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 15, 1973, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Balles
Mr. Brimmer
Mr. Bucher
Mr. Daane
Mr. Francis
Mr. Mayo
Mr. Morris
Mr. Sheehan

Messrs. Clay, Eastburn, Kimbrel, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. MacLaury and Coldwell, Presidents of the Federal Reserve Banks of Minneapolis and Dallas, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. O'Connell, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Andersen, Bryant, Eisenmenger, Hersey, Reynolds, Scheld, and Sims, 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. Coyne, Assistant to the Board of Governors
Mr. O'Brien, Special Assistant to the Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Adviser, Division of International Finance, Board of Governors
Mr. Ettin, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mrs. Peters, Secretary, Office of the Secretary, Board of Governors
Mrs. Stanier, Secretary, Office of the Secretary, Board of Governors

Mr. Black, First Vice President, Federal Reserve Bank of Richmond
Messrs. Link, Boehne, Parthemos, Taylor, and Doll, Senior Vice Presidents, Federal Reserve Banks of New York, Philadelphia, Richmond, Atlanta, and Kansas City, respectively
Messrs. Hocter and Green, Vice Presidents, Federal Reserve Banks of Cleveland and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Sandberg, Manager, Acceptance and Securities Departments, Federal Reserve Bank of New York

Chairman Burns noted that the number of Committee members present was smaller than usual because of Mr. Robertson's resignation on April 30 and Mr. Mitchell's illness. Although Mr. Mitchell was still in the hospital, he was making good progress towards recovery.

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee on March 19-20 and April 17, 1973, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee on March 19-20 and April 17, 1973, were accepted.

The Chairman then noted that a number of Committee members had recently returned from foreign meetings. He invited Mr. Daane to report on the Basle meeting held during the past weekend.

Mr. Daane observed that he had attended the Basle meeting along with Messrs. Hayes, Coombs, and Bodner from the System. The discussion at the Sunday afternoon session of the governors was concerned wholly with a progress report by the Standing Committee on the Euro-currency Market, of which he had been a member since its inception several years ago. No recommendations were included in the Standing Committee's report because of differences of view among the members with respect to both the seriousness of the problems associated with the Euro-currency market and the appropriate policies for dealing with those problems. On the former question, some members of the Standing Committee thought that the market simply offered borrowers an alternative facility for credit that could be obtained elsewhere. The key policy issue was whether national controls of inflows and outflows would be effective or whether a multinational approach was

required because the imposition of controls by an individual country would result simply in a shift of transactions to another country.

At the outset of the discussion, Mr. Daane continued, Chairman Zijlstra observed that the first question facing the governors concerned the significance of the Euro-currency market--specifically, whether flows in that market could have a sufficiently important effect on financial conditions, monetary policies, and so forth in individual countries to warrant efforts to influence or limit such flows. He indicated that his (Zijlstra's) own philosophy could be expressed by a statement in a document of the Standing Committee reading as follows: "In the absence of international controls, the Euro-dollar would seem to resemble a currency working under a system of inconvertibility and according to criteria set by the commercial banks themselves. The banking school, driven out by the currency school in 1844, could thus come in again through the back-way more than a century later." That philosophy led Mr. Zijlstra to the conclusion that the Euro-currency market did have significant effects on national economies and therefore should be subject to limitations. His conclusion was echoed by most of the others in the subsequent discussion. However, two governors indicated that they would share that view in connection with a stable exchange rate system, but that they had some question about it when considering a system of floating rates. He (Mr. Daane) had noted

that, while the possible availability of other credit sources as a substitute for the Euro-currency market made it impossible to quantify the credit-creating potential of that market, it was clear that central bank placements in the Euro-currency market were a more certain source of the credit creation that had proved troublesome to some. In any event, it was the consensus of the group that limitations on the market were warranted.

With that issue resolved, Mr. Daane continued, Mr. Zijlstra turned to the questions of what could or should be done to influence the supply of funds to the Euro-currency market; the demand for funds in the market; and, more directly, what he termed the "meeting place"--the banks participating in the market. On the question of supply, he agreed with a view Mr. Daane had expressed, that particular attention should be given to the placement of central bank funds in the market. He divided the central banks involved into three categories--those in G-10 countries, in non-G-10 countries other than oil-producing countries, and in oil-producing countries--and then he further subdivided them according to whether or not they could be drawn into special arrangements affecting their supply of funds to the market. In the course of the ensuing discussion there was a great deal of comment about the need for rules of behavior governing central bank investments of reserves and about diversification of such investments--matters which were increasingly becoming a source of concern to the Basle group. There also was comment about the

desirability of exploring anew the possibility of joint action to absorb some of those reserve funds or divert them from the Euro-market, in the first instance involving possible issuance of special securities by the U.S. Treasury which could be attractive to foreign central banks.

Mr. Daane noted that the first conclusion reached on the subject of supply related to action regarding central bank placements of the Basle countries themselves. The governors reaffirmed the agreement--first reached in the summer of 1971, rescinded in letter although not in spirit in the fall of that year, and then renewed in the Paris meetings of March 1973--not to place additional funds of their own central banks in the Euro-currency market, and to gradually and prudently withdraw their earlier placements. One governor indicated that since March his central bank had shifted more than half of its Euro-currency placements to the United States and that it planned to do the same with 50 per cent of the proceeds of maturing contracts. Another governor, while not providing quantitative information, indicated that his bank was following a roughly similar course, and the remaining governors expressed intentions of making such transfers. The second conclusion was that the possibility should be explored of--to use Mr. Zijlstra's terminology--"draining the market a bit through open market operations." That was translated--initially, at least--into reviving discussions between the BIS and

the U.S. Treasury of the possibility of tailoring U.S. security issues to the needs of other countries, particularly those in the non-G-10 group, and of using the BIS as an intermediary for channeling funds. While it was agreed that those discussions should be revived, there was no agreement as to where they should lead. As he (Mr. Daane) had noted during the Sunday afternoon session, the U.S. Treasury had been reviewing all possibilities, even including that of offering a public issue which could be subscribed to by non-governmental investors in the Euro-currency market. The British representative at the meeting reported that public corporations in the United Kingdom, such as the Greater London Council, were now being "permitted" to borrow funds in the Euro-currency market and to invest them until needed in the United States, so that those corporations were, in effect, carrying out the kind of open market operation being discussed at Basle. Such transactions had a number of advantages from the British viewpoint: they enabled the public corporations to borrow at rates lower than those available to them in domestic markets; they avoided the additional undesired upward pressure on domestic U.K. interest rates that such borrowing would create; and they resulted in an increase in the reserves of the Bank of England.

As to what might be done to influence demand in the Euro-currency market, Mr. Daane observed that the governors discussed

various national policies--such as the German "bardepot" deposit requirement on foreign borrowings by nonbanks, and the outright prohibition of outside borrowing in the Netherlands. While there were no specific undertakings, Chairman Zijlstra concluded it was clear that the countries represented at Basle would "not be reluctant" to put controls on borrowings from outside. Finally, the governors turned to the "meeting place" issue, a subject to which the major part of the Standing Committee's report had been devoted. There was a great deal of discussion--but no resolution--of the question of whether reserve requirements were desirable and, if so, whether they should be applied to assets or liabilities. The group recognized, but tended to discount, the argument that the imposition of controls by an individual country would result in a shift in transactions to other countries; they felt that such shifts could be limited by national policies affecting the home offices of domestic banks and, in turn, the branches and subsidiaries of those banks. The governors agreed to return to the meeting place question at the July Basle meeting.

In response to questions about the status of the Federal Reserve's marginal reserve requirements on Euro-dollar borrowings of U.S. banks, Mr. Daane continued, he had noted that the Board had published a proposal to reduce the requirement from 20 to 10 per cent and had asked for opinions on that proposal. It was the

consensus of the governors that it would be desirable to reduce the requirement "as much as possible." Subsequently, however, in conversation following the meeting one of the deputy governors expressed great reservations about such advice; he was concerned about the risk of a repetition of the 1969-71 experience, in which there were large flows from the Euro-dollar market to U.S. banks and then back again.

Mr. Daane said he might also comment on certain conversations that occurred outside the formal sessions. As to the very recent unsettlement in the exchange markets, one governor in conversation expressed the view that last week's developments, if they had occurred under a system of fixed parities, would have culminated in a crisis; and that, more generally, the present regional system of exchange rates with particular floats was more resilient than the fixed-rate system. Several governors noted that it was necessary to think in terms of adapting and reinforcing the exchange rate system now existing, and they thought that a substantial increase in the official price of gold would be helpful in that connection.

In concluding, Mr. Daane observed that Mr. Hayes might have some additional comments on the Basle meeting.

Mr. Hayes remarked that he had only one comment to add--namely, that there was a general feeling of unease, uncertainty, and unhappiness about the existing situation in exchange markets.

Mr. Daane agreed, and added that he had not meant to imply the contrary.

In reply to a question by Chairman Burns, Mr. Daane said the discussions with the Treasury about possible means of channeling Euro-currency funds into U.S. securities would move forward promptly. Mr. Coombs added that certain suggestions regarding such means had been transmitted to the Treasury several months ago.

Mr. Morris referred to Mr. Daane's comment regarding the concern expressed privately by one participant in the Basle meeting about a sharp reduction in U.S. reserve requirements on Euro-dollar borrowings, and asked for amplification of the reasoning underlying that concern.

Mr. Daane said he thought the argument was that a sharp reduction in the reserve requirement might lead to a large flow of funds into the United States, and that that might be followed--should monetary conditions subsequently change--by a large reverse flow.

In the ensuing discussion several members, including Mr. Daane, agreed that, in light of the recent enormous outflows of funds from the United States, some reflow at this point would be welcome.

Chairman Burns also agreed with that view, but he added that a succession of large flows in opposite directions, such as had occurred in 1969-71, would not be a happy outcome. The basic question was one that frequently faced policy-makers: whether to focus today on means for dealing with an immediate problem, or whether to take account also of the spill-over effects that would be felt tomorrow.

Mr. Daane remarked that he might add a postscript with respect to a conversation in Basle with Mr. Morse, Chairman of the Deputies of the Committee of Twenty, and with a few other C-20 Deputies present there, concerning a first very preliminary draft outline of reform looking toward eventual presentation to the governors at the annual meeting of the International Monetary Fund in Nairobi in September. The preliminary draft was designed to provide a framework for discussion by Deputies rather than a cohesive plan. Although the Europeans seemed to consider the draft reasonable, it appeared to be inadequate from the U.S. viewpoint. One problem revolved around the manner in which one of the issues was formulated--the issue of whether reserve indicators should trigger action, as suggested by the United States, or simply consultation, as favored by the Europeans. A second problem was posed by the presumption in the outline that the Fund would be deeply involved in all aspects of the new international monetary system, i.e., that everything would be referred to the Fund for ad hoc decision. At one extreme, that could suggest an unrealistic transfer of authority to the Fund. At the other extreme, it could imply that efforts to enforce any new rules of behavior in the monetary area would be limited to "consultations" with the Fund along the lines of present Article 8 consultations which were largely ineffective in producing action. In any case, the Deputies would be discussing the draft outline at their next meeting, after initial discussion of the problems of concern to the less developed countries

such as the link between SDR's and development aid. The meeting, which would be held in Washington, would extend over the week May 21-25.

Chairman Burns noted that Mr. Brimmer had headed the Federal Reserve delegation to the Tenth Meeting of the Governors of Central Banks of the American Continent, held from April 30 to May 2 in Curacao. He invited Mr. Brimmer to comment on developments at that meeting.

Mr. Brimmer observed that the System's delegation to the meeting included Mr. Coldwell, Messrs. Debs, Lang, and Pardee of the New York Bank, and Mr. Maroni of the Board's staff. He had had the privilege of serving as delegation head only because Chairman Burns had found that he was unable to attend the meeting, and the Chairman's presence had been missed. He planned to distribute to the Reserve Banks and to the Board a written report on the meeting--and also on a subsequent meeting of the Assembly of Members of the Center for Latin American Monetary Studies (CEMLA). So he would limit his oral comments to a few points of particular interest to the Committee.

Mr. Brimmer noted that the first session of the meeting of Western Hemisphere governors was concerned with issues related to the reform of the international monetary system. A second session, which he would pass over today, was devoted to the role of central banks in channeling internal bank credit flows in desired directions. The basic paper at the first session was presented by Deputy Governor Mancera of the Bank of Mexico. Mr. Mancera addressed, among other matters, the question of controls over the Euro-currency market.

He noted that such regulation would be a cause of serious concern to the developing countries which depended heavily on those markets for large amounts of development capital. He added that regulation of the Euro-currency markets would not lead to the disappearance of the destabilizing capital flows since the elements contributing to such flows would continue to exist--the leads and lags and the large working balances of powerful companies and wealthy individuals. He also remarked that, while there might be good reasons to suggest that monetary authorities should refrain from placing funds in the Euro-currency markets, for the developing countries the funds so placed often constituted the compensating balances required by the Euro-banks which extended credit to them. For that reason, he thought that the placement of funds in the Euro-currency markets by the central banks of the developing countries should not be viewed in the same way as placements by the central banks of the industrialized countries.

