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, April 18, 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 and Bernard, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Hexter, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Solomon, Economist (International Finance)
Messrs. Boehne, Bryant, Gramley, Green, Hersey, and Hocter, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. O'Connell, General Counsel, Board of Governors

Mr. Chase, Associate Director, Division of Research and Statistics, Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer, Associate Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Rehanek, Secretary, Office of the Secretary, Board of Governors

Messrs. Parthemos, Taylor, Scheld, Andersen, Tow, and Craven, Senior Vice Presidents, Federal Reserve Banks of Richmond, Atlanta, Chicago, St. Louis, Kansas City, and San Francisco, respectively
Messrs. Bodner and Nelson, Vice Presidents, Federal Reserve Banks of New York and Minneapolis, respectively
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York
Mr. Sandberg, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York
Mrs. Greenwald, Economist, Federal Reserve Bank of Boston

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on February 15, 1972, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on February 15, 1972, was accepted.

Chairman Burns invited Messrs. Daane and Hayes to report on the Basle meeting they had recently attended.

Mr. Daane said the Basle meeting, held on Sunday, April 10, was the quietest he had ever attended. President Zijlstra had

considered various possible topics for discussion at the governors' dinner on Sunday evening but had concluded in each instance that there were good reasons for not raising them. Accordingly, no substantive matters were discussed at the dinner.

Mr. Daane remarked that the Sunday afternoon session, which was devoted to a go-around of individual countries, also was rather quiet and uneventful. Perhaps the most interesting comments were those by Governor O'Brien of the Bank of England and Mr. Inoue of the Bank of Japan. Governor O'Brien was quite pessimistic about inflationary prospects in the United Kingdom in light of the highly expansionary British budget policy. He expected no slackening in the efforts to expand the economy and reduce unemployment even if, as he thought likely, the British balance of payments situation deteriorated. Furthermore, he anticipated a recurrence of inflation. Thus far, the expansionary policy had resulted in very little reduction in unemployment. Mr. Inoue reported that the Japanese expected a trade surplus of more than $8 billion in 1972. Speaking for the United States, he (Mr. Daane) had reaffirmed Chairman Burns' observations at the previous Basle meeting regarding the strengthening of the U.S. economy, and had reported that a further uptick in interest rates had occurred. Mr. Hayes had commented on U.S. price prospects.

On the Saturday before the governors' meeting, Mr. Daane continued, the Standing Committee on the Euro-Currency Market had

met to follow up on the governors' discussion at the March Basle meeting. While the session was rather inconclusive, a decision was reached to proceed with some individual country papers on specific aspects of the Euro-currency market for review at the July meeting of the Standing Committee.

Mr. Hayes said he might add a few comments regarding the reports at Basle on the economic picture in the various countries. The Germans were beginning to discern signs of revival in their economy, and the French remained fairly optimistic. Even the Italians expected a turn for the better in the autumn. However, regardless of the strength of their respective economies, almost all of the governors at Basle were deeply worried about the problem of inflation. Some had become completely defeatist on that score; for example, one governor said the only cure for inflation was recession.

Mr. Daane added that while none of the governors thought there was a good solution for the wage-price problem, there was general agreement that until now, at least, the United States was doing better than other major countries in dealing with it.

Chairman Burns then asked Mr. Solomon to report on the meeting of Working Party Three that had been held at the end of March.

Mr. Solomon said the atmosphere at the WP-3 meeting also was calm, and the substantive discussion was similar to that which Messrs. Daane and Hayes had reported for Basle. The rise in short-term

interest rates in the United States and their decline in Europe were credited with having had a strong psychological effect on exchange markets, and even though short-term rates remained higher in Europe than in the United States, the markets had calmed down considerably. That was a source of satisfaction to the participants at the WP-3 meeting, and it no doubt was the major explanation of the calmness at both meetings.

As to basic economic conditions, Mr. Solomon continued, it seemed clear that Europe had turned the corner, and that the recessions or slowdowns earlier evident in the individual countries were coming to an end. In Britain the highly stimulative budget was expected to boost the rate of expansion in real GNP to 5 per cent. About the same growth rate was expected in France. In Germany prospects for expansion had brightened considerably. That fact, together with fears of inflation, had persuaded the government to undertake less fiscal stimulus than had been planned.

Mr. Solomon observed that the situation in Japan had received a good deal of attention at the meeting. The Japanese expected an enormous trade surplus this year, as Mr. Daane had noted; and, in contrast to Europe, Japan was not yet showing signs of acceleration in economic activity. There was a clear need for expansionary fiscal and monetary policies, but a move toward fiscal stimulus was being held back by political considerations. Japanese

reserves would probably increase substantially this year, and--reflecting their willingness to innovate--officials of the Bank of Japan were considering the possibility of investing some of their dollar accruals in various long-term American securities, including Aaa corporate bonds. Apart from the additional interest earned on the long-term securities, such investments would not affect the real balance of payments situation between the United States and Japan. They would, however, affect the payments statistics, because any of Japan's dollar accruals that were invested in U.S. corporate bonds would not appear in the figures for the U.S. deficit and the Japanese surplus.

Mr. Solomon noted that in the four months since December 22 the cumulative deficit in the U.S. payments balance on the official settlements basis had been less than $1-1/2 billion. It was reasonable to think that the basic deficit in that period was considerably larger, given the state of the U.S. trade balance so far this year and the volume of normal capital outflows. Apparently, then, there had been an invisible reflow of short-term capital of sizable dimensions. It was possible that such a reflow would continue for the rest of the year, remaining invisible but serving to keep the exchange markets calm.

In reply to a question by Mr. Mitchell, Mr. Bodner said the Japanese had been discussing with officials of the New York Bank the possibility of investing in U.S. corporate bonds. There were a number of technical problems involved, including certain tax

questions which the New York Bank had referred to the Internal Revenue Service. The whole matter was still in the exploratory stage, and it was quite likely that no investments would be made for a long time.

Mr. Daane remarked that, as he understood it, the Japanese were contemplating only an experimental program, involving rather small monthly purchases. He then referred to Mr. Solomon's remarks about the U.S. payments balance and asked whether one could be certain that the recent invisible inflows were of short-term capital.

Mr. Solomon replied in the negative, noting that the flows were not identifiable. While there were grounds for believing that a large part was of short-term funds, there might also have been some abnormal inflows of long-term capital.

Mr. Brimmer asked Mr. Bodner about the status of the program to have foreign central banks roll over more of their holdings of short-term Treasury securities into longer-term issues.

Mr. Bodner noted that in early April the Treasury had arranged to issue to the German Federal Bank another $2.5 billion of medium-term special nonmarketable securities in exchange for short-term issues held by that Bank. The Japanese had been investing in long-term marketable governments on a regular basis since last June. Their holdings of such securities now totaled about $2.5 billion.

Mr. Hayes commented that during the Sunday afternoon session at Basle the Japanese representative had implied that it would be desirable for other countries to undertake similar investments.

Mr. Mitchell noted that such investments by the Germans and Japanese were highly desirable from the U.S. point of view under current circumstances. He asked what purposes they served for the central banks of those countries.

Mr. Bodner replied that the two central banks involved were those with the largest holdings of dollar reserves, and both found their holdings to be substantially in excess of their short-term requirements. Accordingly, they felt free to seek the higher returns available on longer-term securities.

Mr. Solomon added that both the German and Japanese central banks might feel a special need to improve their earnings in terms of their own currencies at this point because their balance sheets reflected the fairly large losses they had incurred at the time of the recent revaluations.

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 March 21 through April 12, 1972, and a supplemental report covering the period April 13 through 17, 1972. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Bodner said that since the last meeting of the Committee there had been the longest period of sustained calm in the exchange market since the Smithsonian agreement. The quieting of the market that followed the March Basle meeting and optimistic official statements was reinforced by the progressive narrowing, from both sides, of the interest rate gap between the United States and Europe, by the signing of the gold bill by President Nixon, and by a general relaxation of the sense of conflict between the Americans and Europeans. In addition, the feeling that the U.S. economy was beginning to pick up steam, while that of Europe remained stagnant, had contributed to a firming of the dollar and, no doubt, to some inflow of foreign funds to the New York stock market. In essence, the markets appeared finally to have accepted the Washington agreement and to have recognized that the set of exchange rates that emerged from that meeting would not be quickly abandoned.

Mr. Bodner commented that, with the markets in effect taking a breather from the hectic speculative activity of recent months, the dollar had strengthened--especially in the past few days--as market attention had focused on the new German measures to restrict corporation borrowing and on the imminent introduction of the European Community plan to maintain a 2-1/4 per cent internal trading band through intervention in each other's currency. Over recent weeks the EC currencies had been well within the new band, and it was

anticipated that no actual intervention would be required when the scheme first went into effect on April 24. All of the associated currencies were also within the band, as were most of the other major European currencies. That was in part a reflection of the continued relative weakness of the dollar. Although dollar rates had firmed across the board, most of the major currencies were still well above their central rates.

The narrowness of the spread was also, of course, a reflection of the influence of the EC plan itself on the market, Mr. Bodner continued. The lira, for example, had been propped up for some months by the market's awareness that the rate would be tied closely to the stronger Community currencies. At the same time, it was quite possible that the recent drop in sterling--which had fallen 4 cents from its March high--would have been even greater but for the implicit floor resulting from British participation in the new Community plan.

Mr. Bodner said the decline in the sterling rate to near par was attributable to a number of factors, including pressures resulting from the recent strikes, the increasingly evident deterioration in the British trade position, and reaction to a very expansionary new budget. There had also been a decline in the relative attractiveness of short-term U.K. investments following some easing in the rates in Britain while Euro-dollar rates had risen

sharply. Moreover, in the background--but well remembered in the exchange markets--was Chancellor Barber's clear warning that Britain was ready to devalue the pound very quickly should it come under pressure as a result of the drive for domestic growth. Although the British current account was still strong despite the progressive narrowing of the trade surplus, it was nonetheless entirely possible that in coming months sterling would provide the first major test of "the snake in the tunnel," as the new EC arrangement was called, and of the Smithsonian parities.

Mr. Bodner commented that at the moment the markets were quiet as exchange operators, both in banks and corporations, were attempting to assess the implications of the new EC arrangements for their own operations and positions. Clearly, the initial impact had been to reinforce the tendency of multi-national corporations to maintain larger holdings of foreign currencies than they had held in the past. If the scheme worked reasonably smoothly, that tendency might well increase; and there would be a further erosion of the transactions role of the dollar, along with the decline in its use as an intervention currency. In any event, one immediate consequence of all the attention being paid to the "snake" was that the markets were again beginning to think about the relative strengths and weaknesses of individual European currencies and not just about the position of the dollar. That, too, had helped to improve the atmosphere and relieve the sense of impending crisis.

Mr. Bodner said that a few weeks of quiet did not mean that the storms were over. The gains so far were fragile, and it would not take much more than some fresh signs of conflict over monetary reform negotiations to recreate the tensions of February and early March. Nevertheless, it seemed to him that there now was a relatively good chance to move into a period of steady improvement in the dollar and in the U.S. balance of payments, and today's sharp rise in dollar rates was certainly encouraging.

> By unanimous vote, the System open market transactions in foreign currencies during the period March 21 through April 17, 1972, were approved, ratified, and confirmed.

