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 17, 1973, at 9:30 a.m. The meeting began in executive session.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Balles
Mr. Brimmer
Mr. Bucher
Mr. Daane
Mr. Francis
Mr. Mitchell
Mr. Morris
Mr. Robertson
Mr. Sheehan
Mr. Winn, Alternate for Mr. Mayo

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

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

Messrs. Black and Baughman, First Vice Presidents, Federal Reserve Banks of Richmond and Chicago, respectively

Mr. Holland, Secretary

Chairman Burns opened the executive session by commenting on the background and implications of the latest Congressional actions looking toward a simple one-year extension of the authority

embodied in the Economic stabilization Act. He also reported on the issuance yesterday by the Committee on Interest and Dividends of criteria relating to interest rates on commercial bank loans, and explained the philosophy underlying the criteria. He commented on the relevance of those actions to various aspects of monetary policy, including the discount rate.

The following then entered the meeting:

Mr. Broida, Deputy Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. O'Connell, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Andersen, Bryant, Garvy, Hersey, Reynolds, Scheld, and Sims, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. Coyne, Assistant to the Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mrs. Rehanek, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Sherman, Secretary, Office of the Secretary, Board of Governors

Messrs. Boehne, Parthemos, Taylor, and Doll, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Richmond, Atlanta, and Kansas City, respectively
Messrs. Hocter and Green, Vice Presidents, Federal Reserve Banks of Cleveland and Dallas, respectively
Messrs. Anderson and Cooper, Assistant Vice Presidents, Federal Reserve Banks of Boston and New York, respectively
Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on February 13, 1973, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee on February 13 and March 7, 1973, were accepted.

The Chairman 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:

Revised figures indicate an almost unprecedented expansion in consumption expenditures during the first quarter of this year. Total retail sales averaged 6 per cent more than in the fourth quarter--the steepest quarter-to-quarter gain since the time of the Korean War. A good deal of this increase was accounted for by sharply higher consumer prices--especially for food--but consumer takings in real terms also advanced strongly. Sales of new cars were at record-high levels, and furniture and appliance store sales showed equally large gains. General merchandise volume rose substantially from the fourth-quarter level; food store sales--though up considerably--rose somewhat less, surprisingly, than the average for all nondurable goods stores.

For some time we had been projecting extraordinary strength in consumption for the first half of this year, fueled by substantial income gains, the large increase in social security benefits which took effect last fall, and the jump in tax refund payments resulting from the over-withholding of personal income taxes throughout 1972. But the increase in consumption appears to have greatly exceeded our expectations. Four weeks ago we projected that consumption would rise at an 11-1/2 per cent annual rate in the first quarter; now, we are estimating that it in fact rose by around 15 per cent. The rise in outlays considerably exceeded the advance in disposable income, partly reflecting special accounting procedures for the tax refunds, so that the personal saving rate is estimated to have dropped by almost a full percentage point, rather than rising as we had expected.

The problem now is to determine whether the upsurge in consumption can persist, and what the induced effects may be on business attitudes and planning. I am inclined to view the size of the increase as an aberration. The most likely explanation is that consumers, sensing a breakdown of Phase III controls, reading of the second devaluation of the dollar, and seeing the soaring cost of meats and other foods, decided that this was the time to expedite their buying plans. To do so they have been going into debt at a record rate and the flow of savings into the depository institutions has been markedly curtailed. Purchases have no doubt been made in anticipation of refunds claimed on the 1972 tax forms that people have been preparing and filing. Meanwhile, higher prices have been boosting dollar outlays on nondurable goods, and real incomes of late have been declining.

This situation simply cannot continue, and therefore some correction in the rate of the consumer spending advance seems highly likely before many more months have passed. In our current green book[1/] projection, we have reduced somewhat our previously projected increases in consumption for the remainder of the year. Fourth-quarter outlays nevertheless are shown to be $3-1/2 billion higher than was the case 4 weeks ago, mainly because of our assumption of a somewhat higher price level. But increases in consumer outlays are expected

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

to moderate from this point on, as employment and income growth slows and the stimulative effects of higher social security and tax refund payments wear off. For the second half of the year, our projections imply increases in real consumption at only a 3 per cent rate.

The problem of handling the induced effects on business spending is even more conjectural. In the short run, the impact of higher consumer buying probably has been to reduce the rate of inventory accumulation, since production schedules had largely been set and the surge in demand undoubtedly exceeded prior expectations. This shortfall in inventory investment is likely to be made up with the passage of time, as production schedules are stepped up, and we have increased our projected rates of inventory accumulation in the second half of the year. But the strength of demand may also be perceived by many businesses as evidencing the need for greater inventory stocking than they had previously planned, and as justification for a further boost in capacity-expanding capital spending projects. We have not yet increased our projections to allow for dynamic effects such as these, mainly because we expect the slowing in consumption growth to become evident before major new commitments are made. The risk, however, is clearly in the upward direction.

The risk of additional business inventory investment also is heightened by apparent shortages of some materials and the lengthening in delivery times for a wide array of purchased materials and component parts. Such reports have become commonplace in the press and in the District summaries included in the red book.[1/] The bottlenecks are no doubt spotty, but they seem most pronounced in the continuous-process materials industries and in building products. We have recently attempted to estimate capacity utilization rates in the major materials industries--an index that was discontinued some years ago by the Federal Reserve because of the refusal of the steel industry to continue providing data on ingot capacity. According to the best estimates that we now can make, the operating rate in these basic materials lines--including primary steel, nonferrous metals, petroleum refining, paper and paperboard, cement and various textiles--approached 94 per cent in the first quarter, on average, higher than at any time during the 1960's.

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

The over-all manufacturing capacity utilization rate remains much more comfortable--at a little over 80 per cent on our index for the first quarter--and it may well be that demands on the basic materials industries will tend to moderate as the year goes on. We are still expecting a decline in homebuilding, and demands for cars, appliances, and other metal-using consumer goods also should tend to ease off in the months ahead. But the much stronger markets for materials over recent months than we had perceived helps to explain the escalating price quotations for industrial commodities. This component of the wholesale price index increased at a 12 per cent annual rate in February and a 13-1/2 per cent rate in March, with the rise especially marked in crude and intermediate industrial materials.

The rapid run-up in nonfood commodity prices has undoubtedly reflected the freedom in pricing policies associated with the shift to Phase III, and also the direct and indirect effects of devaluation on the dollar prices of internationally competitive goods. These special influences should run their course in another month or two. But there is real question whether the underlying inflation rate may not also have accelerated, reflecting the current strength of markets and business expectations of higher costs to come. The increase of hourly earnings in the private nonfarm economy recently has been quite moderate, aside from the impact on payroll costs of higher social security taxes, but who can doubt that employees will be attempting to obtain wage increases in the months ahead sufficient to offset the sharply higher cost of living?

On balance, then, the odds seem higher than 4 weeks ago that the trend of inflation will be somewhat steeper and the period of rapid economic expansion more protracted, due to inventory building later this year, than we are currently projecting. I would still rate a gradual slowing in expansion as the more probable course, and this view tends to be supported by the marked deterioration in consumer and investor sentiment that has taken place. But the risks for the near-term--that is, roughly the remainder of this year--seem to me to be on the side of greater rather than less strength than is set forth in the green book.

> As it is, our projection of nominal GNP for 1973 is $4 billion higher than it was a month ago, entirely reflecting higher average prices. Given an unchanged assumption as to monetary growth, this step-up in GNP implies slightly higher interest rates this year than would have developed in the lower GNP model. If our projection is still too low, whether because of more inflation or larger real output or both, this would imply a still higher level of interest rates to come. This, in turn, would have restraining effects on credit-financed expenditures--such as housing--not now included in the projection, but these effects would mostly be delayed until 1974. Thus, the possibilities for a more cyclical configuration in the performance of the economy would seem to be on the rise.

Mr. Mitchell said he gathered that Mr. Partee thought there was a risk that businessmen might overreact to the bullish first-quarter developments in setting their inventory goals. While Mr. Partee had also commented on consumer attitudes, he had made only passing reference to the attitudes of investors in debt and equity instruments. In general, he (Mr. Mitchell) would like to know whether there were any policy measures that might have a favorable effect on attitudes in all three sectors.

