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, March 21, 1972, at 9:30 a.m.

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

Messrs. Francis, Heflin, Mayo, and Swan, Alternate Members of the Federal Open Market Committee

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

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

Mr. O'Connell, General Counsel, Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Messrs. Eisenmenger, Parthemos, Taylor, Scheld, Andersen, and Tow, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, St. Louis, and Kansas City, respectively
Mr. Debs, Vice President, Federal Reserve Bank of New York
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Cooper, Assistant Vice President, Federal Reserve Bank of New York

The Secretary reported that advices had been received of the election by the Federal Reserve Banks of members and alternate members of the Federal Open Market Committee for the term of one year beginning March 1, 1972; that it appeared that such persons were legally qualified to serve; and that they had executed their oaths of office.

The elected members and alternates were as follows:

Alfred Hayes, President of the Federal Reserve Bank of New York, with William F. Treiber, First Vice President of the Federal Reserve Bank of New York, as alternate;

David P. Eastburn, President of the Federal Reserve Bank of Philadelphia, with Aubrey N. Heflin, President of the Federal Reserve Bank of Richmond, as alternate;

Willis J. Winn, President of the Federal Reserve Bank of Cleveland, with Robert P. Mayo, President of the Federal Reserve Bank of Chicago, as alternate;

Bruce K. MacLaury, President of the Federal Reserve Bank of Minneapolis, with Eliot J. Swan, President of the Federal Reserve Bank of San Francisco, as alternate;

Philip E. Coldwell, President of the Federal Reserve Bank of Dallas, with Darryl R. Francis, President of the Federal Reserve Bank of St. Louis, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after February 28, 1973, with the understandings (1) 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; and (2) that insofar as the titles of the positions to which they were elected differed from those heretofore specified in the Committee's By-Laws and Rules of Organization, conforming changes were to be made in those documents:

Arthur F. Burns	Chairman
Alfred Hayes	Vice Chairman
Robert C. Holland	Secretary
Arthur L. Broida	Deputy Secretary
Murray Altmann, Normand R.V. Bernard, and Charles Molony	Assistant Secretaries
Howard H. Hackley	General Counsel
David B. Hexter	Assistant General Counsel
J. Charles Partee	Senior Economist
Stephen H. Axilrod	Economist (Domestic Finance)
Robert Solomon	Economist (International Finance)
Edward G. Boehne, Ralph C. Bryant, Lyle E. Gramley, Ralph T. Green, A. B. Hersey, William J. Hocter, John H. Kareken, and Robert G. Link	Associate Economists

Secretary's Note: In consequence of the foregoing action, the opening sentences of Sections 2, 3, and 6 of Article II of the Committee's By-Laws, and the first sentence of Section 3 of the Committee's Rules of Organization, were amended to read as follows:

By-Laws:

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ARTICLE II. OFFICERS

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Section 2. Secretary and Deputy and Assistant Secretaries - At its first meeting on or after March 1 of each year, the Committee shall elect a Secretary and one or more Deputy and Assistant Secretaries to serve until the first meeting on or after March 1 of the next year. . . .

Section 3. Economists - At its first meeting on or after March 1 of each year, the Committee shall elect one or more Economists to serve until the first meeting on or after March 1 of the next year. The Committee shall also from time to time, as it may decide, designate one or more of its elected Economists as Senior or Associate Economists, or otherwise qualify their titles. The Economists shall prepare for the use of the Committee and present to it such information about business and credit conditions as will assist the Committee in the determination of open-market policies, and shall perform such other duties as the Committee may require.

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Section 6. Filling Vacancies - At any meeting the Committee may fill any vacancy in the offices described in this Article.

Rules of Organization:

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SECTION 3 - PERSONNEL

> (a) Official Staff.-The official staff of the Federal Open Market Committee includes its Secretary, Deputy Secretary, and Assistant Secretaries, General Counsel and Assistant General Counsel, and Senior Economist, Economists, and Associate Economists, who perform the duties indicated by their titles. . . .

In connection with the foregoing action, Mr. Holland suggested that the Committee might want to authorize the Chairman to have an ad hoc staff committee review its By-Laws, its Rules relating to Organization, Procedure, and Availability of Information, and its general Regulation on open market operations, with a view to developing recommendations for whatever technical changes in those documents might be appropriate in light of developments since they were last revised.

There was general agreement with this suggestion.

> Secretary's Note: Subsequent to the meeting Chairman Burns designated the following as members of the ad hoc staff committee: Mr. Hackley, chairman; Mr. Broida; and Mr. Debs of the Federal Reserve Bank of New York.

Mr. Brimmer noted that in recent years a number of improvements had been introduced in the manner in which the Committee conducted its deliberations on policy. He thought, however, that further improvements might be possible. One recent suggestion worth

considering, for example, was that the Committee plan to devote several meetings each year to an intensive discussion of the economic situation and outlook and of monetary policy objectives for the longer-run; and to confine its policy discussions at intervening meetings to reviews of the situation in light of developments in the interim.

In response to Mr. Brimmer's observation, Chairman Burns suggested that members who would like to propose major or minor modifications in the Committee's procedures forward their proposals to the Secretary. When such proposals had been received he would review them with the Secretary and decide how they might be handled. Some proposed modifications might be so obviously desirable as to call for their immediate adoption. Others might require an evaluation by the Committee, possibly with a prior staff analysis.

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Federal Open Market Committee after February 28, 1973.

By unanimous vote, Alan R. Holmes and Charles A. Coombs were selected to serve at the pleasure of the Federal Open Market Committee as Manager of the System Open Market Account and as Special Manager for foreign currency operations for such Account, respectively, it being understood that their selection was subject to their being satisfactory to the Directors of the Federal Reserve Bank of New York.

Secretary's Note: Advice subsequently was received that Messrs. Holmes and Coombs were satisfactory to the Board of Directors of the

Federal Reserve Bank of New York for service in the respective capacities indicated.

By unanimous vote, the action of Committee members on February 29, 1972, increasing from $2 billion to $3 billion the limit on changes between Committee meetings in System Account holdings of U.S. Government and Federal agency securities specified in paragraph 1(a) of the continuing authority directive, was ratified.

Mr. Holmes noted that the Committee's action of February 29 had been intended as a temporary precautionary measure. Since the larger limit no longer appeared likely to be needed, he suggested that the earlier limit of $2 billion now be restored.

By unanimous vote, the limit on changes between Committee meetings in System Account holdings of U.S. Government and Federal agency securities specified in paragraph 1(a) of the continuing authority directive was reduced from $3 billion to $2 billion.

By unanimous vote, the action of Committee members on March 7, 1972, suspending until close of business on March 21, 1972, the lower limit on repurchase agreement rates specified in paragraph 1(c) of the continuing authority directive, was ratified.

Messrs. Brimmer and Robertson noted that they had dissented from the action of March 7.[1] Having so recorded their positions,

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1/ Mr. Brimmer had dissented from the March 7 action because he felt that excessive reliance was being placed on RP's in open market operations. He was also disturbed about the frequency with which discretionary RP rates had been used recently. He thought that since discretionary RP rates were typically below yields on 3-month Treasury bills, their continued use might give the market a misleading impression of the Committee's policy objectives. Mr. Robertson had dissented from action in question for the same reasons underlying his dissents from similar (Footnote continued)

they did not consider it necessary to dissent also from the ratification.

> By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on January 11, 1972, were approved.

> The memoranda of discussion for the meetings of the Federal Open Market Committee on January 11 and February 14, 1972, were accepted.

Chairman Burns observed that Messrs. Daane, Coombs, and he had attended a recent meeting of central bank governors in Basle. The Chairman invited Mr. Daane to report on the meeting.

Mr. Daane said he had found the meeting particularly useful and constructive, and he believed it had made a significant contribution to a better international monetary climate. That contribution had been underscored by subsequent developments in the foreign exchange markets and by the related remarks made by President Pompidou regarding the outlook for the dollar. The most important outcome of the meeting was a reaffirmation by the governors of their determination to support fully the exchange rates established in the Smithsonian Agreement, even if such support involved continued additions of dollars to their holdings.

Mr. Daane added that the favorable outcome of the meeting was due in no small measure to the participation of Chairman Burns.

(Footnote continued)

actions taken in December and January. In his judgment the procedure was wrong; the Federal Reserve should be buying and selling outright so that the market could see what the System was doing.

The Chairman had been very effective both in his presentation and in his responses to the questions and concerns of the other governors. Those questions and concerns were really threefold. First, there was a concern, voiced most specifically by the French governor but shared by others, with regard to what was viewed as the lack of a U.S. program to accompany the Smithsonian Agreement. The French governor noted that a devaluing country normally devised a program to make a new parity viable, but it appeared that the U.S. budgetary deficit was mounting and that U.S. monetary policy had fostered a sharp decline in interest rates since the Smithsonian meeting. There were related questions with regard to the prospects for the U.S. balance of payments and U.S. controls on capital outflows. A second point of concern raised at the meeting related to what the governors regarded as a negative U.S. attitude with respect to facilitating repayments to the International Monetary Fund. A third concern related to what was viewed as U.S. unwillingness to open up discussions on the issues of international monetary reform.

Mr. Daane noted that in his responses Chairman Burns had emphasized the difference between a country which devalued its currency during an economic boom and a country like the United States which devalued at a time when it continued to face a stubborn unemployment problem and a relatively sluggish economy. The Chairman pointed out that the United States had adopted a very forceful program directed toward wages and prices. He also indicated that the Government deficit had been overstated and

stressed that he expected expenditures to flatten out. In the latter connection he also drew attention to the President's call for an expenditure ceiling.

Mr. Daane added that in his comments on interest rate developments the Chairman noted that recent declines in short-term rates were not solely the result of monetary policy but had reflected market forces, including sizable purchases of bills by foreign monetary authorities. He indicated that the Federal Reserve recently had concentrated its purchases in the longer-term area and that the Treasury had reinforced those efforts to moderate the downward pressures on short-term rates by marketing a bill strip. There had resulted a rise of 60 basis points or more in bill rates during recent weeks. With regard to the concerns about the U.S. balance of payments, the Chairman had underscored the need for patience. He had also focused attention on the very small gains that had been realized so far in the trade negotiations. He also observed that there had been strong pressures in the United States to remove controls on capital outflows, but those pressures had been resisted thus far; and the prospects were that only minor technical changes would be made in the controls with minimal balance of payments effects.

Mr. Daane said that in response to the concerns about the future of the IMF, the Chairman had indicated that the United States was interested in the effective functioning of the IMF, that its attitude with regard to repurchase transactions was not

intransigent, and that it would play its proper role in support of the IMF in the future. He also indicated that the United States was willing to participate in an early meeting on the subject of international monetary reform without prejudging the particular forum or forums for discussion.

Mr. Daane added that Chairman Burns' quiet and effective remarks had fostered a spirit of reconciliation and the meeting had ended with a good atmosphere prevailing. There was considerable discussion with regard to the manner in which the press should be handled and it had been decided not to change past procedures. That meant there would be no press communique and no press "backgrounder."

Mr. Daane observed that the Sunday afternoon meeting had been mainly devoted to a discussion of a report by the Standing Committee on the Euro-Currency Market. The meeting had resulted in a directive to the Standing Committee to focus its attention on a study of two possibilities: The first was the manner in which flows into the Euro-dollar market might be influenced by the Bank for International Settlements through transactions resembling open market operations, and the second involved a hard look into the ways and means of controlling directly the activities of Euro-dollar banks and the implications of employing alternative techniques.

In response to the Chairman's question, Mr. Coombs indicated that he had nothing to add to Mr. Daane's comprehensive report of the meeting.

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 February 15 through March 15, 1972, and a supplemental report covering the period March 16 through 20, 1972. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that since the last meeting of the Committee there had been several developments favoring a recovery of the dollar on the exchange markets. Continuing slack activity and declining interest rates in Europe had been accompanied by economic recovery and rising short-term rates here, with the result that the interest rate gap was being squeezed from both sides. European efforts to bring inflation under control generally seemed far less successful than the U.S. programs. The British trade surplus had already shifted into sizable deficit, while the latest figures from Germany, Switzerland, France, and Italy also suggested that a turning point in their trade balances might have been reached. It was his

impression that Japan was benefiting from those developments, but he also thought the U.S. trade balance would soon begin to reflect the trends in Europe.

Mr. Coombs added that if, as he was inclined to believe, the U.S. trade figures for 1971 were grossly distorted by expectations of currency changes, the unwinding of such speculative factors could swing the U.S. trade figures into surplus far sooner than estimates of the underlying trends might suggest. The improvement in the U.S. stock market and rising business profits should be arousing the interest of foreign investors. Finally, all of the central banks party to the Smithsonian Agreement had shown no hesitation so far in living up to their commitments to take in inconvertible dollars when offered them by the market.

Unfortunately, Mr. Coombs continued, those favorable developments had been swamped so far by recurrent speculative attacks on the dollar. The latest speculative wave, which crested out on March 9, was set off by a tough speech by the French Finance Minister Giscard d'Estaing. In unusually blunt language, the French Minister warned that unless the United States took action to check the outflow of dollars European countries would resort to exchange controls, since they were no longer prepared to take in large amounts of inconvertible dollars and would not accept a further revaluation of their currencies. The shock effect of that statement was further intensified a few days later by a formal

agreement reached by the Common Market countries to narrow the margin of fluctuation between their currencies to 2-1/4 per cent as a major step towards monetary unification. In the eyes of the market, that agreement greatly increased the possibility of a concerted European effort to liberate itself from the dollar either through controls, as advocated by the French Finance Minister, or through a joint float, as had been recommended by German and Italian officials. To the exchange market, those two risks signaled the same warning: to stockpile now those European currencies that might become more expensive or even unavailable later on. The main thrust of that new speculative attack was directed toward the Dutch guilder and Belgian franc. The two central banks had shown no hesitancy in buying up more than $500 million offered at their ceiling rates but it was significant that both countries had taken immediate action to reinforce their controls against further speculative inflows. Such controls helped to fend off further capital flows from the United States to Europe but they simultaneously tended to lock in existing U.S. corporate positions in European currencies. Those corporations hesitated to take profits in a currency which they might not be able to reacquire when it was needed.