Mr. Bodner noted that two System drawings on the Bank for International Settlements would shortly mature for the third time--a $600 million drawing of Swiss francs on May 12 and a $35 million drawing of Belgian francs on May 18. Also, a $715 million System drawing on the Bank of England would mature for the third time on May 17. He recommended renewal of those drawings.

> Renewal for further periods of three months of System drawings of Swiss and Belgian francs on the Bank for International Settlements maturing on May 12 and May 18, 1972, respectively, and of a System drawing on the Bank of England maturing on May 17 was noted without objection.

Mr. Bodner then noted that eight System drawings on the National Bank of Belgium, totaling $325 million, would mature

between May 4 and 25. There appeared to be little alternative to renewing those drawings pending further discussion of the terms of settlement, and he would recommend their renewal. Because the Belgian swap line had been in continuous use for more than a year--since June 30, 1970--specific Committee approval was required under the terms of paragraph 1D of the foreign currency authorization.

> By unanimous vote, renewal for further periods of three months of the eight System drawings on the National Bank of Belgium maturing in the period May 4-25, 1972, was approved.

Mr. Bodner said he would also recommend renewal of three System drawings on the Swiss National Bank, totaling $1 billion, that matured between May 10 and 18. That swap line had been in active use since May 19, 1971, so that specific approval was required for those renewals also.

> By unanimous vote, renewal for further periods of three months of the three System drawings on the Swiss National Bank maturing in the period May 10-18, 1972, was approved.

Next, Mr. Bodner reported that three System drawings on the German Federal Bank, totaling $50 million, would mature on May 30, 1972. The German swap line had been in continuous use since May 7, 1971. He was hopeful that those drawings could be repaid soon, but in the event that did not prove possible he would recommend their renewal.

By unanimous vote, renewal for further periods of three months of the three System drawings on the German Federal Bank maturing on May 30, 1972, was approved.

In connection with the preceding action Mr. Bodner observed that he had submitted a memorandum to the Committee dated April 14, 1972, and entitled "Settlement of Special Drawing with Germany."[1/] As noted in the memorandum, for some months the Account Management had been discussing with the German authorities the basis on which the outstanding System drawings should be settled. It was the Desk's position that under the revaluation clause in the swap arrangement the Federal Bank should bear the costs resulting from the revaluation of the German mark. The Germans had taken the position that they had no obligation with respect to those costs because the swap had originally matured at a time when the mark was floating. Recently the Germans offered a compromise under which they would share the costs of the mark revaluation equally with the System.

Although the amounts involved were not large, Mr. Bodner continued, the Account Management recommended that the compromise offer not be accepted, at least not without further negotiation. Attached to his memorandum was a draft of a statement setting forth the System's position. After any modifications considered desirable, that statement might be sent to the German Federal Bank in the form of a letter from the Special Manager. He recommended that

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

the matter be referred to the subcommittee, consisting of Chairman Burns, Vice Chairman Hayes, and Mr. Robertson, to which the Committee had earlier referred the question that had arisen in connection with the Belgian swap drawings.

In reply to a question by Mr. Mitchell, Mr. Bodner said he thought a matter of principle was involved. In the opinion of the Account Management the Germans had a contractual obligation to bear the costs in question. The Germans believed they had no such obligation, but in order to resolve the issue they were willing to compromise.

Mr. MacLaury asked whether the manner in which the question was settled would set a precedent for other outstanding swap drawings.

Mr. Bodner replied that no other central banks to which the System was indebted had taken the position the Germans had. The Belgians had specifically recognized the principle the System was advancing in the discussions with the Germans.

Mr. Daane said he thought it would be desirable to delegate the matter to the subcommittee, and other members agreed.

> 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 terms of settlement of the outstanding System drawings on the German Federal Bank.

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 marked improvement noted four weeks ago in the incoming business statistics, and in attitudes regarding the prospects for an accelerated economic resurgence, has persisted since then. Probably the most welcome news for forecasters was the sharp pickup reported in retail sales for March. But also most welcome has been the evidence of increasing strength in the employment situation, survey findings that there has been a significant improvement in consumer attitudes, the maintenance of manufacturers' new orders at an advanced pace, and the continuing and broadly based upsurge in industrial output. The clear strengthening trend of activity is not only shown in the aggregate figures but is reflected also in the majority of District summaries of current developments reported in the red book.[1]
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> Under the circumstances, the staff has felt increasingly comfortable with its projection of relatively rapid growth in GNP and related measures during 1972. Indeed, the first-quarter performance appears to have been stronger than seemed most likely a few weeks ago. We have just learned that the initial Department of Commerce estimates, to be released late this week, show a first-quarter GNP increase of $30.3 billion, with real growth estimated at a 5.3 per cent annual rate. The increase in current dollars is somewhat larger than had been anticipated by Commerce four weeks ago, but real growth is slightly smaller in reflection of a higher implicit deflator. Importantly, the first-quarter gain was achieved despite an indicated decline in inventory accumulation to practically zero. Larger consumption, buoyed

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

by the March increase in retail sales, and an unexpectedly large pickup in defense and State-local expenditures more than made up the difference.

We continue to expect rapid expansion in the economy in the quarters ahead. Consumption should rise at least in line with expanding incomes, now that the initial impact of tax overwithholding is behind us and consumers are in a more optimistic frame of mind. Business investment outlays should be rising steadily, more than offsetting an expected leveling off in residential construction activity. Evidence that building is in fact peaking is provided by an 11 per cent drop in housing starts last month, although starts for the quarter were still at a 2-1/2 million annual rate. Federal expenditures should be rising at least as much as projected in the budget, although it now appears that the planned bulge in spending will be partly diffused into the second half of the year. And inventory investment should be rising along with expanding output and sales, in view of the prevailing relatively conservative inventory ratios. Altogether, we have raised our sights slightly on the GNP prospects for the year as a whole, but with a little more weight given to second-half relative to first-half rates of expansion than we were projecting four weeks ago.

With the economy now clearly developing upward momentum, we can be fairly confident, I believe, that something like the gains in real output projected will materialize. But our earlier assumption, that the rate of inflation will subside into the upper part of the 2 to 3 per cent range set as the Administration's goal, is a more dubious matter. Revised figures indicate that average hourly earnings in the private nonfarm economy, adjusted for overtime and interindustry employment shifts, rose at a 6 per cent annual rate from December to March. This is appreciably above the 5-1/2 per cent rate we had assumed for the year, and there is little to suggest that the rate of increase in compensation is likely to diminish. The wage cases now pending before the Pay Board average considerably in excess of 6 per cent, deferred increases scheduled under existing contracts are in the vicinity of 7 per cent (assuming only a 3 per cent rise in the consumer price index), and the likely increase to $2.00 in the Federal minimum wage would raise pay scales substantially in the lower-paid occupations.

Nor does the situation seem more promising if one looks at prices. True, most if not all of the near-term rise in food prices may be behind us, given the outlook for increased food production and the increased sensitivity, by the Price Commission and food distributors alike, to the behavior of marketing margins. But industrial commodities in the wholesale price index have increased at a 4.2 per cent rate over the past four months. Some of this rise undoubtedly reflects a post-freeze catch-up, but the increase persisted at the 4 per cent rate into March and it is considerably higher than would be consistent with an over-all rate of price increase of 3 per cent or less. Service prices, which rose at a comparatively moderate rate of 4.4 per cent in the CPI in the three months ended in February, can be expected to come under greater upward pressure with passage of the higher minimum wage and the sharp increases in utility rates clearly in prospect. So far, the staff projection has incorporated only a slightly higher price assumption, with the rise in the private fixed-weight deflator revised upward to just above 3 per cent in the second half of the year. But we will be reviewing developments carefully over the next month, with the possibility of a more substantial upward revision in mind.

For the most part, the growing uneasiness about wage and price prospects reflects the persistence of the cost-push problem and the apparent inability of the wage-price restraint program to deal with it fully. Except for construction materials and some internationally traded commodities and meats, the pull of strengthening demand on market prices does not appear to have been a significant factor. Nor is demand-pull inflation likely to emerge during the remainder of this year. Our projection of the labor market situation--despite an improving job picture--still envisages a 5.4 per cent unemployment rate in the fourth quarter, and our estimate of capacity utilization in manufacturing--despite a substantial recovery in output--still rises only to 77 per cent. These indicators, which reflect the slack created by more than two years of sluggish economic growth, suggest that there is still ample potential for greater output, even if our current projections prove to err on the conservative side for the quarters immediately ahead.

> My policy prescription, therefore, remains the same as it was at the Committee's last meeting. I believe that monetary policy should remain accommodative to an accelerating economic recovery, by providing for a reasonably liberal growth rate in the monetary aggregates--7 to 8 per cent, for example, in the narrowly defined money supply. I also believe that it is desirable, for the time being, to do what reasonably can be done to moderate upward tendencies in long-term rates and to avoid increases in the general rate structure so sizable as to endanger a continuing substantial flow of savings to the depository institutions. At the same time, however, it is important that monetary policy avoid too vigorous a defense of any particular structure of interest rates and the associated risk that the monetary aggregates may balloon upward. The economic recovery no longer seems to me to be of a fragile character. The danger is shifting instead toward the possibility that the resurgence may become too robust, in which case excessive monetary expansion would help to fuel speculative exuberance and a gradual but growing expectational pull on wage and price behavior.

Mr. Eastburn referred to the staff's projection that the capacity utilization rate in manufacturing would rise to only 77 per cent by the fourth quarter. He thought the view was becoming increasingly widespread that a large part of existing excess capacity consisted of inefficient, high-cost facilities. It was also his impression that much of the capital investment under way was being undertaken for environmental purposes. In light of those considerations, he wondered whether the measurement procedures which yielded a 77 per cent utilization rate were valid or whether a new yardstick was required.

Mr. Partee said the staff had been quite concerned with that problem; the question of what capacity was economically viable was a hard one to answer. The Census Bureau had been investigating the

possibility of developing such information through direct questions to manufacturers, and hopefully their work would lead next year to improved benchmark data for current measures that could be used in revising the Board's index of capacity utilization rates. Meanwhile, he was not prepared to defend any one of the various measures now available. At the same time, he thought the fourth-quarter projection of 77 per cent in the Board's series was sufficiently low so that, even if it involved a substantial understatement of the utilization rate for effective capacity, it offered assurance that there was considerable room for expansion of output.

Mr. Hayes said he concurred in almost all of Mr. Partee's comments, particularly in the latter's views that the economy was moving up at a fairly rapid pace and that employment was strengthening even though there was a continuing problem of unemployment. His own attitude with respect to the price-wage outlook might best be described as nervous optimism. At the consumer level average prices of services and of commodities other than food had performed rather well recently, but he agreed with Mr. Partee that such prices might come under more upward pressure soon. The outlook for wages was rather cloudy. He had been struck by the fact that during the past year the United States had done better than other major countries with respect to the rise in labor costs per unit of output, but one could not be sure that that situation would persist.

Mr. Hayes said he might add a word about Mr. Partee's comments on long-term interest rates. Solicitude for long-term rates was a policy that could easily backfire. While he would like to see such rates remain in a reasonable range, it seemed to him that the economy was strong enough to absorb some firming. In his judgment an overt effort by the System to hold down long-term rates was likely to have a perverse effect by fostering inflationary psychology.

