticipated some slowing in outlays for residential construction but rising outlays for plant and equipment and for inventories, which would increase demands for credit.

Mr. Coldwell noted that Mr. Partee had recommended against an overt move toward restraint at present and had suggested instead that the Committee follow a middle course for policy. He (Mr. Coldwell) was concerned about timing, in view of the lags between policy actions and their effects. He asked Mr. Partee what lag he had had in mind in developing his policy recommendations.

Mr. Partee replied that the staff tended to think in terms of a variety of lags, differing in length for different sectors rather than an average lag for the whole economy. In some cases, such as plant and equipment expenditures, the lag was quite long; in others, such as mortgage flows and residential construction, it was much shorter. In the housing area, important decisions affecting activity in calendar 1973 would be made on the basis of credit conditions in the closing months of this year, so that policy actions taken rather late in the year would still have a fair chance of influencing the course of construction in 1973.

Mr. Eastburn remarked that in projections made at the Philadelphia Bank the unemployment rate was indicated to decline only to about 5.5 per cent in the fourth quarter of this year, compared with 5.2 per cent in the latest Board projections. A major part of the difference appeared to reflect differences in the expected behavior of business inventory investment. In that connection he might note that recent surveys of business attitudes conducted by his Bank had disclosed no enthusiasm for inventory building. He asked Mr. Partee how much confidence he had in the Board staff's projection that inventory accumulation would reach an annual rate of $12 billion by the fourth quarter.

Mr. Partee replied that $12 billion was not a high rate of inventory accumulation, given the current size of the economy. The staff had been surprised by the weakness of inventory accumulation thus far, however, and it was possible that a return to what might be considered a normal rate would be delayed as businesses continued to follow very conservative policies. In addition, there was always the possibility that an unexpected surge in final demands would initially serve to reduce inventory holdings. In short, the $12 billion figure for the fourth quarter was conjectural.

Mr. Partee added that while the projection of a 5.2 per cent rate of unemployment in the fourth quarter might also be considered a guess, it was an informed guess based on a careful study of underlying elements. In particular, it was expected that--despite a 4 per cent rate of increase in output per manhour--employment would continue to grow at a substantial rate over the rest of the year, and that the labor force would expand less rapidly than it had recently.

Mr. Daane noted the importance of achieving a proper mix of fiscal and monetary policy and asked how the staff would assess the current impact of fiscal developments, including particularly the effects of overwithholding of personal income taxes.

Mr. Partee replied that since the green book[1/] had been prepared the staff had developed new estimates of Federal receipts

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

and expenditures for fiscal year 1972. The estimated effect of overwithholding on receipts in the first half of calendar 1972 had been raised to $5.5 billion; no allowance for overwithholding had been made in the January budget document. In addition, April 15 receipts of payments made in connection with 1971 tax liabilities exceeded January expectations by about $1.4 billion for corporations and $1.3 billion for households. Altogether, receipts were now indicated to be $8.2 billion above the estimates of last January. Expenditures were indicated to be $5.1 billion below the January estimates, with the result that the current staff estimate of the deficit for fiscal year 1972, at $25.5 billion, was more than $13 billion smaller than the amount estimated in January.

The change from the January budget projections of the Treasury's cash needs was even greater, Mr. Partee continued. Taking account of the very large cash balance held by the Treasury at the end of calendar 1971 and of the inclusion in estimated expenditures of many payment checks that would not have been cleared by June 30, 1972, estimated cash needs were reduced from the $18 billion of last January to a negative figure of $700 million currently.

In response to a further question by Mr. Daane, Mr. Partee observed that the high employment budget was projected to be in deficit in the third and fourth quarters, following the surpluses of the first two quarters. Thus, the "fiscal drag" had about come to an end.

Chairman Burns remarked that the projections indicating an end to the fiscal drag did not take account of the new atmosphere in the Office of Management and Budget--the new determination to hold Federal expenditures under strict control. He should add that such efforts had not always proved successful in the past and it was by no means sure that they would succeed now.

Mr. Mayo observed that the economic expansion had been very strong even though the budget deficit was falling far short of earlier expectations. That fact raised the question of whether Federal outlays for revenue sharing and other new programs--which, once launched, could not easily be restrained--would soon provide more stimulus to the economy than monetary policy could cope with.

Mr. Brimmer commented that a senior official of the Department of Defense had indicated to him informally that he expected defense spending in the fourth quarter of 1972 to exceed earlier estimates by an amount roughly equal to that Mr. Partee had cited in his statement. The official also thought that in the next few months there might well be a request for a supplemental appropriation for defense.

Mr. Brimmer then referred to the Committee's decision earlier today to hold an extended meeting in June in order to provide more time for the presentation and discussion of new staff projections. In response to the Chairman's request at the March meeting for suggestions regarding Committee procedures, he had sent a memorandum[1/] to the Secretary outlining a proposal for an occasional extended meeting to be focused on the economic and financial outlook and

1/ A copy of this memorandum, dated April 14, 1972, and entitled "Reorganization of FOMC meetings," has been placed in the Committee's files.

monetary policy for the longer run. In view of the plans for June, he thought it would be useful to distribute copies of his memorandum to the Committee.

Chairman Burns agreed. He asked the Secretary to distribute Mr. Brimmer's memorandum and also a letter from Mr. Morris on the same subject.

Mr. Morris said he concurred in Mr. MacLaury's view that the Committee should be taking account of prospective economic developments through the first half of 1973 in formulating its policy today. Personally, he thought that coming quarters would be characterized by increasing fiscal stimulus and very rapid economic expansion. At the same time, he shared Mr. Eastburn's skepticism that inventory investment would have risen as much by the fourth quarter of 1972 as the staff's projections indicated, and that the unemployment rate would have fallen as low as 5.2 per cent. And he thought it was highly unlikely that the unemployment rate would decline to 4 per cent by mid-1973, as suggested by the econometric projections Mr. MacLaury had mentioned earlier.

Chairman Burns observed that the unemployment rate had typically declined by 1-1/2 to 2 percentage points in the first nine to twelve months of economic recoveries. Admittedly, the current recovery had been unusually sluggish until recently. He wondered, however, why Mr. Morris was so dubious about the possibility of a substantial decline in the unemployment rate over the next year or so.

Mr. Morris replied that, unlike many other observers, he expected the labor force to continue to grow rapidly, at a rate well above that typical of past recoveries. He then referred to the staff projection that real GNP would rise at a rate of nearly 8 per cent in the second half of 1972. If such a growth rate were sustained for long, he thought there would be serious doubts about the possibility of avoiding renewed inflation. In that connection, it would be helpful at the June meeting to have a staff analysis of the rate of growth in real output that was likely to be compatible with some further moderate abatement of inflationary pressures.