In reply, Mr. Partee remarked that consumer sentiment regarding the future was growing increasingly gloomy largely because of the rate of inflation anticipated and the feeling that the present favorable business and employment situation could not persist. While such attitudes had the immediate effect of stimulating spending, over the longer run they should serve as a moderating factor.

Investors also were reacting to expectations of inflation, but stock market investors were now apparently focusing more on the recession they anticipated in 1974 than on the short-run outlook. With respect to possible policy actions, any measure would be constructive if it suggested there would be greater restraint on the economy for the period through early 1974 and then a countervailing stimulus. He could not say what kind of a measure would accomplish that objective, but it seemed more likely to be found in the area of fiscal policy than monetary policy. In any case, it was important to recognize that the present problem of attitudes was a double one: it was necessary to offer assurances not only that the boom would be damped but also that a recession would not ensue.

Chairman Burns observed that he had been following closely the attitudes of the three groups Mr. Mitchell had mentioned--businessmen, consumers, and financial investors. Businessmen were extraordinarily bullish; observing that the volume of their orders was rising and that their profits were improving--and suffering, as they always did in inflationary periods, from a money illusion--they were in an extremely optimistic mood. Among consumers, on the other hand, there had

been a sharp deterioration in sentiment and a spreading fear not only of inflation but also of recession. As to the third group, investment bankers and heads of brokerage firms with whom he had talked were highly pessimistic--in large part because of the relative lack of interest in new capital issues, the low volume of activity on the stock exchanges, and the depressed level of stock prices, particularly on the American stock exchange. Also, he understood from an analyst who had recently surveyed a number of institutional investors--including heads of pension funds, mutual funds, and bank trust departments--that investor confidence was very low and sinking further.

The Chairman noted that this was not the first time in economic history that the sentiment in different groups was moving in very different directions. Such a divergence could not persist, and the thinking of three groups could be expected --perhaps rather soon--to come together again.

Mr. Black asked whether the trade-off between unemployment and the rate of advance in prices had become less favorable recently, so that a higher rate of price advance would now be associated with a reduction in unemployment to an acceptable level.

Mr. Partee replied that prices could not be expected to continue upward at their recent pace; as he had indicated, that advance reflected a number of special factors, including the crop failures of the past year, the world-wide increase in industrial demands, and the transition from Phase II to Phase III. Nevertheless, he thought the answer to Mr. Black's question was yes. The staff had addressed that question in a number of recent presentations to the Committee, including the report at the previous meeting of the results obtained by using the Board's econometric model. Those calculations indicated that in the foreseeable future--over, say, the next 2 or 3 years--an unemployment rate in a 4-1/2 to 5 per cent range was likely to be associated with a rate of price advance of 4 to 4-1/2 per cent. While that was far below the inflation rate of the past few months, it was well above the 2-1/2 per cent guideline the President had established as his target for the end of 1973.

Mr. Black expressed the view that the forces contributing to that outlook for prices were largely beyond the control of the Federal Reserve, and Mr. Partee agreed.

Chairman Burns said he found it useful to think of present price developments as reflecting forces falling in three

categories: an underlying inflationary trend; the stimulation that is normally associated with a business cycle expansion; and the additional stimulation, particularly to prices of industrial raw materials, resulting from the world-wide nature of the current cyclical expansion. In addition, the devaluation of the dollar was a special factor influencing industrial materials prices in the United States.

Mr. Hayes observed that he agreed almost entirely with Mr. Partee's analysis, and would add only a few points. In connection with the extremely disturbing rate of price advance, it was worth noting that--while the various special factors Mr. Partee had mentioned clearly were at work--some of the largest individual price increases were consequences simply of shortages and excess demand. In his judgment, the traditional series on capacity utilization rates was relatively meaningless unless supplemented in the manner suggested by Mr. Partee today, and some rethinking was needed about the meaningfulness of the unemployment figures. A propos Mr. Black's question, he believed that any unemployment rate below the 5 per cent level might be associated with dangerously strong inflationary pressures.

Mr. Hayes said he fervently hoped that the rate of economic expansion would moderate. Such moderation was the

sine qua non for bringing the current inflation under control, and he was not at all sure that it would come about. In any case, the risks were still very much on the side of excessive overheating. He believed that the shift from Phase II to Phase III in the economic control program had been the single most important source of damage to consumer and investor confidence, and that a move to firmer controls on wages and prices would go a long way toward restoring confidence.

Chairman Burns asked Mr. Partee to amplify his comments about the new staff estimates of operating rates in major materials industries.

Mr. Partee noted that the index, which had been developed only in the past few weeks, was essentially a reconstruction of a measure of capacity use in the so-called "continuous process" industries which the Federal Reserve had compiled until about 1962. The figures on plant capacity were obtained from varied sources, including trade publications in many cases. For the steel industry, official figures on ingot capacity were no longer available, but informed industry judgments about capacity at various dates had been obtained in substitution. There were some differences from the old index,

including the absence of series for certain basic chemicals--such as sulfur, sulfuric acid, and cholorine--and the availability of more complete data for textiles.

In reply to a question, Mr. Partee said the figures for steel indicated that ingot production was now running at 95 per cent of capacity. While it was technically possible for output slightly to exceed the 100 per cent capacity level under certain circumstances, the measure suggested that there was virtually no room for increases in ingot output from the plants presently in operation.

Mr. Sheehan remarked that for several reasons it was extremely difficult to define capacity in many types of manufacturing operations. For one thing, the potential output of a manufacturing facility could depend on the product mix; thus, the gasoline capacity of petroleum refineries depended in part on anticipated requirements for home heating oils. For another, uncertainties were created by ecological problems. For example, it was not clear whether the open hearth furnaces of a particular steel plant near Birmingham, Alabama, would be brought into operation this year, as they had in past periods of strong demand, because of newly imposed pollution restrictions. Finally, plant managers might simply be unsure of their production capabilities,

perhaps because their facilities were relatively new. That was the case with many steel plants. He might add that under the current pressures to maximize output, the steel industry was getting better insights into its production capabilities with each passing day.

In reply to a question, Mr. Partee said that the capacity use index under discussion had declined from a level of about 92 per cent in late 1969 to a little above 85 per cent in 1970 and the early part of 1971 and a little below that level in the latter part of that year. Thus, the industries covered had not experienced particularly low operating rates during the recession. Since the third quarter of 1971 the index had risen by roughly 10 percentage points--from 83 per cent to the current figure of 93.6.

Chairman Burns remarked that he had no reason to quarrel with the cyclical pattern of fluctuations in the index, but he was rather skeptical of its accuracy in reflecting absolute capacity use at any one time. The subject was an important one, and the problems of measurement obviously were severe.

Mr. Eastburn said he would like to pursue the question of a possible recession in 1974. As he had noted at the previous meeting, estimates developed by the staff at his Bank, making use of the Board's econometric model, indicated that if M_1

were to expand at a rate of 3-1/2 per cent real GNP would decline by the fourth quarter of 1974. In looking at possible patterns of change by sectors, however, the staff had found it difficult to construct a plausible sequence of events that would culminate in a recession. He asked whether Mr. Partee could describe such a sequence.

Mr. Partee said one possibility would begin with a very large rise in inventory investment--substantially larger than incorporated in the latest green book projection--as a consequence of the current surge in consumption expenditures. Inventory accumulation might remain at a high rate into early 1974, but then slacken when it became clear that such a rate was not supported by consumption spending. Housing construction might be dropping off--perhaps sharply--in late 1973 and early 1974, and while plant and equipment spending probably would hold up for a longer period, it too could be moving down in the latter part of 1974. If the annual rate of inventory accumulation should reach, say, $25 billion and then fall off to $5 billion--a not inconceivable pattern of change--and if consumption expenditures were not particularly strong, it was rather hard to imagine what sectors might show the kind of strength that would be needed to avoid a decline in GNP.

Mr. Eastburn observed that there had been some feeling as recently as a month ago that business inventory behavior was more moderate than in past cyclical swings, perhaps because more effective inventory controls had been developed. He asked whether Mr. Partee was now skeptical of that view.