In reply to a question by Mr. Brimmer, Mr. Partee said the GNP projections shown in the latest green book[1/] involved only minor modifications from those of four weeks ago. One of the more important changes was a shift to the third quarter of some Federal expenditures originally projected for the second quarter.

Mr. Brimmer then noted that the projection for calendar 1972 of the Federal deficit on the national income accounts basis had been reduced by nearly $5 billion since the previous projection. He asked whether that change mainly reflected a revision in the estimate of the amount of overwithholding of income taxes.

Mr. Partee responded affirmatively. He noted that overwithholding in the first quarter was now estimated at about a $10 billion annual rate, considerably higher than the previous estimate. As a

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

result, the estimate of the rate of personal saving in the first quarter had been reduced from 8.4 to 7.7 per cent. It was expected that the amount of overwithholding would decline gradually over the course of the year as people filed W-4 forms in response to the Treasury's educational campaign directed at reducing excess withholdings. Also, as a result of the overwithholding that had occurred, quarterly payments on 1972 tax liabilities would be reduced by about $1-1/2 billion.

Chairman Burns said it was also worth noting that, according to the staff's latest estimates, Federal revenues in fiscal 1972 would exceed the Administration's January estimates by $4.7 billion--of which $3.5 billion was accounted for by overwithholding and $1.2 billion by larger than anticipated revenues from the corporate income tax. Since outlays were now expected to fall short of the January estimate by $5 billion, it appeared that the deficit in the fiscal year would be about $10 billion below that shown in the budget document. For fiscal 1973, however, the deficit was likely to exceed the January estimate.

Mr. Brimmer observed that while the staff had substantially lowered its projections of the personal saving rate in the first and second quarters, it had not reduced the figures for consumption expenditures; indeed, it had raised the latter. He asked why overwithholding was expected to depress saving but not spending.

In reply, Mr. Partee said the Committee would recall that in January, February, and March the staff had progressively lowered its projections of the rise in consumer spending in the first half of 1972. Those revisions had been made mainly because incoming data on retail sales were weaker than anticipated; and while the underlying cause of that weakness was not clear at the time, it now could be explained partly in terms of overwithholding. The latest upward adjustment in the consumer spending estimates was based mainly on the surge in retail sales in March. He might note that the figure for consumption expenditures in the newly available Commerce Department estimates of first-quarter GNP was about $1 billion above the staff's estimate.

Mr. Partee said he might also mention that in the staff's projections for the second half of 1972 it was assumed that Social Security benefits would be increased at mid-year by 5 per cent--an assumption also included in the Administration's budget estimates. It now appeared likely that the increase would be larger. Although both the size of the increase and its effective date were still uncertain, he suspected that in its next projection the staff would be allowing for a larger rise than 5 per cent.

Mr. Heflin remarked that economic conditions were booming in the Fifth District. That was reflected not only in the results of the Richmond Bank's latest survey, as reported in the red book, but also in the comments by the directors of the Bank and of the

Charlotte Branch in their joint meeting yesterday. One question the directors discussed at length concerned the comparative effects on bond markets of rising short-term interest rates and of substantial growth in the monetary aggregates. It was the sentiment of the group that the latter would be less disturbing than otherwise if market participants were reasonably sure that prices would not be advancing rapidly during the next few months. However, their confidence in the effectiveness of the Pay Board and Price Commission was declining.

In his judgment, Mr. Heflin continued, the question of the outlook for prices lay at the heart of the Committee's policy problem today. He asked Mr. Partee to amplify his comments on that subject.

Mr. Partee remarked that, as he had indicated in his statement, the staff planned a detailed review of the price situation during the coming month. He would, of course, be in a better position to comment on the outlook when that review was completed. He might note, however, that the staff earlier had thought there was a good chance of reducing the rate of price advance to just under 3 per cent by the end of 1972, which was within the Administration's 2 to 3 per cent goal under Phase II. In arriving at that judgment the staff had assumed rates of increase of about 5-1/2 per cent in wage rates and 6 per cent in total employee compensation; it had not anticipated problems in connection with food prices; and it had

not expected an advance in the minimum wage to $2, which now seemed likely. On all three counts, recent developments suggested that the amount of upward pressure on prices had been underestimated. While the Price Commission probably would be enforcing its rules on profit margins more rigorously than it had to date, rising wage costs would be providing justification for further price increases. The advance in food prices, while perhaps in large part ended, had greatly damaged public confidence in the control program. If the minimum wage was raised to $2, the cost of most services--provided by hospitals, hotels, restaurants, cleaning establishments, and so forth--would advance considerably. On balance, he would not be surprised if average prices were rising at year-end at a rate about 1/2 percentage point higher than contemplated under the Administration's goals.

Mr. Daane asked how Mr. Partee would assess the risk that inflationary expectations would be stimulated by a growth rate of M_1 somewhat greater than, say, the 7 to 8 per cent rate the latter had recommended.

Mr. Partee said he thought the Committee was faced with a difficult policy decision at present. There had been no developments suggesting that the unemployment rate in the fourth quarter would be lower than the staff had been projecting for some time--5.4 per cent. Nor had anything occurred to lead the staff to believe that demand-pull pressures would emerge in areas other than

those in which they were already evident; indeed, such pressures might even be reduced in some areas, such as construction. His instincts suggested that if growth in real output proved to be greater than anticipated as the year progressed, expectational factors would have some effect on wage and price decisions. The question the Committee had to face was whether, in light of that risk, it should deliberately act to slow the rate of growth in the economy and thus reduce the progress made on the unemployment problem. In his view the time for such action was getting closer, but he doubted that the economic outlook was sufficiently strong to justify it now.

Chairman Burns said he might add a comment at this point. He had been concerned for some time about the workings of the Phase II stabilization program, and some of his fears with respect to wage and price movements appeared to be materializing. If one compared the rates of increase in wages and prices in the last three months with those in the period before August of 1971 one would find a little improvement, but only a little, and the differences were narrowing. The Commerce Department's fixed-weight price index for private GNP increased at rates of about 5.0 and 4.8 per cent in 1969 and 1970, and at a rate somewhat above 5 per cent in the first half of 1971. For the first quarter of 1972 the rate of increase was now estimated at 4.6 per cent. As to the rate of advance in wages, the Administration's 5-1/2 per cent guideline was proving in effect to be a 6.2 per cent

guideline when account was taken of fringe benefits, and deferred increases were tending to raise the figure even higher.

Thus, the Chairman continued, wage and price conditions were in a danger zone. One implication of that fact was that the Cost of Living Council would have to reappraise its entire program. That undoubtedly would be done over the next month or two, and there might be changes in the program of a more than marginal character. He should stress the word "might" because the outcome was entirely unpredictable at this point.

Referring to Mr. Heflin's comment on interest rates, the Chairman observed that the key question was whether increases in short-term rates would spread to the long-term market--particularly, to rates on mortgages. There already were signs of such a tendency in the secondary mortgage market. If that tendency continued, the Committee on Interest and Dividends would undoubtedly come under mounting pressure to stabilize such rates at existing levels.

In sum, the Chairman said, he would place even more stress than others had today on the dangers in the present wage and price situation. At the same time, he thought the members should have in mind the two other considerations he had mentioned, concerning possible changes in the program of the Cost of Living Council and the risks that would attach to rising interest rates on mortgages.

Mr. Coldwell said he thought there already were signs of rising inflationary expectations--for example, in investor attitudes

toward longer-term securities and in the corporate planning now under way. On the latter score, he understood that some major industrial firms in the Eleventh District had decided to formulate their plans on the assumption of a rate of inflation of 5 to 5-1/4 per cent over the rest of 1972 and close to 6 per cent in 1973. If their assumptions proved accurate the nation would be faced with real difficulty. The firms in question were planning to make large investments for pollution control which would not increase their capacity or productivity; indeed, those investments were expected to reduce output per manhour. In general, he thought inflationary expectations had re-emerged to a greater extent than others had suggested. It was his impression that people were becoming increasingly skeptical of the effectiveness of the Phase II controls. He was also concerned about the possibility that the present calmness in international financial markets might prove to be only temporary; as Mr. Bodner had noted, it would not take much to recreate the earlier tensions in those markets.

Mr. Winn observed that relatively little had been said today about the outlook for the housing industry. It seemed unlikely that demands would be adequate to sustain expansion at the recent pace, given current trends in vacancy rates and in family formation. Perhaps the problem of speculative overbuilding would come to a head in the fall, with repercussions in other parts of the economy.

Chairman Burns noted that housing starts had declined in March. Personally, he would not expect serious difficulties to develop in the housing industry this year. However, if starts remained near the recent high rate for long, there might well be problems in 1973.

Mr. Partee said he thought that people in the housing field were very much aware of the danger of overbuilding and that lenders in some parts of the country were beginning to react to that threat. Vacancy rates had been rising gradually, but--thus far, at least--they were not very high. The staff believed that the peak in housing starts had passed, and it was holding to its earlier projection of 2.2 million starts in 1972. It was too early to say whether or not the adjustment would be gradual, as implied in the staff's projections.

In reply to Mr. Winn's question, Mr. Partee said the starts figure he had mentioned excluded mobile homes, the production of which was currently at a rate of 550,000 per year.

Mr. Winn then observed that he also continued to be concerned about conditions in the stock market, particularly in light of the recent sharp increase in margin credit.

Mr. Hayes said he shared Mr. Winn's concern, and Chairman Burns noted that the Board had been watching developments in that area closely.

Mr. Mayo commented that his observations tended to support Mr. Partee's optimism about economic activity. The groups that met regularly at the Chicago Bank had been more bullish about the outlook for capital goods, machine tools, and so forth during the past month than at any time since he had become associated with the Federal Reserve.

Mr. Mayo then said he would suggest that the Board staff and perhaps the Board of Governors itself undertake a new examination of the whole problem of reserve requirements on Euro-dollar borrowings, assuming that had not already been done. A reduction or elimination of those requirements might well be desirable on balance of payments and other grounds.

Chairman Burns observed that that question had been raised in connection with the proposed amendment of Regulation D, and that the Board planned to take it up. A study had already been done by the International Finance Division and he understood that another paper on the subject would be completed in a few days.

Mr. Sheehan said he found the indicators of economic growth to be impressive, and he believed that a solid expansion was under way at the present time. But as he listened to the other members of the Committee he got the impression that a number of them felt the expansion was "locked in." He would like to focus for a few minutes on what the average chief executive officer of an American

corporation was probably thinking about at this juncture since business confidence was certainly a key--and since the average chief executive was, it would seem, somewhat less informed than hopefully he was now after a number of months in the Federal Reserve System. Yet he was new enough to his present role to still be able to put on a chief executive's hat and feel comfortable.

Mr. Sheehan remarked that in looking at the record the average chief executive probably saw one good, solid month of substantial growth--March--after a January-February period of relatively modest recovery. Phase II results were cloudy--how much inflation was there really? Perhaps 15 per cent or so less than a year ago at this time? The average executive would probably want to wait until perhaps June, July, or even August before confidently concluding that the economy was surging.

Parenthetically, Mr. Sheehan observed that few chief executive officers in their chairs today had lived in a time like this as chief executives. The last strong inflationary period was in the era of the 1950's when most of them were aspiring executives and not wearing the leader's mantle.