Mr. Coombs noted that the markets recently had calmed down considerably. The further rise of short-term rates here had had a useful effect. Press commentary on the March BIS meeting

also proved helpful, while recent expressions of support for the dollar by President Pompidou relieved earlier fears of an imminent clash with the French. The dollar had lifted off the floor against the major European currencies and its technical position was now even stronger as a result of new short positions built up since the beginning of the year. The root of the confidence problem, however, lay in persuading the market that the Smithsonian Agreement on parities could and would be reinforced by inter-governmental efforts to rebuild the world financial system. On that score, the markets still remained skeptical and, so far, the major victim of that skepticism had been the dollar.

Mr. Coombs added that he would like to say a few words about the new Werner Plan to narrow the band among the Common Market currencies to 2-1/4 per cent. As he had indicated in a memorandum[1/] to the Committee, he thought the longer-term implications of a narrower band among the European currencies were ominous in the sense that it would tend to erode not only the reserve but also the transactions role of the dollar. The tendency would be accentuated if, as was now being planned, the European countries were to conduct the bulk of their intervention in their own currencies. Moreover, the new Werner Plan involved setting up machinery for joint, coordinated market intervention

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1/ A copy of this memorandum, dated March 8, 1972, and entitled "Common Market Exchange Rate Policy" has been placed in the Committee's files.

by the European central banks. Such intervention could readily be transformed into a joint float against the dollar, probably reinforced by tough exchange controls, and it would further increase the risk in the eyes of the market that Europe might move towards a defensive monetary bloc.

Mr. Coombs noted that the very negotiation of the new Werner Plan had reacted against the dollar in the sense of creating a presumption in the market that the floor on sterling and the Italian lira, for example, would probably be significantly higher than the official floor in the Smithsonian Agreement. The upward trend of the lira and sterling in January and February clearly had been strongly influenced by that presumption. But now that the Agreement had been signed and all of the European central banks, including the Bank of England, were committed to maintaining a 2-1/4 per cent spread against each other's currencies, he could see a real possibility that sterling and the Italian lira, both of which had been vulnerable to speculative attack, might become even more vulnerable. Thus, if either sterling or the lira came under selling pressure, the central banks of both countries would initially be forced to intervene at rates well above the ultimate floor levels set by the Smithsonian Agreement. But, if the market, as he thought would be its inclination, regarded the Werner Plan floor rates as no more than temporary defense lines, with the possibility of falling back to the final defense lines of floor rates set by

the Smithsonian Agreement, the Werner Plan could easily encourage further speculation against European currencies running into trouble. If that prospect materialized, the big question then would be whether outflows from European currencies becoming subject to such speculation would be directed mainly towards the dollar area or towards other European markets such as the German mark or the Dutch guilder. If the recovery of confidence in the dollar was strong enough to attract such money flows in the direction of the United States, those flows would help a great deal to bridge the gap until the fundamentals of the U.S. balance of payments were corrected. On the other hand, if confidence in the dollar remained weak, if there continued to be skepticism regarding the prospects of longer-term negotiations, and if outflows from London resulted in a further buildup of inconvertible dollars in the hands of other European central banks, the Smithsonian Agreement would be further threatened. That there might be grounds for concern about shifts of funds from weaker to stronger European currencies as well as outflows of dollars from the United States to Europe served to emphasize the urgency of resolving the underlying problems.

Mr. MacLaury remarked that since mid-August the swap lines had not been usable as a cover for dollar accumulations by foreign central banks. He wondered, however, whether the United States would be expected to support the currencies of its swap-line

partners if they should experience speculative outflows of dollars. Would the British and the Italians, for example, look initially to the Federal Reserve for funds in that eventuality or would the other European countries undertake to support those currencies?

Mr. Coombs replied that he thought the United States would retain full discretion as to whether it would supply the funds. Under the new Werner Plan, the initial support for a European currency under pressure would be worked out among the Common Market countries. For example, in a situation where the lira was weak, the mark was strong, and the spread between the lira and the mark was widening, the Bank of Italy would intervene in the market with marks borrowed from the German Federal Bank on a one-month basis. At the end of the month the Bank of Italy would pay off the mark debt--if necessary, by drawing down its reserve assets in proportion to its holdings of such assets. Beyond that one-month credit, the Bank of Italy could make use of the system of swap-line credits arranged among Common Market countries. He did not know whether the Bank of Italy might eventually turn to its U.S. swap lines, but he suspected there would be strong pressure to provide the necessary financing from within the Common Market.

Chairman Burns said he thought there would also be resistance in this country to providing financial assistance.

Mr. Coombs suggested that it might well be desirable for the Europeans to handle such market intervention themselves. Over

the longer run the nature of the support transactions would depend, of course, on the structure of the international financial mechanism and in particular on whether a truly international or a two-bloc structure materialized.

Mr. Brimmer noted that the System had had drawings outstanding on the swap line with the National Bank of Belgium continuously since June 30, 1970, and on other swap lines since the spring and summer of 1971. He wondered how much progress was being made in reducing the System's indebtedness.

Mr. Coombs replied that the System had paid off about $190 million equivalent of its swap drawings since last August. The most recent repayment, amounting to $35 million, had been made just before the year-end.

Mr. Brimmer inquired whether the uncertain prospects with regard to further System repayments had created a problem in terms of the Committee's own regulations. He was raising the question because the Committee's Authorization for System Foreign Currency Operations contemplated that the duration of any swap-line use would be limited to one year. He wondered whether that regulation had any real meaning under current circumstances.

Mr. Coombs noted that the Committee had expressly authorized all extensions of swap drawings beyond one year, as provided for under paragraph 1D of the Authorization. He added that thus

far the European central banks seemed to have a full understanding of the reasons why repayments were being delayed and were not in any sense critical of the Federal Reserve. They understood that the repayments would become feasible only when a return flow of dollars to the United States developed and that when it did materialize the repayments would be automatic.

In further comments on this issue some members of the Committee observed that the Committee did not seem to have much choice with regard to the extensions, although the U.S. Government could always undertake to pay off the System's indebtedness through use of the nation's reserve assets.

Chairman Burns said it was his impression that in the process of accumulating the swap-line indebtedness a sufficiently clear picture of the country's reserve-asset position had not been conveyed to foreign central banks or perceived by U.S. officials. Those assets appeared to be larger than they in fact were. In any event, the issue of the appropriate duration of drawings was one that the Committee would want to consider in the future. He agreed that such drawings could be very helpful, but he thought they should be strictly limited to short periods. In his view the Committee had been wise when it drew up regulations which required relatively prompt repayments.

In response to questions by Messrs. Brimmer and Mitchell, Mr. Coombs observed that foreign central banks would be delighted to be repaid in reserve assets. While they were prepared for the present to take in inconvertible dollars from the market, whether they would do so indefinitely was another question. The Federal Reserve had not been asked to acquire foreign currencies in the market for the purpose of repaying its drawings; indeed, the British, Belgian, and Swiss authorities had resisted such an approach on the ground that exchange rates would be driven up and the risk of a new wave of speculation would be generated.

Responding to a question by Mr. Coldwell, Chairman Burns indicated that discussions were under way with Treasury officials regarding the possibility that the System's swap drawings might eventually be liquidated with reserve assets provided by the Treasury. No decisions had been reached thus far by the Treasury; the problems involved were difficult and it would take time to resolve them. The conversations had been given special impetus by the recent hearings on the gold bill, and by the preceding discussion of his proposed testimony with Treasury officials. In the course of his testimony he had commented at some length on prospective Federal Reserve losses stemming from the new foreign exchange parities.

Mr. Mitchell indicated that he was troubled by the possibility that the System's inability to repay its swap drawings

might threaten the longer-run viability of the System's swap network.

Mr. Coombs said he thought the System's swap network had been damaged, but whether the damage would be permanent was an open question. The present situation was so abnormal that he hesitated to reach any firm conclusions with regard to the longer run. He might note, however, that the British had settled their indebtedness after a long delay. It appeared likely that in the future the European countries would place primary reliance on their Common Market partners in financing deficits in their balance of payments.

At Mr. Brimmer's suggestion it was agreed to insert in the memorandum of discussion for today's meeting the portions of Chairman Burns' testimony on March 2, 1972 before the House Banking and Currency Committee relating to the System's potential losses on its swap drawings. The testimony in question read as follows:

> "The Federal Reserve System will be affected by the financial and accounting adjustments in two ways. First, the Treasury will be able to issue new gold certificates to the Federal Reserve Banks in an amount equal to the increment in the book value of the Treasury gold stock. To the extent that it does so, the Treasury's cash balance will rise. A subsequent return of its cash balance to previous levels would of itself result in an increase of bank reserves, but this increase could be offset--in whole or in part--by Federal Reserve open market operations.
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> "The other effect on Federal Reserve transactions and accounts will occur in connection with settlement

of commitments under the reciprocal currency arrangements with foreign central banks. Use of a 'swap' arrangement by the Federal Reserve entails an obligation to deliver a specified amount of foreign currency at a future date. Similar commitments have been undertaken by the Treasury on its debt securities denominated in foreign currencies. At the present time, the Federal Reserve has outstanding foreign commitments of $2.86 billion. Inasmuch as the dollar prices of the affected currencies--namely, Swiss francs, Belgian francs, pounds sterling, and German marks--have risen since the swap drawings were made, there will be a cost to the Federal Reserve--presently estimated at less than $200 million--of liquidating these drawings.

"The purpose of the swap transactions carried out in 1971, as in earlier years, was to defer or reduce declines in reserve assets that might otherwise have occurred. The losses to be taken when the swaps are settled will reduce the earnings of the Federal Reserve System that are turned over to the Treasury. But against this loss the Treasury may have a roughly offsetting profit on the gold and other reserve assets which it still holds because of the willingness of foreign central banks to accept Federal Reserve swap drawings instead of demanding reserve assets from the Treasury."

By unanimous vote, the System open market transactions in foreign currencies during the period February 15 through March 20, 1972, were approved, ratified, and confirmed.

Mr. Coombs said that he had recommendations on swap-drawing renewals which related to the Committee's discussion today. As had been noted earlier, the swap line with the National Bank of Belgium had been in continuous use since June 30, 1970. Four drawings on that Bank, totaling $130 million, would mature in the period from April 4 through April 28. He did not know whether it would be possible to work out some arrangement with the

Belgian authorities for paying off the drawings, through the market or through other means. Accordingly, he would recommend that the Committee authorize their renewals for further periods of three months should it not prove feasible to liquidate the drawings at maturity.

In response to a question by Mr. Coldwell, Mr. Coombs indicated that the Belgians thus far had not suggested that they would resist renewal of maturing drawings.

Mr. Mitchell said it was not clear to him how the drawings might eventually be liquidated and in particular what position the Treasury would adopt with regard to backstopping the Federal Reserve.

Mr. Coombs observed that one possible avenue of repayment would be the provision of reserve assets by the Treasury as contemplated in a letter dated July 23, 1968, from then Secretary of the Treasury Fowler to Chairman Martin. A second and preferable avenue would involve a reversal of speculative flows that would enable the System to buy the required Belgian francs in the market. A third avenue would be to reach an agreement with the Belgian authorities on an amortization schedule. That approach presumably would involve the purchase of Belgian francs at the ceiling from the National Bank of Belgium. Such a possibility had been raised with the Belgian authorities at the Treasury's suggestion but thus far no response had been received.

Mr. Coombs added that paragraph 4 of the Committee's foreign currency authorization provided that foreign currency transactions should be coordinated with foreign central banks. The Belgians had been opposed to System market purchases of francs that would drive up the exchange rate and intensify speculative pressures. What was at stake, of course, was the viability of the parities established in the Smithsonian Agreement.

By unanimous vote, renewal for further periods of three months of the four System drawings on the National Bank of Belgium maturing in the period April 4-28, 1972, was authorized.

Mr. Coombs then noted that a memorandum from Mr. Bodner, entitled "Activation of revaluation clause in Belgian swap arrangement," had been distributed to the Committee yesterday.[1/] The memorandum described a Belgian proposal regarding the manner of effectuating the revaluation clause protection given the System under the swap arrangement. The question had been complicated, however, by the fact that the Treasury had made a counter-proposal yesterday afternoon. In view of the complexity of the issue and the fact that negotiations involving the Treasury and the Belgians would be required, he would recommend that the Committee delegate authority to act on its behalf in the matter to the subcommittee designated in paragraph 6 of the foreign currency authorization--

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

namely, Chairman Burns, Vice Chairman Hayes, and Mr. Robertson, or their alternates.

> It was agreed that a subcommittee, consisting of the Chairman and Vice Chairman of the Committee and the Vice Chairman of the Board of Governors, or designated alternates, should be authorized to act on behalf of the Committee with respect to the manner of effectuating the revaluation clause in the System's swap contract with the National Bank of Belgium.

