FEDERAL RESERVE

press release

For immediate release August 9, 1971

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on May 11, 1971.

Such records are made available approximately 90 days after the date of each meeting of the Committee and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based on the information that was available to the Committee at the time of the meeting, rather than on data as they may have been revised since then.

Attachment

RECORD OF POLICY ACTIONS
OF THE FEDERAL OPEN MARKET COMMITTEE

Meeting held on May 11, 1971

Authority to effect transactions in System Account.

Preliminary estimates of the Commerce Department indicated that real output of goods and services had increased at an annual rate of 6.5 per cent in the first quarter, after having declined at a 3.9 per cent rate in the fourth quarter of 1970. The strength of the first-quarter rise was attributable primarily to a resumption of higher automobile production following the strike in that industry, and more moderate growth of real GNP appeared to be in prospect for the current quarter.

In April nonfarm payroll employment again remained about unchanged and the unemployment rate edged up to 6.1 from 6.0 per cent in the previous month. Tentative estimates indicated that industrial production had risen somewhat. The latest data for retail sales suggested that there had been a pick-up in consumer spending, apart from the post-strike recovery in automobile purchases; revised figures revealed that nonautomotive sales had strengthened somewhat more over the course of the first quarter than had been thought earlier, and according to preliminary indications for April such sales were continuing at about the level they had reached in March. Private housing starts increased substantially further in March.

Wholesale prices of industrial commodities rose sharply in April, after having advanced at a moderate pace earlier in the year. The rate of increase in the consumer price index slowed in March for the third successive month, reflecting to an important extent a further decline in mortgage interest costs. Wage rates continued to rise rapidly.

Growth in real GNP was projected to slow in the second quarter mainly because of the waning effect of the post-strike recovery in the automobile industry. In light of the recent strengthening of retail sales, the projected amount of improvement in personal consumption expenditures had been raised somewhat, although it remained well below the gain recorded in the first quarter. The staff projections continued to suggest a further decline in defense spending and further substantial increases in residential construction expenditures and State and local government outlays--and also a step-up in business inventory accumulation, in part reflecting stockpiling of steel in anticipation of a possible strike in the industry when current wage contracts expire at the end of July.

While the possibility of a steel strike continued to cloud the outlook for the second half of the year, the average rate of growth was still expected to be somewhat higher than in the second quarter if the duration of any such strike did not exceed 60 days or so. It appeared likely that the rate of growth in residential construction outlays would slacken as the year progressed. However, prospects were for further large increases in State and local government expenditures and moderate gains in outlays for business fixed investment. Various developments were expected to help sustain expansion in consumer spending during the second half of the year: the recently enacted increase in social security benefits, under which payments retroactive to January 1 were scheduled to be made in late June; a possible increase in military pay scales around midyear; and a possible decline in the rate of personal saving in the third and fourth quarters.

Although the U.S. merchandise trade balance improved somewhat in March, exports exceeded imports by only a small margin over the first quarter as a whole. The over-all payments balance was in extremely large deficit during the quarter on both the liquidity and official settlements bases, and tentative estimates indicated that the deficit was again very large in April. In great part the deterioration of the payments balance in the first 4 months of 1971 reflected outflows of short-term capital, at first primarily in response to higher interest rates abroad and later also in response to a growing belief that there might be increases in the exchange rates for certain European currencies.

Movements from the dollar into the German mark and some other European currencies, which had been particularly heavy in the first few days of April, subsided during the next 3 weeks. The atmosphere in foreign exchange markets remained uneasy, however, and a new wave of uncertainty was evidenced late in the month by an upsurge of demands for forward marks. On April 28 the German monetary authorities announced that they were discontinuing forward sales of marks; and during the next few days, against the background of various public statements and market rumors regarding possible exchange rate policies, upward pressures intensified on the exchange rate for the mark and for several other European currencies. Flows of funds, particularly into marks, reached massive proportions on May 4 and 5, and on the latter date the central banks of Germany, Switzerland, the Netherlands, Belgium, and Austria suspended sales of their currencies for dollars. On Sunday, May 9, announcements were made that exchange rates for the German mark and the Dutch guilder would be allowed to float for the time being, and that the Swiss franc and Austrian schilling were being revalued upward, by 7.07 and 5.05 per cent, respectively.