Continuing, Mr. Sheehan said a chief executive would know that unemployment was still high and that it had increased in March by 0.2 to 5.9 per cent. Furthermore, few chief executives would be adding employees--and many undoubtedly were approving work force additions personally. The war in Vietnam would be quite unsettling,

with the recent invasion of the south by North Vietnamese regular divisions. The massive Federal deficit would continue to be on the minds of most chief executives; and although the current forecast was for perhaps $30 billion of deficit spending in fiscal 1972 instead of $38-40 billion, most would still consider that to be gross overspending on the part of the Federal Government. And the difference between $30 billion and $40 billion would not seem all that significant. Taxes were high and people were talking about tax reform; and most chief executives suspected that when politicians talked about tax reform what they really meant was higher corporate taxes and elimination of depreciation tax shields. This was an election year and there was much confusion about it. And how did one read the returns from Wisconsin? The work force was probably restive, given its perplexed outlook relative to Phase II. And finally, the average chief executive officer would have just read the latest Business Week article about the Federal Reserve and was probably puzzled about the author's conclusion that the System didn't know what it was doing and would probably tighten money, and interest rates would soar soon.

Given the foregoing, Mr. Sheehan said, the average chief executive officer would conclude that "one swallow doesn't make a spring" and that the March experience would need to be repeated several times before he placed a large bet on the recovery. Therefore, while he (Mr. Sheehan) was much more comfortable about the

economic outlook--to the extent that business confidence was a key--than he had been on January 1, 1972, the recovery still appeared to him to be somewhat tender. Accordingly, he would urge the Committee not to move abruptly to moderate the growth in reserves and consequently to force interest rates sharply higher. While he would agree that the business community would no doubt lag in its understanding of the recovery as it was occurring, their confidence was what he was concentrating on. He would not want to jar that confidence by a Federal Reserve action which could be just as damaging as a failure to act soon enough and to see current Federal Reserve actions, through creating too much money in the system, rekindling inflation somewhat later.

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 March 21 through April 12, 1972, and a supplemental report covering the period April 13 through 17, 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 period since the Committee last met continued to go relatively smoothly under the reserve target approach adopted by the Committee. The monetary aggregates in March and April appeared to be coming out reasonably close to the paths selected by the Committee, and with a somewhat lower Federal funds rate--averaging under 4-1/4 per cent--

than had appeared likely at the time of the last meeting. With the economy showing signs of greater strength, with money and credit expanding vigorously and some evidence of rising loan demand, market sentiment turned towards expectations of rising interest rates. Government securities dealers built up a substantial short position in Treasury issues maturing in more than a year, and investors in long-term corporate and municipal issues adopted a wait-and-see attitude. As a result, interest rates in these maturity areas drifted up.

Treasury bill rates, in contrast, were quite stable over the period. In yesterday's regular Treasury bill auction, average rates of 3.85 and 4.28 per cent were set for three- and six-month bills, down 7 and 4 basis points, respectively, from the rates established just prior to the last Committee meeting. A marked improvement in the Treasury's cash position allowed it to discontinue weekly additions to the regular Treasury bill auctions, thus reducing pressure on the supply side. Current estimates now imply a deficit of under $30 billion for the 1972 fiscal year, compared to the earlier official estimate of close to $39 billion. The improvement may well continue on a substantial scale in the second half of the calendar year. As this news becomes more apparent to the market--provided the market finds it creditable--there could be a substantial boost to market sentiment.

Given its improved cash position, the Treasury is in process of building up its balances with the Federal Reserve Banks to minimize the size of its tax and loan accounts in commercial banks. This, of course, will increase the need for the System to supply reserves during the build-up, with a reverse situation occurring in June. While the Treasury's management of its cash balances represents a complicating factor for open market operations, it appears desirable to accommodate it so long as we do not run into serious problems. The Treasury will be announcing the terms of its May refunding next week. With no immediate need for new cash, and with the public's holding of maturing issues only about $2-1/2 billion, this should be a routine operation, although even keel considerations are of course involved.

As far as open market operations are concerned, it appeared early in the period that reserves available against private nonbank deposits and the monetary aggregates were coming in on the high side. As a result the Desk was cautious in adding to the reserve supply and

there was some firming in the money market. Later, however, revisions of the data brought both reserves and the aggregates into line with Committee desires, and more recently a fairly steady atmosphere has prevailed in the money market with Federal funds trading at about 4-1/4 per cent or a bit below. Over the period banks generally tended to run somewhat higher excess reserves than normal and this, together with several sizable shortfalls in the reserve projections, made for some day-to-day instability in the money market. In supplying reserves over the period, the Desk acquired $1.3 billion Treasury bills, made $3.2 billion in repurchase agreements, and bought $410 million Treasury coupon issues. Despite the fact that dealers had a large net short position in Treasury coupon issues, such issues were readily available--as the response to the two go-arounds held during the period testified. Such acquisitions, it was hoped, would be marginally helpful to long-term markets.

Looking ahead, the blue book[1/] indicates that a 9-1/2 per cent growth rate in reserves available to support private nonbank deposits in April and May would be consistent with about the same pattern of growth of the monetary aggregates that the Committee adopted at the last meeting. At the same time, the Federal funds rate is expected to be in about the middle of a 3-3/4 to 4-3/4 per cent range--little changed from the current situation. New York Bank projections indicate somewhat greater strength in the aggregates, showing about 1 to 1-1/2 percentage points more growth over the second quarter than does the blue book. Thus, we would have both M_1 and M_2 growing at about a 9 per cent rate over the quarter rather than at the 7-1/2 and 8 per cent rates shown in the blue book. On our projections, the credit proxy would grow at a 6-1/2 per cent rate rather than at the blue book's 5-1/2 per cent rate.

Mr. Holmes then referred to the Committee's decision yesterday to adopt an auction technique for System repurchase agreements. As amended, paragraph 1(c) of the continuing authority

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

directive specified that RP rates should be determined by competitive bidding "unless otherwise expressly authorized by the Committee." The Desk would need a few days to work out the details of the new procedure and to review them with the dealers who would be participating in the auctions. Accordingly, he recommended that the Committee authorize the Desk to continue to use for a brief period the previous technique for setting RP rates.

Chairman Burns suggested that the Committee authorize continued use of the prior technique for a period of up to one week, on the understanding that if the necessary arrangements had been completed the new technique might be introduced before a week had elapsed.

There was general agreement with that suggestion.

By unanimous vote, the Federal Reserve Bank of New York was authorized, for a period up to one week from the date of this action, to employ the procedures for establishing rates on repurchase agreements that were in effect prior to the amendment on April 17, 1972, of paragraph 1(c) of the continuing authority directive with respect to domestic open market operations.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period March 21 through April 17, 1972, were approved, ratified, and confirmed.

Chairman Burns observed that the Committee was now ready to hear Mr. Axilrod's report on the monetary relationships discussed in the blue book and to undertake its own deliberations on monetary policy. He thought the effectiveness of those deliberations would be increased if the customary "go-around," in which each member spoke in turn, was replaced by an open discussion of policy with no specific order for the comments of individuals. When that discussion had been completed the Committee could hold a brief go-around in which the members could indicate their preferences for the directive language and specifications.

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

> The current staff expectation is that all monetary aggregates will expand at slower rates in the second quarter than in the first even if short-term interest rates do not rise very much further from around current levels.
>
> We expect the slower growth rates in M_2 and the bank credit proxy to be evident in April and May. Growth in M_1 in April and May may moderate from the first-quarter pace, but perhaps only in small degree as a sharp decline expected for U.S. Government deposits in May could provide a temporary fillip to M_1 expansion. For the second quarter as a whole, though, the reserve path associated with pattern I is expected to lead to an annual rate of increase in M_1 of around 7-1/2 per cent and the reserve path associated with pattern II to a 6-1/2 to 7 per cent rate of increase.
>
> If the System provides the reserves associated with pattern I, there may be only a moderate further rise in long-term interest rates over the near-term. To a considerable extent the recent rise in long-term market rates has probably already discounted the reduced bank participation in bond markets that can be expected over the period ahead, when loan demands are

likely to be fairly well sustained at the same time as deposit inflows to banks are reduced. And markets have generally worked themselves into good technical positions, with relatively little overhang of securities in the hands of temporary holders. Nevertheless, if the Federal funds rate should move up toward the upper end of the 3-3/4 to 4-3/4 per cent range shown for pattern I, the increase in dealer financing costs and rising costs of CD funds to banks would likely lead to a further rise in long-term rates.

The technical position of the mortgage market right now seems more uncertain than that of bond markets. As judged by the sharp increase in offerings in the FNMA auctions and to the Federal Home Loan Mortgage Corporation, mortgage brokers and institutional holders are making a substantial effort to protect themselves against anticipated future rate increases. And the primary mortgage market could soon reflect these early signs of nervousness in the secondary market, particularly if there is a significant slowdown in savings inflow to thrift institutions. Net savings inflows to these institutions in March were sustained at a very rapid rate, but if the recent experience of similar deposits at banks is any guide--as it often is--deposit growth at thrift institutions may be expected to moderate in coming months. A reduction in savings inflows to S&L's from the 20 per cent annual rate of the past two months to around a 15 per cent rate or a little under--which would appear more normal, given current short-term market interest rates--is likely to make these institutions more cautious in making new commitments, and in view of the high level of their existing mortgage commitments relative to resources, to lead to some upward pressure on the mortgage rate in the primary market.

While attainment of pattern I aggregates in the second quarter might be consistent with only a modest further rise in interest rates this spring, this could lead to more difficult problems for monetary policy in the summer if the Committee wishes to avoid high rates of growth then in M_1. With transactions demands strengthening, we would expect M_1 growth in the order of an 8-1/2 per cent annual rate in the third quarter if money market conditions remain around those currently prevailing. Given the strong pull of transactions demands, it would appear that money market conditions would have to tighten fairly substantially if the Committee wished to hold M_1 growth in that quarter to a slower pace.

How fast, and to what extent, one might permit tightening is a question of strategy for the Committee. This question of strategy becomes important on the assumption that the staff's projection of future M_1 and interest rate relationships is correct. In that context, I might note that our estimate last month of the funds rate consistent with the reserve and monetary aggregates adopted by the Committee turned out to be about a 1/4 of a point or so high, but it was correct in direction and general order of magnitude of effect.

Any further tightening of the money market, should it prove necessary, can be accomplished more or less gradually. But if done very gradually, the ultimate degree of tightening will probably have to be greater than if the tightening is accomplished more quickly. This is because of the relatively long lag between interest rates and the demand for money, but even if that lag is not as long as we now think, the general point would remain the same.

If the Committee is willing to place a low weight on the risk of rapid expansion of M_1 in the summer it might find pattern I acceptable, although it may wish to lower the odds on a rapid summer rise in money by permitting a funds rate as high as 4-3/4 per cent and by not permitting much departure on the up side from the path implicit in that pattern for RPD--that is, reserves available to support private nonbank deposits. Or, if the Committee wants an additional hedge against large money supply expansion later, it might set a reserve path which takes the 8 per cent April-May rise in RPD shown for pattern II as a lower limit and the 9-1/2 per cent rise for pattern I as the upper limit. This would be likely to produce a funds rate around 4-3/4 to 5 per cent between now and the next meeting.