Mr. Hayes commented that his assessment of the business outlook was quite similar to Mr. Partee's. Projections made at the New York Bank indicated slightly less rapid growth in real output and slightly less decline in the unemployment rate than the Board's projections, and they were a little more optimistic with respect to prices, but the differences were quite small. Personally, he shared Mr. Morris' concern about the implications for prices if the rate of growth in real output projected for the second half should continue into 1973. In his view such a development would seriously jeopardize prospects for reducing the rate of inflation. He thought the Committee should begin to focus now on possible means for lessening the risk of continued inflation.

Mr. Kimbrel observed that the latest reports for the Atlanta District reinforced his feeling that the tempo of the economy had quickened. His enthusiasm was tempered, however, by the notion that if the economy speeded up much more, it would be all the more difficult to slow it down later. He had the uncomfortable feeling that in some areas of the country economic activity was already growing too quickly and required no stimulation from monetary policy. In Florida, for example, not only the southern tip and the central area around "Disney World" were booming, but so also was the usually lagging northern region. Expansion in parts of that State had been so fast that many businessmen and public officials were becoming concerned. Their misgivings went beyond the congestion and the environmental effects; there was a general fear of speculative over-building.

Mr. Kimbrel noted that he was also concerned about the reports of a construction boom because of reported bottlenecks of materials and shortages of labor which, if they became widespread, might make it difficult to hold down construction prices. Such conditions might not be typical, but overenthusiasm and bottlenecks did tend to develop well before the economy reached full employment; as recovery gained momentum, those problems got out of hand.

The implication for policy, in Mr. Kimbrel's view, was that the Committee should not focus narrowly on slack in manufacturing capacity or on the high over-all unemployment rate and should not follow an overly stimulative policy. Although growth in the monetary aggregates seemed to have slowed in May, the increase during the first four months of this year could be interpreted as excessively expansionary.

That view, Mr. Kimbrel noted, was supported not only by some directors and policy advisers at the Atlanta Bank but also by outside economists in the District. The Bank's Research staff recently had conducted three central banking seminars in the District--to which, incidentally, President MacLaury and Messrs. Bodner and Gramley had contributed significantly. There were three findings that might be of some interest. First, a total of 93 out of 131 economists attending the seminars thought money supply growth in the first quarter of 1972 had been too rapid. Second, the majority felt that money supply growth in 1972 should be less than in 1971. And third, they believed that the System should give primary emphasis to monetary aggregates as intermediate targets of open market operations.

Mr. Daane said he wished to stress two aspects of the balance of payments situation that had emerged in the staff's presentation to the Board on the day before this meeting. One was that, assuming the staff's GNP projection was reasonably accurate, the trade deficit in mid-1973 was likely to be at a rate no better than in 1971. The other was that a continuation of capital inflows in the near-term was very important to the viability of the whole Smithsonian agreement.

Mr. Sheehan said he was puzzled by the concern expressed by some members of the Committee about the possibility that the economic expansion would get out of control, at a time when the unemployment rate was 5.9 per cent and was expected--according to staff projections which some speakers today had described as optimistic--to decline only to 5.2 per cent by the fourth quarter. It was worth noting that the anticipated 8 per cent rate of real growth that some found disturbing would carry the utilization rate of manufacturing capacity up to only about 78 per cent in the fourth quarter, and that the rate could probably rise another 15 percentage points or so before causing serious problems. Although he recognized the need to look some distance ahead in formulating monetary policy, he did not understand the kind of concern that was being expressed today.

Chairman Burns observed that in some past meetings he had commented on the sluggishness and fragility of the recovery in economic activity. He thought the recovery was now taking hold and gaining momentum, but he also shared some of the sentiments just expressed by Mr. Sheehan. Thus, the stimulus from home building had about run its course, and exports--if the staff's projections were reasonably close to the mark--would be relatively weak.

The Chairman added that he was surprised by the lack of reference in the discussion today to the Cost of Living Council and the machinery for price and wage controls. Although, like others, he felt some degree of disappointment with the way in which the control programs had worked thus far, they had served a useful purpose. Moreover, there were grounds for believing that the Cost of Living Council would soon be taking a firmer position on price increases.

Mr. Brimmer said he was troubled by the conflicting views about the wage and price programs that had recently been expressed by Government officials. Yesterday, Mr. Ezra Solomon of the Council of Economic Advisers had said at a public meeting that the controls machinery would be dismantled within a year. Near the end of the same meeting Chairman Grayson of the Price Commission had deplored that kind of promise, stressing the difficulty of achieving compliance with any program that was expected to be terminated soon.

Chairman Burns remarked that he agreed with Mr. Grayson and was not aware of any particular basis for Mr. Solomon's remark. However, it was not unusual to have divergent views on policy expressed by different voices within Government. There also were great uncertainties. As a case in point, the Government had embarked on a highly stimulative fiscal policy in mid-1971, but because of enormous errors in the estimates of receipts there had not been any fiscal stimulus. Now there was the new determination to restrain Federal expenditures in fiscal 1973, but the historical record suggested that it was far from clear whether expenditures would in fact be restrained.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period April 18 through May 17, 1972, and a supplemental report covering the period May 18 through 22, 1972. Copies of both reports have been placed in the files of the Committee.

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

> The money and capital markets demonstrated a relatively steady tone in the five-week period since the Committee last met. The terms of the Treasury's May refunding, the Government's stronger cash outlook, and a continued light calendar of new issues touched off an improved atmosphere in the capital markets, an atmosphere that was shaken only momentarily by the President's message on Vietnam. The monetary and credit aggregates, on balance, showed a strong growth pattern even though reserves against private deposits were kept in the lower end of the 7 to 11 per cent growth range specified by the Committee at the last meeting. In May M_1 appears to be growing more slowly than anticipated at the time of the last meeting, but M_2 and the credit proxy--particularly the latter--appear to be expanding more rapidly than expected.
>
> The 3-month Treasury bill rate dipped to under 3-1/2 per cent in early May but rose steadily thereafter. In yesterday's regular Treasury bill auction average rates of 3.82 and 4.23 per cent were established for three- and six-month bills, respectively, little changed from the auction preceding the last meeting but well above the lower rates prevailing early this month. The absence of the System from the market as a buyer of Treasury bills was an important factor in the back-up of bill rates; bill sales by the Treasury, the System, and foreign accounts on key days and the updrift in the Federal funds rate also contributed to the rise.

As you know, the Treasury continues to be in a strong cash position, and it has generally been endeavoring, insofar as consistent with System open market objectives, to keep its balance at the Reserve Banks as high as possible in order to limit the amount held in tax and loan accounts at commercial banks. In the week ending May 17, however, the Treasury temporarily reduced its balance at the Reserve Banks. This, together with the monetization of gold, supplied the $1 billion-odd reserves needed to offset reserves drained by other market factors. The Treasury has rebuilt its balance with the Reserve Banks to more than $2 billion in the current statement week. I believe the System should continue to accommodate the Treasury's desire to keep the balance as high as possible as long as that does not interfere with our own operations, although as a longer-run proposition I believe we should revert to the principle of a stable Treasury balance at the Reserve Banks.