On April 28 the Treasury announced the terms on which it would refund securities maturing in mid-May, including $5.8 billion held by the public. Holders of the maturing obligations were offered the choice of two relatively short-term notes--a new 15-month, 5 per cent note priced at par and a reopened issue of 3-1/2 year, 5-3/4 per cent notes priced to yield about 5.88 per cent. Although the outcome of the financing was affected adversely by the developments in foreign exchange markets around the May 5 closing date for subscriptions, the proportion of publicly held maturing issues redeemed for cash--

about 30 per cent--was less than many observers had expected under the circumstances.

The atmosphere of crisis in foreign exchange markets in early May added to uncertainties already prevailing in domestic financial markets. Interest rates on most types of short- and long-term securities had risen sharply in recent weeks, reflecting continued heavy demands for funds in capital markets and growing expectations on the part of market participants of higher rates to come. Contributing to the change in market psychology were favorable business developments, the recent firming of money market conditions, and the belief that the Federal Reserve would seek still firmer conditions in light of current rapid rates of growth in the monetary aggregates and of developments in international financial markets. Market rates on short-term Treasury bills shared in the general uptrend through most of April; for example, the rate on 3-month bills advanced from about 3.70 per cent on the day before the April 6 meeting of the Committee to slightly more than 4 per cent near the end of the month. Subsequently, however, the 3-month rate declined--to about 3.85 per cent on the day before this meeting--partly as a result of large-scale bill purchases by foreign official accounts.

Interest rates on conventional new-home mortgages declined further in March, but more slowly than earlier in the year. Yields in secondary markets for federally insured mortgages, which had leveled out in March, advanced in late April. Incomplete data for April suggested that inflows of funds to nonbank thrift institutions were remaining close to the extraordinarily high monthly volume recorded in the first quarter.

At commercial banks, inflows of consumer-type time and savings deposits slowed substantially in April from their very high first-quarter pace, partly in response to reductions in rates offered on such deposits. The volume of large-denomination CD's outstanding declined slightly. Business loans outstanding (including loans that had been sold to affiliates) changed little over the course of the month, after having declined in March. On April 22 and 23 a number of major banks announced an increase in their prime lending rates from 5-1/4 to 5-1/2 per cent, and by the date of this meeting the higher prime rate had become general. This increase, which followed a series of reductions during the fall and winter months, was attributed to the advance in short-term market interest rates that had occurred since the last such reduction in March.

Commercial bank holdings of Treasury securities declined during April, following a substantial rise in the first quarter, and holdings of other securities expanded at a somewhat slower pace than earlier in the year. Banks continued to reduce their use of funds from nondeposit sources. Most of the reduction in April was associated with declines in head-office liabilities to foreign branches, largely in connection with branch acquisitions of the $1.5 billion of special certificates offered to them by the Treasury for payment on April 9. Growth in total bank credit, as measured by the adjusted proxy series--daily-average member bank deposits, adjusted to include funds from nondeposit sources--slowed further from March to April.

Estimates of the average March level of both the narrow and broader measures of the money stock--M_1 and M_2--had been revised upward somewhat since the preceding meeting of the Committee. It now appeared that M_1 (private demand deposits plus currency in circulation) had increased at an annual rate of about 9 per cent over the first quarter as a whole[1/] and that M_2 (M_1 plus commercial bank time deposits other than large-denomination CD's) had grown at a rate of about 18 per cent. According to preliminary estimates, both measures of the money stock expanded substantially further from March to April--M_1 considerably more and M_2 slightly more than the Committee had deemed desirable at the time of its previous meeting.

System open market operations immediately following the April 6 meeting of the Committee had been directed at achieving

1/ Calculated on the basis of the daily-average level in the last month of the quarter relative to that in the last month of the preceding quarter.

somewhat firmer conditions in the money market. Shortly thereafter, when available data indicated that M_1, and to a lesser extent M_2, were growing at rates in excess of those expected, some slight additional firming was sought. The Federal funds rate--which had fluctuated mostly around 3-3/4 per cent following the March meeting--moved up to a range around 4-1/4 per cent, where it remained through the end of April. Subsequently, however, despite large-scale reserve-supplying operations by the System, the Federal funds rate advanced to a range around 4-1/2 per cent. This additional firming occurred against the background of the crisis atmosphere in foreign exchange markets, and in part was a consequence of aggressive bidding for funds by major banks in an effort to position themselves against possible outflows of deposits.