Adherence to a reserve path which--if our projected relationships are right--implies a rise in the funds rate would probably require some rise in the rate over the very near-term before the Treasury announces its relatively small May refunding a week from Wednesday. It would also probably mean some further increase after books on the refunding are closed about May 3, but the small size in prospect for this refunding (assuming no advance refunding is done) will help keep even-keel considerations to a minimum. Such a course would risk greater reaction in long-term markets in the short run, and would possibly put the discount rate under pressure

as member bank borrowings rise, but it could yield the dividend of modest, if any, upward pressures on long-term rates in the summer when money market conditions might be somewhat less tight than otherwise and growth in the aggregates might not be overly exuberant.

With respect to directives,[1] the phrasing of alternative C would be consistent with a tighter policy course and reserve path than adopted last time. The phrasing of alternative B in a sense represents the easiest of the three directives presented, since it would encompass an easier reserve path than C and moreover would take effects on capital markets into account in reserve supplying operations, and thus would permit upward deviations from the reserve path if the capital markets weaken. Alternative A may then be considered more as a middle course since it looks to moderate reserve growth and would not necessarily contemplate significant deviations on the up side even if money market conditions tightened somewhat and long-term interest rates rose further--though the directive could well, of course, contemplate continued purchases of coupon and Federal agency issues.

Chairman Burns asked Mr. Axilrod to summarize briefly the differences among the alternative patterns and directive paragraphs.

Mr. Axilrod said the alternative C directive language was associated with pattern II, which was the tighter of the two patterns and was likely to result in firmer money market conditions and higher interest rates. Alternatives A and B for the directive were both associated with pattern I. The difference between them was that B included an additional instruction to the Desk--to take account of capital market developments--which could be construed as calling for more liberal provision of reserves and greater caution in allowing money market conditions to firm in the event that

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

long-term rates were rising significantly. It was in that sense that B could be considered as involving an easier policy than A.

Mr. Hayes asked whether alternative C could not be viewed as consistent with pattern I as well as II.

Mr. Axilrod replied affirmatively.

Chairman Burns said he found the system of labeling alternatives used in the blue book to be unnecessarily confusing and suggested that the staff try to work out a better system.

Mr. Daane noted that he had obtained from the staff the absolute figures for RPD in April, May, and June underlying the percentage growth rates shown in the blue book. For April the figures under patterns I and II were $30,280 million and $30,260 million, respectively--a difference of only $20 million. For May and June the differences were $75 million and $110 million. He found it hard to believe that such relatively small differences in reserve levels would be associated with differences in the degree of pressure on interest rates as large as the staff suggested.

Mr. Axilrod replied that in the staff's judgment the relationships shown in the blue book were consistent with historical experience. April, of course, was already more than half over. For May and June he might note that the pattern II reserve figures reflected even relatively less provision of funds to banks through nonborrowed reserves. It was assumed that that would be partly offset by a rise in member bank borrowings. Thus, not only would

RPD grow less under pattern II, but banks would likely be forced to borrow more from the Federal Reserve to help support the slower rate of growth. For May the projected level of borrowings, seasonally unadjusted, was $180 million higher under pattern II than I; for June it was $200 million higher. Such an increase in borrowings, should it develop, normally would be associated with a noticeable rise in short-term interest rates.

Chairman Burns said he assumed that judgments of that kind were based on correlation analyses. He asked how close the correlations were.

Mr. Axilrod replied that, given the discount rate, the correlation between member bank borrowings and short-term market interest rates was quite close; indeed, it was the best of the whole set of relationships used by the staff for projection purposes. Relationships involving the money supply and other monetary aggregates were a little weaker.

Mr. Daane remarked that he would not be inclined to describe the correlation between borrowings and short-term rates as "very close"--at least, not unless it had recently improved significantly. He then asked Mr. Axilrod to amplify his comment about the consequences of firming gradually or more quickly.

Mr. Axilrod said the essence of his point could be stated briefly. Assuming that the Committee anticipated rapid growth in demand for monetary aggregates this summer--stemming, say, from rapid expansion in economic activity--and wanted to moderate the

rise, it was likely to find that the sooner it began to firm the smaller the amount of firming that would be needed. Although there might be questions about the magnitudes involved, he thought that general proposition was well grounded in experience--including experience of the late 1971-early 1972 period.

In reply to a question by Mr. Sheehan, Mr. Axilrod said the matter was one of probabilities rather than certainty. If the funds rate remained around 4-1/4 per cent now and GNP expanded as much as projected in the third quarter--at about a 10-1/2 per cent annual rate--the transactions demand for money was likely to be large enough to exert a strong pull on the money supply. If the Committee wanted to avoid a rapid increase in M_1 because of its inflationary implications, it presumably would seek higher short-term interest rates in order to reduce demands for money. However, experience indicated that money demands responded to changes in interest rates with a lag. While the average length of the lag was a matter of debate, as long as some lag existed it seemed clear that delaying firming action would mean increasing the amount of firming ultimately required. It was his guess that interest rates would have to rise about one-half of a percentage point less if the Committee started to firm now rather than delaying until the third quarter.

Mr. Daane asked the Manager how much elbow room there might be to probe toward firmer money market conditions without having a substantial impact on conditions in long-term markets.

Mr. Holmes replied that interest rate developments would, of course, be influenced by many factors in addition to money market conditions. For example, if the rate of increase in prices should moderate or if market participants should come to believe that Treasury borrowing would be lighter than expected, there would be a good chance of reasonable stability in long-term rates. A slowing of growth in the monetary aggregates--perhaps to the pattern II rates--also would be helpful in that connection, since market participants were concerned about the rapid growth of the past few months. On balance, he thought there probably was some room to edge up to a higher Federal funds rate at present. He might note that he shared Mr. Axilrod's view that less firming would be needed if the move was started earlier.

Mr. Daane then said he would favor an effort to snug up a bit on short-term interest rates, while keeping an eye cocked on long-term rates. He would not try to translate that policy prescription into a choice between patterns I and II.

Mr. Francis said he agreed with Mr. Partee that the economy was now rebounding. In light of the strengthened outlook, a slower rate of monetary expansion than projected for the period through September seemed to be called for. He thought the Committee should aim for a growth rate of M_1 substantially below the 10 per cent rate recorded in the period since December 1971. There might be some temporary upward pressure on interest rates, particularly short-term

rates, but that price would be well worth paying for the sake of achieving the Committee's objectives over the longer run. If the Committee attempted to prevent interest rates from rising over coming months it would find it necessary to pay a much higher price somewhere down the road in getting the aggregates back into line.

Mr. Mitchell observed that his first reaction on reading the blue book before today's meeting was that the alternative B policy course would be appropriate. After studying the figures on total bank reserves, however, he had become apprehensive. What disturbed him in particular was the indication that a sharp increase in April would bring total reserves to a level $1-1/2 billion above December. For the full year, growth in reserves at an 8 per cent rate--which he thought would be about right--would involve an absolute increase of only $2-1/2 billion. It appeared, then, that 60 per cent of the year's expansion would be accomplished in the first four months.

Chairman Burns remarked that in considering the recent rapid growth of total reserves one should not overlook the fact that the rate of increase in the fourth quarter of 1971 had been only about 2 per cent.

Mr. Axilrod noted that the growth rate of total reserves had fluctuated widely so far this year, mainly because of swings in Government deposits. As the members would recall, the volatility of Government deposits was one of the important considerations underlying the original recommendation that reserves against private

nonbank deposits be used for operating target purposes. Setting Government deposits aside, much of the recent increase in reserves reflected the rapid expansion in time deposits other than large-denomination CD's. The annual rate of growth in such deposits had accelerated to 17 per cent in the first quarter from about 10 per cent in the second half of 1971, reflecting a shift in public preferences from market instruments toward time deposits as a repository of savings. He expected growth in time deposits to slacken in the second quarter and, if anything, to slow even more in the second half. If he was right, the need for reserves would be reduced correspondingly. Of course, the fact that a large part of the year's supply of reserves was likely to be furnished in the first four months was an argument for working toward slower growth in the months ahead.

Mr. Mitchell remarked that Mr. Axilrod's final observation seemed to imply that alternative B was an undesirable choice at this point. As to Mr. Axilrod's preceding comments, he (Mr. Mitchell) was not sure the Committee could afford to ignore Government deposits since they could readily become monetized.

Mr. Maisel noted that data for the 1972 fiscal year lent support to Mr. Mitchell's view regarding Government deposits. He recently had been comparing the projected GNP growth rates for the fiscal year with those for various monetary aggregates. He found that, by the standards of the last 4 or 5 years, the growth rates for both M_1 and M_2 were low but the rate for total reserves was a little

high--perhaps by 1 percentage point. With reserves for Government deposits subtracted from the series, the growth rate proved to be about 1 point lower and in line with historical experience.

Mr. Mitchell asked how the Committee should formulate its instructions to the Manager in order to assure that the reserves supplied to support a large increase in Government deposits were not used later as a basis for expansion of private deposits.

Mr. Axilrod said he thought such assurance could be obtained simply by giving the Desk an RPD target; under such a procedure, the reserves released by declines in Government deposits would be absorbed automatically. As noted in the blue book, the staff expected the large increase in total reserves in April to be followed by a decline in May, when Government deposits were expected to contract. Over the second quarter as a whole, total reserves were expected to grow at a 7 per cent rate under pattern I and at a 5 per cent rate under pattern II.

Mr. Partee added that the System could prevent the monetization of Government deposits by either of two means; it could force a contraction of private deposits whenever Government deposits rose sharply, or it could follow the route Mr. Axilrod had outlined--employing an RPD target, so that reserves were not freed to support private deposits when a bulge in Government deposits was worked off.

In his judgment the latter procedure was preferable; the former would involve unnecessary fluctuations in the supply of private deposits, and hence in interest rates, as Government deposits rose and fell.

Mr. Mitchell remarked that the choice did not seem to him to be as clear-cut as Mr. Partee had suggested. To accommodate fluctuations in Government deposits would be to induce corresponding fluctuations in the volume of bank credit, a development which was not necessarily desirable.

Mr. Axilrod commented that he had a fairly simple view of the matter of short-run fluctuations in Government deposits. When such deposits dropped sharply, funds were transferred to the private sector--primarily to large corporations, particularly if the transfer reflected an excess of outlays over receipts and was not just net debt repayment--and private sector demands for short-term bank credit were thereby reduced. Under such circumstances, the private sector could be induced to hold the same volume of bank credit as before only by forcing interest rates down. The converse held if Government deposits rose sharply, withdrawing funds from the private sector. In general, he saw no advantages to holding bank credit stable in the face of large short-run movements in Government deposits.

Mr. Mayo asked whether the staff had assumed that M_1 would expand at an 8 per cent annual rate in developing the GNP projections shown in the green book.

In response, Mr. Partee said the explicit financial assumption was cast in terms of interest rates rather than M_1 growth; in particular, allowance had been made for some rise in long-term rates later in the year. While that development might well be consistent with an M_1 growth rate of either 7 or 8 per cent, the specific growth rate the staff had had in mind in formulating expected interest rate behavior was 7 per cent.