Mr. Brimmer said he had cited Mr. Mancera's comments on the subject because they reflected a viewpoint that diverged sharply from that of the Basle group of governors which Mr. Daane had described. In his own comments following Mr. Mancera's statement, he (Mr. Brimmer) had focused on the U.S. proposal for using reserves as an indicator of the need for balance of payments adjustment. His presentation was well received. However, one point of particular

interest was made in the subsequent discussion: that if the U.S. proposal were adopted it would be crucial for the large countries to submit themselves to the same kind of discipline as applied to small countries. One speaker commented that the willingness of the United States and other large countries to do so remained to be demonstrated, and that it could not be predicted on the basis of their past behavior.

At the CEMLA meeting which followed, Mr. Brimmer continued, one of the subjects discussed was the plan developed earlier for central bank assistance to the Central Bank of Nicaragua to meet needs arising out of the earthquake of last December. There was considerable criticism of the Federal Reserve for declining to participate in the plan. In an effort to clarify the System's position, he had asked for the floor to read a substantial part of the text of the Chairman's letter setting forth the System's reasons for not participating. Those reasons involved questions not only of legal authority but also of policy, given that assistance of the type in question--which was essentially of a foreign aid nature--was the responsibility of the Agency for International Development. However, the explanation was not well received.

Mr. Brimmer said he might also mention that, following his departure from Curacao, the governors of the Latin American central banks held their Sixteenth Meeting. He was informed by System

staff members, who attended the meeting as observers, that one of the sessions was concerned with the question of whether and how the Latin American central banks might diversify their reserves. Several Latin American central banks made it clear that they had moved out of dollars in the latter part of 1972 and at least one explicitly stated that it had made a profit from the devaluation of the dollar last February. The central banks of the five Central American countries jointly proposed that a study be made of the possibility of diversifying reserves--including the possibility of having exports paid for in the currencies of the markets in which they are sold. The Central Bank of Argentina had already put such a requirement into effect. The Latin American Governors agreed that a study would be worthwhile, and they instructed CEMLA to prepare a report with the help of central bank personnel and technical experts of its choosing.

In response to the Chairman's request for his comments on the Curacao meetings, Mr. Coldwell said he would report a few general impressions. The Latin American central bankers still appeared to be mainly concerned with the problems of obtaining sufficient development capital at low interest rates and with getting access to the capital markets of developed countries. Inflation remained a major concern to all of them.

Mr. Coldwell added that he had been interested in the governors' reactions to the international monetary unrest of the

last few years. That unrest apparently had had a significant impact on the less developed countries, both in raising prices of their imports and in producing new trade barriers to their exports. Also, the exchange controls imposed in some countries were a matter of deep concern to them. From his conversations with a number of governors he concluded that their preferred approach to international monetary reform would involve a better distribution of available reserves. They were fearful that international bodies such as the IMF or the Committee of Twenty might decide on reform measures predicated on the view that aggregate reserves were excessive. They noted that reserves were heavily concentrated in the hands of a few countries, and that from their viewpoint reserves were far from excessive.

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 17 through May 9, 1973, and a supplemental report covering the period May 10 through 14, 1973. Copies of these reports have been placed in the files of the Committee.

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

At the last Committee meeting I questioned the general assumption in the press and elsewhere that the world had moved onto a floating rate system, and I pointed to the emerging efforts by most of the G-10 central banks to stabilize their currencies either against one another, as in the European "snake in the tunnel," against SDR parities, or as a temporary measure against the dollar. Since then, this de facto system of fixed rates outside of the Western Hemisphere has hardened into a reality. We now have rather good figures on foreign central bank intervention over the seven weeks since the markets reopened on March 19, and those figures show a total of roughly $4.5 billion equivalent in central bank exchange operations. I don't think one could have expected a much bigger volume under a formal fixed rate system.

In some cases--notably, Germany, Japan, and the Netherlands--such intervention has taken the form of heavy sales of dollars and other currencies to prevent an abnormal depreciation by temporary factors of essentially strong currencies such as the mark, the yen, and the guilder. Within the European snake, the French franc, the Belgian franc, and the Scandinavian currencies have been restrained by intervention from appreciating further. By varying domestic liquidity, the Swiss National Bank has succeeded in stabilizing the Swiss franc in terms of the German mark.

Perhaps the most interesting policy development, however, has been the shift in the British approach to market intervention. Only a few months ago the British government was more or less openly espousing a clean float for sterling. Since then they have apparently concluded that a further depreciation of sterling, which the big trade deficit expected this year has threatened to bring about, would probably wreck their efforts to restore some measure of price and wage stability. Consequently, the British government has authorized its nationalized industries and local authorities to borrow between now and year-end up to roughly $2 billion of medium-term money in the Euro-dollar market on the condition that the dollars be sold to the Bank of England, which will use them to stabilize the sterling rate. This operation is reminiscent of the central bank credit packages provided to the Bank of England during the 1960's and

the market results have been much the same. Sensing a commitment by the Bank of England to defend the sterling rate at least for the rest of this year, those with money to invest are now encouraged to move uncovered funds into London to take advantage of the high short-term rates prevailing there. Middle East oil money is well represented in these inflows. In effect, therefore, by last week a pattern had emerged in which nearly every major foreign currency was being firmly defended, either on the upside or the downside, while the dollar was floating in isolation without any evidence of intervention by the Federal Reserve. This did not help to restore confidence in the dollar.

I was interested in Mr. Brimmer's report regarding the efforts of Latin American central banks to diversify their reserves by shifting out of dollars. That is a world-wide phenomenon; it is natural for any central banker responsible for protecting his country's reserves to seek to hold them in currencies whose value will be defended rather than in dollars, for which no such commitment is apparent.

Meanwhile, the exchange markets for the dollar remained quiet as profit-taking on earlier speculation served to counterbalance more or less evenly our continuing balance of payments deficit. This tranquility has been abruptly shattered yesterday and today, unfortunately, by a new run on the dollar which has driven up the major European currencies by as much as 3 per cent above last Friday's levels--with forwards out to 7 or 8 per cent--while the gold price has rocketed up to a new peak of $116 this morning in London.

There are a number of reasons for this flare up, not the least of which is Watergate. I am persuaded, however, that one fundamental factor has been the growing feeling in the market that the dollar would not be defended against new speculative attacks, either by the European central banks or by the Federal Reserve. If one were to ask exchange market participants or officials of foreign central banks what event had triggered the explosion, most probably would refer to the statement attributed last week to Mr. Flanigan of the White House staff that the United States might have to devalue the dollar once more to deal with the oil import problem. If Mr. Flanigan did not make that

statement, it would be desirable to have a correction issued as soon as possible. Meanwhile, the increases in the System swap lines which the Committee has discussed at recent meetings have become a matter of some urgency.

By unanimous vote, the System open market transactions in foreign currencies during the period April 17 through May 14, 1973, were approved, ratified, and confirmed.

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

Very little has happened since the last meeting of the Committee to change one's view of the economic situation and outlook. Current trends in orders and output continue very strong. Industrial production in April is estimated to have risen at a 12 per cent annual rate, while new orders received by durable goods manufacturers increased in the first quarter at a spectacular 32 per cent annual rate. The job market also looks strong; the rise in nonfarm employment slowed in April to 110,000, but there was a large gain in manufacturing and a substantial increase in the length of the workweek. Price increases continue very large, with an extraordinarily sharp increase last month for industrial commodities at wholesale and a further substantial advance for wholesale foods. And, as before, we are still witnessing the dichotomy between the strong near-term optimism of businessmen, on the one hand, and a notably weak stock market, on the other.

Our projections of GNP and related measures are little changed from 4 weeks ago, except for a further boost in the expected rate of inflation. This occurs

mainly in the second quarter, and is necessitated by the recent performance of the monthly price indexes, but we have also stepped up slightly the second-half price projection in reflection of the deterioration in the farm production outlook. Growth in real GNP is projected to moderate beginning this quarter, and to be down to an annual rate of about 4 per cent by the final quarter of the year. The principal forces dampening real growth are expected to be a slowing in the growth of consumption, especially for durables, and a declining trend in residential construction. The principal forces tending to fuel the economic expansion are expected to be a continued rapid increase in business capital investment and a sharp acceleration in inventory accumulation. Today I would like to comment briefly on each of these four major influences.

The expansion in consumption, which has been so marked a feature of the economic resurgence this past winter, appears to have been slowed or reversed in April. The dollar volume of retail sales declined 1-1/2 per cent, according to the advance report, and total new car deliveries dropped to an annual rate of 11.6 million units, from a 12.2 million rate in the first quarter. This obviously is too limited a reading on which to base a judgment, but yet I am confident that the major part of the consumer boom is behind us. Consumer opinion surveys continue to show a deterioration in sentiment, and the latest quarterly Census survey also indicates a decline in buying plans for both new cars and household appliances. Consumer credit has been growing at an extraordinary pace, and this is unlikely to be sustained. The payment of the tax refunds will be largely completed this month and will be replaced, in the second half of the year, by a substantially longer period than in the past during which social security taxes represent a drain on spendable income. Adding this all together, and making allowance for the likelihood that anticipatory buying in the first quarter borrowed to some degree from future purchases, I think that the prospects for the months ahead point clearly in the direction of less ebullient consumer product markets generally.

Residential building activity appears also to be in a declining trend. Housing starts declined appreciably in March, and we anticipate another drop

in April, although the figures will not be available until later today or tomorrow. More importantly, signs of a weakening in the housing boom are growing more numerous. Rental vacancies were up appreciably from a year ago in the first quarter, with increases in all sections of the country except the North Central States. Completions of new units, which have been delayed during the past year or more by materials and labor scarcities, are likely now to be on the rise. New home sales by merchant builders have shown a declining tendency over recent months, after seasonal adjustment, while the number of homes for sale has increased to a new high. Finally, reports from around the country in recent weeks indicate a tightening in the availability of mortgage credit, involving not only an upward notching of interest rates but often also the imposition of more restrictive lending terms. We have been expecting a downturn in housing for some time, and now it finally seems to be in progress.

Information on business capital spending, on the other hand, points in a strengthening direction. Quantitatively, the recent McGraw-Hill survey represents a substantial step-up in business plans for 1973, and the strength in new orders for business capital goods certainly is supportive of a sharp upward movement. Qualitatively, also, the impression gained from the red book[1/] and from other reports citing capacity shortages in various strategic areas is suggestive of a major boom in capital spending. The staff had already been projecting more strength in this area than indicated by the official reports, but the incoming information has led us to revise our projections up somewhat further. Most of the revision is in the second half, so that there is now relatively little slowing in the upsurge as the year progresses.

The outlook for inventory investment also grows more robust with the passage of time. Partly this is a matter of shortfalls in realized inventory accumulation thus far this year. The book value of business stocks rose at a $21-1/2 billion rate in the first quarter, but most of this was accounted for by higher prices; inventory accumulation, after valuation adjustment,

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

appears to have dropped substantially below the fourth-quarter pace. Partly, also, the strengthening inventory outlook is influenced by the marked increase that has occurred in final sales. Inventory-sales ratios have dropped progressively over recent months and are now generally at the lowest levels in a good many years. In addition, businessmen continue to complain of slower deliveries, materials shortages, and inadequate stocks to service customer demands. It seems to me obvious that a rather major restoration of inventory positions lies ahead of us. How large it will prove to be, at this point, is a matter of conjecture.

In sum, I feel confident that we have the direction of change right in these four major economic variables for the months ahead. The basic tendencies will be for residential construction to decline, growth in consumption to slow, business capital spending to continue strongly upward, and inventory investment to accelerate substantially. The specific amounts to be attached to these projected changes are much harder to gauge, but the odds still strongly favor moderation in the over-all rate of economic expansion. Even with such moderation, however, inflationary pressures are likely to remain substantial. There are apt to be continuing scarcities in some markets; wages and salaries will be under upward pressure from higher consumer prices and a strong demand for labor; and growth in productivity is likely to be slowing along with slower growth in output. I do not have much hope that these underlying inflationary forces can be dampened appreciably without profoundly adverse consequences for the economy later on.

Another disturbing aspect of the economic outlook is that the forces of expansion appear likely to shift markedly, away from demands that are consumer-oriented to demands based on rising business outlays. Comparing our projection for the next three quarters with actual results over the past three quarters, growth in consumption and housing combined is expected to slacken by more than $20 billion, while investment in business fixed capital and inventory is projected to accelerate by more than $15 billion. This projected shift would give the economy a markedly more cyclical

> configuration by year-end. It would also be likely to produce substantially larger business demands for external finance. The projected increase in business investment over the next three quarters amounts to $30 billion. As a rough and ready--though imprecise--comparison, the internal generation of funds by corporations is projected to rise by only $7 billion over the same period. If the increase in corporate financing that this implies could be moderated without at the same time devastating the mortgage and municipal markets, the prospects for stretching out the upsurge in business investment--and hence the economic expansion--would, I believe, be considerably better than they appear at the moment.

Mr. Winn noted that one of the tax reform proposals submitted to Congress by the Secretary of the Treasury on April 30 would limit the extent to which taxpayers could charge off losses on construction projects begun after that date. It appeared to him that the Secretary had instituted a highly effective control device simply by submitting that legislation. He understood that about 90 per cent of commercial construction and a substantial part of apartment building had been financed under partnership arrangements developed to take advantage of the provision it was now proposed to eliminate, and that since April 30 such construction had dropped off sharply. Some people with whom he had checked expected the proposal to have a dramatic effect on construction activity as long as it was under consideration. Evidently an industry already plagued with sharply rising materials and labor costs was now to experience new difficulties in connection with its financing arrangements.