Mr. Partee said he was not. He still believed that the most probable development as the year went on was that over-all growth in GNP would slow. In particular, he thought it was likely that business inventory behavior would remain relatively moderate, as a result of better controls and of an awareness that the spending upsurge of the first quarter was a bubble rather than a basic increase in demand. At the same time, however, he had to admit that the possibilities were increasing that inventory accumulation could be greater than projected.

Mr. Kimbrel remarked that he was concerned about the speed-up in activity, particularly since it seemed to rest heavily on expectations of price increases or slowdowns in delivery schedules. With anticipatory buying by businesses apparently running at very high rates, even a moderate downward shift in the rate of consumer spending could lead to serious problems of economic adjustment. He might cite a few illustrations of the kinds of developments that disturbed

him. Auto dealers were now buying new cars from one another at prices higher than those charged by the factory. Lumber was increasingly being shipped from mills without an indication of the ultimate destination; the brokers planned to provide further shipping instructions while the lumber was in transit, after they had determined where they could obtain the highest prices. District textile producers, who had long been complaining about depressed market conditions, now found that raw cotton prices were rising almost to record highs and that their sales were increasing sharply. Farmers were seeking to increase output to take advantage of higher prices, but they were encountering difficulty in obtaining diesel fuel to operate their machinery and in obtaining needed fertilizer. The fertilizer shortages in turn reflected shortages of natural gas for use in the manufacture of ammonia and nitrates.

Mr. MacLaury said he had a number of technical questions. First, he noted that according to figures in the supplement to the green book, compensation per manhour in the industrial sector had increased at an annual rate of 12.5 per cent in the first quarter of 1973. He found it difficult to reconcile that figure with Mr. Partee's statement that the rise in average hourly earnings had been quite moderate so far this year, unless the difference was accounted for by the increase in social security taxes on January 1.

Mr. Partee replied that while he believed Mr. MacLaury's suggested explanation was the correct one, he would have an analysis of the difference prepared by the staff.[1/] He thought that the increase in social security taxes also might provide part of the explanation for the recent high rate of advance in prices. The tax increase was, of course, a one-time event which would not recur soon.

Mr. MacLaury then asked Mr. Partee to explain the sense in which price increases associated with the transition from Phase II to Phase III could be considered temporary.

Mr. Partee replied that, in addition to the kinds of price increases that would have occurred in any event, many were made that had been under review by the Price Commission but not yet approved at the time Phase II ended. There might also have been other increases by firms that believed their prices should be higher and considered the point of transition to Phase III to be a reasonable time at which to make the adjustment. In describing such increases as temporary he meant to suggest not that they would be retracted but that they were of a one-time nature.

1/ A copy of the staff's analysis, which the Chairman summarized for the Committee later in the meeting, is appended to this memorandum as Attachment A.

Mr. MacLaury said it was his understanding that the profit-margin rule of Phase II had been continued in Phase III with an additional year added to the base. He asked whether there was reason to believe that any price increases of the kinds Mr. Partee had mentioned were in violation of that rule.

Mr. Partee replied that that question would, no doubt, be thoroughly investigated by the staff of the Cost of Living Council. Of course, one could not determine whether a particular price advance violated the profit-margin rule until data on the firm's profits were available.

Mr. MacLaury noted in that connection that, according to the green book, corporate profits were projected to increase 27 per cent from 1972 to 1973, and to rise at a 60 per cent annual rate from the fourth quarter to the first.

Mr. Partee remarked that the projected increases referred to were before deduction of the inventory valuation adjustment, which apparently was larger in the first quarter than in any quarter since the Korean War. Valuation adjustments were deducted in estimating the profits figures incorporated in the national income side of the GNP accounts. He believed, however, that no such deduction would be allowed by the Cost of Living Council in calculating the profit-margin constraint on allowable price increases.

Mr. Bucher said he might note in passing that a well-known economist was recently quoted as saying that the Board's published series on capacity utilization was of questionable value and that the Federal Reserve itself did not place much credence in the figures. Accordingly, he had been interested in learning that the staff was working on an alternative measure.

Mr. Bucher went on to say that the recent moderation of the rate of increase in average hourly earnings was one of the more hopeful elements in the pattern of developments. He asked whether one could draw any inferences about the likely future trend in hourly earnings from the terms of current wage settlements.

Mr. Partee remarked that there had been too few settlements recently to provide a reliable indication of trends. He might, however, make two comments on the matter. First, the recent marked deceleration in the rate of increase of average hourly earnings--which was widespread by sector, affecting manufacturing, services and trade, and finance and insurance--followed a sharp acceleration in late 1972. He doubted that much significance should be attached to such short-run fluctuations, which might in part reflect seasonal adjustment problems. Secondly, while the 5-1/2 per cent guideline for wage increases remained applicable under Phase III, he did not

see how union leaders could be expected to agree, without considerable resistance, to any settlement that did not include compensation for the very rapid recent increase in the cost of living--particularly given the current fairly strong situation in labor markets. It was his personal opinion that the coming period would be marked by vastly greater difficulties in reaching settlements than had seemed likely a few months ago. He could offer no evidence in support of that opinion other than the hard line taken in recent public statements by a national union leader.

Mr. Coldwell asked whether there were any indications that current business spending on plant and equipment was being directed more at technological upgrading of equipment and expanding assembly facilities than at the construction of new basic capacity. If so, there would be important implications for the likely duration of the capital spending boom, since the time required for improving equipment and completing assembly plants typically was much shorter.

Mr. Partee replied that he had no direct information on that point. He might note, however, that the Commerce Department survey of business plans indicated a slowing in the rate of increase in capital spending in the second half of 1973, which would be consistent with a heavy emphasis in current outlays on

readily constructed plant additions and improvements. He understood from other sources that relatively little expansion was under way in such basic materials industries as petroleum, steel, cement, and copper, in part apparently because of problems of pollution control and plant location. It was possible, of course, that a surge of expansion in basic capacity, such as had occurred in the middle and late 1950's, might develop, but there was not much evidence of that at present.

Mr. Hayes observed that a recent analysis by a business economist suggested that the slow pace of expansion in basic capacity could to a considerable extent be attributed to the greatly worsened profits picture in such industries in recent years.

Mr. Francis noted that the personnel department of the St. Louis Reserve Bank had just made its annual survey of rates of compensation at area financial institutions -- including commercial banks, savings and loan associations, insurance companies, and so forth. While the results had not yet been completely analyzed, the Committee might be interested in some tentative findings. It appeared that average increases over the year ending in February 1973 were within the 5-1/2 per cent guideline. However, the average advance at firms with unionized clerical forces was about twice that at other firms.

In response to the Chairman's request, Mr. Francis said he would have a copy of the analysis sent to the Board as soon as it was completed.

Mr. Brimmer referred to the earlier comments on the rate of capacity utilization and remarked that, whatever the relative quality of different statistical measures, he thought they were transmitting a relatively straightforward message: that the economy was at a stage where the marginal cost of increasing output was rising sharply.

Mr. Partee said he would be inclined to add one qualification to Mr. Brimmer's observation: that the difficulties were unevenly distributed by industry. While there were some pronounced bottlenecks, capacity appeared still to be ample in a great many industries. The existence of those bottlenecks, incidentally, might be attributable to an important extent to the recent devaluation of the dollar. With respect to the steel industry, for example, there was much talk about actual or attempted shifts of buyers from foreign to domestic sources which, in turn, could be creating expectations of shortages and scare-buying on the part of other users. If there had been some panic inventory accumulation of such materials, it was quite possible that the economy could continue to expand over

the next year or so without producing any greater market tightness or higher rates of capacity utilization than existed for these materials now. With that qualification, he agreed with Mr. Brimmer's comment.

Mr. Brimmer then observed that one plausible explanation of recent price increases was that they were a lagged response to developments of last year--an "echo" of the kind observed whenever economic activity began to approach an upper turning point. If so, monetary policy--as opposed to other kinds of stabilization measures--might have only a modest role to play in dealing with those price advances. Such a view was suggested in comments by Professor Eckstein cited in the current red book, and it appeared to be gaining adherents among other observers. If one took account of the lag in the effects of monetary policy and assumed that the main effects of any action taken today would not register for another 6 to 9 months, he might conclude that monetary policy makers had little to do today except to regret that they had missed the boat.