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:

> The economic information that has become available since the last meeting of the Committee shows a notable strengthening in tone. This improvement is reflected in the red book,[1/] with virtually every District reporting at least some further increase in business activity or optimism or both. It is also evident in most of the incoming national business statistics. Thus, industrial production is now shown to have risen substantially in both February and--after upward revision--January; for the two months combined, the increase was at an 8 per cent annual rate and appears to have been unusually broadly based. After surging upward in January, manufacturers' new orders for durable goods in February fell back somewhat, mainly in defense. For the two months, however, total new order volume was 8-1/2 per cent above the fourth-quarter average. And nonfarm employment was

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

revised markedly upward in January; only a moderate further increase was reported for February, but the gain over the past six months has been at a very respectable 2.3 million annual rate.

The one important statistic that has failed thus far to join in the upward parade is retail sales. Total trade failed to show any net recovery in January and February, following the rather disappointing pre-Christmas performance. As a result, sales volume this year has been slightly below the fourth-quarter average. In part, the shortfall from normal growth expectations is accounted for by automobile dealers, whose dollar volume has remained somewhat below the exceptional fourth-quarter performance. In addition, however, sales have shown little or no growth from the fourth quarter in a variety of categories, including food stores, apparel stores, drug stores, and gasoline stations. The major exceptions to this sluggish sales pattern have been furniture and appliance stores, where volume is booming, and general merchandise, where moderate over-all sales gains may also be reflecting strength in the home furnishings departments.

There are a number of factors that could account for the recent lag in consumer spending. First, it now appears that the new Treasury withholding schedules resulted in a very substantial boost in tax payments when they initially took effect in mid-January. Thus, Board staff estimates are that withheld taxes in the six weeks after mid-January were at an annual rate about $14 billion larger than could be accounted for by growth in incomes and other changes in tax law, although the excess of withholdings appears to have declined sharply in March. Second, the unusually warm winter experienced over most of the country this year may have adversely affected sales in some lines, such as apparel and drugs. Finally, it does not seem unreasonable that the surge in new car sales last fall, financed as it was by extensive use of credit, would be followed by a period of somewhat more conservative spending behavior.

Personal incomes have risen sharply in the first two months of 1972, and continuing substantial gains are in prospect as employment recovers and wage rates advance. Therefore, we still anticipate a good growth in consumption this year, along with the rise in incomes. I would not be surprised also to see some decline in the unusually high personal saving rate, though the staff projection does not allow for this until late in the

year. The strength in home furnishing sales, which should continue, is a good omen in this regard, as is the fact that total new car sales in terms of units have held above a 10 million annual rate in the winter months of the year. A gradual strengthening in the labor market should also add to consumer confidence, thus tending to encourage larger outlays in relation to more certain income flows.

The weakness in retail sales has led us, once again, to reduce our estimates of consumption for the first quarter. Also, it appears that the improvement in net exports will be a good deal less than we had been projecting. Nevertheless, the increase in nominal GNP may still be in the $30 billion range, because of offsetting strength in housing and in business capital expenditures. The initial, and highly confidential, Commerce Department estimate for the quarter indicates a rise of $28-1/2 billion in nominal GNP, and a gain of 5-1/2 per cent, annual rate, in real terms. But we think that some upward revision is fairly likely before the first published estimates are made available a month from now.

All of the components of investment are showing considerable present or prospective strength. Housing starts, as you know, were extraordinarily high in February. Even if starts now begin to drop off, which seems likely, residential construction outlays will be higher than we have projected through at least the first half of the year. Business capital expenditures, judging both by the successive surveys of anticipations and new orders for capital equipment, seem clearly to be in a strengthening trend. Here too, the surveys, if taken literally, indicate a stronger expansion in the first half than in the second half of the year. And it seems increasingly likely that business inventory accumulation will be a positive force in the economic recovery this year. The over-all stock/sales ratio has declined further in recent months, to the lowest point in over five years, and durable goods manufacturers appear now to be accumulating inventories for the first time since the runup in steel stocks prior to the threatened strike last July.

In short, although our projection of GNP growth during 1972 has not changed appreciably, I feel considerably more confident that the increase projected will be realized than I did a month or two ago. Qualitatively, if not quantitatively, the economic situation appears to

have strengthened appreciably over this period. True, consumer spending has continued to lag, but I feel reasonably confident that such spending will pick up as output, employment and incomes expand. And the prospects for investment, including housing, seem materially stronger than was the case even a few months ago.

If economic recovery is indeed beginning to develop real strength, then the choices for monetary policy are likely to grow more difficult in the months ahead. It is still clearly vitally important that funds remain readily available during this period to support housing, investment, and other financing needs that are serving to bolster the economy. It is also desirable, in my view, that long-term interest rates remain attractive enough to induce borrowers to carry through on their spending and financing plans. But it is also becoming more important that monetary policy avoid a defense of any particular structure of interest rates at the expense of too swift an expansion in the monetary aggregates. If the economy should begin to develop a real head of steam--exceeding our present projections--rapid monetary expansion now could lead to difficulty later on in 1972 or early 1973.

To be sure, the growth in nominal GNP that we have projected will require a substantial monetary expansion if marked increases in interest rates this year are to be avoided. We have felt that an expansion rate of around 7 to 8 per cent in M_1 would be consistent with these objectives. But I would not be comfortable with monetary growth substantially higher than that, for fear of its longer-term implications. Therefore, I would recommend that the Committee hold to a course that provides only enough reserves to support such an expansion in M_1, and associated growth rates in M_2 and bank credit, even if this should require that money market conditions be tightened further in the weeks and months to come.

Mr. MacLaury asked whether the 7 to 8 per cent rate of monetary expansion that Mr. Partee had said was consistent with the staff's projection of nominal GNP was a rate projected for just the first half of 1972 or throughout the year.

Mr. Partee replied that, as he had reported at the Committee's meeting on February 15, the staff's judgmental model was based on an assumption that long-term interest rates would not rise appreciably before mid-year, and that this seemed consistent with the assumption of expansion in the narrowly defined money stock at a rate of around 7 per cent throughout the year. As part of the staff's rethinking of the judgmental projection for the previous meeting, the quarterly econometric model was rerun using rates of expansion in M_1 of 8 per cent, which was not far from what had been developing, and 6 per cent. Monetary expansion at a rate of 8 rather than 7 per cent produced a little faster rate of increase in GNP as the year progressed and a smaller increase in short-term interest rates. With the 6 per cent rate of expansion in M_1, the rise in interest rates was larger. Mr. Partee noted that in his presentation today, he had avoided being very specific and had cited a rate of expansion of 7 to 8 per cent in M_1, as consistent with a rate of growth of 10 per cent in nominal GNP.

Mr. Francis remarked that he was in agreement with Mr. Partee's assessment of the economic situation. However, he was concerned about an additional element in the situation--namely, the rapid rate of increase in the wholesale price index since last November. The rate of increase in the industrial price level was reminiscent of developments in late 1970 and early 1971.

In response to a question from Chairman Burns, Mr. Wernick reported that wholesale prices of industrial commodities rose at an annual rate of 4.7 per cent in February, 4.8 per cent in January, and 4.2 per cent over the three months from November to February.

Mr. Partee said that he was somewhat perplexed by recent price developments. Such large increases in food prices as occurred in recent months were associated with supply developments and were not determined by advances in wage rates. However, the rate of increase in industrial commodities was relatively high and contrasted with the reported rate of advance in wages. In January and February wage rates rose at an annual rate of only 3 per cent, which was below the trend rate of increase in productivity, and labor costs per unit of output did not rise. It was possible that the Price Commission's program of term-limit pricing arrangements for individual large companies, announced in December, caused some bunching of price increases. He would expect that if wage rates continued to behave as they had recently, the rise in prices would subside.

Chairman Burns commented that profit margins had fallen to abnormally low levels. The stepped-up rate of increase in industrial prices in recent months might reflect an effort on the part of business to restore profit margins.

Mr. Coldwell said that the latest data seemed to support two basic conclusions. First, as Mr. Partee had pointed out, the economic recovery was proceeding at a more rapid pace and it seemed to be more broadly based. Second, the rate of inflation was accounting for a larger part of the advance in nominal GNP. There was some evidence that business inventory demands had picked up. Consumer spending was not expanding, but he suspected that it would not remain static. Housing starts were strong, and business capital outlays were rising--not so much for new plant but for pollution control and new machinery. As yet he saw no evidence of any major new hiring of workers in industry, but efforts to hold and to hire workers with special skills suggested some improvement in the labor market.

Mr. Coldwell observed that there were still elements of uncertainty that the Committee needed to keep in mind. Specifically, the functioning of the Pay Board and Price Commission still tended to create some uneasiness. And the international financial situation was a continuing source of uncertainty, especially as daily comments in the press tended to suggest that settlement of those problems would be long delayed. There were growing fears of a further devaluation and of more exchange controls.

Mr. Kimbrel said he had understood Mr. Partee to say that the staff's judgmental model was based on an assumption that long-term interest rates would not rise before the middle of this year.

He inquired how much more of an increase in short-term interest rates might be possible without exerting upward pressure on long-term rates.

In reply Mr. Partee observed that the market for long-term securities behaved very well over the period since the Committee's last meeting, when short-term rates rose 80 to 90 basis points. Inflows of funds into savings institutions were very large, and mortgage rates were still tending downward. New corporate issues of bonds had moderated, and the volume of new municipal issues was not extremely high. In the long-term market, supply and demand appeared to be pretty well balanced and there was no reason for a rise in rates until later in the recovery. If the rise in short-term rates continued it might well bring some sympathetic increases in long-term rates, but he would not expect such increases to be sustained for long.

Mr. Heflin said he agreed with Mr. Partee that the pace of the recovery appeared to have quickened, and it seemed to him now that the Committee should be looking ahead for the possible roadblocks that might stall further progress. First, he was concerned about the possibility of a dock strike, and he wondered whether the staff had any views regarding the effects such a strike would have on the course of the economy. Second, he was concerned about the recent behavior of consumer spending. He noted that in the staff projection of GNP, consumption expenditures

were indicated to rise by only $11 billion in the first quarter of this year and then to accelerate over the rest of the year. He did not see the sort of consumer enthusiasm and optimism that would support that much of a gain, and he wondered what the projection was based on.

Mr. Partee replied that it was very difficult to appraise the potential effects of a dock strike. Now that the Pay Board had determined to cut the increase on straight wages that had been negotiated for the first year from 16 per cent down to 10 per cent, excluding fringe benefits, the West Coast longshoremen were considering what course to follow. A decision to strike would pose very important issues of Government policy and possibly of law. With respect to the economic impact, the flow of merchandise could be pretty well maintained without operation of the West Coast ports by diversion of goods through Canada, Mexico, and Gulf ports. Should the situation at East Coast ports also develop into such a confrontation, the outlook would be much more serious.

Mr. Wernick commented that labor leaders were scheduled to meet in Washington tomorrow. Decisions probably would be made then concerning both continued labor representation on the Pay Board and a West Coast port strike.

Mr. Sheehan observed that such a strike would be in violation of the Economic Stabilization Act.

Chairman Burns agreed, and commented that it would call into question the whole mechanism of the Pay Board and Price Commission.

Concerning Mr. Heflin's second question, Mr. Partee noted that in his statement he had explained his expectation of a strong rise in consumer spending after the current quarter largely in terms of special factors that had been holding down such spending in the current quarter. The most important factor was the over-withholding of income taxes resulting from the new withholding schedules introduced this year, which had had a substantial impact on middle-income taxpayers. The adverse effects of overwithholding would fade as more and more taxpayers filed the necessary W-4 forms to bring withholdings more in line with their tax liabilities, and there was evidence that the amount of overwithholding was already reduced in March.

Chairman Burns observed that the April filing of estimated tax liabilities for 1972 and simultaneous payment of the first quarterly instalments of taxes for 1972, which would presumably be smaller because of overwithholding from current incomes, would also provide some offset.

A second factor that had been holding down consumer spending, Mr. Partee continued, was the unusually warm weather over most of the country. Third, the surge in new car sales last autumn and the accompanying rise in outstanding instalment credit obligations might have contributed to a more conservative spending

behavior in the first quarter. Since all of these effects were rather temporary in nature, it seemed likely that continued expansion in incomes would soon be accompanied by a stronger expansion in consumer spending.

Chairman Burns observed that rising business investment and Government expenditures in the period ahead would have a multiplied effect on personal income.

Mr. Hayes commented that the analysis of the business situation by the staff at the New York Bank was very close to that presented by Mr. Partee. The prospects for continued improvement in the economy looked stronger now than they had a month or two ago. The recent weakness in consumer spending might prove to be largely temporary. He had been told by some of the directors at the New York Bank that they did not yet see a broad improvement in consumers' attitudes, but there were straws in the wind. For example, purchases of the more or less luxury goods sold by a manufacturer of photographic equipment had been improving.

Mr. Hayes observed that he was cautiously optimistic with respect to price prospects. The Pay Board, in his view, had shown courage in its decision on the West Coast longshoremen's contract and the Price Commission also had taken some very creditable actions. However, he shared Mr. Francis' uneasiness about the recent behavior of wholesale prices of industrial commodities. Finally, there had not yet been any fundamental improvement in

the balance of payments, and the Committee had to remain alert with respect to the international situation.

Mr. Winn said he would like to raise a flag of caution with respect to the stock market, where there was considerable evidence of potentially troublesome speculation. He was not sure what the effect of that was on confidence, but he did wish to call to the Board's attention the fact that since margin requirements had been reduced in early December, there had been one of the sharpest rises in margin credit ever recorded. Such credit at brokers and dealers had now risen almost to the 1968 peak.

Chairman Burns said he was glad that Mr. Winn had called attention to developments in the stock market. He was aware of those developments, and he thought that the Board should pay close attention to them. The situation would be put on the agenda for review at a meeting of the Board.