Although both the Board and New York Bank staffs anticipate a sizable cash need in July, the Treasury believes that its cash position has strengthened enough to get through that month without borrowing, although it might decide to anticipate some later needs. In this unusual cash financing lull, and given the better capital market tone, the Treasury is considering the possibility of an advance refunding in order to achieve some much-needed debt extension. Should the Treasury decide affirmatively, we would have to take account of the operation in our open market activity.

As far as open market operations are concerned, they were conspicuous by their absence over most of the period. Early in the period the System purchased $175 million of Federal agency securities, and it handled temporary reserve aberrations by matched sale-purchase transactions and repurchase agreements. The repurchase agreements, incidentally, were made on the new competitive basis and went without major difficulty. More experience is needed, however, before reaching a conclusion on the viability of the new technique. Most market participants seemed favorably inclined to the procedure, although, as might be expected, there was a fair amount of grumbling from bank dealers who continue to be excluded from these operations. So far in May the System has been in the market only once--to sell bills on May 9. As noted earlier, Treasury operations served to satisfy reserve needs over much of the month to date.

The experiment with reserves against private deposits as a primary target of operations continued throughout the period without any discernible problems. As the written report to the Committee indicates, in approaching an RPD target the Desk has avoided a mechanical adherence to the weekly path derived by the FOMC staff. We have had to make allowance for actual week-to-week deviations in excess reserves from the level assumed in the path, and for deposit shifts among city and country banks that differ from the pattern built into the path. We have also found ourselves looking through the RPD statistics to the growth measures of the monetary and credit aggregates with which the Committee is concerned. For example, over much of the past period we have tended to let RPD growth fall short of the mid-point of the 7 to 11 per cent range decided on by the Committee in light of the behavior of the aggregates. Since our new procedures are admittedly somewhat complicated we realize that some members of the Committee may have questions that are not answered by the written reports. We would be happy to answer questions at any time, and would welcome any comments or suggestions that members of the Committee may have on our implementation of the new procedures. We would also welcome visits to the Desk by Committee members or by staff members from other Reserve Banks and the Board who want to become more familiar with the new techniques.

Looking ahead, the blue book[1/] presents three alternative directives,[2/] of which all--but especially alternatives B and C--would involve supplying reserves at a pace that could lead to a tightening of the Federal funds rate, most likely bringing it above--perhaps well above--the discount rate. It should be noted, however, that recent experience has indicated that attainment of a given RPD target has been associated with a lower Federal funds rate than has been anticipated in the blue book. Conceivably, this might happen again; we might, for example, achieve a pattern B growth rate for M_1 without pushing high up in the 4-1/4 to 5-1/2 per cent Federal funds rate range associated with that pattern. But there can be no guarantee of this, particularly if the demand for money and credit rises with GNP growth.

It is also hard to predict what impact a higher funds rate will have on other interest rates. Certainly a Federal funds rate in the 4-3/4 to 5 per cent range

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

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

would bring about a rise in other short-term interest rates. There could also be an initial reaction in the capital markets, but over time the impact on long-term interest rates could be moderated or even offset should inflationary expectations diminish, the Treasury's budget position continue to improve, and the calendar of corporate and municipal offerings remain light.

It would be particularly helpful for the conduct of operations if members of the Committee would indicate the tradeoff between interest rates and growth of RPD and the aggregates that would be acceptable, and particularly whether long-term rate developments should serve as a constraint in implementing an RPD target.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period April 18 through May 22, 1972, were approved, ratified, and confirmed.

Mr. Axilrod made the following statement on prospective financial relationships:

The expansion in reserves available to support private nonbank deposits (RPD) in April and May has been just above the lower end of the range desired by the Committee. Associated expansion in the broadly-defined money supply (M_2) has been about in line with projections, while growth in M_1 has been somewhat slower than expected. Meanwhile, given the growth in aggregates that has actually developed, short-term interest rates did not show quite as much upward pressure as we expected at the time of the last FOMC meeting. The Federal funds rate edged upwards, but it generally remained 1/8 to 1/4 percentage point below the 4-1/2 per cent mid-point of the funds rate range indicated last time. Bill rates are also now above where they were at the time of the April Committee meeting, but they stayed low for several weeks as the Treasury's cash position turned out to be much more comfortable than anticipated and the mid-May refunding involved repayment of about $3/4 billion of maturing debt. With little or no pressure on short-term markets, long-term markets stabilized, as would have been expected.

While RPD growth in April and May was around the low end of the targeted range, expansion in total bank reserves and in the bank credit proxy series was larger than predicted, reflecting provision of reserves to support a much higher than expected level of U.S. Government deposits at member banks in April and particularly in May. Having been flooded with tax receipts, the Treasury seems likely to undertake minimal cash financing in June and early July, and we would expect U.S. Government deposits to drop sharply over that period. Insofar as monetary aggregates are concerned, this should be reflected mainly in very greatly curtailed bank credit growth, but it would also have some marginal influence tending temporarily to accelerate expansion in M_1 in June and July relative to later in the summer.

The basic influence on demand for M_1 in coming months, however, will be strong transactions needs stemming from the very sizable anticipated advance in nominal GNP. With a strengthening economic outlook, and given the lags in the effect of monetary policy, the Committee may want to consider ways of resisting expanding demands for money and credit. Alternative B presented in the blue book has a reserve path keyed to somewhat slower growth in all monetary and credit aggregates over the third quarter as a whole, with the M_1 track, for instance, represented by a 7-1/4 per cent growth rate in the second quarter and 6-1/2 per cent in the third. The RPD path for the May-June period, though, would still be about the same as April-May, because of the expected temporary rebound of M_1 in June.

Nevertheless, alternative B--and, of course, to a greater extent alternative C--would represent resistance to emerging income-generated demands for money. We would expect short-term interest rates to be under upward pressure in the circumstances as banks and businesses are forced to begin using up some of the liquidity they have built up over the past year or two. But any upward movement of short rates may continue to be quite moderate over the near-term. The prospective rise in short rates depends not only on the strength of economic activity and related private sector money and credit demands, but also on the size and timing of Treasury cash requirements. While no cash borrowing is expected in June, as noted in the blue book there is considerable uncertainty as to Treasury cash requirements over a somewhat longer run--with Treasury projections more optimistic than ours, although we have scaled down a little further our estimate of Treasury cash needs in the third quarter. The more the market comes to believe in optimistic cash forecasts, the more likely are upward pressures on short-term rates to be quite modest.