Mr. Partee expressed the view that there was a good deal to the argument that recent price increases were a counterpart of events in 1972. There had been widespread doubts earlier

that the Phase II controls were having much effect, but developments since the transition to Phase III indicated that the Phase II controls had indeed been successful in holding down price increases. Many of the recent price advances represented a "catch-up" of the kind that could be expected whenever a change in a controls program was perceived by the public as constituting a rather radical relaxation. Other special factors were temporarily contributing to upward pressures on prices--including the tax refunds, which might well be stimulating consumer spending to a greater extent than allowed for in the projections, and anticipatory buying. If general stabilization policy were to react now to the recent escalation of demands and prices, the consequence might very well be to assure a recession in 1974.

Mr. Daane noted that in contrast with the green book projection, foreseeing a gradual deceleration of economic expansion, the possibility had been raised today of a greater boom culminating in an imminent recession. A third possible contour had been suggested by the staff of the International Monetary Fund in their annual consultations with the United States, which were completed just yesterday. In the judgment

of the IMF staff, the most likely pattern for the U.S. economy over the rest of 1973 was a continuation of great demand pressures. He asked whether Mr. Partee would indicate how probable he thought each of those three alternative contours was.

In reply, Mr. Partee said he thought a moderation in the rate of economic growth as the year went on, along the lines of the green book projection, was the most likely of the three contours; it might be assigned a probability of 60 per cent. The next most likely--carrying, say, a 30 per cent probability--was that the rate of expansion would remain rather high through most if not all of the year, with increasing stimulus provided in the second half by inventory accumulation. Least likely, with a probability of 10 per cent, was a recession or a major slowing of growth very soon--in the summer or early autumn. Any such judgments were, of course, highly subjective.

Mr. Balles said it was his impression that only a fraction of the overwithheld taxes had been refunded thus far. If it was true that the great bulk of refunds still lay ahead, there would be grounds for skepticism about the staff's projection that the rise in consumer expenditures would slow in the third and fourth quarters. He asked how Mr. Partee would assess the likelihood of an even stronger surge in consumer spending.

Mr. Partee replied that that possibility could not be ruled out. According to the Internal Revenue Service, the number of refund checks paid out thus far was somewhat below the corresponding number at the same time last year, but the dollar volume of refunds was somewhat greater than a year ago because on the average the checks were about $100 larger than those of 1972. As he understood it, the dollar volume of refunds remaining to be made was substantially larger than at this point last year.

Mr. Wendel noted that cash refunds made so far exceeded those of the 1972 period by about $1 billion, and the payments still to be made were estimated at $5 billion to $6 billion in excess of those remaining at this point in 1972. Some time elapsed between the approval of a refund and the mailing of the check, and IRS data indicated that the refunds approved to date were about $3 billion above the figure at this point last year. Those data supported the view that a large volume of refunds remained to be made. It was not clear, however, whether the refunds tended to stimulate spending mainly at the time the checks were received or at the time the taxpayer became aware that he would receive a refund--presumably when he completed his return.

Mr. Partee added that the staff had assumed in preparing the GNP projections that to some extent consumers were now spending in anticipation of refunds they expected to receive in the next 4 to 8 weeks. If that assumption was correct, the effects of the remaining refunds on consumption would be correspondingly reduced.

Mr. Balles then expressed the view that the recent explosion of prices was one of the most dangerous economic developments to occur in this country in a long time. It was, of course, legitimate to note all of the special factors that had contributed to the price advance, but he was inclined to believe that some, and perhaps much, of the rise was attributed to old-fashioned excess demand inflation.

Mr. Partee said he had meant to suggest that the price advances had been facilitated by the coincidence of high rates of capacity utilization and shortages of industrial commodities with the transition from Phase II to Phase III. In that connection, it was worth noting that the "bubble" of price increases had been much smaller at the time of the transition from Phase I to II. The nature of the two changes in the controls program was not such as to suggest a smaller bubble during the first transition than during the second. In the

earlier period, however, rates of capacity use and levels of demand were such that prices of many commodities remained below those allowable under Price Commission rules all through 1972. Those gaps had narrowed very rapidly over the last few months, suggesting that strengthening demands were having an impact on markets.

In a further observation, Mr. Balles remarked that he fully shared Mr. Partee's concern about the possible impact of the recent behavior of prices on the course of coming wage negotiations.

Chairman Burns said he might offer a word about the concept of "excess demand," which he had found to be a slippery one. One might consider, for example, the low point of the business cycle, when industrial capacity was being utilized at a low rate and unemployment was close to its cyclical maximum. Historically, wholesale price indexes had tended to turn up at that point in the cycle, or even before. Indeed, Bradstreet's index--an old measure of wholesale prices which was no longer published, and which had been heavily weighted with raw materials--used to be a leading indicator. At the low point of the cycle one could hardly say there was excess demand in the economy as a whole; indeed, activity could be said to be at a low point

because there was a shortage of over-all demand. But at the low point activity would be on the verge of turning up; demand would be increasing for raw materials; and because the supply of raw materials is inelastic in the short run, an index of their prices would move up. The rise in the index could be said to reflect demand factors, but they would be peculiar to that branch of industry and would not imply excess demand in the aggregate.

At the moment, the Chairman continued, the world-wide recovery under way was causing sharp increases in demands for industrial raw materials. The U.S. recovery had started much earlier, and the recovery elsewhere was adding to the upward pressures on the U.S. price level.

Chairman Burns then said he might comment briefly on his recommendation of last Wednesday that the Committee members raise the lower limit of the constraint on the Federal funds rate from 6-3/4 to 7 per cent for the remaining part of the intermeeting period.[1/] At that time, in light of the behavior

---

1/ On April 11, 1973, the following message was transmitted to Committee members, by telegram to the President-members, over the signature of Mr. Holland:

> Interpreted literally, Committee's instructions to Manager would call for reserve operations consistent with a reduction in Federal funds rate to 6-3/4 per cent. In view of the imminence of next scheduled meeting, Chairman Burns recommends that lower limit of funds rate constraint be raised from 6-3/4 to 7 per cent for remaining period until meeting. Please advise promptly whether you concur.

(Footnote continued on next page)

of the monetary aggregates, the Committee's directive would have required the Manager to permit the funds rate to decline to 6-3/4 per cent. Against the background of the discussion at the previous meeting, and since less than a week would elapse before today's meeting, he thought it would be desirable to stabilize the situation until the Committee had had a new opportunity to deliberate on policy. Thus, his recommendation was intended only as a holding action for a short period, and it should not be interpreted as an effort to guide the Committee in the direction of further restraint.

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 20 through April 11, 1973, and a supplemental report covering the period April 12 through 16, 1973. Copies of both reports have been placed in the files of the Committee.

In their responses, eleven Committee members indicated that they concurred in the Chairman's recommendation. Mr. Morris replied as follows:

> I dissent from the recommendation that the lower limit of the funds rate constraint be raised to 7 per cent. In the face of a strong economy the monetary aggregates are growing at a substantially slower rate than is compatible with the Committee's longer-term objectives. This creates a presumption in my mind that current policy is excessively restrictive, a presumption which will be rebutted only by clear evidence that the weak growth trend in the aggregates is being reversed. We do not yet have such evidence. I fear that an excessive concern for the stability of short-term money rates could generate an excessively tight monetary policy in the second quarter.

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

In the period since the Committee last met open market operations were aimed at holding down nonborrowed reserves in order to achieve somewhat slower growth in the monetary aggregates than had occurred in the preceding 6 months. Early in the period the aggregates appeared to be growing within the ranges of tolerance specified by the Committee, suggesting the desirability of maintaining fairly stable money market conditions after several months of progressive tightening. While the Desk aimed at reserve conditions that were expected to result in a Federal funds rate of about 7 per cent, there was a tendency in the earlier part of the period for the rate to average closer to 7-1/8 per cent, reflecting heavy bank demand for funds and the Desk's reluctance to be more aggressive in supplying them. As the period progressed it became apparent that private demand deposits were not growing as rapidly as had been expected, bringing M_1 growth in March-April down to 2-1/2 per cent, well below the 4 to 7 per cent tolerance range specified by the Committee, and bringing M_2 growth to the lower end of its 5 to 8 per cent range. In these circumstances it appeared desirable to resolve doubts on the side of somewhat less tautness, while still expecting that the Federal funds rate would average around 7 per cent--the lower end of the new range of tolerance agreed to by Committee members on April 11.