Mr. Mayo said he also agreed with the general tone of the staff presentation on economic prospects. However, he believed the projection of Federal spending was overstated for the second quarter, although it might not be for the calendar year as a whole. With respect to prices, he was concerned about the behavior of food prices and their psychological impact. The rise in food prices could have an important effect on the housewife's gauge of inflation and could have harmful consequences for the course of the economy.

Mr. Swan noted that Mr. Partee had pointed to the over-withholding of income taxes as an important factor in the recent weakness in consumer spending. He asked why that factor would not also have led to a reduction in the rate of personal saving. According to the green book,[1/] the saving rate was rising in the first quarter.

Mr. Partee replied that the first-quarter figures for disposable income and saving contained in the latest green book were too high. They reflected estimated overwithholding at a $4 billion annual rate, and there was evidence now that the rate might be as high as $8 billion. Therefore, the increase in saving rate indicated--from 7.8 per cent in the fourth quarter to 8.4 per cent in the first quarter--was overstated; on the basis of the higher estimate for overwithholding, the first-quarter saving rate was about 8 per cent. As to the high rate of inflows of funds into savings institutions, interest rate relationships were an important determinant. He expected that the inflows would fall off now that market rates of interest had increased.

Mr. Eastburn asked whether the surveys of consumer intentions supported the staff's expectation of stronger consumer spending over the balance of the year.

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

Mr. Partee replied that the Sindlinger survey had shown considerable improvement since last summer, based mainly on better employment prospects, but recent surveys by the University of Michigan Survey Research Center had not indicated much strength. A new Michigan survey was about due. In the past, the Michigan survey had not given much evidence of improvement in consumer attitudes until the rate of increase in employment and income had actually picked up.

Mr. Brimmer said he would like to know the staff's latest assessment of prospects for employment and for the rate of increase in output per manhour during this year. Earlier the staff had expected productivity growth to rise to a rate of 3-3/4 per cent in 1972, compared with 3 per cent over the preceding 18 months. A staff assessment of employment prospects by major industries, made in response to his request, suggested that growth of employment would be slow outside the service and trade sectors even with output growing rapidly. Mr. Partee had expressed concern about the possibility of a still stronger expansion, and he (Mr. Brimmer) wondered what the implications were for the employment situation.

Chairman Burns observed that employment had increased and unemployment had declined, but he was disturbed to find that the unemployment rate had risen for teenagers and had not improved for blacks.

In reply to Mr. Brimmer, Mr. Partee agreed that the rate of increase in productivity was likely to be appreciable--on the order of 3.7 per cent from the end of 1971 to the end of 1972. A high rate was desirable, of course, in that it would help to limit upward pressures on prices, but it would also hold down the gains in employment. Nevertheless, the staff's projections for real GNP and output per manhour implied considerable expansion in employment. A gain of 2.1 million in nonfarm employment was projected from the fourth quarter of 1971 to the fourth quarter of 1972. Most of the gain was expected to occur in trade, services, and State and local government. The prospective increase in manufacturing was small--only about 300,000 over the balance of this year--and that would leave sizable pockets of unemployment among workers ordinarily employed in factories. The over-all rate of unemployment at the end of the year still was expected to exceed 5 per cent.

With that prospect for unemployment, Mr. Partee continued, resources clearly were available to permit a faster rate of expansion in output and employment than that projected by the staff. The concern he had wished to convey in his statement related to the possibility that cumulative forces of recovery would develop to the point that economic expansion could substantially exceed the rate projected by the staff. He had in mind the possibility that consumer buying would rise sharply and that desired inventory

investment would increase markedly in response. Such a development might well signal the need, over the longer run, for a gradual movement in the direction of monetary restraint. He believed, therefore, that in the period immediately ahead expansion in the monetary aggregates at rates in excess of 8 per cent would be too rapid, even with the relatively high rate of unemployment that was in prospect for the end of this year.

Mr. MacLaury remarked that even if cumulative forces of expansion did not develop in the way Mr. Partee described, the staff projection indicated an acceleration of the rise in real GNP through the remainder of the year to an annual rate of 6.7 per cent in the fourth quarter. If that kind of momentum developed, the Committee would need to consider a shift in policy even if the rate of unemployment had not moved down into the desired range.

Mr. Partee responded that the rates of resource utilization projected for the fourth quarter of the year--5.4 per cent for unemployment and 77 per cent for manufacturing capacity--were well below optimal rates. Consequently, real GNP could expand at a rate of 6 or 6-1/2 per cent well into 1973. He would not think in terms of a need to slow down the expansion before the middle of 1973. However, he had wished to draw the Committee's attention to the possibility that economic expansion might proceed more rapidly than projected by the staff and the associated possibility of excessive rates of growth in the monetary aggregates this spring.

Mr. Brimmer observed that while the increase in real GNP was projected to accelerate through the year, so was the rise in the labor force. The projected increase in the labor force was about one-quarter of a million in excess of trend.

Chairman Burns remarked that if the economy developed in line with staff projections, the decline in the rate of unemployment would be abnormally slow by historical standards.

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 February 15 through March 15, 1972, and a supplemental report covering the period March 16 through 20, 1972. Copies of both reports have been placed in the files of the Committee.

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

> Open market operations over the interval since the Committee last met were designed to achieve the reserve targets specified by the Committee for February and March, combined. Attention was also paid to desired rates of growth of the monetary and credit aggregates over the first quarter and to the Federal funds constraint imposed by the Committee. As the period progressed, the System provided reserves more grudgingly as reserves available to support private nonbank deposits appeared to be coming out at or above the upper end of the 6 to 10 per cent range designated by the Committee and as first-quarter growth of the aggregates appeared to be exceeding the Committee's desires somewhat. As a result, the Federal funds rate moved up by 5/8 to 3/4 of a percentage point over the period, with the rate touching the upper end of the 2-3/4 to 4 per cent range specified by the Committee in the final statement week completed in the period.

Treasury bill rates, already under upward pressure from substantial sales of bills by the Treasury, came under further upward pressure as money market conditions firmed and as the market reacted to reports that Chairman Burns had indicated in Europe that the System was no longer fostering aggressive monetary ease. In yesterday's regular Treasury bill auction, average issuing rates of 3.92 and 4.32 per cent were established for three- and six-month bills, respectively, up 85 and 78 basis points from rates established just prior to the last Committee meeting. Other short-term rates also rose, but not as much as Treasury bill rates which had earlier been kept artificially low by a number of factors. Following the rise in short-term rates, two banks with floating rates raised the prime rate to 4-3/4 per cent.

In the long-term markets, upward pressure on rates was less marked, although yields on intermediate-term Treasury securities showed a substantial increase. After a noticeably improved atmosphere in the middle of the period, the corporate and municipal markets became quite cautious as the period came to a close.

Market expectations about the future of interest rates are currently being shaped by increased confidence in business recovery, by speculation over the course of monetary policy, by the anticipated large volume of Government financing, and by lingering uncertainties about the international situation and about prospects for inflation in the months ahead. Any further rise in short-term rates would very likely have some influence on long-term rates. The spread of pressure from short- to long-term securities markets should be moderated, however, by (1) the still relatively wide spread between short- and long-term interest rates, (2) by the slackened corporate demand in the capital market resulting from the better state of corporate liquidity and improved cash flows, (3) by the ample state of liquidity of financial institutions, and (4) by the relatively light inventory of coupon issues held by Government securities dealers--a marked contrast from the situation prevailing a year ago. Recent actions of the Price Commission and Pay Board have been moderately encouraging to the markets, although skepticism persists. There is general agreement that success--or lack of success--on the price and wage front will be a major determinant of inflationary psychology and of long-term interest rates.

As far as open market operations are concerned, the Desk was able to operate within the framework of the

Committee's new emphasis on reserves available to support private nonbank deposits without major operating or market problems. I suspect that the main reason for this was the relatively good staff forecasts of the linkages between reserves and the monetary aggregates on the one hand and between reserves and money market conditions on the other. One can only hope that the good performance of the past few months can be continued into the future. But I suspect that we have not yet had to face the tests that may be posed by a reserve-oriented approach when the linkages turn out to be different from those expected.

Throughout much of the period--as far as actual results were concerned--reserves against private deposits remained well within the 6 to 10 per cent annual growth rate specified by the Committee. But as a deposit expansion earlier in the period began to make its impact felt on reserves with the usual two-week lag, reserves moved up to the upper end of the range. As noted in the written reports, the latest estimates indicate that total reserves available to support private deposits are expected to rise at a rate of about 11 per cent in February and March combined. Several adjustments should probably be made to the figures. First of all, a downward revision of reserves in January means that the February-March growth is overstated by about 1 percentage point. On the other hand, excess reserves absorbed fewer reserves than allowed for in the target path, and a concentration of deposit growth in country banks also resulted in a need for fewer reserves than would have been the case if the ratio of deposits in country and reserve city banks had been unchanged, as the path assumed.

On balance, I would conclude that reserves are turning out in March somewhat above the specified range. This conclusion is supported by evidence that the monetary and credit aggregates rose a bit more rapidly than the Committee desired. Thus, M_1 in the first quarter appears to be growing about 1 to 1-1/2 percentage points above the upper end of the desired range, M_2 by 1 to 2 points, and the credit proxy by 1-1/2 to 2-1/2 points. (In each case the larger number refers to the stronger forecasts made at the Federal Reserve Bank of New York as compared with Board staff forecasts.) The Committee's constraint with respect to the aggregates was thus a factor contributing to the more grudging supply of reserves as the period progressed.

Other Committee constraints also played a role in Desk operations over the period. On March 14, the Federal funds rate pushed above the 4 per cent upper limit, and the Desk resisted the firming by supplying reserves even though the reserve target alone would not have called for such action. Even the reference to international conditions came into play in a minor way when, also on March 14, foreign central bank buying of Treasury bills was exceptionally large. Rather than deplete the market of the shorter-dated Treasury bills desired by foreign accounts, the Desk sold about $150 million Treasury bills from the System Account. This absorbed a corresponding amount of reserves from the banking system on a day when the System was supplying reserves on balance to combat the high Federal funds rate. In effect, this operation meant that we supplied more reserves through repurchase agreements than would otherwise have been necessary.

All of these operations are, of course, covered in the written reports to the Committee. I have commented on them here because we are just in the process of learning how to operate with major focus on reserves available to support private deposits, but with constraints involving the Federal funds rate, the growth rates of the aggregates, and international considerations. I would appreciate any comments the Committee may want to make on the Desk's performance under the new content of the directive.

Looking ahead, staff forecasts indicate that the movement of factors outside the System's control will require us to supply a large volume of reserves over the next few weeks, irrespective of which pattern of reserve growth--as set forth in the blue book[1/]--the Committee decides on. In supplying these reserves, I would expect to include purchases of Treasury coupon and agency issues, perhaps in some size, depending on availability and general market conditions. The reserve picture could change substantially, however, should the Treasury decide to monetize the free gold that will be made available by passage of the legislation to change the price of gold.

As far as the aggregates are concerned, the New York Bank estimates of growth in M_1 and M_2 for the

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

second quarter as a whole are almost identical to those set forth in the blue book, but our forecast of growth in the credit proxy is stronger.

For April, however, there are substantial divergences in expected rates for M_1 and the credit proxy. Assuming no change in money market conditions, the New York Bank staff forecasts an 11 per cent growth in M_1, compared to the Board staff forecast of 7.5 per cent, and a credit proxy growth of 18 per cent, compared to 8 per cent. The deposit growth forecast by the New York Bank would require substantially greater expansion in reserves than would the growth forecast by the Board staff.

The blue book analysis indicates that if the Committee wants to limit reserve supply so as to provide M_1 growth of around 7-1/2 per cent over the second quarter, the Federal funds rate is likely to move to the upper end of the 3-1/2 to 4-3/4 per cent range identified with pattern II. Such a movement in the funds rate would involve a further upward movement in other short rates, and some impact on longer-term rates, although there are forces tending to moderate the spread of upward movements of short rates to long rates, as noted earlier. Whether or not the staff forecast of the linkages between reserve supply, the aggregates, and interest rates will turn out to be right only time can tell. In deciding on a policy stance today, the Committee appears to be faced with the possibility of difficult trade-offs among the supply of reserves, growth in monetary and credit aggregates, and both short- and long-term interest rates. An indication of the weight to be attached to these diverse factors would be most helpful to the Desk in the conduct of operations in the period ahead.

As far as the Treasury is concerned, the cash outlook has improved considerably of late. An announcement is expected this afternoon that the Treasury will discontinue the offering of an additional $300 million of Treasury bills at the regular weekly auctions. At the same time it is possible--although a final decision has not yet been made--that the Treasury will announce the auction of a short- or intermediate-term note in an amount of $2 billion or less. This should provide sufficient cash to last until mid-May. The auction technique

> means that even keel considerations should be minimal, but it would appear appropriate to make some reference in the directive to a "possible Treasury financing."

Chairman Burns said he thought the Desk's performance during the past two months had been excellent.

Mr. Coldwell asked the Manager for his view of the benefits that had resulted from operations in coupon issues.

Mr. Holmes responded that at the beginning of the period since the last meeting of the Committee the Desk had needed to supply reserves, and it had done so by buying coupon issues. He did not think those purchases significantly affected long-term interest rates, but they had contributed to a reduction in dealer positions and thus were marginally helpful. Shortly thereafter, the Treasury balance at the Federal Reserve was reduced sharply and the whole reserve outlook changed considerably.

Mr. Mayo asked what had prompted the Treasury to reduce its balance so sharply and whether the existing ceiling on Government debt had been a factor.

Mr. Holmes replied that the balance had been unusually large and that the Treasury had intended to reduce it sooner or later. The debt ceiling was not a consideration.