Mr. Mayo then noted that, according to the blue book, M_1 would grow at annual rates of 7 and 6.5 per cent in the second and third quarters, respectively, under pattern II. Since M_1 had expanded at a 9.5 per cent rate in the first quarter, the growth rate over the first nine months would average 7-2/3 per cent under that pattern. Under pattern I the corresponding nine-month growth rate was 8-1/2 per cent. Of course, projections for a period of that length were highly uncertain. Nevertheless, the figures suggested that there would be an adequate amount of economic stimulation under pattern II.

Mr. Partee said the staff was inclined to view the 9.5 per cent M_1 growth rate of the first quarter as involving a catch-up from the 1 per cent rise of the fourth quarter of 1971, and to focus on growth from the second quarter on. Interpreted literally, the staff's econometric model suggested that expansion in M_1 at the pattern II rates--which averaged slightly under 7 per cent for the second and third quarters--would be associated with a substantial increase in short-term interest rates over the rest of the year.

Mr. Mayo observed in that connection that the blue book specifications for pattern II included a range of 4-1/2 to 5-1/2 per cent for the Federal funds rate in the coming period, despite the fact that the rate had recently been in the neighborhood of 4-1/4 per cent. He would prefer to specify a range of 4-1/4 to 5-1/4 per cent for the funds rate.

Mr. Mayo then remarked that there were two other considerations leading him to favor the pattern II growth rates for the aggregates, which he would describe as "a little less easy" rather than as "more restrictive." First, he was mindful of the experience in the first half of 1971, when actual growth rates repeatedly exceeded the projections, particularly since there seemed to be some tendency to err in that direction again this year. Secondly, account should be taken of the effects of inflationary expectations on long-term interest rates. An up-tick in short-term rates now would signal a move toward a slightly less easy policy, and that could redound to the benefit of conditions in capital markets over the longer run.

In a concluding comment, Mr. Mayo noted that when the policy record for the Committee's January meeting had been published last week widespread publicity had been given to the statement that the Committee had agreed on growth in total reserves from December to January at an annual rate of 20 to 25 per cent. Although that target had reflected the short-run volatility of the total reserve

series, it had been widely misinterpreted as signifying a highly stimulative policy. He hoped some means could be developed for reducing the chances of similar misinterpretations in the future.

Mr. Robertson said it seemed clear to him that a sturdy business expansion was now under way. In his judgment the Committee should be less concerned than it had been earlier about the risk of dampening the recovery, and more concerned about the danger of fostering inflationary expectations. In particular, he thought the Committee should now start to supply reserves at a slower rate in order to reduce the growth rate of the monetary aggregates.

Obviously, Mr. Robertson continued, such a course would increase the chances of some near-term increases in interest rates. However, the alternative course--of trying to prevent rate advances by permitting reserves and monetary aggregates to continue to rise rapidly--was likely to lead to great difficulties later in the year. He did not favor abrupt action, and he hoped the Federal funds rate would not rise above 5 per cent during the next few weeks. But by beginning to move now, the Committee would reduce the risk of having to move abruptly later. On balance, he favored specifications between those associated with patterns I and II. He would much prefer to err a little on the tight side now rather than to permit the aggregates to continue to expand at recent rates.

Mr. Coldwell said he concurred in the view that the Committee should start shading away from the economic stimulus it had been providing through heavy additions to reserves. He hoped that could be done in a gradual and orderly fashion, without sharp changes in interest rates. In particular, he would like to avoid marked increases in long-term rates.

While he would not place much faith in any particular projected patterns of monetary relationships, Mr. Coldwell continued, it was his view that the money market rates shown under pattern II in the blue book were higher than would prove necessary to reduce growth in the monetary aggregates to a sustainable level. He favored seeking money market rates intermediate to those of patterns I and II, with ranges of 4 to 5-1/4 per cent for the funds rate and 3-3/4 to 4-1/2 per cent for the three-month bill rate. In short, he would support a modest advance in money market rates in the hope of achieving some slowing in the aggregates without producing a sharp increase in long-term interest rates.

Mr. Coldwell said he thought the Committee might soon be faced with the possibility that interest rates would rise either as a direct result of much slower reserve growth or as an indirect result--through expectational effects--of rapid reserve growth. If rates were likely to rise in either of those eventualities, a small probing move toward restraint would seem to be the appropriate action at this time.

Mr. Maisel said he thought the key question facing the Committee concerned the growth rate of money needed to finance the desired expansion of GNP. While others might call such a rate "stimulative," he would refer to it as "accommodative," and to any lower rate as "nonaccommodative" or "restrictive." As he had mentioned earlier, a comparison for fiscal 1972 of the projections of GNP and the monetary aggregates indicated that the growth rates for the aggregates were somewhat low by the standards of the last 4 or 5 years, so that policy for that period would be better described as on the restrictive side rather than stimulative.

Looking to the future, Mr. Maisel noted that the staff was projecting growth in GNP at rates of 10-1/2 and 10 per cent, respectively, in the third and fourth quarters of calendar 1972. If the Committee decided not to permit money to grow at a rate that would be normal for such a rise in GNP, it would have to be prepared to let interest rates rise. One might offer either of two broad reasons for wanting interest rates to rise--that the GNP growth rate projected for the second half was too rapid, or that GNP growth would be too rapid in 1973 unless restraint was imposed now.

In his judgment, Mr. Maisel continued, to accommodate GNP growth in the second half at the projected rate would be consistent with the nation's goals. The Administration had indicated that GNP should grow by at least that much, if not more, and Congress would

view such a rate as low. If a problem of excessive expansion developed in 1973, it would not have been created by the Federal Reserve.

Chairman Burns said it was important to recognize that the current vigorous economic recovery was a most recent phenomenon. While the upturn could be said to have begun in November 1970, the signs historically associated with recoveries had not appeared until the last two months, so that in a real sense the recovery was still in an early stage. It was also important to recognize that fiscal policy in the period from January through June would be a good deal less stimulative than had been thought a number of weeks ago. It now appeared that the Federal deficit in that period would fall short of earlier expectations by some $10 billion; expressed as an annual rate, the difference was $20 billion. He mentioned that fact because monetary policy should be considered not in the abstract but in relation to the state of the economy and the posture of other Government policies.

Chairman Burns then remarked that he wanted to endorse Mr. Maisel's comments. At this stage of the business cycle--given the fact that there had been little actual recovery for more than a year of the so-called recovery period--he did not consider monetary policy to be especially stimulative; by historical standards present policy could even be described as restrictive.

The Chairman noted that earlier today he had expressed his concern about the way in which the Government's incomes policy was working, and had suggested that some further tightening of the program might become imperative within the next few months or so. At this point he could only speculate about the form such changes might take, but if events did follow such a course, any significant advances in long-term interest rates--particularly mortgage rates--would lead to a difficult situation. The Committee had to evaluate that risk as best it could.

Like other Committee members, the Chairman continued, he thought some moderation in the growth rates of the monetary aggregates would be highly desirable. However, he also considered it necessary to keep an eye on interest rates. It might prove possible to achieve some slowing in the aggregates without having a significant impact on the level of long-term rates, but that happy outcome was far from assured. No matter what the Committee decided today he might find it necessary to call for a review of the situation at some point in the period before the next scheduled meeting.

Mr. Hayes said he sympathized in general with the comments of Messrs. Daane and Robertson. He would like to see the Committee view the question of policy in rather broad terms, focusing on

basic considerations rather than narrowly on the choice between the alternative patterns before it. With respect to the economic outlook, it now appeared highly likely that the growth in GNP projected by the staff would be attained. At the same time the problem of inflation was proving to be a very difficult one. While the persistence of that problem might call for some changes in the Administration's program of price and wage controls, in the present setting it was a source of concern to the Committee.

As to the monetary aggregates, Mr. Hayes continued, he thought that recent and prospective growth rates were on the generous side and that some degree of slowing probably would be appropriate. He would be reasonably satisfied with the growth rates recorded for March and anticipated for April if he thought the second-quarter slowing projected in the blue book would materialize. He noted, however, that the New York Bank's projections were higher than those of the Board's staff. Also, he was somewhat disturbed by the Board staff's tentative projections for the third quarter, which suggested an increase in the rate of M_1 growth then.

On balance, Mr. Hayes said, he would favor a modest, gradual move toward further firming, and he would be willing to have the directive formulated in terms of money market

conditions. For the Federal funds rate he would specify a range of 4 to 5 per cent--which was between the ranges associated with patterns I and II--and he would like to see the funds rate tending upward slowly within that range.

Mr. Hayes added that in his view it would be premature to consider changing the discount rate at this time.

Mr. Brimmer commented that the Chairman had already made a number of the points he had planned to make. He would emphasize that the main problem facing the Committee was still one of assuring that the growth rates in real GNP projected by the staff would be achieved. He noted that for the full year 1972 the staff's projection of real GNP involved a gain from 1971 of 5.7 per cent, a bit under the Administration's projection of 6 per cent. The staff's projections indicated that the problem of unemployment would persist and that there would not be much pressure on industrial capacity, or on resources in general, even by the end of the year.

Mr. Brimmer observed that there also was a continuing problem of inflation, despite the control program that had been in effect since mid-August 1971. However, no one should have expected to see the problems of inflation and unemployment

simultaneously resolved within the eight months that had elapsed since last August 15. The significant point was that the Administration had decided at that time--with the support of the Congress and the Federal Reserve--that the way to solve the problem of inflation was to apply direct controls rather than to slow the rate of economic growth and increase excess capacity. If more effective means of fighting inflation were needed they should be sought in tighter controls, perhaps along the lines the Chairman had suggested, and not through monetary policy.

Mr. Brimmer said he agreed with Mr. Daane that the Committee should not tie itself to highly specific quantitative targets; in particular, he believed too much stress was being placed on M_1. As he had indicated, he thought the main problem was to assure a reasonable rate of economic growth this year. He agreed, however, that the chances of doing so were now better than they had been a month or two ago. In his judgment the Committee should seek to moderate somewhat the pace at which the aggregates had been growing. He doubted that that could be done without somewhat higher interest rates, and he would be prepared to accept some advance in rates if it were moderate and gradual.

Mr. Eastburn observed that the Chairman had posed the policy dilemma clearly and forcefully. He would like to make a few brief comments. First, he would note that experiments at the Philadelphia Bank with the quarterly econometric model suggested

that growth in M_1 at a rate of about 6 or 7 per cent would result in a reasonable rate of growth in GNP, a slowing of the rise in the price deflator, and some reduction in the unemployment rate--although not as much as one might like. Secondly, while participating during the last few weeks in the daily conference call on open market operations he had been highly impressed by the Manager's ability to work simultaneously toward the Committee's objectives for the monetary aggregates and money market conditions. He should note, however, that as the period progressed the aggregates had shown a tendency to increase at faster rates than desired. The problem was that good estimates of the aggregates for each statement week were not available until late in the week when there was little scope to correct misses, and recent misses had tended to be in the upward direction. He thought such overshoots might well be typical during the next few months.

Mr. Eastburn added that projections made at the Philadelphia Bank, like those at New York, implied that M_1 would grow over coming months at rates higher than those shown in the blue book. His own intuition--reflecting the experience of last year--suggested that the actual growth rates were likely to exceed those indicated in the blue book.

With respect to current policy, Mr. Eastburn said he would be inclined to focus on the outlook for the monetary aggregates in the third quarter. In his view growth in M_1 at the 8-1/2 per cent

rate projected under pattern I would be too fast. He agreed with Mr. Axilrod that if the Committee was going to seek a lower rate it should begin soon to move toward firmer money market conditions.