Open market operations were complicated by the usual difficulties in projecting reserve availability and by shifts in bank attitudes toward reserve management. On several occasions banks made heavy use of the discount window rather than bidding aggressively for Federal funds and on other occasions, such as around the quarterly statement date, they were very aggressive bidders indeed, putting substantial upward pressure on the Federal funds rate. While there were substantial day-to-day variations in the Federal funds rate, the average for the period--6.98 per cent--was virtually unchanged from the previous 4 weeks.

Concern over inflation and the fate of economic stabilization legislation tended to dominate thinking in the money and capital markets, with sudden shifts in attitudes tending to push interest rates sharply first

in one direction and then the other. The 3-month Treasury bill rate, which rose above 6.5 per cent in early April in the absence of foreign buying, dropped back to 6.19 per cent in the last two weekly auctions, compared with 6.33 per cent at the time the Committee last met. Rates on longer-term bills declined on balance by about 1/4 of a percentage point. Markets for long-term securities were helped by light calendars in the corporate and municipal areas, by the absence of Treasury borrowing, and by the good technical position of the Government securities market.

There is, however, a highly uncertain atmosphere in the markets. The strong rally that developed after the announcement of a large increase in the wholesale price index on April 5 was based on the market's view that things were so bad that decisive Government action on wages and prices was inevitable. With market participants in this frame of mind, a modest System purchase of Treasury bills in the market was widely interpreted as an easing of System policy.

Looking ahead, I would agree with the blue book[1/] assessment that basic supply-demand considerations do not suggest any particular upward pressure on interest rates in the period ahead. Market psychology is so fragile, however, that any deterioration on the inflation front as Congress debates the stabilization bill could have a profound influence on the course of interest rates.

The Treasury, as you know, continues to be in a strong cash position. It postponed a planned $2 billion offering of 2-year notes at the end of March, and it was able to withstand the sharp seasonal decline in its overall cash balance in early April while still maintaining a high balance with the System. It will be announcing on April 25 the terms of a refunding of May 15 maturities, totaling $9.6 billion, of which $4.3 billion are held by the public. The Treasury has many options open to it in this refunding, including the possibility of a long-term bond offering. Should it offer such an issue, I would plan to take only a token amount for System Account--we hold $5.1 billion of the maturing issues--in order not to preempt any significant part of the Treasury's remaining $2.3 billion authority to offer long-term bonds without regard to the interest rate ceiling.

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

Mr. Mitchell asked whether reflows of funds from abroad had been significant in the recent period and whether it had been necessary for the Desk to act to offset their effects on reserves.

Mr. Holmes replied that the Desk had purchased about $900 million of Treasury securities from foreign official accounts during the period in the course of supplying reserves. Not all of that sum reflected reflows; some of the foreign central bank securities sales were part of a portfolio diversification process on their part. On the whole, foreign sales had not led to any particular complications for System operations.

Mr. Daane referred to Mr. Holmes' comment that in early April the market had interpreted certain System bill purchases as an easing of System policy, and asked whether the market still believed the System was on an easing course.

Mr. Holmes replied that that view had been dissipated as a result of market developments over the following days. However, there was still some uncertainty on the matter, and market participants were intensely analyzing the System's day-to-day operations. Incidentally, the money market had been tighter than desirable yesterday and today, partly because member banks had come through the weekend with a large cumulative reserve deficiency. The Desk had been resisting upward

pressure on the funds rate, which opened in a 7-1/2 to 7-3/4 per cent range this morning.

Mr. Brimmer remarked that one press report in early April suggested that the System was engaging in easing operations for the purpose of reducing the bill rate. He asked whether such a view had been widespread.

In reply, Mr. Holmes said that view had been quite widespread on Friday and Monday, April 6 and 9, when the 3-month bill rate had declined by a total of about 30 basis points. It was less widespread on Tuesday, April 10, when the bill rate turned up again.

Mr. Daane observed that the Committee had tended to place greater stress on even keel considerations in connection with some Treasury financings than in connection with others. He asked about the likely importance of even keel during the forthcoming May financing.

Mr. Holmes replied that that would depend on the particular form the financing took. As he had indicated, the Treasury had a wide range of options. Conceivably, it could decide to pay down $2 billion of outstanding debt, and if it did so even keel could be given minimal weight. The situation would be different if it decided to make a sizable long-term bond offering.

Mr. Mitchell asked whether market participants tended to take much notice of rates of change in the bank credit proxy.

Mr. Holmes replied that they did. In general, participants had been quite impressed by the recent extremely rapid growth of bank credit, and while they were noting the current more moderate expansion, they continued to watch the series closely. In interpreting the recent rapid growth, market participants recognized that there had been some shift from the commercial paper market to banks as a source of funds and that there had been lending abroad during the exchange market crisis. But they also believed that there was a fairly good domestic demand for credit, partly for anticipatory reasons.

Mr. Black asked whether, assuming that the funds rate and other short-term interest rates remained about unchanged, a half-point increase in the discount rate would be likely to have much effect on bond prices.

Mr. Holmes replied that under such circumstances a half-point rise in the discount rate might have some impact on long-term markets, but any effects were likely to be quite modest.

Chairman Burns asked for Mr. Axilrod's views on the probable consequences of a half-point discount rate increase on interest rates in general and on long-term rates in particular.

Mr. Axilrod remarked that, even though such discount rate action would lag market rates considerably, in the current environment it was likely to be interpreted as a signal that monetary policy was being tightened somewhat further. The immediate effect, in his judgment, would be some rise in both short- and long-term rates, but in view of the good technical position of the market the increases probably would not be large. If the action was followed by clear indications that the System was seeking to tighten money markets through open market operations, rates would rise further. On the other hand, if there was no follow-through in the open market area, they probably would fall part of the way back.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period March 20 through April 16, 1973, were approved, ratified, and confirmed.

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

> Since the last meeting the money supply has expanded significantly more slowly than had been indicated, given prevailing money market conditions, and bank credit has risen more rapidly. The policy alternatives[1/] we have suggested for Committee consideration of necessity reflect judgments as to the continuation of these tendencies. On balance, for

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

reasons explained in the blue book, we have come to the view that money growth is likely to pick up from its recent slow pace and bank credit expansion to slow down. We would expect this to happen with relatively little change in money market conditions from those currently prevailing.

Thus, the alternative B pattern presented for the Committee indicates an M_1 growth consistent with the longer-run 5 to 5-1/2 per cent target growth rate adopted last time. We would suggest a Federal funds rate band of 6-1/2 to 7-1/2 per cent to go along with such a target, a somewhat wider band than the Committee has adopted recently. The very marked uncertainty about the actual strength of money demand is one reason for the somewhat wider band. While we feel the cumulative impact of sizable interest rate increases since late 1972 will keep money demand moderate for a while even in face of the strong rise in GNP expected in the second quarter, the money supply behavior of the past 3 months has been sufficiently out of the historical pattern to suggest a need to be especially alert to the margin of error.

Should there be further shortfalls, the Committee may wish to permit the Manager to encourage moderate growth by permitting the funds rate to drop. The various models and judgmental projections we have looked at pretty much center around the alternative B pattern, but one--our monthly money market model--indicates that the funds rate would probably fall somewhat below 7 per cent in attaining the alternative B path for the monetary aggregates. On the other hand, should the sluggishness of money demand prove to have been an erratic development that is followed by a sharp resurgence--which in my view is an alternative with high probabilities--the Committee may well wish to give the Manager latitude to hold down reserve growth at least until the funds rate rises about 1/2 point from its current 7 per cent level.