Mr. Francis said he agreed with the Chairman's judgment that the performance of the Desk in following a reserve target over the past two months had been good.

Mr. Maisel observed that the Manager's recent annual report, covering open market operations during 1971,[1] contained one of the best discussions available of the System's operations.

Mr. Daane said that he too wished to commend the Manager for the performance of the Desk in the past two months, but he would also underscore the Manager's observation that there had not yet been a test of the reserve-oriented approach.

Chairman Burns observed that there had been a test but that it had not been a sufficient one. In any case, the Committee had not placed its faith in miracles but had established a mechanism to deal with conflicts in the event that the linkages between reserves, money market conditions, and the monetary aggregates differed from those expected. In that event, the Manager was promptly to notify the Chairman who promptly would consider whether the situation called for special Committee action to give supplementary instructions.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period February 15 through March 20, 1972, were approved, ratified, and confirmed.

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

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

The very rapid expansion in M_1 and M_2 of February appears to be slowing somewhat in March, although we have figures only for the first two weeks of the month. For the first quarter as a whole, M_1 growth is likely to be in a 9 to 10 per cent annual rate range, which would bring growth over the past six months to a 5 to 5-1/2 per cent rate; for M_2 the growth rate is expected to be about double that for M_1.

If recent money market conditions are maintained, the staff estimates that growth in M_1 over the second quarter would be very little smaller than in the first quarter, assuming the projected rapid expansion in nominal GNP for the period is realized. Expanding transactions needs for cash together with the lagged effects of earlier low short-term interest rates are the principal factors enhancing current money demands.

M_2 growth under prevailing money market conditions seems likely to be less rapid than the 13 per cent first-quarter pace, though still remaining around the high end of experience of the past several years. In February growth in time deposits other than large CD's slowed from the exceptionally high January pace. With short-term market rates continuing to rise, there appears to have been a further slowing in early March to a rather more usual pace, which might be sustained into the second quarter.

With increased short-term credit demands--particularly from the Treasury but also in the form of business loans at banks--short-term interest rates have risen sharply as the supply of reserves has been kept to the bounds set by the Committee. The 3-month Treasury bill rate and the Federal funds rate have risen about 70 to 80 basis points from their February lows, and other short rates have adjusted up in sympathy by varying magnitudes. Meanwhile, yields on new high-grade corporate bond offerings have remained about 15 basis points below their February highs. In the markets for State and local and Federal Government bonds, reaction to the recent rise in short-term rates has been a little more marked, though still very modest, and rates on these issues are back close to their February highs.

While one can thus conclude that the rise in short-term rates has had little impact on long-term rates, a look over a longer time period makes it clear that this occurred because the previous sharp decline in short rates--from the beginning of the year into February--had also been discounted by longer-term market participants. That earlier decline in short rates was thought to be temporary, and was not accompanied by a decline in long rates. In fact long rates rose somewhat in that earlier period, and bond yields are now 20 to 35 basis points above their early-January lows, apart from mortgage rates. Bill rates and the Federal funds rate, by way of comparison, are also above their early-January levels by that rough order of magnitude.

With that background, it would seem that the long-term market may indeed become sensitive to further significant rises in short-term interest rates, at least over the weeks immediately ahead. Higher dealer financing costs, expectations of a discount rate hike, and a more cautious approach to bond markets on the part of banks are likely to lead to an over-all reappraisal of bond yields by market participants generally. Strong cumulative upward pressures on bond rates are not likely to develop, however. The spread of long- over short-term rates is very wide, leaving room for short-term rates to rise. And at the moment the long-term market is in fairly good technical condition, with dealer positions much reduced from February levels. Finally, over the longer run, we expect some further abatement in corporate bond offerings to relieve demand pressures on the market. In the period immediately ahead, if the Treasury does reduce the amount of expected bill offerings and auctions a note, as was mentioned as a possibility by Mr. Holmes, this might distribute interest rate pressures marginally more away from short- to longer-term markets.

The near-term impact of short rate movements on the long market is of concern, of course, because of the likelihood that short rates will rise as efforts are made to keep expansion in monetary aggregates on a moderate course by holding growth in bank reserves to something like, say, the pattern II path shown in the blue book. This path indicates noticeable slowing from the first to

second quarters in the expansion of bank reserves--and, in particular, in reserves to support private deposits. Such a slowing in reserve provision at a time when demands for money and also for bank credit are likely to be sustained by considerable growth in economic activity is expected to lead to an increase in the Federal funds rate over the next few weeks to around 4-1/2 per cent and to upward adjustments in other short-term rates of 1/2 percentage point or more. As short-term market rates rise relative to the discount rate, we would expect member bank borrowings to rise to around $200 million, so that the increase in nonborrowed reserves would be even slower than the expansion in total reserves.

If the Committee were to adopt a course that entailed good odds that short-term rates would rise, it may wish to continue emphasizing use of coupon and Federal agency issues in reserve-supplying operations. This might mitigate short-run feedback effects on long markets, although I suspect the more fundamental longer-run effects on long markets would come from containment of inflationary pressures.

An instruction given to the Desk in terms of reserve aggregates still, of course, leaves the Committee with the option of limiting the degree of tightening that might emerge in the money market through a proviso clause instruction so long as it was willing to yield on its aggregate objectives. But if the Committee sets a reserve course to attain moderate monetary growth, it might be desirable not to place too low a ceiling on the extent of tightening in the money market. With an even-keel constraint in prospect by next meeting in view of the mid-May refunding, there is some risk that constraints now on money market conditions would encourage more rapid monetary aggregate expansion than desired, and would then perhaps require a sharp upward interest rate adjustment later in the summer.

Mr. MacLaury inquired how the concurrent constraints of reserve growth and the funds rate were to be interpreted. Specifically, he asked whether the Manager felt that there was no need to influence the funds rate--apart from moderating day-to-day fluctuations--so long

as reserve growth was within the prescribed range, or whether he felt that reserve growth in, say, the lower part of its range called for a lowering of the funds rate within its range.

Mr. Holmes replied that he would endeavor to maintain the funds rate at about its level at the time of the previous meeting so long as the rate of growth in reserves was near the mid-point of the specified range. However, if the rate of growth in reserves moved toward the upper end of the specified range, he would allow the funds rate to move up. Alternatively, if growth in reserves moved toward the lower end of the range, he would step up the growth rate and the funds rate probably would decline as a consequence.

Mr. Mitchell noted that the rate of growth in time deposits was projected to decline in the period ahead, and he asked about the implications for growth in required reserves. He also asked whether changes in Government and interbank deposits were expected to have much influence on required reserves.

Mr. Axilrod replied that the slower growth projected in time deposits accounted for part of the projected reduction in the rate of growth in reserves. With respect to Government and interbank deposits, he expected very little change in April and, therefore, very little effect on required reserves.

Mr. Mitchell then asked whether Mr. Axilrod thought the existing spread between short- and long-term interest rates was great enough to permit the Treasury bill rate to rise as much as, say, one-half of a percentage point without affecting long-term rates.

Mr. Axilrod replied that the long-term market might well become sensitive to further significant increases in short-term rates. However, any increases that occurred in long-term rates might not be permanent, owing to the wide spread between short- and long-term rates and to the favorable technical condition of the long-term market with the volume of new securities coming to market not expected to build up over the months ahead. If long-term rates did rise sympathetically, they could back down again when it became clear that monetary growth was being kept to moderate proportions--provided, of course, that the wage and price stabilization effort did not collapse.

Mr. MacLaury noted that in the blue book discussion of pattern II it was stated that "the staff would expect the Federal funds rate to rise to near the upper end of the 3-1/2 to 4-3/4 per cent range." He had thought it was the staff's usual practice to define such ranges so that the expected funds rate was about at the midpoint.

Mr. Axilrod replied that for both patterns II and III the lower limit of the range shown for the funds rate had been set low enough to encompass the prevailing level, on the assumption that if the Committee adopted either of those patterns it would not want to have an immediate sharp tightening of the money market. As indicated in the blue book, however, the staff believed that the funds rate would have to rise toward the upper end of the indicated ranges--

and that borrowings would increase gradually--if the associated rates of growth in reserves and the monetary aggregates were to be achieved.

Mr. Heflin asked what assumptions had been made with respect to business loans in working out the projections for the second quarter.

Mr. Axilrod replied that the staff thought business loans were likely to grow more rapidly through the second quarter than they had in late 1971. That expectation had influenced the projections in two ways. The stronger expansion in business loans would be a marginal factor exerting some additional upward pressure on short-term rates, assuming provision of reserves at a moderate pace. In addition, it was thought that banks would respond to a slowing in the inflows of demand deposits and consumer-type time deposits by increasing issues of large CD's in order to meet loan demand.

Mr. Brimmer remarked that when he had talked with bankers recently in the Board's offices and on visits to their offices he had followed the practice of asking about their earlier expectations for business loan growth in 1972 compared with 1971 and about the way in which actual developments this year had compared with those targets. Although there was considerable variation in the responses, on the average the bankers in question had expected a year-over-year increase in business loans of about 15 per cent but found that actual loans were falling considerably short of target. In some cases, business loans had declined after correction for seasonal

variation. Bankers were not expecting an upturn in the next three or four months and therefore were not bidding aggressively for CD funds.

Mr. Axilrod commented that he had referred to prospective changes from recent levels. Business loans had shown little net change, seasonally adjusted, in the fourth quarter of 1971. Such loans had grown at a rate of about 6 per cent through January and February, and the staff expected that they would continue to grow at something like that pace. Over all, that might be construed as a moderate rate of expansion, but it would be a significant pickup from earlier experience.

Mr. Hayes commented that while some of the larger banks in his District had observed a quickening in business loan demand, on the whole the pattern appeared mixed.

Chairman Burns then remarked that, before calling for the go-around on monetary policy, he would bring two items of factual information to the attention of the members, without comment or evaluation. First, the Committee had available to it two estimates of the annual rate of growth of real GNP in the first quarter: The Board staff's estimate of 5.9 per cent, and the Commerce Department estimate of 5.4 per cent. Both estimates were, of course, highly provisional at this stage. Secondly, the stock market had declined sharply this morning; at 11:30, the Dow Jones industrial average was down 11 points. As usual, a multiplicity of interpretations were being offered.

With respect to the go-around, the Chairman suggested that the members indicate the constraints they would favor with regard to both growth rates of reserves for private nonbank deposits and the Federal funds rate, and the targets they would prefer for rates of growth of the monetary aggregates. It would also be helpful if the members would express their views on operations in coupon issues and on the discount rate.

Mr. Hayes began the go-around with the following statement:

> The economy looks stronger than it did when we last met, and projections of further substantial recovery this year seem more soundly based than ever. Also, the sluggish growth of M_1 that concerned us for so many months has given way to very generous expansion, which may well continue in the next month or two at least. As we reflect on the current growth rates of the major aggregates taken together, some uneasiness is warranted over the possibility that we have overdone our stimulative policy, very much along the lines of our record a year ago.
>
> Thus, from a purely domestic point of view, I would favor seeking at this point to moderate the growth in money and credit aggregates. International considerations lend support to the same policy conclusion, given the decided lack of confidence in the dollar abroad and the ever-present risk of a new international crisis unless such confidence is restored.
>
> Short-term market rates have, of course, firmed considerably, but I believe they may have to move higher rather promptly if we are to succeed in reducing growth of the aggregates to a satisfactory pace--symbolized, perhaps, by an M_1 growth rate of 7 per cent in the second quarter. I would, therefore, advocate a policy of seeking firmer money market conditions by supplying reserves reluctantly in order to achieve more moderate money and credit expansion. I recognize that there must be a vast element of

> guesswork in any effort to quantify such a relationship, but I would think a Federal funds range of about 4 to 5 per cent might be appropriate for the next four weeks, and I would like to see the rate move toward the upper end of the range unless the data on the aggregates look consistently weaker than expected.
>
> The directive[1/] might well include a reference to international developments, as well as a clause with respect to Treasury financing. I would prefer to see a specific instruction to seek "some firming in money market conditions with a view to moderating the growth in monetary aggregates over the months ahead." But I would go along with the wording in the draft directive, using the words "more moderate", which seems consistent with the specifications of pattern II.
>
> As for coupon issues, I would favor discreet use of them by the Manager about the way he has used them in the last period, when such purchases have been marginally helpful.
>
> I think recent developments have fully vindicated the System's decision to leave the discount rate untouched in the last couple of months despite sizable disparities with market rates. Much of the gap has now been closed by rising market rates, and this movement seems likely to continue. An upward adjustment in the discount rate may become a real possibility later in the spring, but at present an unchanged rate seems appropriate.

Mr. Morris said the specifications shown under pattern II in the blue book seemed to him to be appropriate at this time. In his view, the Committee had to do what it could to maintain the momentum of the economy and at the same time guard against excessive rates of growth in the monetary aggregates. In the period since the last meeting the Desk had had to move the funds rate up to the upper limit specified by the Committee and it might find it necessary to do

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

so again in the next period. In that event, member banks might begin again to borrow from the System. With respect to the discount rate, it seemed clear that the time had passed for a reduction designed to eliminate the gap between that rate and short-term market rates. Finally, he would favor operations in coupon issues to the extent the Manager thought they could further the Committee's objectives without dominating the market.

Mr. Coldwell commented that there were several critical questions involved in the Committee's policy decision at this meeting. One issue concerned the pace at which short-term interest rates should be permitted to rise and what impact that rise would have on long-term rates. A second question related to the posture of policy for the longer run. What concerned him particularly was the possibility that continued efforts to foster growth in the monetary aggregates at this time might result in the need a few months from now to make a sharp adjustment in money market conditions. Another issue related to the relative emphasis that should be placed on reserves, monetary aggregates, and money market conditions. Finally, there were continuing questions of the effects on expectations of interest rate and price developments and of unsettlement in the international area.