Moreover, the financial health of speculative builders, many of whom apparently were in a highly exposed position, might now be called into question; he had already heard of a number of cases of bankruptcy.

Mr. Partee observed that the matter to which Mr. Winn referred had escaped his notice; he had concluded from a review of the Secretary's tax reform proposals that they would not have a significant impact on economic activity.

Chairman Burns remarked that the matter was new to him also. He asked that a staff report be prepared and distributed to the Committee later in today's meeting.[1/]

Mr. Partee added that it would be helpful if any Reserve Bank in a position to assess the impact of the tax proposal in its District would include some comments on its findings in the next issue of the red book.

Mr. MacLaury noted that the GNP projections and analysis prepared by the staff for this meeting extended only through the end of the year. In his judgment the Committee also needed some informed insights into likely developments in the first half of 1974, following the slowdown in growth anticipated over the remainder of 1973. Given the lags of monetary policy, whatever actions the Committee took

1/ A copy of the report subsequently distributed is appended to this memorandum as Attachment A.

today would have important effects in early 1974. Moreover, the current debate among economic forecasters focused primarily on the probable course of developments after the turn of the year. The staff had commented on prospects for 1974 in its chart presentation at the March meeting of the Committee, but he understood that that analysis had been invalidated to an important extent by subsequent events.

More generally, Mr. MacLaury continued, he would urge that the staff regularly present GNP projections extending for a period at least four quarters into the future. As he had reported at previous meetings, from time to time the staff at the Minneapolis Bank attempted to employ the Board's econometric model to make four-quarter projections, and he might note today that their latest projections suggested approximately zero growth in the first quarter of next year and very little growth in the second quarter. Despite the difficulties of projecting for so long a period ahead, he thought it was highly important for the Committee to know whether the Board's staff also held such expectations.

Mr. Partee remarked that if his recollection was correct Mr. MacLaury had made a similar request for four-quarter projections at the Committee meeting one year ago. His response today would be the same as that given a year ago--namely, that the projection period would be extended in the course of a chart presentation planned for the June meeting.

Mr. Partee added that the staff was reluctant to extend its projections into 1974 until the likely pattern of developments in 1973 had become somewhat clearer. There still was a great deal of uncertainty about the probable profile of activity in the second half of 1973; certainly, developments in the last few months had required a modification of earlier judgments about the strength of inflationary pressures. In general, the staff had tried to extend its projections at those points in time at which it thought doing so would be of most help to the Committee. Late April and early May--the period since the previous meeting--happened to be the thinnest period of the year as far as significant new information was concerned. By the time of the June meeting there should be a much better basis for extending the projections. For example, the results would be available of the latest Commerce Department survey of business fixed investment spending intentions, and it would be known whether the weakness in retail sales evident in April had continued in May.

Mr. Eastburn said he had planned to ask a question similar to Mr. MacLaury's. His own view about the outlook was affected by some new calculations his staff had developed with the aid of the Board's econometric model. As he had indicated to the Committee a few months ago, the Philadelphia Bank staff had concluded that an M_1 growth rate of 3-1/2 per cent would produce a decline in real GNP

by the fourth quarter of 1974. However, their latest calculations suggested that even if M_1 were to grow at a 5-1/2 per cent rate economic activity would be rather sluggish in 1974. Despite the prevailing uncertainties, it seemed clear that the Committee was approaching the point at which it would have to face a difficult trade-off between inflation and risks of recession.

Mr. Morris said he also had intended to ask Mr. MacLaury's question, and had found Mr. Partee's response to be highly interesting. At times in the future when the staff was reluctant to present projections for four quarters ahead to the Committee, it would be helpful if they would explain their reasons--as Mr. Partee had done today--in the green book.[1]

Mr. Morris went on to say that he concurred in Mr. Partee's view that the pattern of activity over the rest of 1973 was still highly uncertain. While econometric projections for that period were nearly unanimous in anticipating a slowdown, current business indicators had offered no support for such an expectation until this past month--and even the latest figures offered only fragmentary support. Thus, the outlook for the second half of the year seemed quite as cloudy as Mr. Partee had suggested. The uncertainty was reflected by the disparate views of Professors Samuelson and Eckstein,

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

as cited in the current red book; Professor Samuelson tended to discount the projections and to stress the current indicators, whereas Professor Eckstein leaned the other way. In his (Mr. Morris') judgment, a "middle of the road" approach to monetary policy was appropriate at a time like the present, when it was difficult to determine the direction of the winds to lean against.

Mr. Partee noted that in preparing for today's meeting he had reviewed roughly a dozen econometric projections for the second half of 1973. All but one foresaw a definite moderation in the growth of GNP, most to a rate of roughly 4 per cent by the fourth quarter. The key question, as he saw it, was whether growth would moderate gradually to a subnormal rate or whether there would be a speculative boom in the second half of 1973 that culminated in a major recession next year. He was not yet prepared to offer a judgment on that question.

Chairman Burns remarked that, while he recognized the force of Mr. MacLaury's observations, he thought the staff had demonstrated good judgment in limiting the period for which it presented GNP projections at this time of great uncertainty. It was important not to expect more from the staff than they could supply, and not to put excessive faith in longer-run projections--particularly in view of their unhappy history. Like other Committee members, he had great respect for the staff's views, but given the existing margins of

uncertainty he had even more respect for the humility Mr. Partee had expressed today.

Mr. Brimmer observed that he had asked the staff before today's meeting to update its longer-run econometric projections for his personal information, not for incorporation in the green book. The results conformed roughly to what might have been expected on the basis of judgment--they suggested that the GNP growth rate would slow progressively through the rest of 1973 and well into 1974. He agreed, however, that the Committee had to be particularly cautious at this point in reaching conclusions about the longer-run outlook and that the staff should await the information that would become available during the next month before presenting its considered assessment of that outlook.

Mr. Brimmer added that there were certain judgments which he thought the Committee could appropriately make at this time. In particular, he believed it was correct to say that the main destabilizing force in the outlook was the boom that was developing in the business investment sector, and that it would be helpful to develop some means of moderating that boom. At his request the staff had employed its econometric model to investigate the possibility of using a reduction in the investment tax credit for that purpose. He concluded that such an action--if instituted promptly--would

reduce the demand for capital equipment somewhat and thus might have some beneficial effect.

Mr. Hayes indicated that, while it was important to consider questions concerning the longer-run economic outlook of the sort that had been raised today, he subscribed fully to the Chairman's words of caution about the value of projections for extended periods into the future. The economy was distinctly overheated and the acceleration of inflationary tendencies and expectations was very worrisome. It seemed likely that the economic expansion would slow in the current period, but it was still too early to be sure, and he was fearful that there might be no slowing unless the System did its part in bringing it about.

Chairman Burns asked whether Mr. Hayes was thinking in terms of physical or dollar-value measures of economic activity. If the former, he (the Chairman) thought there was little doubt that a slowing would occur, if only because available resources would not permit the expansion to continue at its recent rate.

In reply, Mr. Hayes agreed that the existence of severe bottlenecks would affect the rate at which output could expand in physical terms. It was clear, however, that the pressures against limited resources were strong and persistent. In his judgment, it was incumbent on the Federal Reserve to try to reduce those pressures rather than to wait for them to slacken of their own accord.

Mr. Hayes went on to say that the price outlook was highly unsatisfactory. Farm prices had apparently stopped rising, at least for the time being, but there were factors in the picture that could push them up further. With regard to industrial prices, the situation now was even more unsatisfactory than it had been a month ago. It was very hard to know how much of the recent acceleration reflected a one-shot adjustment to the shift from Phase II to Phase III, and how much reflected the increasing demand pressures that were evident everywhere. The wage performance had been moderate so far this year, but the reaction of wages to the price explosion remained to be tested. In sum, he believed that the weight of the evidence continued to indicate the need for monetary restraint.

Mr. Francis noted that in recent weeks officials of the St. Louis Reserve Bank had held a series of meetings with business people, culminating last Thursday in a meeting at which reports were presented by the Chairmen of the Bank's branches. From those discussions there had emerged a rather uniform description of the business situation as involving tremendous pressures on labor resources and plant capacity and growing shortages of certain raw materials.

The business people consulted were deeply concerned about the problem of inflation, Mr. Francis observed. In general, they appeared to be more optimistic about demands for their products and less optimistic about their ability to meet those demands than they had been, say,

6 months earlier. Their attitudes appeared consistent with the view that physical output was approaching capacity limits, but not with projections suggesting that demands would ease off in the latter part of the year.

Mr. Kimbrel remarked that attitudes in the Sixth District were generally similar to those Mr. Francis had described. Businessmen with whom he had talked recently did not seem to share the doubts about the continuation of demand pressures that were being expressed in some quarters--at least not to the extent of limiting their willingness to undertake capital outlays or incur additional debt. As in the St. Louis District, their worries appeared to center more on their ability to meet the demands of their customers. He might add that recently prevailing weather conditions did not lend much encouragement to the hope that the rise in food prices would level off; on the contrary, there was a widespread feeling in the District that pressures on food prices would remain strong and might even increase.

In short, Mr. Kimbrel continued, the sentiment in the Sixth District was that some further overheating might lie ahead. He hoped the staff's view--that the odds strongly favored moderation in the over-all rate of expansion--was representative of conditions in the country as a whole. Frankly, he drew encouragement from the projection in the green book that there would be at least some slowing in the average rate of price advance over the rest of the year.

Mr. Black observed that, like others, he was concerned about the mounting fears of inflation on the part of the general public. It was important, however, not to lose sight of the world-wide character of the current upsurge of prices. Indeed, after allowing for the effects of the devaluation of the dollar and the removal of Phase II controls, the performance of prices in the United States might well be found to be better than that in most other countries. While the U.S. price performance, considered alone, certainly had not been satisfactory, it was clear that the System could not expect to eliminate domestic inflation by monetary policy means, and that if it aimed at too low a growth rate it was likely to create a recession.

Mr. Mayo said he was at least as skeptical of longer-run GNP projections as any member of the Committee, particularly after having prepared them for many years during his service at the Treasury Department. Nevertheless, in view of the lags of monetary policy, he was as eager as any member to have the best insights available at this point into the likely pattern of developments in 1974. Accordingly, he had asked his staff to extend the Board staff's judgmental projections through that year by use of the econometric model. The results were highly disturbing; they suggested that a 1 per cent increase in real GNP would be associated with a 5 per cent unemployment rate and a 5 per cent rate of inflation. He hoped that a more sophisticated analysis would yield more encouraging results.

In any case, Mr. Mayo continued, it was important that the Committee have the best judgments that could be developed about the longer-run outlook. There was no question that the economy was overheated at the moment. And there was no question that the rate of expansion in constant-dollar GNP would slow; the recent rate could not possibly be maintained for long. Such observations, however, did not provide an adequate basis for making monetary policy. While he appreciated the problems faced by the staff in making longer-run projections under present circumstances, he would encourage them to do their best with the evidence available. And perhaps next year it would prove possible to extend the projections into additional quarters during May rather than June.

Mr. Coldwell remarked that his own views on the economy were similar to those already expressed, and he would confine himself at this point to a comment on certain observations made last week by two businessmen directors of the Dallas Reserve Bank. Both directors, who happened to be heads of subsidiaries of large conglomerates, had indicated that the chief executive officer of their conglomerates had ordered a cutback in the rate of capital spending. The decisions, which in one case called for a 25 per cent reduction in capital spending over the next 9 months, apparently were taken in light of economic projections indicating a slowdown in growth in 1974. It

was interesting to note that at least some large corporations were now thinking in terms of retrenchment from the very high recent rates of investment rather than further increases.

Mr. Balles noted that his staff also had been getting unsatisfactory results from longer-run econometric projections--unsatisfactory in the sense that various policy assumptions led to undesirably high rates of inflation and unemployment. In addition, he was concerned about the possibility that the recent explosions of prices and of profits would be followed by an explosion of wages--a development that could upset the conclusions that might be drawn from projections, particularly with respect to the likely rate of inflation. He asked Mr. Partee about the staff's current thinking with respect to the outcome of the forthcoming wage settlements.

In reply, Mr. Partee noted that for a number of months the staff's projections had allowed for a substantial rate of wage increase; the latest projections implied a rise of about 6-1/2 per cent in the average hourly earnings index over the remainder of 1973. If any revision were to be made in that figure now, he suspected that it would be upward. It had appeared for a while that a moderate settlement would be reached in the rubber industry but now the nature of the final settlement was very much up in the air, and the initial demands of the Teamsters' union reportedly were for very large increases. It was reasonable to suppose that workers --nonunion as well as union, and salaried employees as well

as wage earners--would be quite insistent on being compensated for the tremendous increases that had occurred in the cost of living.

Mr. Partee observed that that prospect served to illustrate the problems facing economic forecasters at the present time. It had been suggested by a number of speakers today that the Board's econometric model could be used to extend the staff's GNP projections through 1974. It was important to recognize, however, that the model incorporated relationships based on the economic experience of the post-war period, and that the present situation was sharply different from earlier experience in many respects--including the rate of inflation, the level of confidence, the scale of international capital flows, and the concurrence of a business boom with stock market prices so low as to be bordering on the point of massive margin calls. With circumstances so vastly different from that of other recent years it was extremely difficult to make economic projections, and he viewed the task of developing projections for 1974 with trepidation.