Mr. Heflin said he thought the Committee had some difficult choices to make at this meeting. On balance, he would favor proceeding along the lines Mr. Daane had suggested. He would be willing to let upward pressures on interest rates show through to some extent, but until it was clear that the economic recovery had developed real momentum he would be hesitant to follow a policy course that resulted in substantial pressures on long-term rates.

Mr. Heflin added that there was some question in his mind as to whether the blue book was right in indicating that the pattern I aggregate growth rates could be achieved with a 4-3/4 per cent upper limit on the funds rate. While such relationships could not be specified precisely in the present state of the art, he suspected that to keep growth in the aggregates from exceeding the pattern I rates the funds rate would have to rise to 5 per cent, and he would not be disturbed if it did so.

Mr. Kimbrel noted that economic conditions in the Sixth District were currently strong and appeared to be getting stronger. As to monetary policy, he would be reluctant to take any action at this time that would put upward pressure on long-term rates, particularly mortgage rates. Having said that, he would add that he was apprehensive about the recent trend of prices. He might also

note that the District bankers and businessmen with whom he had visited recently were becoming increasingly skeptical about the possibility of diminished inflation. He thought the time had arrived for the System to begin supplying reserves at a somewhat less expansive pace and to be prepared to accept a very gradual rise in short-term interest rates.

Mr. MacLaury said he might begin by making a number of suggestions concerning staff procedures. First, he hoped the staff would include information in each issue of the green book on the assumptions with respect to monetary policy underlying the GNP projections shown. He, for one, found it difficult to recall from one meeting to the next what the latest assumptions were and he gathered from Mr. Mayo's question earlier today that he was not alone. Second, he noted that in the current blue book the staff's projections of M_1 for the third quarter were given in the text but not in the tables; it would have been helpful to have that information in the tables also. Finally, he thought the money market specifications given in the blue book for pattern II differed too much from prevailing conditions to constitute a realistic alternative.

With respect to substantive matters, Mr. MacLaury said his confidence in the strength of the current recovery was increasing even though he recognized that the upswing had only recently become a vigorous one. As to long-term interest rates, he was sure no member of the Committee would like to see increases at this time. As he had indicated at the previous meeting, he thought there was

a better chance of avoiding such increases over the next few months by preventing the aggregates from growing at excessive rates than by keeping short-term rates from rising.

Mr. MacLaury observed that it was far from clear that the rate of growth in M_1 would slow to a 7 or 7-1/2 per cent rate in the second quarter, as the staff was projecting. He noted in that connection that the staff's projection was predicated on a rather sharp reduction in the growth rate in June. It was also worth noting that all three of the monetary aggregates had been on the high side of expectations in March and early April, and that the New York Bank's projections suggested that the aggregates would grow more in the second quarter than the blue book indicated.

Also, Mr. MacLaury continued, the M_1 growth rates shown in the blue book for the third quarter were higher than he considered desirable. His concern on that score was enhanced by the prospect that fiscal policy would become increasingly stimulative in the second half of the year according to the staff's projections, which showed a deepening of the high-employment deficit after midyear. Also, while the 5.7 per cent rate of growth in real GNP projected for 1972 as a whole might be less than hoped for, it was worth noting that the average growth rate projected for the third and fourth quarters was over 7 per cent. That was nearly double the long-term average rate of growth in the economy's capacity to produce, which was usually estimated at about 4 per cent. Thus,

the upswing in economic activity would be gaining momentum at a rather rapid rate in the second half.

In response to questions, Mr. MacLaury said he did not mean to dispute the staff's projection that the unemployment rate would still be high in the second half, or to suggest that the anticipated rate of growth in real GNP was undesirable in itself. His point, rather, was that such a growth rate implied a momentum for the economy that would be difficult to slow as full employment was approached next year unless the Committee began to offer some resistance in the monetary area now.

Mr. Swan said he was concerned about the risk that the Committee might again find itself in a position in which abrupt changes in interest rates were required to avoid excessive growth in the monetary aggregates. Consequently, he agreed with those who favored taking some action now to slow the aggregates. While some increase in short-term interest rates presumably would be required, he doubted that rates would have to rise into the upper part of the ranges associated with pattern II. In sum, he thought the Committee could best deal with the problem of the aggregates by beginning to act in a gradual manner now rather than by delaying action until later. He preferred aiming for the pattern II growth rates, but if the aggregates in fact increased at the pattern I rates he would not be disturbed.

Mr. Swan then offered a further observation, relating to the trade-off between the rate of advance in prices and the unemployment rate. He noted that the Committee was sometimes criticized for being overly concerned with upward price pressures, particularly when they resulted from cost increases rather than from excess demand. He wondered, however, whether in considering current and projected rates of unemployment the Committee did not also have a tendency to overlook the contribution of structural unemployment to the total. To an important extent the two situations seemed to him to be parallel.

Mr. Clay remarked that the Committee was faced with a difficult policy decision today. Against the background of the recent high growth rates in the monetary aggregates, the prospective rates shown under pattern I would be a cause for some concern. On the other hand, any marked upward movement in interest rates--particularly long-term rates--as suggested in connection with pattern II also would be of considerable concern.

In his judgment, Mr. Clay continued, the problem of upward pressures on interest rates could not be avoided by accepting high rates of expansion in the monetary aggregates. Excessive growth rates in the aggregates might delay, but would not remove, those pressures; and it could ultimately intensify them. Since long-term rates already reflected a substantial allowance for inflationary expectations, further upward pressures might be restrained by

evidence of slightly more moderate rates of expansion in the monetary aggregates. In his view a move in that direction would be in the best interests of the economy.

Mr. Morris said it seemed to him that the business expansion was firmly rooted--even though the evidence had become available only recently--and that there had been a fundamental improvement in business confidence. He had been particularly impressed by the fact that the stock market had held its ground during the past week in the face of the dramatic developments in Vietnam. It was important to recognize that monetary policy operated with very long lags and that the policy decisions made in the second quarter of this year would have an impact on economic developments through 1973. He was impressed by Mr. MacLaury's observation that fiscal policy would become much more stimulative after mid-1972, and he thought the logical counterpart of that development would be for monetary policy to become less stimulative.

Mr. Morris said he considered the rapid growth of the monetary aggregates in the first quarter to have been entirely appropriate in light of the shortfalls that had occurred in the latter part of 1971. However, most members of the Committee seemed to agree that the growth rates should be cut back. It was likely to be much more difficult to do so if action were delayed until later in the year--partly because monetary policy in the second half would be operating under the constraint of large-scale Treasury

financings, involving net borrowings from the public of almost $21 billion. If reasonable aggregate growth rates were to be achieved for the year as a whole it was necessary for the Committee to start slowing those rates now.

Under current market conditions, Mr. Morris continued, there appeared to be very little the Committee could do to influence long-term interest rates directly. In a meeting with a group of sophisticated investors last week he had been surprised by the bearishness of their outlook for bond prices. Those investors were not focusing on short-term interest rates and they were not worried that monetary policy might become too restrictive. They were concerned, rather, about the possibility of a new wave of inflationary expectations. Maintaining the status quo in money markets would not have a favorable effect on such attitudes; if anything, the effect could be perverse. The better course, in his judgment, would be to permit short-term rates to move higher--but gradually enough to avoid creating the expectation of a major change in monetary policy. For the Federal funds rate he favored a range of 4 to 5 per cent.

Mr. Sheehan said he concurred in the views expressed by Messrs. Brimmer, Maisel, and Burns. He recognized that excessive growth in the monetary aggregates could fuel inflationary expectations and increase the inflation premium in long-term rates. But he also noted that in the fourth quarter, according to the staff

projections, there still would be an unemployment rate of 5.4 per cent and a rate of capacity utilization in manufacturing of only 77 per cent. Short-term interest rates had risen considerably in recent weeks, and he thought substantial damage could be done by further marked increases.

Chairman Burns observed that the Committee's discussion had been candid and useful. He suggested that the Committee now hold a brief go-around of views on the directive and specifications, beginning with Mr. Hayes.

Mr. Hayes said he thought alternative C, calling for "more moderate growth in monetary aggregates over the months ahead," was an appropriate directive. He would prefer to see the aggregates grow at the pattern II rates. However, for the Federal funds rate he favored a range of 4 to 5 per cent, which was between the ranges associated with patterns I and II.

Mr. Francis observed that he also liked the alternative C language for the directive, but he thought both patterns I and II involved undesirably rapid growth of M_1. Thus, under pattern I the growth rate over the first nine months of the year would be 8-1/2 per cent, and under II it would be reduced only to 7.7 per cent. He would prefer to work toward a 5 per cent rate of expansion in M_1 for the rest of the year, which would yield a 6 per cent growth rate over the full year. In his view such a policy would tend to dampen inflationary expectations without impairing the

economic recovery. It might also go a long way toward removing the risk of a credit crunch in 1973 or 1974.

Mr. Kimbrel said he would be quite happy with rates of growth in the aggregates between those of patterns I and II.

Mr. Eastburn said he preferred alternative C for the directive and the specifications of pattern II. He would not be disturbed, however, if the Federal funds rate was somewhat below the 4-1/2 per cent lower limit shown under II.

Mr. Winn concurred in Mr. Eastburn's views.

Mr. Sheehan said he would favor holding policy unchanged.

Mr. Brimmer remarked that his preference was for specifications between patterns I and II. Like Mr. Hayes, he would favor a 4 to 5 per cent range for the funds rate.

Mr. Maisel said he would favor alternative A for the directive and the pattern I growth rate for RPD. In place of the 3-3/4 to 4-3/4 per cent range for the funds rate in pattern I he would use the broader range of 3-1/4 to 5 per cent.

Mr. Daane said he favored language along the lines of alternative A. He noted, however, that the staff proposed to omit the clause "while taking account of international developments," on the grounds that conditions in exchange markets were now quieter. He thought some reference to international developments should be retained in the operational paragraph.

Chairman Burns remarked that, while there was merit in Mr. Daane's suggestion, the balance of considerations might argue against retaining such a reference. What concerned him was the possibility that when the directive was published in 90 days the reference might be misinterpreted as indicating that the Committee lacked confidence in the durability of the Smithsonian agreement.

Mr. Hayes commented that an instruction to the Desk to "remain alert to the international situation" might be warranted in view of recent events in Vietnam.

After further discussion, Chairman Burns suggested that in the interest of time the Committee refer the question at issue to a subcommittee consisting of Messrs. Daane, Hayes, and himself. There was general agreement with the Chairman's suggestion.

> Secretary's Note: Following the meeting the subcommittee decided against including a reference to international developments in the operational paragraph of the directive.

Mr. Daane then observed that he would prefer to formulate operating instructions mainly in terms of money market conditions. He favored aiming for conditions between those shown under patterns I and II. While he would be prepared to let the aggregates fall where they might, he hoped their growth rates would moderate somewhat.

Mr. Mitchell said he favored alternative B for the directive and the pattern I specifications, including a growth rate of RPD in the second quarter of 7-1/2 per cent. He was not sure it would prove possible to attain that growth rate; and, as he had indicated earlier, he had some misgivings about using a reserve measure that excluded reserves against Government deposits. However, he could not quarrel with the 7-1/2 per cent rate as a target; any lower target would be too low. He disagreed completely with those who favored seeking firmer money market conditions without waiting to see how the aggregates performed under current conditions.