With respect to today's decision, Mr. Coldwell said, he would like to see the increase in reserves shaded down from the recent rate. He would favor specifications in the general area of

those shown under patterns II and III. While he would not name any specific target for M_1, he thought the growth rate could be expected to slow as money market conditions firmed.

Concerning operations in coupon issues, Mr. Coldwell said he was perfectly willing to have the Desk supply reserves in that way but he hoped it would not concentrate its purchases in coupon and agency issues to the extent that it had in the past month. He also thought that the recent use of repurchase agreements had been excessive, and he hoped the Desk would make less use of them in the period ahead. He noted that two or three days after the Desk had last reduced the RP rate it had found it necessary to raise it again. That increase had led to market speculation that the Committee's policy had been changed, which to his mind was an unfortunate development. He would not favor a change in the discount rate now that market rates were coming back into line with the current discount rate.

Mr. Swan said he favored pattern II, which represented a continuation of the course for the monetary aggregates that the Committee had established at the last meeting. Although it appeared now that the actual growth rates in the first quarter would be a little above the desired rates, the pattern II growth rates for the second quarter seemed to him to be reasonable goals. He hoped that the pattern II rates would not be exceeded and, in that connection, he would be willing to extend the upper limit for the funds rate

from 4-3/4 to 5 per cent. In the directive he thought it would be better to describe the desired growth in the aggregates as "moderate" rather than "more moderate", even though the growth rates sought for the second quarter were slightly less than those likely to be recorded for the first quarter.

With respect to coupon issues, Mr. Swan agreed that purchases should be made when it appeared that they would be helpful and not unduly disturbing to the market. He also agreed that the time for a reduction in the discount rate had passed, and he saw no immediate prospect of a need to raise it.

Mr. MacLaury remarked that over the past three months the Committee had been led to focus on policy for the very short run by various circumstances--including concern about the slow pace of the economic recovery, concern about the lack of adequate growth in the monetary aggregates, and a seeming loss of confidence in projections of the relationships between money market conditions and the aggregates. In his view the Committee had been concentrating too closely on the objective of influencing the behavior of the aggregates on a current basis--an objective which he, at least, thought was unattainable in the present state of the art. He hoped the Committee would now begin again to formulate policy with a longer horizon. Given the uncertainties in the projected relationships between money market conditions and the aggregates, he thought the Committee should proceed more gradually than it had recently, whether it was moving

in the direction of easing or firming. Now that his own recent concern about the lack of growth in M_1 had been mitigated, he would favor aiming for the conditions specified under pattern II.

Mr. MacLaury said he did not have any strong views regarding operations in coupon issues. The policy response to any tendency for longer-term rates to move upward would have to be based on a judgment as to whether such a tendency might best be moderated by providing additional reserves, or by permitting short-term rates to rise somewhat as an indication to the market that the Committee was not going to allow a repetition of the rapid rates of growth in the aggregates that occurred in 1971. In his judgment, within the relevant time period the latter course was the more likely to be successful in keeping long-term rates from rising. As to the discount rate, he would be content to keep it unchanged at present.

In concluding, Mr. MacLaury observed that in earlier Committee discussions several members had commented on the need to educate the market about the increased emphasis on reserve targets. However, he was not aware of any public comment on that subject, and he wondered whether information about the shift had been conveyed to the market.

Chairman Burns remarked that in testifying before the Joint Economic Committee last month he had made a rather general reference to the shift.

Mr. Brimmer observed that in the normal course of events an explicit statement about such a policy action would not be made before publication of the policy record 90 days after the meeting.

Mr. Morris commented that the Committee might have to consider the need to inform the market earlier if it appeared likely that the Manager's efforts to achieve the Committee's reserve objectives would produce unusual movements in money market conditions. Such circumstances had not developed thus far under the new approach.

Chairman Burns said it would be important not to exaggerate the significance of the shift, which in fact had been a modest one. The Committee had decided to place greater emphasis on reserves as an operating target, but it was not abandoning constraints on changes in money market conditions and it was continuing to specify targets for the various monetary aggregates. In the future it might decide to move further along the road on which it had started, but it might also decide to move back.

Mr. Mayo said he considered pattern II to be a reasonable course. He would not want to push interest rates up unduly in the effort to follow the narrow line between avoiding inflation and stimulating economic activity. Like Mr. Swan, he would extend the upper limit of the range for the funds rate to 5 per cent, in the belief that the wider range of 3-1/2 to 5 per cent was consistent with the greater emphasis the Committee was placing on reserves as an operating target. An upper limit of 4-3/4 per cent, as specified

under pattern II in the blue book, was likely to provide an undue constraint. He would regard a second-quarter rate of expansion in M_1 within a range of 6-1/2 to 8 per cent as reasonable, although he believed that in that case also the range could be widened a little. In his view, the pattern II growth rates for the aggregates were "moderate," and he favored using that word in the directive.

Concerning operations in coupon issues, Mr. Mayo said he would like to see the Desk continue its purchases but he believed that they could have no more than a marginal influence on long-term rates over a period of time. With respect to the discount rate, he thought there was no immediate need for a change in either direction at present, although he suspected that the next change would be upward. He would urge that, if there were no adverse reactions to the announcement of the proposed changes in Regulations D and J, the Board give serious consideration to putting the redesigned discount window into operation in the near future. He thought that prevailing interest rate relationships and the general economic environment were suitable for that step.

Mr. Clay said he would summarize the statement he had prepared and submit the full text for inclusion in the record. He then summarized the following statement:

> Recent growth rates in the monetary aggregates are larger than it would be appropriate to continue in the interest of balanced economic growth. While there is considerable slack in the economy and substantial improvement is desired,

> the Federal Reserve System has already supplied a high degree of liquidity to the financial system. In weighing the proper growth rates in the aggregates, account needs to be taken not only of the immediate desire to stimulate economic growth and employment but also of the risk of excess liquidity becoming an inflationary force as the upswing advances.
>
> Reducing the rates of expansion in the monetary aggregates will tend to push money market rates higher. This development already has begun within the range of targets given the Manager at the last Committee meeting. This is a necessary accompaniment of the shift in policy. Within limits it should not interfere with domestic economic improvement, and it may prove helpful on the international side.
>
> It is hoped that these money market developments will not have a pronounced upward impact on long-term interest rates. At the same time it must be recognized that the problem of long-term interest rates would be intensified by evidence of an overly expansive monetary policy, arousing inflationary expectations, particularly in view of the current and prospective Government budget position.
>
> Pattern II seems to provide the proper target package, calling for a moderate growth in the monetary aggregates.

Mr. Clay added that he would favor operations in coupon issues of a probing nature. He agreed that the time for a reduction in the discount rate had passed, but he disagreed with the view expressed by Mr. Hayes that the decision not to lower the rate earlier had been vindicated by the recent rise in market interest rates. In his opinion it would have been better if the discount rate had been lowered earlier and then raised again now, thus keeping it reasonably in line with market rates. If the discount rate was held unchanged for a long enough period, the market would always eventually confirm its level.

Mr. Heflin said he was somewhat more concerned than others appeared to be today about the prospect for upward pressures on short-term interest rates. The pace of expansion in economic activity seemed to have picked up and business demands for short-term credit would be strong. If at the same time renewed confidence in the dollar should stimulate the return flow of funds from abroad and precipitate sizable sales of Treasury bills by foreign central banks, interest rates generally could rise. However, he believed that the Committee's emphasis at this point should be on controlling the rates of growth in the aggregates and not on trying to hold interest rates down.

Specifically, Mr. Heflin continued, he would aim for growth in reserves against private nonbank deposits in a range of 9 to 12 per cent for the March-April period. He would set the range for the funds rate at 3 to 4-1/2 per cent, preferring that the funds rate not rise above the discount rate in the period until the next meeting if it could be prevented from doing so. He would favor growth rates in the aggregates in the neighborhood of those shown under pattern II, perhaps shaded in the direction of pattern I; and he would use the word "moderate" in the directive to describe the desired growth rates.

Mr. Mitchell said he was agreeable to the pattern II specifications as recommended by the staff. Also, he would encourage the Manager to purchase coupon issues whenever such operations appeared to be consistent with the Committee's objectives.

Mr. Mitchell then said he thought there was merit in Mr. MacLaury's observations about the conflicting factors influencing the course of long-term interest rates. But he (Mr. Mitchell) would note that portfolio managers were likely to increase their takings of long-term securities if short-term rates remained low much longer. If short-term rates rose, however, they would be given additional incentives not to invest at long term.

Mr. Daane commented that he, like others, found pattern II to provide a reasonable framework for operations. He thought Mr. MacLaury had posed the issue concerning long-term interest rates very well. He was inclined to agree with Mr. MacLaury that the chances of limiting increases in long-term rates would be better if the Committee controlled the rate of expansion in the aggregates and allowed some increase in short-term rates. However, one could not be sure about such judgments. As to the directive, he would be agreeable to describing the desired growth in the aggregates either as "moderate" or as "more moderate". With regard to coupon issues, while he concurred in Mr. Mayo's observation that purchases of such issues would have only marginal effects, he thought they were useful nevertheless. In that connection, he would not want the Committee to appear to be guilty of "benign neglect" in the international financial area and would support both coupon purchases and the suggestion for including a reference to international developments in the directive.

Mr. Maisel noted that at recent meetings and again in his annual report the Manager had urged the Committee to indicate the relative amount of weight it wanted him to place on the various

monetary aggregates. He (Mr. Maisel) hoped the Committee would specify its objectives simply in terms of a growth rate of reserves. At present he would favor aiming at a rate of growth of 8 to 9 per cent in reserves against private nonbank deposits over the first half of 1972. That would be consistent with pattern II for the near term. As to operations in coupon issues, he thought decisions should be made by the Manager on the basis of his judgment as to their likely effects on market expectations and long-term interest rates.

Mr. Maisel then referred to Mr. MacLaury's comment on the subject of a possible public statement regarding the recent shift in the Committee's operating targets. He thought such a statement might be needed to avoid market misinterpretations of policy if the pursuit of pattern II specifications led to a substantial rise in the funds rate. The System should stand ready to issue such a statement on very short notice if necessary.

Mr. Brimmer said he also favored the specifications of pattern II. He considered the choice between the terms "moderate" and "more moderate" for describing the desired growth rates in the monetary aggregates to be substantive rather than semantic. Use of the latter term would imply a slight shading toward a less expansive policy--a step which in his judgment would be premature by at least a month. He thought the directive should include an instruction to take account of international developments and a possible Treasury financing.

Mr. Brimmer remarked that, like Mr. Mitchell, he would encourage the Manager to operate in coupon issues when feasible. Such operations could be particularly useful if upward pressures on long-term interest rates emerged under the pattern II policy course.

In his view, Mr. Brimmer continued, information on the Committee's shift toward greater emphasis on reserves should be made public in the usual manner, when the policy record was released 90 days after the meeting. He did not consider the change to be of such major character as to warrant a special public statement before that date.

Mr. Brimmer then observed that before this meeting the staff had distributed a sheet listing the five points for guidance to the Manager agreed upon at the February meeting and indicating the specifications under each point the Committee had approved then. He had been pleased to have that information provided in convenient form. However, the sheet would have been even more useful if it had been distributed shortly after the February meeting, since it would then have been of value in reviewing the course of operations during the ensuing period.

Mr. Sheehan noted that no one had commented on Mr. Coombs' observation about the possibility of a faster than expected improvement in the balance of payments, and he wondered what implications such a development might have for monetary policy. With respect to the immediate policy decision, he felt that business confidence

had improved in the period since he had joined the System and he was less concerned about the state of the economy than he had been two months ago. He was prepared to go along with the pattern II specifications, except that like Mr. Heflin he would prefer a 4-1/2 per cent upper limit for the Federal funds rate. He would favor operations in coupon issues insofar as they were likely to reduce upward pressures on long-term interest rates.

Mr. Winn said he questioned whether the Committee had quite as much flexibility with respect to policy as might appear at first glance. He suspected that the rise in food prices was likely to lead to a widespread public feeling that inflation was getting out of hand. Under such circumstances there probably would be a strong reaction to a rise in long-term market interest rates or an increase in the discount rate. However, he would not expect a similar reaction to advances in short-term rates. He favored giving the Manager more flexibility with respect to the funds rate than was called for under pattern II; specifically, he would set the upper limit for that rate at 5 rather than 4-3/4 per cent.

Mr. Eastburn remarked that the Committee had to decide how quickly it should try to slow the growth in the monetary aggregates and how much of an increase in long-term interest rates it was willing to countenance. Given the outlook for the economy, he thought that continued growth in M_1 at the 9-1/2 per cent rate now estimated for the first quarter would be clearly undesirable. He would favor aiming for a second-quarter growth rate of 6 to 8 per cent--preferably near the lower end of that range--while looking

forward to a further slowing, perhaps to 5 per cent, in the third and fourth quarters. For the coming period he would specify a 4 to 5 per cent range for the Federal funds rate. Thus, the specifications he preferred were between those of patterns II and III.

Although short-term interest rates probably would rise under such a policy course, Mr. Eastburn continued, he did not think an increase in the discount rate would be required in the near term. There was also a good chance that long-term rates would come under upward pressure. While he would hope that pressures on long-term rates could be moderated by System operations in coupon issues, he would be willing to accept increases in such rates as the necessary price of avoiding excessive growth in the monetary aggregates. Developments last year had demonstrated that the longer the Committee delayed in moving to limit growth in the aggregates the more difficult that task became, and he thought it would be desirable to face up to the problem now.