Mr. Bucher remarked that one aspect of the present uncertainty involved the question of where buyers might be found for all of the goods that industry was likely to be producing. Noting that there had been no reference in the discussion thus far to exports, he asked whether they might play a significant role in that connection.

Mr. Partee replied that the staff anticipated large increases in exports over coming quarters as a result of the devaluation of

the dollar. He had no reason to disagree with that expectation, although export growth might be held down in the short run by supply limitations. In reviewing prospects for the remainder of 1973 he had not mentioned exports--or, for that matter, Government purchases--because the changes expected in those sectors were minor in comparison with the very large changes anticipated in consumer expenditures, residential construction, business fixed investment, and inventories.

Mr. Eastburn noted that about a year ago the Board had submitted a proposal to Congress for a variable investment tax credit. He asked about the current status of that proposal.

Chairman Burns replied that he had been working, with the assistance of Mr. Cardon of the Board's staff, to develop modifications in certain details of the original proposal in order to make it more congenial to Congress and the business community. He had not pushed the proposal as energetically as he might have, partly because of the pressure of other business and partly because of his belief that, since it was a tax measure, its advocacy should be left mainly to the Administration. Administration officials considered the plan acceptable. However, they thought it was likely to be viewed as a device for raising revenue, and since the Administration was committed to a policy of not increasing taxes, they had declined to press it. Revenue effects were, of course, implicit in the proposal,

and they would tend to be in the cyclically desirable direction. However, he had never considered the variable tax credit to be primarily a revenue device; he had thought of it mainly as a measure to stabilize business capital investment with spill-over effects on the home building industry, and he had focused on the stabilization aspect in conversations about the plan.

The Chairman observed that a further difficulty had arisen when Mr. Mills, a key member of Congress, had taken a public stand against the Board's proposal. It turned out that the Congressman's opposition was based on an imperfect understanding of its elements and, of course, he did not have knowledge about the modifications that were being developed. The Congressman was now giving the proposal fresh consideration. While he (Chairman Burns) was not optimistic that the Congressman would take the lead in pressing the matter--or that the Administration would do so--he planned to pursue those possibilities.

The Chairman added that he might comment briefly on the modifications he had mentioned. First, if Congress were to consider the proposal in the form in which it was originally recommended by the Board, a bunching of investment orders--and thus an intensification of the capital spending boom--might occur. Such a development could be prevented by writing the legislation in two

parts, of which the first would provide for a reduction in the credit from the present 7 per cent to some lower level--say 3-1/2 or 4 per cent; and the second would provide for a variable credit at some subsequent time. A second modification was designed to give Congress an active rather than a passive role in decisions on variations in the level of the tax credit. In the original proposal the Board had attempted to take account of the traditional reluctance of Congress to give the President discretionary authority in the area of taxation. Specifically, a provision patterned after one in the Reorganization Act had been included under which either House of Congress would override a Presidential decision to modify the level of the credit by voting it down within a certain period. Under the modified version, Congress would have the additional power of modifying the level of the tax credit decided upon by the President within specified limits; for example, if the President proposed to set the tax credit at 10 per cent, Congress could raise or lower that percentage--perhaps within a range of 8 to 12 per cent.

With respect to attitudes in the business community, Chairman Burns continued, the original proposal was defective with regard to the possible range suggested for the tax credit--"from zero to 10 or perhaps 15 per cent." Businessmen, having had some experience with the tax credit in the past, were disturbed by the reference to

a zero level since it raised the possibility of complete termination. Had the range been specified as, say, 3-1/2 or 4 up to 15 or 18 per cent, more support from business undoubtedly would have been forthcoming, and he believed that such support could still be obtained when the matter was clarified.

Chairman Burns expressed the view that the proposal for a variable investment tax credit made very good sense. Better stabilization tools were needed; the reliance on monetary policy should not be as great as it had to be under present circumstances. The modifications he had described should make the proposal more acceptable to Congress and the business community. What was needed now was some political push of a kind not yet in being.

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 17 through May 9, 1973, and a supplemental report covering the period May 10 through 14, 1973. 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 period since the Committee last met was one of considerable confusion. RPD's were running below the lower end of the Committee's desired range while M_1 and M_2 were running above the upper end of their ranges;

computer breakdowns made reserve figures and forecasts more uncertain than ever; and the persisting shortage of collateral in the Government securities market hampered the Desk's efforts to supply reserves needed by the banking system. With the aggregates exhibiting stronger growth than the Committee desired, despite the RPD performance which is described in some detail in the blue book,1/ the Desk supplied reserves with increasing reluctance. And with the Treasury financing going smoothly, the Federal funds rate was allowed to move to the upper limit of 7-1/2 per cent specified by the Committee. In the statement week ended last Wednesday--and subsequently also--the funds rate has been above the 7-1/2 per cent level despite rather strenuous efforts by the Desk to supply reserves. In general, the tightness of the money market did not appear to have much effect on the general market atmosphere nor did it interfere with the success of the Treasury's May refunding.

There was a substantial need for the System to supply reserves over the period as the Treasury kept its balance at the Federal Reserve Banks at a high level and other market factors absorbed reserves on balance. We were fortunate enough to be able to buy $1-1/4 billion of Treasury bills directly from foreign accounts over the period. Otherwise, given the market shortages of Government securities, we had to rely heavily on repurchase agreements to supply reserves, making a total of more than $7 billion of such agreements. As mentioned earlier, shortages of collateral in the market hampered our efforts to supply reserves, as has occasionally been the case in recent months. I trust that this is only a temporary phenomenon, brought about in part by the Treasury's unusual cash position which should be straightened out shortly. Should the phenomenon persist, however, we might well have to give some serious thought to new methods of reserve management.

The Treasury's May refunding, which involved a paydown of $1.65 billion of the maturing issues, went quite smoothly with good secondary market demand developing for both the 7-year note and the long bond. The Dutch auction technique--under which all bonds are

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

awarded at the lowest acceptable price--was used in the bond offering and again failed to attract the widespread investor response which, in theory at least, it is supposed to do. While some further experimentation with the technique will probably be considered, experience to date has not been encouraging, and I believe that the technique has raised the Treasury's borrowing costs somewhat.

Treasury bill rates backed and filled during the period, with last week's increase in the discount rate tending to push the 3-month bill back above the 6 per cent level to which it had declined. In yesterday's regular Treasury bill offering, average rates of 6.18 and 6.46 per cent were established for 3- and 6-month bills, little changed from the 6.19 and 6.39 per cent rates in the auction just preceding the last Committee meeting.

Although there was a substantial firming of the money market, longer-term markets remained reasonably stable. The Government, corporate, and municipal markets are all in good technical position, and new issues of corporate and municipal bonds have continued to be on the light side. The Federal agency market has been more active, but most new issues, including a three-pronged $2 billion Federal Home Loan Bank offering, were well received.

I should note that the Desk has started doing business with a new firm--Lehman Government Securities, Inc.--bringing the number of firms with which we do business to 25. Since 1965 we have added eight new names to the list, while three firms have been dropped. A substantial number of other firms have expressed an interest in becoming Government dealers and are in various stages of development. As, if, and when they demonstrate their ability to make markets in Government and agency securities, we will consider adding them to our dealer list.

Chairman Burns asked the Manager to indicate how a firm's "ability to make markets" was determined by the Desk.

In reply, Mr. Holmes said the key question was whether the firm stood ready to operate on both sides of the market at all times. Many firms operating in Government securities were essentially speculators; they were willing to buy only when they expected prices to rise and to sell only when they expected prices to decline. Since the Desk itself was on both sides of the market, it preferred not to deal with such firms.

The Chairman remarked that he would find some discussion of that procedure helpful. He invited comments from Messrs. Daane and MacLaury.

Mr. Daane observed that the procedure was of long standing and in his judgment entirely appropriate. He noted that the "quote sheets"--lists of bids and offers for various Treasury issues--issued by some firms had little meaning, since the firms were not in fact prepared to either buy or sell all of the issues listed.

Mr. MacLaury agreed that the System should deal only with firms that made markets in the sense Mr. Holmes had described. He also considered appropriate the Desk's procedures of reviewing the financial responsibility and capital adequacy of would-be dealer firms and of observing their actual transactions during a trial period before deciding whether to add them to its dealer list.

Mr. Brimmer asked about the range of transactions engaged in by the firms that had most recently been added to the list. He wondered, for example, whether those firms were participating in System repurchase agreements, and whether they took positions in coupon-bearing and agency issues as well as Treasury bills.

Mr. Holmes replied that the new firms were participating in both RP's and matched sale-purchase transactions with the System. There were, of course, differences among dealers in the scale of their operations and in their emphasis on particular maturity ranges. As to scale, the firms were expected to be reasonably active but not necessarily to engage in a very large volume of transactions. The performance of one of the new firms was better in the note and bond area than in bills--which was atypical, since the bulk of most dealers' operations was in bills. The Desk had advised that firm that it would be expected to expand its bill activity.

In response to a question by Mr. Mayo, Mr. Holmes said that one or two of the dealers on the Desk's list dealt almost exclusively in bills.

Mr. Daane noted that for many years some firms had concentrated on the bill market, but had been extremely active in that sector. It was his impression that the Desk had traditionally been quite sympathetic to firms interested in meeting the System's qualifications, offering them encouragement and advice.

In reply to a question by the Chairman, Mr. Holmes said he believed it was generally known in the market that the System would welcome the participation of any firm that met the established criteria.

In response to a question by Mr. Coldwell, Mr. Holmes said that the newer dealers were not taking unusual advantage of the securities-lending facilities made available by the System. If anything, they probably were taking less advantage of those facilities than the older dealers.

Mr. Brimmer then asked the Manager to amplify his comments on the Treasury's experience with the Dutch auction technique.

In reply, Mr. Holmes noted that dealers had been very aggressive bidders in the first such auction, contrary to theoretical predictions, and then had encountered difficulties in making secondary market distribution. Although the dealers bid more cautiously in the second auction, they still acquired the bulk of the securities issued. Their experience in secondary market distribution of both the bond and the note was, however, quite good. According to the theory, ultimate investors in Government securities should find the Dutch auction technique particularly attractive. It appeared, however, that most such investors--many of whom presumably were interested in swapping out of corporate bonds or other securities--preferred to make their transactions in the secondary market.

In response to a further question by Mr. Brimmer, Mr. Holmes observed that the Dutch auction technique had not posed any particular problems for the Desk in connection with the length of the even keel period or in other ways.

Mr. Coldwell noted that dealers had sharply reduced their over-all positions in Government securities for a time during the recent inter-meeting period. He wondered whether their behavior reflected expectations for longer-run changes in securities prices.

Mr. Holmes replied that two factors seemed to account for the development in question. First, dealers built up large short positions in coupon issues in advance of the May refunding. Secondly, the bond and note markets had performed rather well recently, with evidence of new retail demand. How long that situation would last it was impossible to say.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period April 17 through May 14, 1973, were approved, ratified, and confirmed.

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

As noted in the blue book, we expect that bank reserve and money market conditions consistent with the longer-run target for the aggregates adopted by the Committee at its last two meetings will involve some further rise in the Federal funds rate, perhaps up to around the 7-7/8 to 8 per cent area. One might begin to think a funds rate that high is approaching a cyclical peak. Whether it is or not depends on the extent to which the Committee wishes to restrict growth rates in the aggregates and on the degree to which GNP growth moderates from the recent rapid pace.

In the last half of 1969, the funds rate was up to around 9 per cent and the 3-month bill rate was around 7 per cent most of the time, but growth in the monetary aggregates in that period dropped to rates much slower than so far contemplated by the Committee. While GNP weakened in the last quarter of 1969, rising interest rates indicated continued monetary restraint at the time. And over the second half of 1969 as a whole M_1 slowed to a 1-1/2 per cent annual rate of growth, M_2 was showing virtually no growth at all, and the bank credit proxy declined by about 2 per cent. In the third quarter of this year, by contrast, growth rates around 4-1/2 per cent for M_1 and 6-1/2 per cent for bank credit seem consistent with the money market conditions contemplated in alternative B.[1/] Sharply tighter money market conditions would appear to be required in the summer and fall only if the Committee wishes to clamp down significantly further on the aggregates, assuming, of course, that GNP is no stronger than projected.

In two previous periods of monetary restraint--1966 and 1969--a large-scale rechanneling of credit flows and an accompanying relatively sharp constraint on the mortgage market developed as money market conditions approached cyclical peaks. The divergence of funds away from thrift institutions to market instruments that was so prominent a feature of the two earlier periods has only just begun to appear in a significant way. In April net savings inflows to nonbank savings institutions dropped to a 5 per cent

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

annual rate, and Federal agencies have begun to provide sizable support to the mortgage market. We do not think that May will be as bad as April, but with some further rise in market interest rates in prospect, the weeks around the mid-year interest-crediting period may well see further diminished savings flows. At banks, too, we would expect the summer months to see a further scaling down of net inflows of consumer-type time deposits at current Regulation Q ceilings.

These developments are tending once again to focus restraint on the mortgage market. Some restraint is, of course, required in that market to help cool down the economy. But it would seem desirable to attempt to spread the effects of monetary restraint more widely, particularly since business spending is becoming the main propulsive force behind economic expansion and the demand for funds.