Assuming for the weeks immediately ahead no more than a modest rise in short rates, long-term rates are not likely to show a significant upward movement. There is ample liquidity around to cushion adjustments to a tightening monetary policy, and we are not likely to see any significant increase in recourse to bond markets by business borrowers.

Apart from an obvious failure to keep inflation under control or additional international political disturbances, perhaps the principal threat to long-term markets would occur when and if short-term rates rise to the point where inflows of time deposit funds to commercial banks and other savings institutions were strongly curtailed. Before that point, long-term rates might be rising, but at that point the market for mortgages in particular would become especially vulnerable, with feedback effects on other markets, including, of course, the market for Federal agency securities. Inflows of savings to banks and thrift institutions will diminish as short-term rates rise, but we would not expect an extremely sharp diversion of funds away from institutional lenders--given current interest rate ceilings on consumer-type time deposits and the maturity structure of such deposits--until the 3-month bill rate moved above 5 per cent, perhaps to around 5-1/2 per cent.

Chairman Burns then called for a general discussion of monetary policy, in the course of which the members might direct any questions they had to the staff. He noted that he would call for a brief go-around of views on specifications and directive language following the general discussion.

In reply to questions by Mr. Mitchell, Mr. Holmes said the Treasury's effort to maintain as large a balance as possible at the Reserve Banks complicated matters for the Desk because changes in the balance led to opposite changes in member bank reserves which, when not desired from the point of view of monetary policy, had to be offset by open market operations. Such complications would arise whether the Treasury was increasing or decreasing its balance. However, there was an additional problem when the balance was rising; insofar as the offsetting open market operations involved purchases of Treasury bills, they would put downward pressures on Treasury bill rates that might be considered undesirable at present on balance of payments grounds.

Mr. Mitchell then cited the statement in the blue book that the Federal funds rate might have risen less than otherwise in the recent period because a decline in the overnight rate on Euro-dollars had induced an inflow of funds into the United States, particularly through U.S. agencies of foreign banks. Since the Euro-dollar market represented an alternative source of funds to U.S. banks, he thought the level of Euro-dollar rates would ordinarily be among the factors influencing the relation between the Federal funds rate and the rate of growth in bank reserves. He was surprised, therefore, that the blue book discussed prospects for that relationship in the coming period without reference to the possibility of further changes in Euro-dollar rates.

Mr. Axilrod agreed that changes in Euro-dollar rates could affect the level of the funds rate at any given pace of reserve supply. In the blue book the staff had not taken account of possible future changes in Euro-dollar rates partly because it did not have a good basis for forecasting those changes. More generally, however, particular rates of reserve growth might be associated with Federal funds rates above or below those projected by the staff because of unanticipated developments of many kinds, including changes in the intensity of demands for money. The relatively wide ranges given for the funds rate in the blue book specifications provided leeway for such errors of estimate.

Mr. Mitchell said the possibility that U.S. banks might acquire large amounts of funds in the Euro-dollar market seemed to him to pose a policy problem for the Federal Reserve. The Euro-dollar market could become a particularly attractive source of funds to U.S. banks if rates there were to remain stable while the Federal funds rate rose substantially. He asked whether the staff's projections might not prove to be very wide of the mark in the event of such a development.

Mr. Axilrod said he thought that outcome was unlikely. Although changes in interest rates in the Federal funds and Euro-dollar markets could differ not only in timing and magnitude but also in direction, as they had recently, under present institutional arrangements pressures in one market tended to be reflected in the other. On balance, he would consider unexpected Euro-dollar rate developments to be one of the more marginal sources of error in the staff's projections of relationships among monetary aggregates, reserves, and interest rates.

Mr. Solomon added that some time ago the staff had prepared an analysis of the domestic consequences of Euro-dollar borrowings by U.S. banks. The conclusion was that such borrowings had no net effect on the aggregate volume of member bank reserves or on the volume of funds available for lending and investing by the U.S. banking system as a whole. That was because borrowing in the Euro-dollar market by one U.S. bank set in train processes which resulted in the loss of an equivalent volume of funds by other U.S. banks.

Chairman Burns remarked that it would be desirable to distribute a staff report on the subject Mr. Mitchell had raised.

Mr. Solomon said he would distribute copies either of the earlier analysis he had mentioned or of a new analysis if the earlier one appeared to need modification.

Mr. Daane referred to the Manager's comment about a possible advance refunding by the Treasury. He asked whether Mr. Holmes thought open market operations would be subject to significant even keel constraints during such a refunding, and whether the operational paragraph of the directive should therefore include a reference to possible Treasury financing.

Mr. Holmes replied that while the constraints imposed by an advance refunding might be slightly less limiting than those of other types of Treasury financings, they would still be significant. He should note, however, that the Treasury's plans were highly uncertain at the moment. The Committee might either refer to a possible financing in the directive it adopted today or plan to amend the directive during the inter-meeting period if the Treasury should make a definite decision to undertake the refunding.

Mr. Daane then noted that the Manager had asked for guidance from the members with respect to the acceptable trade-off between interest rates on the one hand and growth rates in RPD and the aggregates on the other. He asked Mr. Holmes to clarify the kinds of choices facing the Committee.

In reply, Mr. Holmes observed that under all three of the alternative patterns discussed in the blue book the Federal funds rate could move well above its recent average level, which was a shade over 4-1/4 per cent. Under alternative B, for example, the range shown was 4-1/4 to 5-1/2 per cent. If the funds rate were in fact to rise above 4-1/2 per cent, market participants would begin to focus increasingly on the possibility of a rise in the discount rate. It was hard to say how interest rates would react; the effects could be mild or drastic. The kind of question he had in mind was whether the Committee would want him to work toward its objectives for RPD and the aggregates regardless of the size of any interest rate increases that might ensue, or whether it would want him to temper efforts to bring RPD and the aggregates into line if, say, long-term rates were coming under substantial upward pressure.

Mr. Hayes said he thought it would be useful in deciding on policy today for the Committee to focus on a broader perspective than it had tended to do at recent meetings. It would be desirable, in his view, for the Committee to base its judgments on the developing economic and financial situation, broadly viewed, rather than concentrating too narrowly on erratic monetary statistics, including unreliable short-term projections.

In his judgment, Mr. Hayes continued, the economy was clearly in a stage of vigorous and full-scale expansion, with widespread evidence of growing business and consumer confidence. The success of the Government's anti-inflation program still hung in the balance; and he was troubled by the likelihood that the Federal budget might be unduly stimulative in the latter half of the coming fiscal year, at a time when private demand might be a good deal stronger than it was now and there would be fewer unused resources in the economy. Most observers expected demands for credit, especially for short-term credit, to grow substantially over the coming months. The Committee should also have in mind that somewhat firmer short-term market rates--especially bill rates--would be most helpful from an international point of view, by tending to enhance general confidence in the dollar as well as to encourage a return flow of short-term capital. The money and credit aggregates as a whole had been growing in recent months at rates that had to be regarded as excessive if continued much longer, and the current projections for the second quarter as a whole seemed to him to be on the generous side.