Mr. Kimbrel said he found himself close to Mr. Eastburn's position. It seemed inevitable that there would have to be some continued slight firming of short-term interest rates if excessive rates of expansion in the monetary aggregates were to be avoided. The current policy decision, as he saw it, required an answer to two questions: Should the rate of growth in the aggregates be moderated from that of the first quarter, especially that of March? If so, by how much and how soon? To his mind, the answer to the first question was "yes." A less exuberant rate of growth in the

aggregates seemed adequate for an orderly expansion in the economy; continuing growth in M_1 at or above the first-quarter rate would carry inflationary potentials which would ultimately require adoption of a restrictive policy that could seriously upset a pattern of sustained economic expansion.

Mr. Kimbrel commented that he would be a lot happier if during the latest three quarters the Committee had achieved a consistent growth rate in M_1 of 5 to 6 per cent. However, to attempt now to suddenly reduce growth to such a rate seemed clearly undesirable; it would constitute the kind of "off and on" policy the Committee was trying to avoid. He would prefer to move consistently but less aggressively toward moderation. Under present circumstances specifications somewhere between those of patterns II and III would best fit his views.

Concerning operations in coupon issues, Mr. Kimbrel thought the Committee would be well advised to continue granting a good deal of discretion to the Manager with the idea that purchases could be made when they might have a favorable influence on the market for long-term securities. He would not move now on the discount rate, but he thought the time was near at which the System would want to consider some adjustment.

Mr. Francis observed that since January monetary actions had produced average rates of growth in the aggregates generally within limits established by the Committee and without deviation from the ranges specified for the Federal funds rate. He thought

recent pressures against the upper limit for the Federal funds rate did necessitate a decision on whether those limits should be raised and widened or whether there should be an increase in the present path of monetary aggregates. In view of the performance of wholesale prices, he hoped the Committee would choose to widen and to shift upward the limits around the funds rate.

For the forthcoming period, Mr. Francis preferred alternative III which provided for continuation through the second quarter of the aggregate growth paths adopted at the last meeting. Alternatives I and II would represent a shift toward a more expansive policy. In view of the economic analysis presented in the green book, which indicated more total spending and more inflation than previously, he did not believe that additional stimulus was needed.

Mr. Francis noted that alternative III provided for an 8 per cent rate of growth in money for the first half of the year. He believed that before long the Committee would be considering a reduction in the long-run expansion paths of the aggregates in spite of the possible upward pressures on interest rates. In his judgment the recovery was no longer fragile and a slight increase in interest rates would have minimal detrimental effects domestically while it would contribute significantly to the solution of international problems.

Mr. Francis said he would leave decisions with respect to operations in coupon issues to the Manager's discretion. He saw no need for action on the discount rate at this time.

Mr. Robertson made the following statement:

> It seems to me there are more and more signs of strengthening in the business picture. That is all to the good, so long as the process is an orderly one.
>
> In this kind of situation, the Federal Reserve ought to be feeding enough monetary expansion into the system so as not to thwart the business recovery, but not so much as to rekindle inflationary expectations. To me, that means we ought to be moving toward rates of expansion somewhat less than those indicated for February and March.
>
> I regard the aggregate specifications associated with pattern II in the blue book as in accord with this objective, and I would support those, with appropriate ranges, as targets for the Manager to shoot for.
>
> I like the new structure of directions to the Manager which we have evolved, placing primary emphasis on supplying reserves to support private demand deposits, with secondary attention to money market constraints, and tertiary consideration given to deviations in the deposit aggregates. I would certainly continue that form of guidance to the Manager.
>
> Insofar as specific ranges and constraints are concerned, I will confine myself to saying that the Manager should not conduct his reserve operations so as to allow the funds rate to rise enough to call the current discount rate into question, except after prior consultation with the Committee. My own impression is that such a funds rate threshold is around 4-1/2 or 4-3/8 per cent.

Mr. Robertson added that his concern about the funds rate reflected his belief that a level above the discount rate would encourage market expectations of continued increases in interest rates--long- as well as short-term. He thought decisions regarding purchases of coupon issues should depend on judgments with respect

to their effect on expectations. He had no objections to such operations but he would not want them to be overdone; if carried out on too large a scale they could have undesirable effects.

Chairman Burns said it was clear that a preponderant majority of the members favored the targets and constraints set forth in connection with pattern II. Also, it appeared that the language of the draft directive for pattern II would be acceptable with the addition of a reference to Treasury financing. With that addition the second paragraph would read as follows: "To implement this policy, while taking account of international developments and possible Treasury financing, the Committee seeks to achieve bank reserve and money market conditions that will support moderate growth in monetary aggregates over the months ahead."

Mr. Robertson remarked that he was sympathetic with Mr. Hayes' suggestion to use the term "more moderate" to describe the desired growth in the monetary aggregates. While he did not consider the matter to be of major importance, he thought that term would help make clear to readers of the record that the Committee was aiming for growth rates in the aggregates somewhat slower than those of the first quarter.

Chairman Burns observed that he would prefer to retain the term "moderate" since the Committee had not changed its

targets for the aggregates. In his judgment it would be a mistake to suggest that the Committee had modified its policy at this point, when the economy was first beginning to show signs of vigorous recovery.

Mr. Hayes said he thought there was merit to the Chairman's observation. However, he still considered the term "more moderate" to be preferable because the second-quarter rates of growth for the monetary aggregates specified under pattern II were below the recent rates. He agreed with Mr. Robertson, however, that the matter was not of great importance.

After further discussion the Committee decided to retain the term "moderate."

The Chairman then observed that many members of the Committee had expressed concern about the behavior of long-term interest rates, and in varying degrees they favored continued operations in Treasury coupon and agency issues. As for the discount rate, there was no sentiment for a change at this time.

At this point, Chairman Burns continued, he wished to comment on an issue of particular concern to him. He thought the country was heading into a season in which there would be an increasing outcry not only about rising prices of foods but also about the sharp increases in rates for utilities and other services. It seemed inevitable that the prices of services--to which the public paid a great deal of attention--would be rising sharply.

Administration policies with respect to the Pay Board and the Price Commission were going to be tested. If there was an outcry about inflation, and if at the same time interest rates were rising sharply, many people would link the difficulties facing the country with the interest rate policies of the Federal Reserve as those policies would be described and interpreted in the press.

The Chairman noted that the three-month Treasury bill rate had increased from about 3.00 per cent a month ago to about 3.90 per cent now. According to the blue book specifications for pattern II, the bill rate could go as high as 5 per cent in the coming period and the Federal funds rate might reach 4-3/4 per cent. If the bill rate rose to the upper limit specified it would have increased by 2 percentage points in two months or less. No matter what happened to long-term rates, such a rise in bill rates was likely to be interpreted as reflecting a move by the Federal Reserve to raise interest rates. Moreover, the discount rate would be called into question. He had been surprised at the limited amount of attention paid in the go-around to the linkage between levels of money market rates and market speculation about possible Federal Reserve action on the discount rate. If such speculation was to develop it would in turn have implications for the behavior of short-term interest rates. He would be greatly disturbed by a possibility that the Federal Reserve might have to raise the discount rate at so early a stage of the

recovery. That subject required more attention than had so far been given to it.

With those thoughts in mind, Chairman Burns continued, he would suggest that the Committee adopt the specifications of pattern II, but that it also agree on what might be called a "resting point" for the Federal funds rate. Under the fifth point of the five-point procedure the Committee was now employing for guiding the Manager, the latter was instructed to notify the Chairman promptly if it appeared that the Committee's various objectives and constraints were not going to be met satisfactorily in the period between meetings. Within that framework, the Committee might instruct the Manager not to allow the Federal funds rate to go above 4-1/4 per cent without informing the Chairman that the Committee's objectives could not be attained in the absence of a higher funds rate. In that event, the Chairman would consult with the Committee. The implication was not that the funds rate would be prevented from going above 4-1/4 per cent, but that the Committee would have an opportunity to review all of the circumstances prevailing at the time before instructing the Manager to aim at a higher funds rate.

In response to a question by Mr. Brimmer, Mr. Holmes said the effective Federal funds rate had averaged 3-7/8 per cent last week and was 4 per cent this morning.

Mr. Brimmer then remarked that the proposed resting point of 4-1/4 per cent would permit very little upward movement in the

funds rate before Committee consultation was called for. He asked whether 4-1/2 per cent might not be a better choice.

Mr. Daane expressed a similar view.

Chairman Burns said he had suggested 4-1/4 per cent because any further increase would bring the funds rate into the neighborhood of the 4-1/2 per cent discount rate and was likely to generate speculation about a possible increase in the latter.

Mr. Mitchell remarked that while he was inclined to agree with Messrs. Brimmer and Daane he would like to hear the Manager's views.

Mr. Holmes observed that it was very hard to predict the effects on expectations of rate changes. While the funds rate had moved up substantially, a 4 per cent level had not yet been fully established. He suspected that a further step-up to a 4-1/4 per cent level would have some impact on expectations.

Mr. Daane remarked that maintenance of the 4-1/2 per cent discount rate as the funds rate rose to, say, 4-1/4 per cent might in itself dampen expectations, with constructive effects on intermediate- and long-term interest rates.

In reply to a question by Mr. Eastburn, Mr. Holmes noted that the Board staff's estimates indicated that the pattern II growth rates for M_1--6-1/2 per cent in April and 7-1/2 per cent in the second quarter--would be associated with a rise in the funds

rate to near the upper end of the 3-1/2 to 4-3/4 per cent range specified under that pattern. According to the New York Bank's estimates attainment of the pattern II growth rate for April would involve even more upward pressure on the funds rate.

Chairman Burns noted that the Desk would not be taking steps to raise the funds rate unless the need for such action was indicated by new information on the aggregates.

In response to a question by Mr. Coldwell, the Chairman observed that the 4-1/4 per cent resting point he had suggested might be interpreted in terms of a weekly average.

Mr. Mitchell remarked that on that basis he would have no objection to 4-1/4 per cent as a resting point.

Mr. Daane said he would prefer to leave the question to the judgment of the Manager and the Chairman. If it appeared that the Committee's objectives were not going to be met, the Chairman had the right and the obligation to consult with the Committee under point five of the procedure being employed. He would not want the decision to be tied closely to some specific figure for the funds rate.

Mr. MacLaury said he was in full agreement with the Chairman's concern about the discount rate. Under present circumstances, with price and wage controls in effect, he would be prepared to let short-term interest rates rise more with no change in the discount rate than he would ordinarily consider desirable.

What concerned him was the apparent reluctance to let market interest rates rise. In his view, the Committee was in danger of once more permitting short-run considerations to take precedence over its longer-term objectives, thereby storing up problems for the future. The fact that the Committee would be faced with even-keel considerations at the time of its next meeting sharpened the question of how far it was prepared to let short-term interest rates rise in the interim.

In his view, Mr. MacLaury continued, the Committee probably would have to face the prospect of permitting short-term interest rates to rise some time this year. He agreed with the Chairman that the Federal Reserve would be subject to criticism from many quarters when the rate advances occurred, but he thought it would be easier to cope with that criticism if it came in the near term rather than later. As to the recent advance in the Treasury bill rate, the rise was as large as it was because the rate had been driven so low earlier, partly by events outside the Committee's control. On the whole, he would prefer to set the resting point for the funds rate at 4-1/2 rather than 4-1/4 per cent.

Mr. Hayes said it was his impression from the go-around that almost all of the members were willing to see the funds rate rise to 4-1/2 per cent if necessary to achieve the Committee's objectives for the aggregates. A majority considered acceptable the 4-3/4 per cent upper limit shown in the blue book under pattern II,

and some had expressed a preference for a 5 per cent upper limit. Against that background, he would consider 4-1/2 per cent conservative as a stopping point for the funds rate and 4-1/4 per cent extremely conservative. In his judgment the Committee could not afford to let the aggregates get out of hand for the sake of keeping the funds rate from exceeding 4-1/4 per cent.

Chairman Burns observed that he had proposed a 4-1/4 per cent funds rate not as a "stopping point" but as a "resting point." In effect, he was advising the members that he would be following interest rate developments closely during the coming period and would plan on consulting with the Committee about the possible need for further instructions if at any point he thought that rates were rising faster than was consistent with the Committee's basic objectives. It was his present thinking that consultation was likely to be desirable before the weekly average funds rate was permitted to exceed 4-1/4 per cent.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's draft for the first paragraph and the modified version of the second paragraph as he had read it earlier. It would be understood that in implementing that directive the Manager would be guided by the specifications of pattern II in the blue book, within the framework of the five-point procedure agreed upon at the meeting of February 15, 1972.

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

The information reviewed at this meeting suggests that real output of goods and services is increasing in the current quarter at about the stepped-up rate attained in the fourth quarter of 1971. Several measures of business activity have strengthened recently and demands for labor have improved somewhat, but the unemployment rate remains high. Wholesale prices continued to rise rapidly in January and February, in part because of large increases in prices of foods. However, the advance in wage rates slowed markedly after the post-freeze surge in December. Following a period of sluggish growth, the narrowly defined money stock increased sharply in February, partly reflecting a substantial reduction in U.S. Government deposits. Inflows of time and savings funds at bank and nonbank thrift institutions continued rapid in February, although below January's extraordinary pace. Short-term interest rates have risen considerably in recent weeks while yields on long-term securities have changed little on balance. Exchange rates for most major foreign currencies against the dollar appreciated further in February and early March, as recurrent speculative outflows of capital added to the U.S. balance of payments deficit. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

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

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

Chairman Burns noted that a memorandum from the System Account Manager, entitled "Six-month Review of System Lending of Securities," had been distributed on March 8, 1972, along with a related memorandum from the Committee's General Counsel.[1/] He asked Mr. Holmes to comment.