The proposed marginal reserve requirement on large CD's and similar instruments1/ would contribute to focusing restraint on business spending by increasing the marginal costs to large banks of the money market funds that are the typical means by which banks accommodate expanding loan demand. As noted in the blue book, we would expect this proposal to cut back some on CD issuance and to tighten bank lending terms to business somewhat further. Thus, if such a proposal were adopted, we might see a little less expansion in bank credit than we have assumed. There would probably, as a result, be spill-over effects tending to raise interest rates marginally in other markets. And announcement of the action might well be taken--against the background of the recent discount rate hike and tightening of the funds market--as signaling a further stage of restraint, thereby leading to some anticipatory interest rate increases. The proposal is basically a modest step, though, and would appear to affect the distribution more than the volume of credit and the structure more than the level of interest rates. In that context, I would not expect any significant near-term effect on M_1 or M_2 for a given Federal funds rate.

1/ The proposals referred to were described in a staff memorandum to the Board, dated May 10, 1973, and entitled "Reserve Requirements on CD's, Euro-dollars, and related proposals." Copies of the memorandum were distributed to the Reserve Bank Presidents on that date, with advice that the Board planned to act on the approach described on May 16, 1973.

> In closing, I would mention that we have not presented an alternative that shows the aggregates that might accompany unchanged money market conditions. It is not that the staff thinks it necessarily illogical for the Committee to seek unchanged money market conditions at this juncture. Rather, it is more of a technical problem. If one takes the longer-run aggregate path adopted by the Committee as a starting point, the tightening that seems implied is not really a very marked change from the money market conditions that most recently have come to prevail. In other words, if prevailing money market conditions were maintained, we would not expect aggregates far off the alternative B path. A result somewhere between A and B would be a good approximation, though if one were to utilize a straight average of the two alternatives, the associated Federal funds rate would be a little below the 7-5/8 to 7-7/8 per cent range of most recent days.

Mr. Daane noted that the operational paragraph of the directive issued at the previous meeting had called for "moderate" growth in monetary aggregates over the months ahead. In contrast, all three of the alternatives presented for consideration today described the growth desired over coming months relative to average rates in some past period. For example, alternative B called for "somewhat slower growth in monetary aggregates over the months ahead than occurred on average in the past 12 months." He was not sure what was gained by such a modification, and he wondered whether the same outcome could be achieved by retaining the previous language.

Mr. Axilrod observed that the staff had used past growth rates as reference points in the draft directives in response to

comments on the subject of directive language by a number of Committee members at the previous meeting. In his view, the term "moderate" would be consistent with the aggregate growth rates shown under either B or C in the blue book.

Mr. MacLaury noted that the M_1 growth rate for the second and third quarters combined shown under alternative B--5-1/4 per cent--could be achieved, according to a blue book table, as the average of a 6 per cent rate in the second quarter and a 4-1/2 per cent rate in the third. He asked about the likely implications for interest rates of open market operations designed to reduce the M_1 growth to 4-1/2 per cent in the third quarter.

Mr. Axilrod replied that the Federal funds rate probably would have to move up to the neighborhood of 8 per cent--the top of the range shown under alternative B--by the next meeting of the Committee if the second-quarter M_1 growth rate was to be held to 6 per cent. In the staff's judgment, a funds rate of 8 per cent was likely to be consistent with a 4-1/2 per cent M_1 growth rate in the third quarter, so that no further money market firming would be required. The rise in the funds rate to 8 per cent over coming weeks probably would be associated with an increase in bill rates, and some further bill rate advance was likely in the summer when the Treasury was expected to come back into the market.

Mr. Coldwell asked whether the staff's projections incorporated an allowance for a near-term decline in the Treasury balance.

In reply, Mr. Axilrod said the staff anticipated a rather sharp drop in the Treasury balance at both commercial banks and Federal Reserve Banks between now and mid-June. In fact, one reason for the expectation that bill rates would be under upward pressure in coming weeks was the prospect that the System would be selling bills to absorb the reserves released by the anticipated decline in the balance at the Federal Reserve. According to Board staff projections, that balance would drop by roughly $1 or $1-1/2 billion by mid-June; according to Treasury projections, the decline would be larger. He might add that those projections had been made before the most recent wave of speculative pressures in foreign exchange markets. The impact of those pressures on the Treasury balance was anybody's guess at this point.

Chairman Burns then called for a general discussion of monetary policy, including comments on any aspect of the subject that the members deemed important.

Mr. Brimmer said he thought that at this point the Committee should look to the Board of Governors for further steps with respect to monetary policy. On the assumption that the Board would adopt the marginal reserve requirement measures to which Mr. Axilrod had referred, the Committee should avoid innovation in open

market policy and limit itself to preventing slippage. While he would not comment on specifications in detail, he thought those associated with alternative B were in the right general neighborhood.

Mr. Brimmer added that he would avoid innovation at this time even with respect to the language of the operational paragraph of the directive. In that connection he noted that the alternative B language mentioned by Mr. Daane differed from the tentative draft included in the blue book.[1/] The new version was better than the tentative draft, but he would still prefer to use language like that of the directive adopted at the previous meeting.

Mr. Hayes observed that, as he had indicated earlier, the economy was in a real boom and the slower pace that was generally expected for the second quarter was not a certainty. Inflationary pressures were, if anything, more severe today than they had been when the Committee last met.

In that context, Mr. Hayes remarked, he would like to see the longer-run target for M_1 edged down to a 4-1/2 to 5 per cent range. That, it seemed to him, would provide some recognition of the fact that present estimates of the M_1 growth rate in April-May were running 2 percentage points above the midpoint of the 4 to 6 per cent range adopted by the Committee at its previous meeting.

1/ The draft of alternative B shown in the blue book called for "...growth in the narrowly defined money stock over the months ahead at about the average rates of the past 6 months and slower growth in other key monetary aggregates."

As to the funds rate, he thought the lower limit should be set at 7-1/2 per cent, only very slightly below the level of the past 2 weeks. He felt that any significant easing in the money market might, in the present environment, create the misleading impression that the System was backing away from a firm stance. Also, he would raise the upper limit to 8-1/4 per cent, and he would expect the Manager to move the funds rate up gradually from its present level if the aggregates appeared to be running on the high side.

In general, Mr. Hayes observed, the specifications he favored were between those of alternatives B and C. He liked the kind of operational paragraphs the staff had proposed for consideration today, and among the several alternatives he preferred C.

With respect to the Board staff's proposals, Mr. Hayes said he would favor the imposition of marginal reserve requirements provided that it was linked with the suspension of the remaining Regulation Q ceilings on large-denomination CD's. He would certainly favor the extension of reserve requirements to cover ineligible acceptances. Those measures might well encourage the use of documented discount notes as an alternative method of raising funds, and he would urge that administrative action be taken to close off that potential loophole. Whether a 3 per cent marginal reserve requirement would exert sufficient restraint was debatable, but he believed it was a good starting point. It should be kept in

mind that, if the contemplated measures tended to push interest rates somewhat higher, the Committee should not use open market policy to nullify that effect. That was one consideration underlying his preference for a somewhat higher range of tolerance for the Federal funds rate. As to Euro-dollar borrowings, he agreed that the treatment should be kept separate from that accorded domestic liabilities. He preferred the procedure under which the reserve-free base would be phased out and a uniform 8 per cent requirement applied to all Euro-dollar borrowings--although he believed a good case could be made for a 5 rather than 8 per cent requirement.

Mr. Hayes went on to say that the proposed letter asking for voluntary compliance by nonmember banks might be a useful way of dramatizing one of the problems arising from the absence of uniform reserve requirements for all commercial banks. As to restraint on the use of funds obtained from U.S. branches and agencies of foreign banks, he would favor the guideline approach along the lines adopted in 1969.

In concluding, Mr. Hayes said he would submit for the Committee's records a number of memoranda dealing with the matters under discussion that had been prepared at the New York Bank.1/

1/ Copies of these memoranda have been placed in the Committee's files.

Mr. Balles remarked that the comments Chairman Burns had made from time to time concerning the importance of confidence as a determinant of the economic outlook appeared to be especially relevant at this point. Evidence that confidence was in a rather perilous state could be found in various indicators, of which he would mention only three: the stock market, surveys of consumer expectations, and markets for gold. In his judgment, a good part of the recent deterioration in confidence could be attributed to fear that inflation would not be brought under a reasonable degree of control. He was disturbed by the inflammatory nature of some of the comments by responsible parties that were appearing in the business and financial press. For example, the recently published April survey of the National Association of Purchasing Management referred to fears that the current boom might be headed toward a condition described as "running wild." And, as he had indicated earlier, he was concerned about a possible explosion in wages following on the heels of the very sharp rise in prices and profits. The April increase in wholesale prices of industrial commodities, the largest in 22 years, certainly did not offer any comfort about the prospects for prices at the retail level.

In short, Mr. Balles continued, he considered inflation to be the clear and present danger, and he believed it was crucial for the System to give overt signals to the public and to the

financial markets that monetary policy was leaning against the winds of inflation. Partly by accident, the first-quarter growth rates of M_1 and M_2 were considerably below the fourth-quarters rates, and a strong rebound in the second quarter would have highly unfortunate effects on public and market attitudes. Whatever the course of Committee policy, both the rate of inflation and the rate of unemployment would be higher than desirable. In his judgment, however, the B specifications were likely to represent the least destructive of the unpleasant alternatives available. As to the operational paragraph of the directive, he favored the language of the tentative draft of alternative B that had been shown in the blue book. The problem with the revised version of B, which called for "somewhat slower" growth in monetary aggregates than over the past 12 months, was that the 12-month growth rates referred to were rather high: 6.3, 9.0, and 9.7 per cent for M_1, M_2, and RPD's, respectively. He would like to see the aggregates grow at rates much lower than those.

Mr. Balles said he would make two observations regarding the marginal reserve requirement proposals. First, the measures were not likely to have much restraining effect unless banks were able to pass through the higher cost of funds in the prices they charged their customers. The measures should be expected, therefore, to give further upward impetus to the prime rate. Secondly, he was

highly skeptical that nonmember banks would comply with the request that they voluntarily observe the marginal reserve requirements to be imposed on member banks. Indeed, they probably would be urged not to comply by their State supervisors. On the other hand, he thought the request would do little harm, and as Mr. Hayes had suggested, it might serve a useful purpose by dramatizing the inequities in the existing differences between reserve requirements applicable to member and nonmember banks.

Mr. Mayo agreed that it was important for the Committee to take account of the existing overheating of the economy and to do its best to deal with the problem of inflationary psychology. However, it was necessary also to recognize that the policy decision taken today would have important effects not only on the present situation but on that prevailing a year from now and perhaps even later. With those considerations in mind, he had a rather strong preference for most of the specifications shown under alternative B, including the retention of the existing 5 to 5-1/2 per cent longer-run target rate for growth in M_1. The one exception he would make related to the range of tolerance for the funds rate. If the Board should approve the marginal reserve requirement proposals, he would expect some ratcheting up of CD rates with spill-over effects on other rates. Accordingly, like Mr. Hayes, he thought it would be desirable to raise the funds rate specification by a quarter of a point, to a range of 7-1/2 to 8-1/4 per cent.

With respect to the directive language, Mr. Mayo said he felt quite strongly that the Committee would be ill-advised to move in the direction suggested in the drafts the staff had submitted for consideration today. He noted that in both alternatives A and C the desired growth rates of the aggregates were expressed relative to the actual growth over the past 6 months, whereas in the revised version of alternative B the past 12 months were used as a reference period. Perhaps at the next meeting it would be found necessary to use the past 8 months, or some other interval, as a reference for expressing the objectives associated with one or more of the alternatives. It would be unfortunate to start down that path. Personally, he thought the term "moderate growth" was quite acceptable as a description of the Committee's objectives for the aggregates.

Mr. Mayo remarked that he would heartily applaud a suspension of the remaining ceilings on large-denomination CD's, should that move be associated with the adoption of the marginal reserve requirement proposals. He thought those proposals themselves were excellent. In particular, he considered the technique of applying a marginal requirement to a combination of items on the liability side far more acceptable than the alternative--which might otherwise have to be faced later on--of applying reserve requirements to categories of assets. He suspected that it was not necessary at

this point to include finance bills among the liabilities covered; while the use of finance bills could expand rapidly under tight credit conditions, he would not expect such expansion if the ceilings on large-denomination CD's were removed. However, no particular harm would be done by including finance bills.

As to Euro-dollar borrowings, Mr. Mayo continued, he favored phasing out the existing reserve-free bases and making reserve requirements on such borrowings conform to those on other non-deposit liabilities. One possibility would be to have the banks pool all of their nondeposit liabilities, including Euro-dollar borrowings, for purposes of reserve requirement calculations. Such a procedure need not mean giving up the opportunity to apply differential reserve requirements to Euro-dollar borrowings, should that prove desirable later, and it might have some advantages. However, equivalent results could be obtained without pooling liabilities.

Mr. Mayo noted that implementation of the marginal reserve requirement proposals could lead to a further advance in the prime rate, and it might also militate in favor of another increase in the discount rate following the rise to 6 per cent that became effective last Friday. Indeed, it was quite possible that the directors of the Chicago Reserve Bank would vote for another discount rate increase before the next meeting of the Committee. He

thought the prospect of further upward pressure on the prime and discount rates should not deter the Board from implementing the proposals.