All of those considerations suggested to Mr. Hayes that it would be desirable for the Committee to supply reserves less readily than it had been doing and to move toward somewhat firmer money market conditions, having in mind the substantial lags between any such move and significant results in terms of the aggregates and effects on the real economy. Alternative B in the blue book looked about right to him. However, he would stress that he was talking of only a cautious approach, symbolized perhaps by an early move to a Federal funds rate centering around 4-1/2 per cent or a bit higher. The difficulty he found with the recent stipulation of a wide range for the Federal funds rate was that, in fact, the rate had been kept close to the lower end of the range rather than near the middle.

Chairman Burns observed that the Desk had not sought higher funds rates because that was not found necessary in order to achieve the Committee's objectives.

Mr. Hayes commented that he had not intended to criticize the Desk; his point, simply, was that if he had been making policy on his own he would have called for funds rates above the lower end of the range that had been specified. Under present conditions, he would like to see the floor at something like 4-1/4 per cent; and, although the range might go as high as the 5-1/2 per cent upper limit suggested under pattern B in the blue book, he would not contemplate approaching that level unless there were very strong signals in the coming weeks of a much more exuberant economy, or much stronger inflationary pressures, or much more rapid growth of the aggregates than now seemed likely. Specifically, he would not be inclined to place any emphasis on reacting to week-to-week swings in monthly projections for any single aggregate. He had been struck, for example, by the fact that the Board's projections of the May growth rate of M_1 had changed in successive weeks from 8 to 10 to 5 per cent, while the New York Bank projections had moved from 15 to 11 to 6 per cent. Such erratic changes, in his view, did not provide any good basis for a change in policy with respect to money market conditions.

Chairman Burns remarked that the uncertainties attached to the projections had led at least some members of the Committee to favor having less emphasis placed on those projections in making operating decisions and more on the observed actual behavior of the monetary aggregates.

Mr. Hayes observed that, despite the problems with the projections, the Committee had to take account of likely future developments in formulating policy, particularly in light of the lags involved. He thought the broad considerations he had mentioned called for a move toward somewhat firmer money market conditions at this time.

Mr. Leonard commented that in the recent past the monetary aggregates had been controlled without destabilizing movements in money market conditions, and that had been an encouraging development. The marked increase in money since January, when combined with the lack of expansion last fall, had given an average 6 per cent rate of money growth over the past six or seven months. That was virtually the same pace as in the past year and, in fact, as over the period since late 1966 when the trend rate of money had last been accelerated.

In view of the concern on the part of many regarding unused resources and the earlier slow pace of economic expansion, Mr. Leonard observed, monetary growth at that rapid trend rate might have been appropriate over the past year, although a somewhat less variable expansion of money would probably have been desirable. Continuation of money growth at a 6 per cent trend rate, however, would make it more difficult to reduce the rate of inflation. He would, therefore, favor a gradual move to a lower trend rate of monetary expansion.

Mr. Leonard expressed a preference for the targeted growth of aggregates associated with alternative C. He realized that the staff projection of money market conditions consistent with that path, which included a range for the Federal funds rate of 4-3/4 to 6 per cent, might alarm Committee members. He noted, however, that alternative A, for which a funds rate range of 3-3/4 to 5 per cent was specified, called for additions to reserves over May and June that were only $60 million greater than those of alternative C. He had difficulty in preceiving how such a small difference in reserve growth would generate a difference of 100 basis points in the funds rate. Therefore, he recommended as a compromise that the Committee adopt the aggregate paths of alternative C, with the understanding that if before the June meeting the Federal funds rate rose to 5 per cent, which was the upper limit of the range now in effect, the Chairman would consider consulting with the members in accordance with step 5 of the procedure the Committee had been following since early this year.

In view of the strong economic expansion under way, Mr. Leonard thought the alternative C paths for the aggregates could be attained without adversely affecting the recovery. Since late 1966 the trend growth in money had been at a 6.1 per cent annual rate. Under alternative A the growth of money would be at a 7.5 per cent rate from April to September. Under alternative B money would expand at a 6.6 per cent rate and under C at a 5.8 per cent rate. If permanent progress against inflation was to be made, he felt that a gradual slowing in the trend growth of money had to occur.

Chairman Burns asked Mr. Axilrod to comment on the question Mr. Leonard had raised about the reasonableness of the staff projections.

Mr. Axilrod noted that Mr. Daane had raised a similar question at the previous Committee meeting. While the staff's various sets of projected relationships were not necessarily correct, he believed they were not unreasonable. The explanation, briefly, was that in assessing the amount of pressure on the funds rate it was not sufficient to consider the level of reserves; account also had to be taken of the importance of borrowed reserves in the total. For example, the specifications of alternative C involved holding back on the provision of nonborrowed reserves to banks; given prospective demands for reserves in the current economic outlook, that would likely involve rising short-term interest rates and increased bank borrowings at the discount window. As indicated in the blue book, borrowings were projected to be in a range of $250-800 million under alternative C, compared with $50-300 million under A. Such a difference in borrowings was quite consistent historically with the differences between the funds rate ranges of A and C. RPD would grow somewhat less under C than under either B or A, as the increase in borrowings did not fully offset the reduction in the rate at which nonborrowed reserves were supplied. Of course, if demands for bank credit, deposits, and ultimately bank reserves were not as strong as assumed, there would not be as much pressure on short-term interest rates as estimated nor as much demand for member bank borrowing.

Mr. Coldwell said he believed the Committee's objective should be to provide sufficient credit to continue the economic growth but not enough to add to inflationary demand-pull pressures. The problem seemed to be one of meshing a slow retrenchment in monetary stimulation with the rising fiscal stimulus that lay ahead in order to avoid excessive growth. To meet the problems that were likely to exist in the fall he thought the Committee would have to slow the rate of reserve injection, but he would not want to do that so precipitously that economic growth was significantly retarded. Considerations of timing were very important.

At this point, Mr. Coldwell continued, he would favor moving toward a slightly tighter set of money market conditions in order to achieve a slower rate of growth in the monetary aggregates over the coming quarters. He would like to move the funds rate up slowly and steadily rather than have it jump sharply.

Mr. Morris remarked that a key point in considering policy today was that it was likely to become increasingly difficult for the Committee to control the monetary aggregates as the year progressed. Expansion in real GNP at a rate close to that projected was bound to generate large transactions demands for money in the second half. At the same time, short-term money market rates would be under upward pressure as a result of large-scale Treasury financing operations; the Treasury was expected to borrow some $11 billion from the public in the third quarter and $10 billion in the fourth. That prospect offered a strong argument for moving now toward the amount of slowing called for under alternative B.