If adherence to reserve objectives does lead to a further tightening of money market conditions, the repercussions on savings flows and credit markets may be rather marked. Net inflows of consumer-type time and savings deposits slowed substantially at both banks and thrift institutions in February and March--at banks to a 7-1/2 per cent annual rate and at thrift institutions to an 8-1/2 per cent rate, both 4 to 5 percentage points below their fourth-quarter pace. Weekly figures for banks in the first half of April and reports from thrift institutions as to experience in the interest-crediting period suggest somewhat slower growth is in the offing even at current interest rates. Thus, we are probably just about at the threshhold of a considerable curtailment in the supply of funds to the mortgage market through deposit flows. This curtailment will no doubt be at least partially offset through the activities of Federal agencies. But in the process mortgage rates are likely to rise somewhat further and institutional mortgage loan commitment policies to tighten.

Bank credit growth has expanded sharply in the last 2 months even as growth in consumer-type time deposits has slowed. This has been in large part structural as borrowing has shifted out of the commercial paper market to banks, given interest rate relationships, and as banks have to some extent financed outflows of funds to abroad. This structural shift has been financed by CD expansion. I would estimate that perhaps 8 to 10 percentage points of the 18 per cent annual rate of growth in the proxy in February-March might be attributed to these special developments.

Just as these shifts in credit flows have distorted the bank credit proxy in the past 2 months, it is entirely possible that an unwinding of the special developments will also distort the proxy in the months ahead, but in an opposite direction. That is, repayments of loans associated with international flows and shifts of business customers back to the open market, given the dual prime rate, would substantially reduce banks' need for CD funds and thereby introduce a downward bias, relative to basic demands on banks, in the measured growth in the proxy.

In the blue book we have assumed a gradual transition, so that the proxy over the next 2 months is projected to grow at about a 10 per cent annual rate. Measured bank credit growth could well come in lower than this, however, if the unwinding of domestic and international flows proceeds more rapidly than anticipated.

These special factors make the credit proxy particularly difficult to interpret under current circumstances in gauging the impact of monetary policy. But even apart from that, the credit proxy has its problems as an indicator of current policy. To a large extent the proxy reflects the strength of credit demands, as determined by the growth in GNP. And the strength of credit demands and GNP are, of course, affected by monetary policy only with some lag.

In gauging the course of current monetary policy, I would have more confidence in money supply aggregates and the level of interest rates than in the credit proxy. But I would not want to espouse the extreme view that bank credit is no more than the passive product of the strength of credit demands and the structure of interest rates. At banks, and also at thrift institutions, there is, of course, some rationing out of borrowers who do not have real recourse to alternative sources of funds, permitting demand restraint to be accomplished to some degree through non-price factors.

With respect to the immediate outlook for monetary policy operations, the Committee will also have to give consideration to even keel. As Mr. Holmes mentioned, the Treasury will announce its mid-May refunding a week from Wednesday. I would hope that the Treasury will utilize auction techniques in the refunding so as to minimize the even-keel need. In any event, if the monetary aggregates begin to show undesired strength, it would seem to me that reserve objectives should be emphasized under current economic circumstances--certainly at least up to the point given by a funds rate increase of 1/2 percentage point and on the assumption that an adequate Treasury financing operation would not be forestalled by some moderate tightening in money market conditions.

Mr. Mitchell asked whether, assuming the Committee desired to influence business psychology and inventory behavior during, say, the next 2 months, it would be desirable for it to focus its attention on the course of bank credit.

Mr. Axilrod replied that he personally would recommend against focusing on bank credit if the objective was to have a moderating effect on inventory accumulation and on credit extended for that purpose. It was true, of course, that a great deal of inventory accumulation was financed by bank credit. Experience had demonstrated, however, that when growth in bank credit was restrained the borrowers rationed out were not the large businesses seeking to finance sizable increases in inventories, but rather people seeking mortgage and consumer credit and also, to a degree, small businesses. In his judgment it would be better for the Committee to focus on both the money supply aggregates and interest rates. Efforts to hold growth in the money supply down to desired rates might, of course, be associated with higher interest rates.

Mr. Balles said he had been surprised at Mr. Axilrod's earlier comment that a half-point increase in the discount rate would be interpreted by the public as a further tightening of

policy. He would not expect such an interpretation, considering that the discount rate was very far out of line with market rates, that that fact had been widely recognized in the business and financial press, and that financial commentators had been anticipating action to bring the discount rate into better alignment.

Mr. Axilrod remarked that he would expect some expectational reaction to a discount rate increase at this point because it would immediately follow the institution of the dual prime rate, a development which the market was likely to view as freeing the System to move toward further restraint. As the members would recall, the last discount rate increase was made immediately after a rise in the prime rate.

Mr. Brimmer observed that comments he had heard from a number of bankers recently suggested a different reaction. Those bankers thought the System would have increased the discount rate earlier, in association with its actions to firm money market conditions, had it not been for the problems that that would have posed for the Committee on Interest and Dividends. Thus, once the dual prime rate was in effect, they would presumably expect the discount rate to be increased to

the level at which it "should have been" all along. On that basis, no additional uptick in market interest rates would be anticipated.

Mr. Balles remarked that his interpretation of the situation was similar to that described by Mr. Brimmer.

Chairman Burns noted that Mr. Brimmer had reported views of bankers; businessmen might react differently. In any case, the question of how a half-point increase in the discount rate would be interpreted was a matter of opinion, and differing opinions had been expressed today.

Mr. Black noted that in the first quarter a very large rise in nominal GNP had been associated with relatively little growth in M_1, implying a substantial increase in the income velocity of money. The question in his mind concerned the extent to which multinational firms and others in a position to move funds across international boundaries were meeting their needs for cash balances by holding foreign currencies instead of dollars. If foreign balances had, in fact, been substituted for dollars to an important extent, the slowing of the rise in M_1 would be less significant than it might appear. Similarly, it would be desirable to discount the significance of the acceleration in M_1 that presumably would be associated with a return flow from abroad.

In reply, Mr. Axilrod said the staff had been unable to develop any firm information on the degree to which the outflow of funds had been financed directly by drawing down demand balances rather than by selling securities or by borrowing. He had no doubt that some of the outflow came directly out of demand balances; for example, speeding up payments to foreigners would often involve a reduction in some domestic balances for a few weeks. Personally, however, he suspected that the outflow was mainly financed by borrowing or by liquidating short-term assets, and thus was not a highly significant factor in explaining the slow first-quarter growth of M_1 and the associated sharp increase in income velocity. He would be inclined to place more stress on the kinds of factors mentioned in the blue book, including the slower-than-expected processing of tax refunds, the dampening effect on money demands of the recent large rise in short-term interest rates, and the effects of retail price advances in causing consumers at least temporarily to reduce their money holdings.

Mr. Coldwell noted that acquisitions of U.S. Treasury securities by foreign official holders over the past few months had reduced considerably the amount of financing the Treasury had had to undertake domestically. He asked whether that development had not had some effect on the pattern of change in M_1.

Mr. Axilrod observed that, apart from the Treasury's having issued somewhat more securities than it otherwise might have in the period, the development in question amounted basically to a change in the distribution of the Federal debt between domestic and foreign holders. That change might have had some influence on the structure of short-term interest rates, lowering bill rates relative to others, but he doubted that it had had much impact on the general level of short-term rates. And since demand for money was a function of interest rate levels, he suspected that the growth rate in M_1 would have been roughly the same even if there had been no change in the debt distribution.

Chairman Burns noted that, as the members would recall, the Committee had devoted so much time to foreign currency matters at its previous meeting that it had had relatively little time to deliberate on domestic monetary policy. Because he believed that monetary policy was now at a critical phase, he thought it was important to assure that there would be an opportunity for a full discussion today. Accordingly, he had asked that the agenda be rearranged to place that discussion before the discussion of foreign currency operations and of certain other matters requiring consideration. It was clear, however, that it would not be feasible to complete the discussion of domestic policy before luncheon. Therefore, he suggested that the Committee consider the other matters he had

mentioned in the time remaining this morning, and that immediately after luncheon it turn to foreign currency operations. It might then devote whatever time was necessary to domestic monetary policy.