Mr. Morris remarked that, as he had indicated earlier, he considered it advisable for the Committee to follow a middle course on policy at this juncture in view of the uncertainties in the economic outlook. Accordingly, he favored alternative B. He hoped it would not prove necessary to let the Federal funds rate rise to the upper limit of 8 per cent shown under that alternative, but he would certainly not object to such a funds rate if it should prove necessary in order to dampen excessive growth in the monetary aggregates.

Mr. Morris said his general reaction to the marginal reserve requirement proposals was that they would represent a great step forward. To implement them would, in effect, be to announce that the System intended to control bank credit expansion through the use of reserves rather than interest rate ceilings; such an announcement would clear the air in a positive and constructive way. Like Mr. Hayes, he was concerned about the loophole represented by documented discount notes, and he hoped high priority would be given to developing means for closing that loophole. Also, it was important not to raise reserve requirements so high as to create incentives for banks to spin off part of their lending activities

to affiliates. Although he did not think the level now under consideration was high enough to have such an effect, he was not sure where the threshhold might be. If further increases were contemplated, it would be necessary to remain alert to signs that the threshhold was being reached.

Mr. Morris added that he considered it highly desirable to make a sharp distinction between Euro-dollar borrowings and funds obtained from domestic sources. It should be clear that System actions affecting reserve requirements on domestic funds would be governed by domestic economic considerations alone, but that actions affecting Euro-dollar borrowings would also be influenced by balance of payments and other international financial considerations. He would favor introducing a differentiation at the outset, by setting a lower requirement on Euro-dollar borrowings, so as to avoid giving observers the impression that all sources of funds would be dealt with on the same basis.

In reply to a question by Mr. Sheehan, Mr. Morris said he thought changes in reserve requirements on Euro-dollar borrowings would prove useful in the future as a means for influencing international flows.

Chairman Burns observed that the establishment of uniform requirements at the present time would not preclude the System from varying the requirement on Euro-dollars separately in the future.

Mr. Eastburn commented that the reasons for concern about inflation had been amply described in the discussion thus far. As he had indicated earlier, however, he believed that the Committee also had to take account of the increasing dangers of recession. That led him to three conclusions. First, it was important to guard against overdoing restraint. It appeared now that M_1 would expand in the first half of 1973 at a rate slightly below 4 per cent. In his judgment, growth at or below that rate in the second half would be too slow, given the lags of policy. Accordingly, he favored a longer-run target range for M_1 of 5 to 5.5 per cent, as shown under alternative B.

Secondly, Mr. Eastburn continued, he thought the Committee should not try to compensate for the overshoots in the monetary aggregates that had occurred thus far in the second quarter. That led him to favor the ranges shown under alternative B for growth in the aggregates in the short run. He preferred the revised alternative B language the staff had proposed. While he recognized that there were some problems with that language, its general thrust was in the direction of greater precision, and that, in his view, was the direction in which the Committee should constantly seek to move. Terms like "moderate growth" were not very precise.

Mr. Eastburn observed that his third conclusion related to the proposed marginal reserve requirement measures. It was important for the System to remain alert to the risks of a credit crunch and--since a crunch was essentially an availability phenomenon--to work through credit cost rather than availability to the extent possible. That consideration argued for the adoption of the proposed measures. In his judgment, however, it was essential that those measures be accompanied by a suspension of Regulation Q ceilings on large-denomination CD's. Otherwise, the effects on the market would be much too drastic.

Mr. Kimbrel remarked that observers in the Sixth District had become increasingly anxious in recent weeks about the prospects of getting assistance from fiscal policy in the economic stabilization effort. Those anxieties, coupled with the sense of frustration arising from the latest disturbances in foreign exchange markets, were certainly not contributing to the factor of confidence, which in his view was playing as important a role as any other factor at the moment. Against that background, he hoped the Committee would be able to avoid unduly rapid growth in the monetary aggregates. He liked the language of alternative B and the specifications for longer-run targets shown under that alternative in the blue book. It might be desirable to give the Manager slightly

more latitude in his efforts to achieve those targets by raising the upper limit of the range for the funds rate from 8 to 8-1/4 per cent.

Mr. Kimbrel noted that he had favored the imposition of marginal reserve requirements in 1971. He certainly hoped that the latest proposals would be implemented and that the Regulation Q ceilings on large-denomination CD's would be suspended at the same time. One advantage of the proposals was that they would result in more equitable treatment with respect to nondeposit sources of funds that were used as substitutes for CD's. He had wondered whether a one percentage point increase in reserve requirements might not be preferable to the introduction of marginal requirements, but he did not feel strongly on that point. As others had suggested, implementing the proposals might strengthen the case for a further increase in the discount rate.

Mr. Francis observed that both the long- and short-run specifications for growth in the monetary aggregates shown under alternative B seemed appropriate to him in the present situation. There was some question in his mind as to whether it would be possible for the Manager to achieve those growth rates if the upper limit for the funds rate range were set at 8 per cent; he would prefer to set that limit at 8-1/2 per cent, to give the Manager more latitude in the case of need.

For the directive, Mr. Francis continued, he favored the draft of alternative B shown in the blue book because, in calling for a continuation of the M_1 growth of the past 6 months and some slowing in growth of other key aggregates, it seemed to him to describe accurately the needs of the present situation. To illustrate his point, he might note that Federal Reserve credit increased at annual rates of 18 per cent in the 6 months ending in April, 11 per cent in the 12 months ending then, and 8.5 per cent over the 5-year period from early 1967 to early 1972. Growth in the monetary base also was faster in the last 6 months than in the other periods. In contrast, growth in M_1, which was at a rate of 6.2 per cent in the 1967-72 period and 6.3 per cent in the 12 months ending in April, was at a rate of 5.3 per cent in the last 6 months and even less--4.5 per cent--in the last 3 months. He believed that the recent deviation of the growth rate in M_1 from that of the other aggregates could be explained by the large build-up of Treasury balances at commercial banks, and that M_1 growth would tend to deviate in the upward direction as those balances were reduced. Under such circumstances, it would be correct to describe the Committee's objective as that of keeping M_1 growth close to the rate of the past 6 months while slowing growth in other key aggregates.

With respect to the marginal reserve requirement and related proposals, Mr. Francis observed, he would be happy to see the remaining Q ceilings on large-denomination CD's removed. However, he had considerable doubts about the implications of the proposals for monetary policy. He believed the record would indicate that when reserve requirements had been increased in the past the Committee had usually sought to offset the effects temporarily by open market operations, and the "temporary" offsets had frequently tended to be rather lasting. Considering the proposals from a cost-benefit viewpoint, he agreed that their direct costs to the System would not be very great. However, they might also have an opportunity cost in the form of diverting System resources from other uses.

Beyond those considerations, Mr. Francis continued, he thought that with regard to controlling credit, the System's primary emphasis should be on total credit. He believed that the impact of the proposals would be confined to bank loans and he doubted that they would have any effects on total credit. In his judgment the only way the Federal Reserve could come to grips with total credit was by supplying fewer reserves to the banking system.

Mr. Black remarked that he saw no good reason for the Committee to change its longer-run targets for the monetary aggregates at this stage. As others had noted, the economy was certainly

in a boom or near-boom situation and inflation was the most urgent near-term problem. Nevertheless, it was important not to allow monetary policy to fall into the stop-go pattern that had characterized it too frequently in the past, especially around cyclical turning points. The Federal Reserve had anticipated the present boom--or near-boom--last fall and had undertaken a series of restrictive moves which added up to an impressive package. The Committee's present longer-run target of a 5 to 5-1/2 per cent growth rate in M_1, which apparently would be undershot in the first half of 1973, represented a substantial slowing from the rate of more than 8 per cent recorded in the second half of 1972. That amount of deceleration struck him as risky enough; he would be reluctant to push further, especially in view of the pronounced slowing in real GNP growth projected for the rest of the year.

With respect to the short run, Mr. Black observed, he believed that a point had been reached at which caution was called for in any further move toward tighter money market conditions. Key money rates were now at or close to their 1966 and 1969 levels, and the 6 per cent discount rate could prove to be an important psychological barrier. Also, the threshhold of disintermediation might have been reached. While he favored the specifications of alternative B--and also the alternative B language, in the form shown in the blue book--he would not like to see the Federal funds

rate move as high as 8 per cent unless it was clear that the aggregates were growing at rates significantly above the upper limits of their specified ranges.

Turning to the question of marginal reserve requirements, Mr. Black said he would certainly prefer the staff's proposals to the use of Regulation Q ceilings as a method of controlling bank credit. As Mr. Francis had pointed out, however, it was far from clear that the proposed measures would prove to be an effective device for controlling total credit. It seemed entirely possible that tighter control over bank credit would have interest rate effects leading to more intensive use of demand deposits by non-bank lenders to satisfy credit demands not accommodated by banks. One of the economists at the Richmond Bank had developed a theoretical model for examining that question which appeared to be quite useful. Although his report was not yet in final form, copies of a preliminary version were available to those interested.

Mr. Black went on to say that, despite his doubts about the effectiveness of the proposed measures in controlling total credit, he thought there were some important reasons for putting them into effect. In periods of tight money, the liquidity problems of banks would be less acute if marginal reserve requirements were substituted for Q ceilings on large-denomination CD's. That could be a key factor at some later stage. Secondly, implementing the

proposals would put an end to the cat-and-mouse game the Federal Reserve had played with banks in recent periods of tight money, under which the System acted to limit bank access to particular sources of funds and the banks reacted by developing new sources. Third, reliance on marginal reserve requirements rather than Q ceilings would insure that large banks, which were the principal suppliers of business loans, would not be as effectively cut off from money market sources of funds in tight money periods, and therefore that there would be less tightness in business loan markets in such periods. Finally, marginal reserve requirements would appear to be much more equitable than Q ceilings. The latter tended to undercut the competitive position of banks relative to that of other lenders in tight money periods, and it seemed only fair to permit banks to continue to engage in the process of credit intermediation in such periods.

With respect to Euro-dollar borrowings, Mr. Black continued, he agreed with Mr. Morris that the reserve requirements for them should be kept distinct from those against domestic money market instruments in order to facilitate their use as a means for influencing international flows of funds. He would favor phasing out the reserve-free base, ending up with a straight 8 per cent requirement against Euro-dollar borrowings. In view of the current

uncertainties in foreign exchange markets, he would prefer to use one of the slower phase-out schedules mentioned in the staff materials--5 or 7 per cent per computation period--rather than the 10 per cent schedule. As to the proposed request for voluntary compliance of nonmember banks, he shared Mr. Balles' skepticism about its probable effectiveness. Like Mr. Balles, however, he thought that the request would be helpful in dramatizing the inequities involved in the existing situation with respect to reserve requirements for member and nonmember banks.

Mr. Coldwell remarked that for the short run inflation was the major economic problem; for the longer run, there were questions about the rate of growth of economic activity. In his view, the main source of difficulty related to the state of confidence, and he could find little reassurance on that score in light of recent developments in the stock market and in foreign exchange markets. He was especially disturbed by the latter; if the international financial situation did not quiet down soon, he would become concerned about the possible consequences for the Committee's freedom of action with respect to monetary policy.

With respect to the alternatives before the Committee today, Mr. Coldwell said he preferred the specifications of alternative B and the revised language the staff had submitted for that alternative. In his opinion, however, the Committee had been

paying too much attention to M_1, the movements of which had been giving false signals. He would favor putting more emphasis on the objective of limiting growth in the bank credit proxy. As to the Federal funds rate, he thought a range of 1 percentage point--roughly from 7-3/8 to 8-3/8 per cent--would be appropriate.

Mr. Coldwell observed that there was much to attract him in the package of proposals put forward by the Board's staff, including the suggested removal of the remaining Regulation Q ceilings on large-denomination CD's, the phasing out of the reserve-free Euro-dollar base, and the introduction of reserve requirements against ineligible acceptances. With respect to marginal reserve requirements themselves, he had a number of reservations. Before mentioning them, however, he might note that the effects desired from the marginal requirements would not be achieved unless the Committee was prepared to validate the tendency toward higher market interest rates that their imposition would produce.

Mr. Coldwell noted that one of his reservations related to the complexity of the proposals. He suspected that banks would have some difficulty in adapting to another new arrangement for calculating their reserve requirements and in understanding some of the detailed provisions. Partly because the proposals were complex, banks were likely to seek ways of avoiding the marginal requirements. There would appear to be some good loopholes; for

example, the banks that made markets in Federal funds could absorb into their own positions an increased proportion of the funds they acquired, and banks in general could sell participations in their loan portfolios to nonaffiliates. Finally, he wondered whether the effects of the proposals would be equitable, in view of past differences among banks in the vigor with which they had acquired CD funds.

Mr. Coldwell said he shared the skepticism others had expressed about the extent to which nonmember banks were likely to concur in the request that they comply voluntarily with the marginal requirements imposed on member banks. However, he had long favored efforts to get nonmember banks to recognize their responsibilities in the field of monetary policy, and accordingly he thought there were good arguments for sending the proposed letter.

In light of his reservations about the marginal reserve requirements, Mr. Coldwell continued, he believed that the objectives sought might be better achieved by a simple increase in existing reserve requirements, coupled with a further advance in discount rates. Like Mr. Francis, he thought the Committee itself could best impose restraint by curtailing the rate at which it injected reserves. As he had indicated earlier, however, the

System's freedom of action in coming weeks might well be limited by developments in the international financial area. Both the foreign exchange situation and the rapid waning of confidence in the Government's ability to stabilize the economy and control inflation offered real grounds for concern.