Mr. Daane expressed the view that both domestic and international considerations suggested that reserves should be supplied somewhat less liberally. He would favor braking the rate of reserve supply a bit, and he would view firmer money market conditions not as a cost but as a desiderata. As to the policy alternatives presented by the staff, like Mr. Leonard he found the differences in the reserve levels associated with them to be very small and he was skeptical of the degree of fine tuning they implied.

Mr. Black said he would be reluctant to take any action that was likely to be interpreted as a tightening move until there had been some concrete progress with the unemployment problem. Moreover, there was a possibility that a firming of money market conditions might undermine the recently improved tone in long-term markets. Nevertheless, in view of the strengthened business outlook and the prospective pickup in the demand for both loans and cash, it might be necessary to accept less easy conditions now to avoid the need for a sharper and potentially more disruptive swing in policy later on.

Accordingly, he leaned toward alternative B, but he would interpret it as an instruction to the Desk to let growing pressures show through in higher funds rates and not as an instruction to actively seek higher rates. Also, he would hope that the Desk would use the leeway in the specified range for RPD growth to resist any sharp upward movement in the funds rate, particularly a movement above the 5 per cent level.

Chairman Burns said he would make one comment at this point. Since February the Committee had been engaged in an experiment with regard to the directive. It could terminate that experiment at any time, but until it decided to do so the members should not lose sight of the essential elements of the present approach. The Committee was focusing on a reserve target, subject to a Federal funds rate constraint. There was no preference for funds rates at any particular point within the specified range; if it appeared that the reserve target--and the associated growth rates specified for the monetary aggregates--were being met with a funds rate at the lower end of the range, the Desk was not expected to seek an increase in the rate. If the Committee were to change the elements of the experiment he would hope that it would do so deliberately, not inadvertently.

Mr. Hayes asked about the kind of evidence the Manager should be expected to consider in deciding whether to modify money market conditions. He was particularly interested in the role of the projections for the near term.

Chairman Burns noted that the Manager had been operating skillfully over the several months since the present experiment had been launched. He asked Mr. Holmes to comment on the kinds of evidence he had been considering in making his decisions.

Mr. Holmes said he had been giving more weight to actual developments in the recent past, for which relatively firm figures were available, than to projections of the future. As had been noted, the projections made at the Board and the New York Bank often differed considerably, and both were subject to great variability. However, some attention was paid to prospective developments. Thus far in May, for example, the anticipated decline in Government deposits had failed to develop, and M_1 was falling short of expectations. However, account was being taken of the likelihood that Government deposits would fall in June and July and that M_1 growth would accelerate then.

Mr. Brimmer said he was inclined to share Mr. Hayes' view that the Committee should be forming a judgment about the general posture of monetary policy in light of the economic situation that appeared to be unfolding, rather than trying to pinpoint a short-run reserve target within some narrow range. The length of the lags between policy actions and their effects on the economy was uncertain, but it was clear that those lags tended to be fairly long; and in his judgment the economic outlook through the period extending into 1973 justified some modification in the posture of policy at this time.

Thus, while he shared Mr. Sheehan's concern about the probable persistence of substantial unused resources through the fourth quarter of 1972, he would favor action now to moderate somewhat the rates of growth in reserves and thus in money and bank credit. The specifications of alternative B were consistent with the general policy posture he considered appropriate, except that he would favor an upper limit for the Federal funds rate below the 5-1/2 per cent figure shown in the blue book.

Mr. Winn observed that he had participated in the daily conference call on open market operations during the past five weeks and wanted to compliment the Desk on its performance. Like others, he had been disturbed by the frequent large revisions in the staff's projections, and he found himself wondering whether the projections served any useful purpose.

Chairman Burns remarked that despite the large measure of uncertainty attached to the projections they did contain an element of predictive power which he thought the Committee would not want to deny itself.

Mr. Axilrod noted that under current procedures the blue book presented projections of two types of relationships: between bank reserves and deposits, and between such measures and interest rates. Over the past three months the relationships involving interest rates had worked out reasonably well, although most recently interest rates had been a little lower than the staff had anticipated for the growth rates in reserves actually recorded. In his judgment, however, the projections of the relationships between reserves and deposits had proved out quite well. No doubt that outcome was partly a matter of luck, but he thought luck was not the whole explanation. In any case, to the extent the projected relationships between reserves and deposits could be relied on, the Manager was relieved of the necessity for making continuing projections of the consequences for deposits of particular changes in reserves; he simply supplied the indicated amounts of reserves and the desired growth rates in deposits would tend to be attained. Since the projections in question had been generally reliable they had been helpful in that respect.

Mr. Winn then expressed the view that some braking of the growth in the monetary aggregates would be desirable at this point. It was his feeling that the growth rates in reserves and M_1 shown under alternative C might prove consistent with the range for the Federal funds rate shown under B. While he could not be sure of that judgment, he wondered whether the Committee was not engaged in overly fine-tuning when it approached the policy question in terms of a choice among such alternatives.

Mr. MacLaury said he concurred in the views that the economy was strong, that fiscal policy would be unduly stimulative during the coming fiscal year, and that monetary policy would once again be put into the breech. He believed the Committee should begin to act now, both because of the lags in monetary policy and because firming actions could be expected to put less upward pressure on short-term interest rates at this time than later in the year, for the reasons Mr. Morris had mentioned. He would favor aiming for growth rates in the monetary aggregates between those associated with alternatives B and C; specifically, he would like to see M_1 grow at a rate of about 6 per cent in the third quarter. He recognized, however, that the Committee could not be oblivious to short-term rate developments, and he would limit the Federal funds rate to a range of 4-1/4 to 5-1/4 per cent.

Mr. Brimmer referred to Mr. Winn's observation that an effort to choose among the policy alternatives shown in the blue book might represent overly fine-tuning. He assumed Mr. Winn was thinking in terms of the very short-run, since the staff's analysis suggested that for the period through the third quarter the different policies described would involve significant differences. He (Mr. Brimmer) wanted to stress the need for the Committee to begin moving now precisely because the effects of any actions it took would appear only with a lag.

Mr. Mitchell said he agreed with Mr. Brimmer that the policy courses shown in the current blue book represented meaningful alternatives. That was not always the case, however, sometimes because the circumstances prevailing made some one policy course the only realistic alternative. If the staff were instructed to offer a single policy prescription when such circumstances arose, the Committee might be able to save a good deal of time at its meetings.

Chairman Burns remarked that Mr. Mitchell's suggestion struck him as a counsel of perfection.