Mr. Holmes observed that in his memorandum he had summarized System lending operations since the last semi-annual review and had expressed the judgment that such operations continued to be necessary for the effective functioning of the Government securities market in light of the continuing problem of securities delivery failures. Accordingly, he recommended that the underlying authority, contained in paragraph 3 of the continuing authority directive, be continued at this time.

Also, Mr. Holmes continued, he suggested that the Committee's periodic review of lending operations be shifted from a semi-annual to an annual basis in view of the long-term nature of the underlying problem and the consequent likelihood that lending operations would remain necessary for the most effective functioning of the market. If the situation should change significantly

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

between annual reviews he would, of course, report the facts promptly to the Committee.

Mr. Daane said he concurred in the Manager's recommendations.

Mr. Robertson commented that continuing reliance by the market on System lending operations might in itself make such operations necessary for an indefinite period. He thought the authority to lend securities should be used cautiously. He noted that according to the Manager's memorandum some $2.4 billion of securities had been lent during the past six months. That was a considerably larger volume than he had expected.

In response to questions, Mr. Holmes reported that the average amount of security loans outstanding at any one time was in the neighborhood of $40 or $50 million. The loans tended to be repaid quickly, and since they were covered by good collateral they involved no risks to the System.

Chairman Burns asked when the question of the need for the lending authority had last been studied by the staff.

Mr. Holland replied that the matter had been considered closely before the original authorization was agreed upon in October 1969. Since then it had been reviewed semi-annually by the Committee on the basis of memoranda from the Manager.

The Chairman then remarked that the Manager's advice regarding the need for the authority was, of course, fundamental to the Committee's judgment. However, he thought a useful purpose

would be served by having the question examined from another point of view also. He suggested that the Committee agree to retain the authority to lend securities at this time, on the understanding that the staff would make an independent study and submit recommendations when the question was next considered.

Mr. Brimmer remarked that whatever the findings of the staff he would favor continuing the present practice of making semi-annual reviews rather than shifting to an annual basis.

Mr. Heflin noted that in the opinion of the Committee's Counsel lending operations were legally authorized only if the Committee determined that they were reasonably necessary to the effective conduct of open market operations. In his (Mr. Heflin's) judgment it would be desirable to have something more than an expression of the Manager's view on that question; such views should be documented.

Mr. Holmes remarked that there had been very little change in the factual situation since the Committee had first authorized lending operations.

After further discussion, Chairman Burns suggested that the Committee plan on next reviewing the need for lending operations in six months. Both the Manager and a senior member of the Board's staff might be asked to present carefully considered oral statements to the Committee at that time, to provide the basis for the review.

There was general agreement with the Chairman's suggestion.

It was agreed that the authorization for the lending of Government securities from the System Open Market Account should be retained at this time.

Consideration was then given to the continuing authorizations of the Committee, according to the customary practice of reviewing such matters at the first meeting in March of every year.

Secretary's Note: It had been agreed at the meeting on March 10, 1970, that certain authorizations among those that the Committee had reviewed annually in the past would remain effective until otherwise directed by the Committee, and would no longer be submitted routinely for review each year. Instead, it was understood that these authorizations would be called to the Committee's attention before the first meeting in March of each year and that members would be given an opportunity to raise any questions they had concerning them. Accordingly, copies of the authorizations in question (listed below) had been distributed to the Committee on February 28, 1972, with a request that members advise the Secretariat if they wished to have any placed on the agenda for consideration at today's meeting. No such requests were received.

The authorizations in question were as follows:

1. Procedure for allocations of securities in the System Open Market Account.
2. Distribution list for periodic reports prepared by the Federal Reserve Bank of New York.
3. Authority for the Chairman to appoint a Federal Reserve Bank as agent to operate the System Account in case the New York Bank was unable to function.
4. Resolutions providing for continued operation of the Committee, and for certain actions by the Reserve Banks, during an emergency.
5. Resolution relating to examinations of the System Open Market Account.

Reference was made to the procedure authorized at the meeting of the Committee on March 4, 1955 (and most recently amended on March 9, 1971, to authorize the Secretary to act on the Chairman's behalf in considering proposals for the addition of members of the Board's staff) whereby, in addition to members and officers of the Committee and Reserve Bank Presidents not currently members of the Committee, minutes and other records could be made available to any other employee of the Board of Governors or of a Federal Reserve Bank with the approval of a member of the Committee or another Reserve Bank President, with notice to the Secretary.

It was stated that lists of currently authorized persons at the Board and at each Federal Reserve Bank (excluding secretaries and records and duplicating personnel) had recently been confirmed by the Secretary of the Committee. The current lists were reported to be in the custody of the Secretary, and it was noted that revisions could be sent to the Secretary at any time.

> It was agreed to retain the existing procedure for making minutes and other records of the Committee available to employees of the Board of Governors and the Federal Reserve Banks, including authorization to the Secretary to act on the Chairman's behalf in considering proposals for the addition of members of the Board's staff to the list of those having access to Committee minutes and other records.

By unanimous vote, the continuing authority directive to the Federal Reserve Bank of New York with respect to domestic open market operations, as shown below, was reaffirmed:

CONTINUING AUTHORITY DIRECTIVE WITH RESPECT TO DOMESTIC OPEN MARKET OPERATIONS

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall

not exceed (1) $125 million or (2) 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York, whichever is the lower;

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

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

3. In order to insure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

By unanimous vote, the authorization for System foreign currency operations, as shown below, was reaffirmed:

AUTHORIZATION FOR SYSTEM FOREIGN CURRENCY OPERATIONS

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, and with the Bank for International Settlements:

Austrian schillings
Belgian francs
Canadian dollars
Danish kroner
Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Mexican pesos
Netherlands guilders
Norwegian kroner
Swedish kronor
Swiss francs

B. To hold foreign currencies listed in paragraph A above, up to the following limits:

(1) Currencies purchased spot, including currencies purchased from the Stabilization Fund, and sold forward to the Stabilization Fund, up to $1 billion equivalent;

(2) Currencies purchased spot or forward, up to the amounts necessary to fulfill other forward commitments;

(3) Additional currencies purchased spot or forward, up to the amount necessary for System operations to exert a market influence but not exceeding $250 million equivalent; and

(4) Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $200 million equivalent.

C. To have outstanding forward commitments undertaken under paragraph A above to deliver foreign currencies, up to the following limits:

(1) Commitments to deliver foreign currencies to the Stabilization Fund, up to the limit specified in paragraph 1B(1) above; and

(2) Other forward commitments to deliver foreign currencies, up to $550 million equivalent.

D. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	200
National Bank of Belgium	600
Bank of Canada	1,000
National Bank of Denmark	200
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000
Bank of Italy	1,250
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	300
Bank of Norway	200
Bank of Sweden	250
Swiss National Bank	1,000
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,000

3. Currencies to be used for liquidation of System swap commitments may be purchased from the foreign central bank drawn on, at the same exchange rate as that employed in the drawing to be liquidated. Apart from any such purchases at the rate of the drawing, all transactions in foreign currencies undertaken under paragraph 1(A) above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces.

4. It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested insofar as practicable, considering needs for minimum working balances. Such investments shall be in accordance with Section 14(e) of the Federal Reserve Act.

6. A Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) is authorized to act on behalf of the Committee when it is necessary to enable the Federal Reserve Bank of New York to engage in foreign currency operations before the Committee can be consulted. All actions taken by the Subcommittee under this paragraph shall be reported promptly to the Committee.

7. The Chairman (and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors) is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities; and

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

10. The Special Manager of the System Open Market Account for foreign currency operations shall keep the Committee informed on conditions in foreign exchange markets and on transactions he has made and shall render such reports as the Committee may specify.

By unanimous vote, the foreign currency directive, as shown below, was reaffirmed:

FOREIGN CURRENCY DIRECTIVE

1. The basic purposes of System operations in foreign currencies are:

A. To help safeguard the value of the dollar in international exchange markets;

B. To aid in making the system of international payments more efficient;

C. To further monetary cooperation with central banks of other countries having convertible currencies, with the International Monetary Fund, and with other international payments institutions;

D. To help insure that market movements in exchange rates, within the limits stated in the International Monetary Fund Agreement or established by central bank practices, reflect the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public; and

E. To facilitate growth in international liquidity in accordance with the needs of an expanding world economy.

2. Unless otherwise expressly authorized by the Federal Open Market Committee, System operations in foreign currencies shall be undertaken only when necessary:

A. To cushion or moderate fluctuations in the flows of international payments, if such fluctuations (1) are deemed to reflect transitional market unsettlement or other temporary forces and therefore are expected to be reversed in the foreseeable future; and (2) are deemed to be disequilibrating or otherwise to have potentially destabilizing effects on U.S. or foreign official reserves or on exchange markets, for example, by occasioning market anxieties, undesirable speculative activity, or excessive leads and lags in international payments;

B. To temper and smooth out abrupt changes in spot exchange rates, and to moderate forward premiums and discounts judged to be disequilibrating. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified or curtailed unless upon review and reassessment of the situation the Committee directs otherwise;

C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2) differences in phasing of international economic activity that give rise to unusually large interest rate

differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions. Whenever exchange market instability threatens to produce disorderly conditions, System transactions may be undertaken if the Special Manager reaches a judgment that they may help to reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. In such cases, the Special Manager shall consult as soon as practicable with the Committee or, in an emergency, with the members of the Subcommittee designated for that purpose in paragraph 6 of the Authorization for System foreign currency operations; and

D. To adjust System balances within the limits established in the Authorization for System foreign currency operations in light of probable future needs for currencies.

3. System drawings under the swap arrangements are appropriate when necessary to obtain foreign currencies for the purposes stated in paragraph 2 above.

4. Unless otherwise expressly authorized by the Committee, transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken only (i) to prevent forward premiums or discounts from giving rise to disequilibrating movements of short-term funds; (ii) to minimize speculative disturbances; (iii) to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders; (iv) to allow greater flexibility in covering System or Treasury commitments, including commitments under swap arrangements, and to facilitate operations of the Stabilization Fund; (v) to facilitate the use of one currency for the settlement of System or Treasury commitments denominated in other currencies; and (vi) to provide cover for System holdings of foreign currencies.

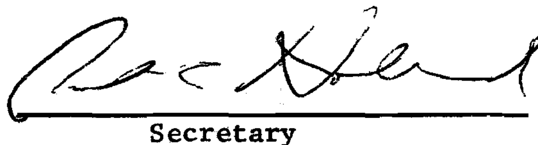
Chairman Burns then noted that the Committee had planned to discuss certain other matters today--namely, a proposed procedure for making historical Committee records available to the

public, the report of the staff committee on repurchase agreements, and a proposed revision of the guidelines for operations in agency issues. In view of the lateness of the hour, however, it might be desirable to defer consideration of those matters. He asked whether there would be any objections to such a course, and no objections were raised.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, April 18, 1972, at 9:30 a.m.

The Chairman remarked that he might decide later to call an additional meeting of the Committee for Monday, April 17, for the purpose of discussing the three matters being deferred today.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

CONFIDENTIAL (FR) March 20, 1972

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on March 21, 1972

The information reviewed at this meeting suggests that real output of goods and services is increasing in the current quarter, at about the stepped-up rate attained in the fourth quarter of 1971. Several measures of business activity have strengthened recently and demands for labor have improved somewhat, but the unemployment rate remains high. Wholesale prices continued to rise rapidly in January and February, in part because of large increases in prices of foods. However, the advance in wage rates slowed markedly after the post-freeze surge in December. Following a period of sluggish growth, the narrowly defined money stock increased sharply in February, partly reflecting a substantial reduction in U.S. Government deposits. Inflows of time and savings funds at bank and nonbank thrift institutions continued rapid in February, although below January's extraordinary pace. Short-term interest rates have risen considerably in recent weeks while yields on long-term securities have changed little on balance. Exchange rates for most major foreign currencies against the dollar have appreciated further in February and early March, as recurrent speculative outflows of capital added to the U.S. balance of payments deficit. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of international developments, the Committee seeks to achieve bank reserve and money market conditions that will support (I - ample, II - moderate, III - more moderate) growth in monetary aggregates over the months ahead.

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

March 24, 1972

Points for FOMC Guidance to Manager In Implementation of Directive (as agreed upon 2/15/72)	SPECIFICATIONS As agreed, 3/21/72 (Pattern II)
1. Desired rate of growth in aggregate reserves expressed as a range rather than a point target.	9-13% seas. adj. annual rate in R. for pvt. nonbank deposits in Mar.-April.
2. Range of toleration for fluctuations in Federal funds rate--enough to allow significant changes in reserve supply, but not so much as to disturb markets.	3-1/2 to 4-3/4%
3. Federal funds rate to be moved in an orderly way within the range of tolerance (rather than to be allowed to bounce around unchecked between the upper and lower limit of the range).	
4. Significant deviations from expectations for monetary aggregates (M_1, M_2, and bank credit) are to be given some allowance by the Manager as he supplies reserves between meetings.	(SAAR)
5. If it appears the Committee's various objectives and constraints are not going to be met satisfactorily in any period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.	(As indicated at the March 21 meeting, Chairman Burns may call for a Committee review of the need for supplementary instructions in the period before the next scheduled meeting under other circumstances also, depending on the course of interest rates and other relevant developments.)

(SAAR) specifications for point 4:

	Mar.	Apr.	2nd Q
M_1:	11	6.5	7.5
M_2:	10.5	8	8
Proxy:	15	7	6