Mr. MacLaury said he did not sense any real disagreement today with respect to the present state of the economy or the prospects for the next 6 months, although--as several speakers had noted--the outlook for the period thereafter was considerably more cloudy. Insofar as there was an open question, it related to the extent to which monetary policy could be used to counter the existing overheating without damaging the economy 6 months hence. With that question in mind, he found himself favoring the specifications of alternative B. Initially he had been inclined to shade the upper limit of the funds rate down from 8 to 7-7/8 per cent, but he now thought that his objective could be accomplished with the formulation suggested by Mr. Black, under which the funds rate would be permitted to rise to 8 per cent only if the monetary aggregates were significantly stronger than expected. For the directive he favored the blue book version of alternative B.

Mr. MacLaury observed that he did not see a very close relationship between the proposed marginal reserve requirement measures and the question of the general credit policy stance to

be adopted by the Committee. Like Messrs. Francis and Black, he questioned the advisability of focusing restraint on bank credit, given the ready access of large businesses to credit from other sources. In his judgment, special restraints on bank credit could not be pushed very far. The small size of the proposed marginal reserve requirement--3 percentage points--was consistent with the view that such a device could be expected to be only marginally effective. Indeed, he thought its main merit was as a substitute for the Regulation Q ceilings on large-denomination CD's with maturities of 90 days or more. In that connection, a statement in the staff memorandum reading "As part of the package of proposed policy actions, the Board might wish to consider extending the suspension of Regulation Q ceilings to such deposits" seemed to him to put the cart before the horse; if the Q ceilings were not to be suspended, he thought the other proposed actions also should not be taken.

Mr. MacLaury noted that he agreed entirely with Mr. Morris' view that a distinction should be preserved between reserve requirements on Euro-dollar borrowings and on funds from domestic sources. The staff memorandum included some well-taken observations on the absence of significant advantage to an appearance of symmetry in the treatment of funds from those two sources. However, the memorandum did not press that point to a conclusion he would consider

logical--that different percentage reserve requirements should be set initially on the two types of funds. Like Mr. Morris, he would favor a lower initial requirement--specifically, 5 per cent--on Euro-dollar borrowings. He had no strong feelings about the alternative means discussed for dealing with the existing reserve-free Euro-dollar bases.

In concluding, Mr. MacLaury asked whether any thought had been given to the question of how and under what conditions the new base that would be established for calculating marginal reserve requirements might be phased out in the future.

Mr. Axilrod replied that the proposal had a "self-destructing" aspect in the sense that the marginal reserve requirements on large-denomination CD's would become irrelevant to banks under the very circumstances in which they might no longer be needed. Specifically, at some point on the road back to easy money market conditions, market interest rates would drop to levels at which banks could sell CD's in denominations of less than $100,000 at or below the ceiling rates applicable to small CD's. Thus, by issuing CD's in denominations of, say, $90,000, banks could avoid the marginal requirement.

Chairman Burns remarked that, even apart from the feature that Mr. Axilrod had mentioned, the Board of Governors presumably would stand ready to eliminate marginal reserve requirements when it concluded that they were longer needed.

Mr. Winn observed that the nation was experiencing one of the biggest consumer spending booms in its history, fueled in large part by expansion of consumer credit. An aspect of the situation which was not being widely discussed but which nevertheless worried him deeply was the increasing tendency of lenders to lengthen maturities on instalment loans. He could not believe it was healthy for banks, for example, to extend the maturities on new car loans to 48 months at the very peak of a boom in automobile sales. He understood that, under the provisions of the Credit Control Act of 1969, the President could direct the Federal Reserve to issue regulations controlling credit extensions, including terms on consumer loans. Enforcing limitations on consumer loan terms could, of course, involve a tremendous administrative burden. However, the experience under recent price control programs suggested that such limitations could be made effective even if the enforcement apparatus consisted mainly of spot checks rather than of efforts to police every individual retailer and lender.

With respect to the form of the directive, Mr. Winn said that while he saw the advantages of greater precision in the description of the Committee's objectives, he might note that increased precision in that respect would not necessarily be matched by increased precision in the degree to which the objectives were met. He meant no criticism of the Manager; indeed, he thought

the latter was doing an excellent job in his efforts to achieve the results the Committee desired. However, because of sudden international flows, unexpected changes in the Treasury balance, and similar developments, the outcome would often appear to be wide of the mark at the time--90 days after the meeting--when the directive was made public. He was concerned that publication of a highly precise description of the Committee's objectives at that time might give a misleading impression of the System's ability to achieve its goals.

Mr. Winn then noted that he was disturbed about the current inflationary thrust. He thought it was likely that during the next 3 months or so there would be an explosion of wage rates which, in turn, might have ramifications of a kind that could not be foreseen now. As to policy, he would want to hold "steady as you go" to the extent possible. Accordingly, he favored the alternative B directive, and he hoped that it would be possible to come reasonably close to the targets specified under that alternative.

Mr. Winn remarked that he had nothing to add with respect to the marginal reserve requirement proposals. He would like to second the view others had expressed that the implementation of those proposals should be accompanied by a suspension of the remaining Q ceilings on large-denomination CD's.

Mr. Clay observed that, with real economic growth projected to slow and with the pace of the expansion generating demand pressures on prices, monetary policy should pursue a moderately restraining course in order to avoid exaggerating either tendency. He shared the preference most others had expressed for alternative B.

Mr. Clay then noted that he had found the staff memorandum on marginal reserve requirements to be highly interesting. While any reactions he might offer were necessarily tentative in view of the limited time available to study the document, he did want to express certain concerns. First, he thought that the measures proposed would place the major burden for reducing business loan expansion on the large member banks, and that their implementation would create additional pressures forcing such financing outside of normal member bank channels. Specifically, he believed that the measures would accelerate efforts by banks to shift lending activities to affiliates, and that they would encourage businesses to do their financing outside of banking channels or go to nonmember banks. While it was proposed to ask nonmember banks to comply voluntarily with the marginal reserve requirements, he would question the effectiveness of such a request. The staff memorandum suggested that the request be directed only to the nonmember banks with a large volume of money market-type borrowing outstanding, estimated at less than 100. Not only were those banks likely to complain, but

the many hundreds of smaller nonmember banks undoubtedly would become concerned about the possibility that they might be brought under the control of the Federal Reserve.

Secondly, Mr. Clay continued, member banks might attempt to circumvent the marginal reserve requirements by issuing CD's in denominations of less than $100,000. As indicated in the staff memorandum, however, the present relationship of market interest rates to the ceiling rates on small-denomination CD's would prevent any significant volume of such activity. Finally, he continued to be bothered by the fact that the retention of Regulation Q rate restrictions on smaller-denomination CD's and their removal from large-denomination paper would make it more difficult for small rural banks to compete in financial markets. To the extent that the proposed measures would encourage the expansion of affiliates, they would force many rural areas to turn increasingly to nonbank sources of funds. Despite all the platitudes pertaining to the benefits of having large banking empires to finance rural areas, research done on that subject continued to indicate that such benefits did not accrue to rural communities. Personally, he would like to see the removal of Regulation Q ceilings from all types of bank liabilities.

Mr. Daane remarked that it was probably too late in the meeting and too late in the economic boom to say or do anything

very new. In his view, both international and domestic considerations clearly called for a continuation of the present stance of monetary policy. Any overt actions that might be needed to underscore that stance should be taken in areas other than open market operations. At this time, the System should demonstrate steadiness of purpose. It should also recognize fully the limitations on what could be achieved through monetary policy and on the feasible types of policy actions. He favored the specifications of alternative B, and like Messrs. Brimmer, Mayo, and Winn, he would not want to introduce additional quantification in the directive. Having the staff's assurance that the B specifications were consistent with language like that of the previous directive, he would prefer to retain such language.

Mr. Bucher observed that the case for moderation had been eloquently made by others, and he had nothing to add on that score. He, too, favored the specifications of alternative B, although like Messrs. Black and MacLaury, he would be reluctant to see the funds rate rise to the indicated upper limit of 8 per cent. As far as directive language was concerned, he should note that he had been among those who had raised questions at the previous meeting about the use of such terms as "moderate" and "modest" to describe the rates of growth in the monetary aggregates sought by the Committee. He believed, however, that the particular manner in which the staff

had formulated more specific language was likely to cause greater difficulties than would the use of the term "moderate." While it might be possible to develop better means for making the directive more specific, today he shared Mr. Daane's preference for retaining language along the lines of that in the previous directive.

Mr. Sheehan said he concurred in Mr. Bucher's position. He added that he had been impressed by Mr. Black's comments on policy today and would like to associate himself with those comments.

Chairman Burns remarked that a majority of the Committee was clearly in favor of the specifications of alternative B and of some version of the B language for the operational paragraph of the directive. He did not find the majority's position unacceptable, but for reasons which he would not elaborate on at this point he would prefer a somewhat different course. Perhaps the best procedure would be for him to describe the directive language and specifications he favored and determine whether they would be acceptable to the Committee. If the members believed that further deliberation would be useful, the meeting might be recessed for luncheon and then continued in the afternoon.

With respect to the directive, the Chairman said, he would prefer to use alternative C of the staff's drafts, with two modifications: in the phrase "while taking account of credit market developments," the words "credit market" would be replaced by

"international and domestic financial market"; and in the phrase "somewhat slower growth in monetary aggregates over the months ahead" the word "immediately" would be inserted before "ahead." The paragraph would then read as follows: "To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat slower growth in monetary aggregates over the months immediately ahead than occurred on average in the past 6 months."

As to specifications, the Chairman continued, he would suggest adopting the longer-run targets of alternative B, which would involve the retention of the present 5 to 5-1/2 per cent target range for growth in M_1 over the second and third quarters combined. For the associated ranges of growth in the May-June period, he would suggest those shown under alternative C: 7-1/2 to 9-1/2 per cent for RPD's, 3-1/2 to 5-1/2 per cent for M_1, and 4-1/2 to 6-1/2 per cent for M_2. For the range of tolerance in the Federal funds rate during the intermeeting period, he would suggest 7-1/4 to 7-7/8 per cent. It would be understood, as in the past, that it might prove necessary for the Committee to consult during the intermeeting period about possible modifications in those specifications. In the present case, consultation might well be required rather early in the period.

Following some discussion, Chairman Burns said he thought it would be desirable to recess at this point and resume the discussion after luncheon.

The meeting then recessed. It resumed at 2:30 p.m., with staff attendance limited to Messrs. Holland, Broida, Partee, and Holmes.

The Chairman said he had asked that staff attendance be limited at this afternoon session because he wanted to make certain observations which he thought would best not be made in the presence of a large group. At the moment the country was passing through a political crisis. He personally could not say what effect that crisis was having on domestic business and financial opinion, although he had received some disturbing reports about the impact on attitudes abroad. He had noted at the previous meeting of the Committee that consumers were becoming increasingly pessimistic about the economic outlook, and in the month since then there had been additional evidence to that effect. Financial investors--including investment bankers, managers of investment and pension funds, stock exchange brokers, and individual traders--had been in a depressed mood in recent months, and their depression had deepened in recent weeks and days. Businessmen remained highly confident, but perhaps they were a shade less confident than a month ago. In view of all of the uncertainties prevailing at

present, and in view of the probability that the Board of Governors would take certain important actions tomorrow with regard to member bank reserve requirements, he thought it would be a serious mistake for the Committee today to set the upper limit on the range of tolerance for the Federal funds rate as high as 8 per cent. A week from now he personally might well be advocating an upper limit of 8-1/4 per cent; at the moment, however, he would not want to go above 7-7/8 per cent.

With respect to directive language, Chairman Burns continued, he thought there was good reason at this point for describing the Committee's objectives for the aggregates in terms somewhat more explicit than the phrase "moderate growth." As had been noted in the discussion this morning, real GNP was expanding at a dangerously rapid rate, and the risk that inflation would continue, and possibly accelerate, was very great. Indeed, Mr. Partee had just advised him that revised figures to be published by the Commerce Department would show a substantially larger first-quarter increase in the deflator than had been indicated by earlier estimates. Under such circumstances, he considered it important for the Committee to record its desire not simply for "moderate" growth in the aggregates but, for the months immediately ahead, for somewhat slower growth than the average of the past 6 months.

In response to a question, the Chairman said he did not think the language he had proposed would imply a narrower focus on M_1 than the Committee intended. For one thing, it would include an instruction to take account of international and financial developments; for another, the term "monetary aggregates" was plural.

In reply to a further question, Chairman Burns remarked that, if the term "monetary aggregates" were taken to cover the credit proxy as well as RPD's, M_1, and M_2, it would be correct to say that the Committee sought "substantially" slower growth than that of the past 6 months. However, he did not consider it necessary to spell out the objectives in such fine detail.

Mr. Francis observed that he preferred the Chairman's proposal for the operational paragraph to the type of language employed in the previous directive.

Mr. Hayes said he also liked the Chairman's language proposal. With respect to the suggested specifications, he wondered whether it was reasonable to expect that the indicated growth rates for the aggregates would prove consistent with a funds rate range having an upper limit of 7-7/8 per cent.