Mr. Merritt said he concurred in much of what had been said in the discussion so far. Like others, he was impressed by the potential for economic expansion in the third and fourth quarters, and he thought the time had come to provide bank reserves more grudgingly. He would prefer to have the aggregates grow at the alternative C rates, but he thought the 4-3/4 to 6 per cent range shown for the Federal funds rate under that alternative was too high. He would favor a range from 4-1/4 to perhaps 5-1/4 per cent, and he would not be disturbed if the funds rate went no higher than 4-1/2 or 4-3/4 per cent in the period before the next Committee meeting.

Mr. Leonard said that while the discussion had revealed little disagreement about the desirability of aiming for slower growth in the monetary aggregates, there was a good deal of concern about the level of the funds rate. Perhaps the Committee might agree to go as far as possible towards reducing the growth rate of the aggregates within some acceptable range for the funds rate.

Chairman Burns then called for a brief go-around of views on the directive and specifications, beginning with Mr. Hayes.

Mr. Hayes indicated that the language and specifications of alternative B were generally satisfactory to him.

Mr. Morris said he could support alternative B.

Mr. Coldwell noted that he preferred the specifications for the aggregates associated with alternative C. However, he would set a 5-1/2 per cent upper limit on the range for the Federal funds rate. Within that upper limit, he thought any tradeoff should be largely in favor of fostering slower growth in the aggregates rather than moderating upward movement of the Federal funds rate. As to directive language, he would prefer to use the word "slower" in place of "more moderate" in describing the objectives for growth in the monetary aggregates over the months ahead.

Mr. Merritt indicated a preference for the aggregate growth rates shown under alternative C. The Federal funds rate should not exceed 5-1/2 per cent and should move up slowly. Mr. Coldwell's suggestion for directive language was acceptable to him.

Mr. Hayes observed that Mr. Coldwell's suggestion was acceptable to him also.

Mr. MacLaury said he would like to see the aggregates grow at rates midway between those associated with alternatives B and C; as he had suggested earlier, he was focusing particularly on growth in M_1 in the third quarter. He would set an upper limit of 5-1/4 per cent on the Federal funds rate.

Mr. Mayo said he was satisfied with alternative B.

Mr. Clay remarked that his conclusions on policy were similar to Mr. Leonard's. He favored the alternative C growth rates for the aggregates but he thought the increases in money market rates shown under alternative C in the blue book were larger than would be desirable at this time. Accordingly, he hoped the Board staff projections would prove to be wrong. Perhaps a solution could be found by indicating some level of money market rates, such as a 5 per cent rate for Federal funds, which if maintained for several successive days would require the Manager to seek further guidance from the Committee.

Messrs. Black and Mitchell expressed a preference for alternative B.

Mr. Daane said he favored a Federal funds rate in the alternative B range but he hoped such a range would result in aggregates nearer those associated with alternative C, particularly in the third quarter. With regard to directive language, he did not see a great difference between alternative B, which called for "somewhat more moderate growth" in monetary aggregates, and alternative C, which called for "more moderate growth." On balance, he would prefer C because he thought it would be more expressive of a change in the posture of policy and he regarded that as important. Also, he would be agreeable to Mr. Coldwell's proposed language change.

Mr. Brimmer said he favored alternative B, but as he had indicated earlier he would not like the Federal funds rate to move as high as 5-1/2 per cent. He would amend the language of B by inserting a reference to possible Treasury financing. Also, like Mr. Coldwell, he would use the word "slower" to describe the desired growth in monetary aggregates. In his view the Committee had been using the word "moderate" in its directive for so long that the word had lost much of its meaning. If the Committee were going to change its policy posture somewhat, this would be a good time to drop the word.

Mr. Sheehan said he was in favor of a policy approaching alternative B but leaning a little toward A. He agreed with Mr. Brimmer regarding the Federal funds rate. He would be happy with the language of B as drafted.

Mr. Winn said he favored the Federal funds rate associated with alternative B, but he hoped the aggregates would come out between those of B and C and preferably closer to C.

Mr. Eastburn expressed a preference for alternative B.

Mr. Kimbrel preferred alternative B for the near term but found the aggregate growth rates associated with C more to his liking for the longer run. He would substitute "slower" for "more moderate" in the staff draft of alternative C.

Mr. Leonard said he favored the aggregate growth rates of alternative C and he thought they could be achieved with the Federal funds rate range specified under alternative B.

Chairman Burns remarked that a majority of the members appeared to be leaning toward alternative B. He also was inclined toward that alternative, except for the specification of a 4-1/4 to 5-1/2 per cent range for the Federal funds rate. Personally, he would not want the funds rate to rise as high as 5-1/2 per cent in the coming period.

The Chairman added that some of the comments in the go-around, like some earlier in the meeting today, seemed inconsistent with the aspect of the Committee's current experiment under which the Federal funds rate was a constraint and not a target. The objective under the experiment was to achieve a certain rate of growth in reserves with a view to attaining certain growth rates in the monetary aggregates; but because the Committee did not want to see highly volatile interest rates it set limits to the fluctuations in the Federal funds rate.

As a matter of fact, the Chairman continued, it could be argued that the lower limit of the range specified for the coming period should be below the 4-1/4 per cent figure of alternative B, since that figure was very close to the current funds rate. Reducing the limit to, say, 4 per cent would give the Desk some leeway to react if reserves and the monetary aggregates were growing at rates below those specified by the Committee.

Mr. Daane said it would be useful to have the Manager's views regarding the possible effects on expectations in financial markets of a decline in the Federal funds rate and perhaps in short-term interest rates generally.

Chairman Burns suggested that the question be sharpened by supposing that the Federal funds rate slipped to 4-1/8 per cent at a time when the growth rates of bank reserves and the monetary aggregates were well below those specified under alternative B.

Mr. Holmes replied that if the market felt the System had the monetary aggregates completely under control and if also there was evidence that inflationary expectations were diminishing he would see little risk in letting the Federal funds rate slip back. He would emphasize that the state of inflationary expectations would have a particularly important influence on the market's reaction to an easing of the Federal funds rate.

Mr. Daane commented that several months would have to elapse before it could become clear to the market that the aggregates had been brought under control.

Mr. MacLaury remarked that the theoretical point underlying the Chairman's question was well taken but a practical point seemed to have been lost. If the staff projections meant anything--and he recognized that some members were discounting them heavily--growth in M_1 during June and July would be at an annual rate in the 8 to 10 per cent range under any of the policy alternatives being considered today. Given relatively rapid growth in the monetary aggregates, a reduction in the Federal funds rate would be seen by the market as a policy move.

Chairman Burns commented that under the supposition he had described the Federal funds rate would be reduced only if the monetary growth rates fell well short of the target.