There was general agreement with the Chairman's suggestions.

The Chairman noted that two memoranda, from the Manager and the General Counsel, on the subject of System lending of Government securities had been distributed on April 9, 1973.[1/] He asked Mr. Holmes to comment.

Mr. Holmes observed that in November 1972, when the Committee had last acted to continue the authority--contained in paragraph 3 of the authorization for domestic open market operations--to lend U.S. Government securities held in the System Account, several members had expressed the hope that it might be possible to terminate the program when the authority was next reviewed. As his memorandum indicated, however, he could not in good conscience recommend that course of action. If anything, there was more need now for System lending of securities than when the program was introduced in the fall of 1969, since lending by others had continued to decline because of collateral shortages. Accordingly, he recommended that the Committee find that System lending of securities was reasonably necessary to the effective conduct

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

of open market operations, and that it continue the authority for such lending in its present form, subject to review in 6 months.

Chairman Burns asked whether the lending in question was wholly riskless to the System.

Mr. Holmes replied that he doubted that any lending operation could be considered wholly riskless. He believed, however, that the System was fully protected against loss by its collateral requirements on loans of securities.

In reply to questions, Mr. Holmes said the lending operation earned high marks on a cost-benefit basis; it permitted the Federal Reserve to provide a useful service to the market, it assisted the Federal Reserve in its own operations, and it earned a net return for the System. He knew of no viable alternatives to System lending. The Home Loan Banks were considering similar lending operations, but their operations could not substitute for the System's because their portfolio of Government securities was so much smaller.

Mr. Coldwell observed that the dealers, knowing that they could borrow securities from the System, might be inclined to guarantee delivery at times when they could not be certain of obtaining the securities by other means. If so, the System lending program could be encouraging them to be less efficient than they might otherwise be.

Mr. Holmes replied that in his judgment that was not the case. The problem at which System lending was directed--that of delivery failures--was not a "back office" problem of dealer firms but rather a reflection of the shortage of securities in the market. On the initial loans with 5-day maturities, dealers were charged a rate of 3/4 of 1 per cent--which was 1/4 point above the going market rate; and substantial penalties, ranging from 1-1/2 to 6 per cent, were exacted on extensions. In general, he believed that System lending increased the efficiency of the market for Government securities, since efficiency would be lower if dealers had to wait until they had securities in hand before undertaking to sell them. He agreed that other measures should be taken to deal with the problem of delivery failures, if measures could be worked out, and he had asked the dealers' association to place that subject high on their agenda.

Mr. Mitchell said that he considered the lending operation to be a resounding success; if he had been in the Manager's place, he would have recommended that it be expanded.

Mr. Brimmer noted that, as indicated in the memorandum from Committee Counsel, the legal authority for the lending of securities derived from the incidental powers of the Reserve

Banks and depended upon the factual question of whether that activity was reasonably necessary to the effective conduct of open market operations. In Mr. Hackley's opinion, the activity was within the incidental powers of the Reserve Banks if the Committee concurred in the Manager's judgment that it was necessary for the purpose.

In response to the Chairman's inquiry, no members expressed a view contrary to the Manager's.

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

Chairman Burns then noted that two memoranda from the Secretariat, regarding the release of the 1967 Committee minutes, had been distributed on March 13, 1973.[1/] He asked Mr. Broida to comment.

Mr. Broida said the staff recommended that the 1967 minutes of Committee discussions and actions be released in the same manner as employed for earlier minutes--namely, by transmitting the original signed copies to the National Archives, where microfilm copies would be made available for sale, and placing bound reproductions in the libraries at all Federal Reserve offices. "Work copies" of the minutes would

---

1/ The first of the two memoranda, from Mr. Broida, was entitled "Release of 1967 FOMC minutes." The second, from the Secretariat, was entitled "Passages recommended for deletion when 1967 minutes are initially released." Copies of both memoranda have been placed in the Committee's files.

be made available for inspection by the public at the Board and the New York Bank during the period in which the microfilms and bound volumes were being prepared.

Mr. Broida added that, as in past years, it was recommended that certain sensitive passages--all in the foreign currency area--be withheld when the 1967 minutes were initially released. The proposed deletions, and suggested footnotes indicating the general nature or subject of each deleted passage, were shown in the materials distributed to the Committee.

In the course of the ensuing discussion Mr. Daane commented that some of the potentially sensitive passages the staff had decided not to recommend for deletion were close cases. While he was not proposing that they be withheld, he might note that they would be if it were the Committee's policy to err on the side of caution in avoiding damage to international relations.

Chairman Burns observed that he had not had an opportunity to make a detailed review of the minutes proposed for release. In general, however, he favored complete publication except where there were overriding reasons for deletion.

Mr. Daane said that was his view also.

In response to a question, Mr. Coombs expressed the view that the staff's recommendations represented a good balance between the conflicting objectives of full disclosure and of avoiding damage to international relations.

> By unanimous vote, transfer to the National Archives of the FOMC minutes of actions and memoranda of discussion for the year 1967, on the basis described in a memorandum from the Secretariat dated March 13, 1973, was authorized.

Chairman Burns then asked Mr. Holmes to comment on his memorandum to the Committee dated March 12, 1973, and entitled "Proposed revisions in guidelines for System operations in agency issues."[1/]

Mr. Holmes noted that the proposed revisions were relatively minor. As the members knew, most of the individual guidelines were still in the form approved by the Committee when operations in agency issues had first been authorized in August 1971, and two of them--numbers 3 and 4--included references to "initial" activities. Thus, number 3 read "As an initial objective, the System would aim at building up a modest portfolio of agency issues, with the amount and timing dependent on the ability to make net acquisitions

---

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

without undue market effects," and number 4 read "System holdings of maturing agency issues will be allowed to run off at maturity, at least initially." Now that the initial phase of System operations in agency issues had passed, it appeared desirable to recast the two guidelines in question to remove those references.

By unanimous vote, numbers 3 and 4 of the guidelines for the conduct of System operations in Federal agency issues were amended to read as follows:

3. System holdings of agency issues shall be modest relative to holdings of U.S. Government securities, and the amount and timing of System transactions in agency issues shall be determined with due regard for the desirability of avoiding undue market effects.

4. System holdings of maturing agency issues will be allowed to run off at maturity.

Chairman Burns then invited Mr. Daane to report on developments at the recent Washington meetings of the Deputies and of the Ministers of the Committee of Twenty.

Mr. Daane noted that the C-20 Deputies had met for two days on March 22-23 and the Finance Ministers and Governors for a day and a half on March 26-27. The meetings were largely anti-climactic, since they followed so closely the Paris meetings of March 9 and 16 on which the Chairman had reported at the previous FOMC meeting. Procedurally, however, the Washington

meetings might have served a useful purpose in giving additional impetus to the work of the Deputies on international monetary reform. In effect, the Deputies were asked by their principals to work faster, harder, and for longer hours. Accordingly, the Deputies had scheduled a full-week meeting for May 21-25 and tentatively planned to meet again in both June and July.

As he had noted at the previous FOMC meeting, Mr. Daane continued, the Deputies earlier had agreed to change the agenda for their March meeting. They deferred discussion of the special problems of developing countries in favor of a close look at the implications of the events of February and early March for reform work in two areas--that of improving the adjustment process, and that of dealing with disequilibrating capital flows. As part of their effort to accelerate their work schedule, they tentatively agreed to establish two technical working parties--to consider, respectively, the matter of objective indicators of the kinds discussed in the U.S. proposals of last November, and the matter of capital flows. The establishment of those working parties was subsequently approved by the Ministers and Governors.

Turning to the substance of the discussions, Mr. Daane noted that there were differences of view among the Deputies

regarding the use to which objective indicators should be put; the Europeans were generally inclined to have particular movements in the indicators trigger consultations rather than actions. While there was considerable sentiment in favor of controls for dealing with disequilibrating capital flows, the view also was widespread that such controls were not likely to be highly effective.