It was noted that the current outlook for the monetary and credit aggregates was more uncertain than usual because of the possible impact on domestic financial markets of developments in foreign exchange markets. Staff analysis suggested that, if conditions in the money market were similar to those prevailing during most of April, inflows of time and savings deposits would slacken in the second quarter and growth in M_2 and the bank credit proxy would moderate considerably from the first-quarter pace. M_1, on the other hand, was expected to expand at an annual rate of approximately 9 per cent over the second quarter, or about as rapidly as in the first quarter. The analysis suggested that, if money market conditions were somewhat firmer, expansion in M_1 would slow gradually during coming months; but that--in part because of the sharp increase that had already occurred in April and in part because of lags in responses to changed money market conditions--M_1 would still grow at a rate of about 8.5 per cent over the second quarter as a whole. It appeared that a sharp firming of money market conditions would be required to slow expansion in M_1 sufficiently during the rest of the second quarter to achieve a substantial moderation of growth over the quarter as a whole.

In the discussion Committee members expressed concern both about the recent high rates of growth in the monetary aggregates and about the marked increases that had occurred in long-term interest rates. The view was widely held among members that expansion in M_1 at the first-quarter pace for an extended period would be inconsistent with an orderly reduction in the rate of inflation. Also widely held, however, was the view that sharp increases in long-term rates at this juncture might have adverse consequences for spending, particularly in the residential construction and State and local government sectors, and might thus pose a threat to the economic recovery under way.

Although there were some rather marked differences in the stress that individual members placed on these two types of considerations, the Committee agreed that it would not be desirable at present either to revert to the money market conditions that had prevailed until the end of April or to seek the amount of firming that evidently would be required to achieve a substantial slowing of growth in the aggregates over the second quarter. Instead, the Committee decided that in the early part of the coming period, when open market operations in any case would be conditioned by even-keel considerations related to the current Treasury refunding, the objective should be to maintain the money market conditions currently prevailing. Similar conditions were to be sought later if the monetary aggregates appeared to be on paths consistent with gradual moderation of growth during the second quarter. If the aggregates appeared to be deviating significantly from such paths, the objective was to be modified accordingly--except that any firming of money market conditions directed at slowing excessive growth was to be carried out cautiously, with a view to avoiding undue reactions in capital markets.

The Committee agreed that, in light of the uncertainties prevailing in domestic financial markets and in foreign exchange markets, the Account Manager should have more than the usual degree of discretion in making day-to-day operating decisions. However, the Committee also agreed that it would be advisable at present for the System to engage in purchases of longer-term Government securities on a smaller scale than in recent months in the process of meeting needs for reserves.

The following current economic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that real output of goods and services rose substantially in the first quarter primarily because of the resumption of higher automobile production, and more moderate growth appears to be in prospect for the current quarter. The unemployment rate remained high in April. Wage rates in most sectors are continuing to rise at a rapid pace. The rate of advance in consumer prices and in wholesale prices of industrial commodities moderated in the first quarter, but the rise in industrial prices stepped up again in April. The money stock both narrowly and broadly defined expanded substantially further in April but growth in bank credit slowed. Inflows of consumer-type time and savings funds to banks moderated, partly as a result of reductions in the interest rates offered by banks, but flows to nonbank thrift institutions continued heavy. Interest rates on most types of short- and long-term market securities rose sharply in April and early May, reflecting uncertainties about domestic, and more recently international, financial prospects. The over-all balance of payments deficit in the first four months of 1971 was exceptionally large, in great part reflecting short-term capital outflows. Recently, after further large international flows of funds, several European central banks suspended sales of their currencies for dollars; subsequently, announcements were made that the German mark and Dutch guilder would be permitted to float for the time being, and that the Swiss franc and Austrian schilling were being revalued. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments.
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> To implement this policy, the Committee seeks to moderate growth in monetary and credit aggregates over the months ahead, taking account of the current Treasury financing, developments in capital markets, and uncertainties in foreign exchange markets. System open market operations until the next meeting of the Committee shall be aimed initially at maintaining

currently prevailing money market conditions, and thereafter conducted with a view to maintaining bank reserves and money market conditions consistent with the above-cited objectives.

Votes for this action: Messrs. Burns, Hayes, Brimmer, Clay, Daane, Kimbrel, Maisel, Mayo, Mitchell, Morris, Robertson, and Sherrill. Votes against this action: None.