Mr. Hayes said he thought the Committee was in danger of overlooking a significant fact--that in the short run the Federal funds rate was by far the most visible indicator of System policy. Participants in financial markets did not have adequate means of assessing short-run changes in reserves and the monetary aggregates, and their attitudes were not likely to be affected much by any changes that might occur in those measures over a brief interval. On the other hand, they were likely to interpret even a relatively moderate increase or decrease in the Federal funds rate as signaling a policy change.

Chairman Burns observed that the Committee's responsibility was to exercise its best judgment regarding the monetary policy course that was proper for the economy. The objective was not to raise interest rates but to supply money and credit at rates that would enable the economy to go forward without stimulating new inflationary pressures. He did not think that objective would be served if the monetary aggregates fell well short of the Committee's targets and the Federal funds rate was held unchanged or was actually raised.

Mr. Hayes remarked that the level of interest rates in itself had important effects on market psychology, the demand for credit, and the economy.

Mr. Daane said he regarded the time dimension as an important consideration in deciding on the action to be taken if RPD and the monetary aggregates were falling short of the Committee's objectives. In his view a shortfall occurring over a relatively long period--say, a quarter--would have quite different implications from one occurring over, say, a two-week period. Under prevailing circumstances he would not want to reduce the Federal funds rate or encourage declines in other short-term rates simply because of a shortfall during a brief period.

Mr. Hayes expressed agreement with Mr. Daane's view.

The Chairman then asked the Committee members to indicate whether they preferred the 4-1/4 to 5-1/2 per cent range for the Federal funds rate shown under alternative B or the slightly lower range of 4 to 5-1/4 per cent. A majority of the members expressed a preference for the former.

Chairman Burns observed that he might well find it necessary to consult with the Committee about policy in the period before the next scheduled meeting if the Federal funds rate was moving into the upper portion of the 4-1/4 to 5-1/2 per cent range.

Turning to the language of the directive, he noted that in its drafts of the operational paragraph the staff proposed to omit the clause of the previous directive which called for taking account of both capital market developments and "the forthcoming Treasury financing." He personally would prefer to retain the reference to capital market developments and to include a reference to "possible" Treasury financing.

The Committee agreed to retain the reference to capital market developments. With respect to the language referring to possible Treasury financing, it was noted that the Treasury's plans were highly uncertain at the moment. After considering the alternative Mr. Holmes had mentioned earlier--of omitting the reference on the understanding that the directive could be amended after today's meeting if appropriate--the members decided to include a reference. However, since the financial operation under consideration was an advance refunding, it was agreed to refer to possible Treasury "refunding" rather than "financing."

In response to the Chairman's question, most of the members indicated that they would be reasonably content with either the phrase "somewhat more moderate growth" or the phrase "somewhat slower growth" as a description of the objectives for the monetary aggregates over the months ahead. However, a majority preferred the latter phrase.

The Chairman then suggested that the Committee vote on a directive consisting of the three general paragraphs drafted by the staff and an operational paragraph with the language just decided upon. It would be understood that in implementing the directive the Manager would be guided by the specifications shown under alternative B in the blue book, within the five-point procedure the Committee had been following since the meeting of February 15, 1972.

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, including recent data for such measures of business activity as industrial production and employment, suggests that real output of goods and services may be growing at a faster rate in the current quarter than in the two preceding quarters, but the unemployment rate remains high. In April wholesale prices of farm and food products changed little--after having declined in March--but the rise in prices of industrial commodities remained substantial. The consumer price index, which had been stable in March, increased somewhat. Wage rates continued to rise at a substantial pace. The U.S. balance of payments on the official settlements basis has been in small surplus since mid-March, but the payments balance on the net liquidity basis has apparently remained in deficit. In March merchandise imports continued to be considerably in excess of exports.

Growth in both the narrowly and broadly defined money stock slowed in April from the rapid rates in February and March. Inflows of savings funds to nonbank thrift institutions also slowed, but they remained at a relatively advanced pace. Reflecting a further increase in U.S. Government deposits and a rise in the outstanding volume of large-denomination CD's, the bank credit proxy continued to expand at a rapid rate. In recent weeks, market interest rates have fluctuated in a narrow range.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

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

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

It was agreed that the next meetings of the Federal Open Market Committee would be held on Monday and Tuesday, June 19-20, 1972.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) May 22, 1972

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on May 23, 1972

GENERAL PARAGRAPHS

The information reviewed at this meeting, including recent data for such measures of business activity as industrial production and employment, suggests that real output of goods and services may be growing at a faster rate in the current quarter than in the two preceding quarters, but the unemployment rate remains high. In April wholesale prices of farm and food products changed little--after having declined in March--but the rise in prices of industrial commodities remained substantial. The consumer price index, which had been stable in March, increased somewhat. Wage rates continued to rise at a substantial pace. The U.S. balance of payments on the official settlements basis has been in small surplus since mid-March, but the payments balance on the net liquidity basis has apparently remained in deficit. In March merchandise imports continued to be considerably in excess of exports.

Growth in both the narrowly and broadly defined money stock slowed in April from the rapid rates in February and March. Inflows of savings funds to nonbank thrift institutions also slowed, but they remained at a relatively advanced pace. Reflecting a further increase in U.S. Government deposits and a rise in the outstanding volume of large-denomination CD's, the bank credit proxy continued to expand at a rapid rate. In recent weeks, market interest rates have fluctuated in a narrow range.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

To implement this policy, the Committee seeks to achieve bank reserve and money market conditions that will support (A - moderate, B - somewhat more moderate, C - more moderate) growth in monetary aggregates over the months ahead.

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

May 23, 1972

Points for FOMC Guidance to Manager In Implementation of Directive (as agreed upon 2/15/72)	SPECIFICATIONS As agreed, 5/23/72
1. Desired rate of growth in aggregate reserves expressed as a range rather than a point target.	7.5-11.5% seas. adj. annual rate in RPD in May-June
2. Range of toleration for fluctuations in Federal funds rate--enough to allow significant changes in reserve supply, but not so much as to disturb markets.	4.25-5.5%
3. Federal funds rate to be moved in an orderly way within the range of tolerance (rather than to be allowed to bounce around unchecked between the upper and lower limit of the range).	
4. Significant deviations from expectations for monetary aggregates (M_1, M_2, and bank credit) are to be given some allowance by the Manager as he supplies reserves between meetings.	see table below
5. If it appears the Committee's various objectives and constraints are not going to be met satisfactorily in any period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.	(It was indicated at the May 23 meeting that Chairman Burns might consult with the Committee in the period before the next scheduled meeting under other circumstances also, depending on the course of interest rates.)

(SAAR)

	May	June	2nd Q	3rd Q
M_1:	4.5	8.5	7.25	6.5
M_2:	9.5	10.0	9.0	7.0
Proxy:	17.0	2.5	11.0	6.5