Mr. Heflin said he favored specifications between patterns I and II, including a 4 to 5 per cent range for the funds rate.

Mr. Clay said he preferred pattern II but would find specifications between I and II acceptable. He liked alternative C of the directive drafts.

Mr. Mayo favored the specifications of pattern II except that he would lower the limits of the range for the funds rate by 1/4 point, to 4-1/4--5-1/4 per cent. For directive language he preferred alternative A, which called for "moderate growth" in the monetary aggregates. He thought the pattern II growth rates would fit that description.

Mr. MacLaury said he also would choose the alternative A language. He favored specifications between I and II, including a range of 4 to 5-1/4 per cent for the funds rate and a target growth rate of 6-1/2 to 7 per cent for RPD in the second quarter.

Mr. Swan favored pattern II with some slight reduction in the upper limit for the funds rate. Like Mr. Mayo he thought the pattern II growth rates for the aggregates could be described as "moderate," and he therefore preferred alternative A for the directive. If the Committee chose alternative C, however, he would suggest inserting the word "somewhat" before "more moderate growth in monetary aggregates."

Mr. Coldwell concurred in Mr. Swan's views on the directive but favored specifications between those of patterns I and II. He suggested that the Committee plan to reexamine policy in the period before the next scheduled meeting if the funds rate was approaching the 5 per cent level and if it appeared that long-term interest rates were beginning to react.

Mr. Morris commented that he would like to see the Desk move the Federal funds rate up gradually by slowing the rate of expansion in reserves to that shown under pattern II. He would prefer not to have the funds rate exceed 5 per cent in the coming inter-meeting period. In view of the small size of the forthcoming Treasury financing, he thought the need for even keel would be more limited than usual.

Mr. Robertson favored specifications between those of patterns I and II, with any errors to be made in the direction of II rather than I. To his mind alternative C was best for the directive,

since the Committee was in fact seeking more moderate growth in the aggregates.

Chairman Burns suggested that the Committee consider an operational paragraph that employed the phrase "somewhat more moderate growth" in describing the objective for the monetary aggregates and that also included an instruction to take account of capital market developments. The specific language he had in mind was as follows: "To implement this policy, while taking account of capital market developments and the forthcoming Treasury financing, the Committee seeks to achieve bank reserve and money market conditions that will support somewhat more moderate growth in monetary aggregates over the months ahead."

In reply to a question, the Chairman said he thought the reference to capital market developments would be helpful as a word of caution with respect to long-term interest rates. In that connection, he might note that he would want to consult with the Committee in the period before the next scheduled meeting if long-term rates began rising at a rate likely to be disturbing to the economy.

After discussion, the Committee agreed that the language read by the Chairman would be acceptable for the operational paragraph of the directive.

The Chairman then observed that the Committee's consensus on specifications seemed to be intermediate to those shown under

patterns I and II in the blue book. He suggested that the members consider specifications half-way between the two patterns. Specifically, under the first point of the five-point procedure the Committee was now employing, the desired range for the annual rate of growth in reserves available to support private nonbank deposits would be 7 to 11 per cent during April and May together. Under point 2, the range for the Federal funds rate in the period before the next meeting would be 4 to 5 per cent. Under point 4, the expected growth rates for the several monetary aggregates in April, May, and the second quarter would be the averages of those indicated under I and II; for example, for the second quarter the expected growth rates would be taken as 7-1/4 per cent for M_1, 7-1/2 per cent for M_2, and 5-1/4 per cent for the credit proxy.

Mr. MacLaury noted that adoption of those specifications could result in no change from prevailing money market conditions. Personally, he would like to see the Federal funds rate move up gradually within the indicated range over the coming period.

Chairman Burns observed that the Desk would be expected to let a higher funds rate develop if that appeared necessary to achieve the Committee's objectives for reserves and monetary aggregates. He did not think the Committee favored seeking firmer money market conditions without regard to the aggregates.

Mr. MacLaury noted that the aggregates recently had been tending to exceed expectations.

Mr. Hayes indicated that he shared Mr. MacLaury's view. It was his impression from the discussion that a majority of members thought a cautious move toward somewhat higher funds rates was warranted by the information already available on growth rates in the aggregates.

Mr. Daane noted that the operational language in the directives the Committee had been employing since February was couched in terms of both reserves and money market conditions. It was because of that dual emphasis that he had been willing to go along with the new procedures. He thought it would be consistent with those procedures to instruct the Desk to start probing toward a higher funds rate at the outset of the coming period, in the hope that the aggregates would fall into place. As he had indicated earlier, he would want the Desk to back off if the firming operations appeared to be producing an undesired reaction in long-term markets.

Mr. Mitchell said he personally would not want to aim for firmer money market conditions unless the aggregates appeared to be exceeding the desired growth rates.

Chairman Burns remarked that there evidently were differences of opinion regarding both the nature of the procedures the Committee had been following recently and the views of members today on how the specifications should be interpreted. The second question could be resolved readily by asking the members to indicate their

preferences. With respect to the first question, it was his understanding that under present procedures the Desk was expected to observe unfolding developments with respect to reserves and the monetary aggregates, and to adjust its objectives for the Federal funds rate within the specified range if those measures appeared to be deviating from the specified targets. It would be helpful, however, to have the Manager explain how he had, in fact, been operating.

Mr. Holmes commented that the Chairman's summary was descriptive of actual procedures. It was the Desk's practice to review the course of reserves daily--and, he might add, thus far it had been more successful than he had anticipated in keeping the rate of reserve growth within the desired range. At least once a week the Desk reviewed the latest information on the monetary aggregates, putting more weight on actual developments than on projections. Money market objectives were not changed so long as reserves and the aggregates appeared to be on track. If, for example, the Committee had specified a 4 to 5 per cent range for the funds rate and that rate was 4-1/4 per cent on a particular day, the Desk would resist any tendency for the funds rate to change in the absence of evidence that reserves and aggregates were departing from the Committee's desires. Upward and downward pressures on the funds rate often were a signal that actual reserves were

deviating from estimates, and operations to resist such pressures were helpful in correcting the shortfall or excess.

The Chairman then asked whether the Manager would interpret the specifications described earlier as calling for a prompt increase in the Federal funds rate.

Mr. Holmes said he would not. Some increase might be called for later in the period if the New York Bank's projections of the aggregates, which were higher than those in the blue book, proved to be the more accurate. Such a development might pose a problem since operations in the coming period would be affected by even keel considerations.

Chairman Burns indicated that, like Mr. Morris, he thought that even keel considerations in this period would be less of a constraint than usual because of the small size of the Treasury's financing. There remained the question of the Committee's preferences with respect to the interpretation of the consensus. He thought it would be helpful if Mr. Hayes would outline his proposed interpretation.

Mr. Hayes noted that the members appeared to favor growth rates for RPD and the monetary aggregates half-way between those shown under patterns I and II, and that they expected such growth rates to be consistent with a Federal funds rate somewhere in the range between 4 and 5 per cent. It was his understanding that there was no general preference for funds rates near the lower or

the upper end of that range. However, the current funds rate was nearer the lower end, and present prospects were for rather generous growth in the aggregates. Those considerations would justify probing cautiously toward a higher funds rate while keeping a close watch on the aggregates.

Chairman Burns asked the members to indicate whether they favored the interpretation outlined by Mr. Hayes, and four members responded affirmatively.

The Chairman then suggested that the Committee vote on a directive consisting of the three general paragraphs drafted by the staff and the operational paragraph he had read earlier. It would be understood that in implementing the directive the Manager would be guided by the specifications he had described, within the five-point procedure the Committee had been following since the meeting of February 15, 1972.

Mr. Hayes said he was rather reluctant to vote affirmatively because he was dissatisfied with the proposed course. He planned to do so, however, because the difference of view was not sufficiently great to warrant his casting a dissenting vote.

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 grew in the first quarter at about the stepped-up rate attained in the fourth quarter of 1971. Most measures of business activity have shown strength recently and demands for labor have improved further, but the unemployment rate remains high. The rise in wholesale prices slowed in March as some farm and food products declined sharply, but the rise in prices of industrial commodities remained substantial. Wage rates also rose substantially in March and over the first quarter as a whole. The dollar has strengthened somewhat in exchange markets in recent weeks, and the over-all U.S. balance of payments deficit on the official settlements basis has been small. In January and February merchandise imports continued to be considerably in excess of exports.

The narrowly defined money stock expanded rapidly in February and March, bringing the annual rate of growth over the past 6 months to about 5-1/4 per cent. Inflows of consumer-type time and savings deposits to banks have been strong thus far this year, although they moderated as the first quarter progressed; inflows to nonbank thrift institutions remained very large. Mainly reflecting swings in U.S. Government deposits, a modest increase in the bank credit proxy in February was followed by a large increase in March. Market interest rates generally have continued to rise in recent weeks.

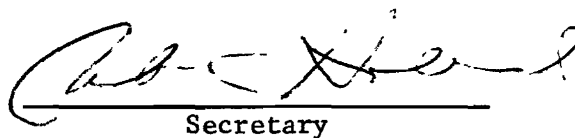
In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of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

To implement this policy, while taking account of capital market developments and the forthcoming Treasury financing, the Committee seeks to achieve bank reserve and money market conditions that will support somewhat more 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.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, May 23, 1972, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

April 17, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on April 18, 1972

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services grew in the first quarter at about the stepped-up rate attained in the fourth quarter of 1971. Most measures of business activity have shown strength recently and demands for labor have improved further, but the unemployment rate remains high. The rise in wholesale prices slowed in March as some farm and food products declined sharply, but the rise in prices of industrial commodities remained substantial. Wage rates also rose substantially in March and over the first quarter as a whole. The dollar has strengthened somewhat in exchange markets in recent weeks, and the over-all U.S. balance of payments deficit on the official settlements basis has been small. In January and February merchandise imports continued to be considerably in excess of exports.

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

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of the forthcoming 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.

Alternative B

To implement this policy, while taking account of capital market developments and the forthcoming 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.

Alternative C

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

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

April 18, 1972

Points for FOMC Guidance to Manager In Implementation of Directive (as agreed upon 2/15/72)	SPECIFICATIONS As agreed, 4/18/72
1. Desired rate of growth in aggregate reserves expressed as a range rather than a point target.	7-11% seas. adj. annual rate in RPD in April-May
2. Range of toleration for fluctuations in Federal funds rate--enough to allow significant changes in reserve supply, but not so much as to disturb markets.	4 to 5%
3. Federal funds rate to be moved in an orderly way within the range of tolerance (rather than to be allowed to bounce around unchecked between the upper and lower limit of the range).	
4. Significant deviations from expectations for monetary aggregates (M_1, M_2, and bank credit) are to be given some allowance by the Manager as he supplies reserves between meetings.	(see table below)
5. If it appears the Committee's various objectives and constraints are not going to be met satisfactorily in any period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.	(It was indicated at the April 18 meeting that Chairman Burns might consult with the Committee in the period before the next scheduled meeting under other circumstances also, depending on the course of long-term interest rates and other relevant developments.)

(SAAR)

	Apr.	May	2nd Q
M_1:	8	8.5	7.25
M_2:	8	7.5	7.5
Proxy:	8.5	-2.5	5.25