The Chairman agreed that the several specifications might well prove inconsistent. It was with that thought in mind this morning that he had mentioned the provisions for consultation in

the intermeeting period and had suggested that consultation might be needed rather promptly after today's meeting.

In reply to a question by Mr. Francis, Chairman Burns said he was not proposing any special commitment with respect to consultation. His reference was simply to the understanding which, in the recent past, had been regularly associated with the list of specifications agreed upon by the Committee.

Mr. Brimmer noted that the understanding to which the Chairman referred was set forth as item C on the specification sheet captioned "Points for FOMC guidance to Manager in implementation of directive."

After further discussion, Mr. Holland suggested that an additional sentence, reading as follows, be added to that paragraph: "It was understood that the chances are greater than usual that consultation may be needed in the coming period because of inconsistencies among the various operating constraints."

There was general agreement with that suggestion.

Mr. Daane said he could accept the directive language proposed by the Chairman if it was not necessarily to serve as a prototype for future directives.

Chairman Burns remarked that he personally preferred more general language under ordinary circumstances. He believed, however,

that there were times when it was desirable to be a little more specific and that this was such a time.

Mr. Bucher commented that he would favor varying the format of the operational paragraph with the needs of the occasion. He had objected earlier to the staff's draft of alternative B because he was uncomfortable with the particular formulation, not because he was opposed to more specific language in principle.

Mr. Hayes said he was prepared to accept both the language and the specifications proposed by the Chairman.

Mr. Eastburn noted that most members had expressed a preference for the short-run ranges for aggregate growth rates shown under alternative B. He asked if the Chairman would elaborate on his reasons for suggesting that the Committee agree on the alternative C ranges.

Chairman Burns replied that he felt less strongly about the choice of short-run ranges for the aggregates than he did about either the funds rate range or the language of the directive. The C specifications involved growth rates for the May-June period slightly lower than those of B; specifically, they were 1/2 percentage point lower for M_1, 1 point lower for M_2, and 1-1/2 points lower for RPD's. He had thought that it might be well to lean toward the conservative side at this point. However, he would have no objection to using

the ranges of B, or ranges intermediate to those of B and C, if that was the members' preference.

Mr. Daane noted that the May-June range for M_1 shown under B was 4 to 6 per cent. He questioned whether it would be correct to describe growth in such a range as "somewhat slower" than the average growth rate of the past 6 months, which was 5.3 per cent.

In the ensuing discussion it was suggested that the range for M_1 might be narrowed somewhat--perhaps to 4 to 5-1/2 per cent--or that some historical period other than the past 6 months be used for reference purposes.

Chairman Burns expressed the view that neither of those alternatives was desirable.

Mr. Partee observed that for both RPD's and M_2 the upper limit of the alternative B ranges was below the average growth rate of the past 6 months. While that was not the case for M_1, the midpoint of the range for that variable--5 per cent--was below the 6-month growth rate.

A number of members commented that they would not consider the alternative B ranges to be inconsistent with the directive language under consideration.

The Chairman then asked that the members indicate informally their preferences for May-June growth rates in the monetary aggregates, first as between those of alternatives B and C, and second as between those of alternative B and those intermediate to B and C.

In both polls, a majority of members expressed a preference for the alternative B ranges.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs--including the revised statement on foreign exchange market developments that had been distributed today--and the language for the operational paragraph that he had proposed. It would be understood that the directive would be interpreted in accordance with the specifications shown under alternative B in the blue book, except that the range of tolerance for the daily-average Federal funds rate in the statement weeks until the next meeting would be 7-1/4 to 7-7/8 per cent; and that the usual understanding with respect to intermeeting consultation would be amplified in the manner that Mr. Holland had suggested.

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

The information reviewed at this meeting suggests that growth in real output of goods and services is likely to moderate somewhat in the current quarter from an exceptionally rapid pace in the two preceding quarters. Over the first 4 months of this year, employment rose considerably but the unemployment rate remained about 5 per cent. Retail prices of foods continued upward at

an extraordinary pace in March, and in April average wholesale prices of consumer foods rose further. Increases in wholesale prices of industrial commodities were large and widespread in April, as in the two preceding months. In foreign exchange markets, which had been relatively quiet since mid-March, speculative pressures have developed in recent days and exchange rates for major European currencies have appreciated against the dollar. The U.S. merchandise trade balance improved considerably in the first quarter, reflecting in part an especially large increase in agricultural exports.

In April growth in the narrowly defined money stock picked up from its low first-quarter rate, and growth in the broadly defined money stock also increased. Growth in business loans at banks slowed, and banks reduced the pace at which they issued large-denomination CD's; consequently, the bank credit proxy expanded somewhat less than in other recent months. In recent weeks Federal Reserve Bank discount rates have been increased in two steps of one-quarter point to 6 per cent by May 11. Most short-term market interest rates, which had risen sharply earlier, have advanced slightly further. Interest rates on long-term market securities have been relatively stable.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to abatement of inflationary pressures, a more sustainable rate of advance in economic activity, and progress toward equilibrium in the country's balance of payments.

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat slower growth in monetary aggregates over the months immediately ahead than occurred on average in the past 6 months.

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

Mr. Hackley entered the meeting at this point.

Chairman Burns noted that a memorandum from the Secretary, dated May 8, 1973, and entitled "FOMC Counsel positions," had been distributed to the Committee. He invited Mr. Holland to comment.

Mr. Holland observed that the several recommendations contained in his memorandum were occasioned by the fact that Mr. Hackley planned to retire from the staff of the Board of Governors at the end of this month, and that his service as General Counsel of the Committee, which had extended over a period of 16 years, would automatically terminate at the same time. The purpose of the recommended actions, all of which would be effective June 1, 1973, was to provide for a better sharing of the prospective legal work of the Committee and to achieve in the legal area the same kind of coordinated staff support between the Board and New York Bank as the Committee already had in the research and operational areas. He recommended, first, that the Committee amend Section 4 of its Rules of Organization in the manner indicated in the memorandum to provide for the position of Deputy General Counsel in addition to those of General Counsel and Assistant General Counsel. Secondly, he suggested that Thomas J. O'Connell, General Counsel of the Board of Governors and presently Assistant General Counsel of the Committee, be named to succeed Mr. Hackley as General Counsel of the Committee; that Edward G. Guy, Vice President and

General Counsel of the Federal Reserve Bank of New York, be named Deputy General Counsel of the Committee; and that John Nicoll, Assistant General Counsel of the Board, be named Assistant General Counsel of the Committee.

After discussion, it was agreed that the Committee should act favorably on Mr. Holland's recommendations.

> By unanimous vote, paragraphs (a) and (d) of Section 4 of the Committee's Rules of Organization were amended, effective June 1, 1973, to read as follows:

SEC. 4. Staff. (a) Selection of staff officers. At its first meeting on or after March 1 of each year, the Committee selects, from among the officers and employees of the Board and the Federal Reserve Banks, the following staff officers to serve until the first meeting on or after March 1 of the next following year: Secretary, Deputy Secretary, and one or more Assistant Secretaries; General Counsel, Deputy General Counsel, and one or more Assistant General Counsel; and Economists, one or more of whom may be designated as Senior or Associate Economists or given titles reflecting their areas of particular specialization.

* * * * * *

(d) General Counsel and Deputy and Assistant General Counsel. The General Counsel furnishes such legal advice as the Committee may require. In the absence of the General Counsel, the Deputy General Counsel or an Assistant General Counsel acts as General Counsel pro tem.

By unanimous vote, Thomas J. O'Connell, Edward G. Guy, and John Nicoll were elected General Counsel, Deputy General Counsel, and Assistant General Counsel, respectively, of the Federal Open Market Committee, effective June 1, 1973, to serve until the election of their successors at the first meeting of the Committee after February 28, 1974, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, as the case might be, they would cease to have any official connection with the Federal Open Market Committee.

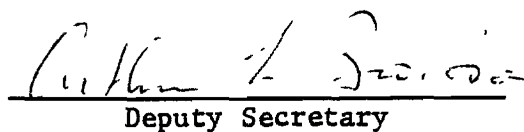
Chairman Burns expressed the members' gratitude to Mr. Hackley for his many years of outstanding service to the Committee. It was agreed that the Chairman should also write a letter to Mr. Hackley on behalf of the Committee expressing similar sentiments and extending the members' best wishes.

The Chairman then noted that the staff planned to make a chart presentation on the economic outlook at the next meeting. He suggested that, in order to provide adequate time for that presentation and Committee discussion thereof, the meeting be scheduled to begin on the afternoon of Monday, June 18, and to continue on the morning of Tuesday, June 19.

No objections were offered to that suggestion.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Monday and Tuesday, June 18-19, 1973, beginning on the afternoon of June 18.

Thereupon the meeting adjourned.



Deputy Secretary

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ATTACHMENT A

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 15, 1973

To Chairman Burns

From Bob Fisher & Helmut Wendel

Subject: Tax Shelters in Real Estate

The Treasury proposals on limitations of artificial accounting losses are designed to affect individuals who use initial losses incurred in apartment construction and early apartment operation to offset net income gained in other enterprises. There is no change in the Treasury proposals as regards people in the real estate business to the extent that such individuals are receiving more income from ongoing real estate operations than the losses involved in new projects. The Treasury proposals thus do not affect ongoing real estate businesses that are in a net profit position. They do affect, however, the ability of such corporations to obtain outside funds from individuals who are engaged in other business or professional pursuits. Such individuals could no longer find a tax shelter from artificial losses by investing funds into the real estate business. Construction firms have been getting large portions of their initial capital for apartment building and commercial construction from such outside individuals. Hence the proposal indicates a need to shift to other sources of capital or to develop new financing techniques. It is therefore quite possible that the proposed rules affecting new projects to be started beginning May 1, 1973, would be a pronounced short run deterrent on apartment buildings and commercial construction. For instance, the developers

of Columbia Maryland have told us that they have stopped new commitments for rentals and commercial buildings until uncertainties regarding the proposals can be clarified. A similar report was obtained from a leading real estate advisory firm in Chicago that felt that this legislation would substantially halt speculative construction rental housing and force new construction into condominium and cooperative types of financial arrangements.

Many real estate experts have not yet had time to evaluate the effects of the Treasury's proposals, so that our judgment now is very tentative. The Treasury's staff has told us informally that they do not expect a major effect from these provisions. Their argument is that the estimated revenue effect of the proposed revenue amounts to only a few $100 million. They do not believe that such a small tightening of tax provisions would have a pronounced impact on the housing market. They are working now with HUD on developing transition rules such as to protect projects already in process. The new rules would apply only to projects that have not yet begun.

ATTACHMENT B

May 14, 1973

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on May 15, 1973

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that growth in real output of goods and services is likely to moderate somewhat in the current quarter from an exceptionally rapid pace in the two preceding quarters. Over the first 4 months of this year, employment rose considerably but the unemployment rate remained about 5 per cent. Retail prices of foods continued upward at an extraordinary pace in March, and in April average wholesale prices of consumer foods rose further. Increases in wholesale prices of industrial commodities were large and widespread in April, as in the two preceding months. In foreign exchange markets, which had been relatively quiet since mid-March, speculative pressures have developed in recent days and exchange rates for major European currencies have appreciated against the dollar.1/ The U.S. merchandise trade balance improved considerably in the first quarter, reflecting in part an especially large increase in agricultural exports.

In April growth in the narrowly defined money stock picked up from its low first-quarter rate, and growth in the broadly defined money stock also increased. Growth in business loans at banks slowed, and bank reduced the pace at which they issued large-denomination CD's; consequently, the bank credit proxy expanded somewhat less than in other recent months. In recent weeks Federal Reserve Bank discount rates have been increased in two steps of one-quarter point to 6 per cent by May 11. Most short-term market interest rates, which had risen sharply earlier, have advanced slightly further. Interest rates on long-term market securities have been relatively stable.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to abatement of inflationary pressures, a more sustainable rate of advance in economic activity, and progress toward equilibrium in the country's balance of payments.

1/ This statement on foreign exchange market developments incorporates the revisions suggested by the staff in a note distributed to the Committee at the outset of the meeting.

OPERATIONAL PARAGRAPHS

Alternative A

To implement this policy, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat faster growth in the narrowly defined money stock over the months ahead than occurred in the past 6 months on average but somewhat slower growth in other key monetary aggregates than in that period.

Alternative B

To implement this policy, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat slower growth in monetary aggregates over the months ahead than occurred on average in the past 12 months.

Alternative C

To implement this policy, while taking account of credit market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat slower growth in monetary aggregates over the months ahead than occurred on average in the past 6 months.

ATTACHMENT C

May 15, 1973

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 5/15/73)
A. Longer-run targets (SAAR): (second and third quarters combined)	M_1	5 to 5-1/2%
	M_2	6 to 6-1/2%
	Proxy	9 to 9-1/2%
	RPD's	7-1/2 to 8%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (May-June average):		9 to 11%
2. Ranges of tolerance for monetary aggregates (May-June average):	M_1	4 to 6%
	M_2	5-1/2 to 7-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		7-1/4 to 7-7/8%
4. Federal funds rate to be moved in an orderly way within range of toleration		

5. Other considerations: account to be taken of international and domestic financial market developments.

C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the 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 understood that the chances are greater than usual that consultation may be needed in the coming period because of inconsistencies among the various operating constraints.