Mr. Daane observed that the conclusions of the Ministers and Governors were summarized in a March 27 communique which the FOMC members might want to review if they had not already done so. One of the more important statements in the communique was that ". . .in the reformed system the exchange rate regime should remain based on stable but adjustable par values. It was also recognized that floating rates could provide a useful technique in particular situations." The communique also called, among other things, for "better international management of global liquidity" and for "a strong presumption against the use of trade controls for balance of payments purposes."

The meeting then recessed. It reconvened at 3:15 p.m., with the same attendance as at the morning session except that Mr. Pizer, Adviser in the Division of International Finance, was also present.

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 20 through April 11, 1973, and a supplemental report covering the period April 12 through 16, 1973. Copies of these reports have been placed in the files of the Committee.

Mr. Coombs said he would submit the full text of the statement he had planned to make orally for inclusion in the record, but in the interests of time he would pass over today the early part, dealing with recent developments in foreign exchange markets.

Mr. Coombs' statement read as follows:

> Since our last meeting the dust has begun to settle somewhat in the foreign exchange markets. Volume remains abnormally low, but the spreads between bid and offered rates have narrowed considerably and rate movements over the past weeks have been less jumpy and exaggerated. Confidence in the dollar still remains at a low ebb, with no signs as yet of large-scale return flows from Europe. The forward markets remain in bad shape, partly reflecting new controls and negative interest rates on foreign placements in many European currencies, with continuing premia of 4-1/2 per cent on the mark, Swiss franc, and Belgian franc, and more than

6 per cent on the guilder. Generally speaking, I would say that recent market behavior mainly reflects the absence of any seriously disturbing news coming over the ticker during the past few weeks. The markets remain highly vulnerable to new political and economic troubles, however, which might mount a serious challenge to the new arrangements from one week to the next.

I think we can now discern a bit more clearly the broad outline of the new system which is beginning to emerge from a number of ad hoc policy decisions. First of all, the floating component of the new system is already far smaller than one might gather from the newspapers, and it may well become smaller still over coming months. In Europe, a Common Market bloc plus Sweden and Norway are maintaining, without much trouble, a fixed 2-1/2 per cent band among their currencies, with both Italy and Britain committed to rejoin the monetary bloc as soon as they get their economies under control. Switzerland, with so much of its trade with the Common Market, will almost inexorably be drawn into the same monetary orbit. Such a fixed rate system covering all intra-European trade would encompass 25 per cent of world trade.

At the time of the last devaluation of the dollar, most of the African, Middle East, and Asian countries joined the Europeans in maintaining their SDR parities and many of these countries continue to diversify their exchange reserves in favor of the European currencies. Germany, for example, already has taken in more than $8 billion of foreign official money, most of it belonging to small countries outside of the Group of Ten. If the dollar should begin to slide again, I think it highly likely that most of these countries will maintain a fixed rate relationship with Europe rather than floating downward with the dollar.

As for the so-called floating yen, the Bank of Japan is maintaining a thoroughly dirty float which has stabilized the yen rate within even narrower limits

than before. Even if the Japanese permit the dollar to weaken against the yen over coming months, they will probably try to maintain a high degree of stability in the yen rate vis-a-vis the European currencies. In general, therefore, I think that what is beginning to emerge is a pattern of fixed or firmly stabilized exchange rates everywhere in the world outside the Western Hemisphere, with the dollar no longer functioning as the hub of the wheel. In fact, European central bank officials now quite openly argue that their currencies can hardly be considered to be floating against the dollar. The real situation, they contend, is that the dollar and other Western Hemisphere currencies are floating against the rest of the world. In fact, the dollar is now the only major currency that is floating cleanly against every other currency.

In any event, this brings us to the question of what the Federal Reserve, in cooperation with the European central banks, might be prepared to do to avoid disorderly conditions in exchange markets where the dollar and the European currencies are currently floating against one another. At the last meeting of the Committee, it was decided that the Special Manager should explore with certain foreign central banks the possibility of arranging an over-all increase in the swap network not to exceed $6 billion. Since then I have spoken on a confidential, bilateral basis with the governors of the central banks of Germany, France, the Netherlands, Belgium, and Italy. Our discussions focused on the following three points.

First of all, each of the governors I talked with agreed that the increase in the swap network would have to be very sizable--say, on the order of 50 per cent--in order to get the desired effect upon confidence. This would come close to the $6 billion figure discussed at the last Committee meeting. On the other hand, they saw quite clearly that a 50 per cent increase across-the-board would not be appropriate since this would involve a further big increase in the already disproportionately

high British line, while it was questionable whether increases in the lines with the smaller countries, such as Mexico and Austria, would contribute anything to restoring confidence. Both the Germans and the French, for example, quickly saw that the only hope of achieving a $5 or $6 billion increase in the over-all swap network would lie in a doubling of their lines, from $1 billion to $2 billion, together with smaller but nonetheless substantial increases in the lines with Italy, Switzerland, Belgium, and the Netherlands. The Bank of Italy would be quite prepared to see its line increased from $1-1/4 to $2 billion, while the Belgians volunteered a 50 per cent increase, from $600 to $900 million or even $1 billion. The Dutch were noncommittal as to an appropriate increase in their line, which is on the low side at $300 million, but I would assume that they would fall in with whatever pattern was agreeable to their Common Market partners. As a result of these exploratory conversations, I think that we are now at a stage where we could move fairly quickly, even by telephone, to line up increases in these six swap lines amounting to nearly $4 billion without taking into account possible increases in the lines with the Japanese and Canadians, with whom I had no discussions.

Secondly, I found that most of the Europeans had been thinking of market tactics in roughly the same way as I suggested to the Committee at its last meeting--that is, if there is pressure, let the rate ride up and the market thin out before intervening. In the course of the conversations, I got the impression that there has been a distinct change in European central bank attitudes with respect to renewed intervention to defend the dollar. Most of the European central banks have suffered extremely heavy capital losses as a result of the various devaluations and revaluations of recent years, and there is a natural reluctance to assume new big risks in this area. Furthermore, their earlier commitments under the Smithsonian Agreement to buy dollars without limit severely undermined their inflation control policies during the past year or so and, with inflation in Europe continuing to gain momentum, the central banks now seem generally less willing to risk heavy

new inflows as a price of firmly stabilizing their currencies against the dollar. Also, I think a number of European central banks have become somewhat fearful of political direction of their exchange operations.

Finally, and this came in for a certain amount of critical attention at the April Basle meeting, the European central banks now have the impression that a very sizable percentage of the speculative flows during the first quarter originated in operations of U.S. banks together with foreign branches and agencies located in this country. They are, perhaps understandably, asking themselves what point there is in exposing their economies to new heavy inflows of dollars, without a clearer understanding of what, if anything, the United States is prepared to do to deal with the problem of speculation at one of its major sources-- i.e., U.S. bank lending abroad.

This shift in European central bank attitudes leads me to think that none of them is likely to intervene massively to forestall a new depreciation of the dollar. They will probably be prepared to do moderate amounts and they are clearly hopeful that we will participate, also on a moderate scale, in joint operations to defend the dollar. Generally speaking, I think they will approach the intervention question cautiously, with full recognition of the risks involved, and are unlikely to urge us to intervene massively to defend any particular rate level. This approach is close to that which I suggested to the Committee at the last meeting.

The third major point covered in our discussions, that of the revaluation guarantee, proved to be a major stumbling block. If the dollar were to be formally devalued again, we should of course have to suffer the cost of any short position in foreign currencies; this is inherent in the very nature of the swap arrangement. With respect to a formal revaluation of European currencies which we might have borrowed, I think there is a pretty good chance that they might retreat from the position they took last summer of insisting that the revaluation clause should apply only if a European currency were to revalue in isolation.

Now I think they might be prepared to revert to the original revaluation guarantee, which would be applicable even in the event of a joint revaluation of the European currencies.

The root of the negotiating difficulty rather lies in a situation in which parities might remain unchanged at their present levels, but the exchange rates of European currencies in which we were indebted might nevertheless float upward--or the dollar float downward, depending on the point of view--by as much as 5 or 10 per cent. Which party, in such a situation, should bear the cost of settling the debt at the new and higher rate of exchange on the European creditor currency?

I took the position, along the lines specified by the Chairman at the last meeting, that the United States could not accept the risk of loss in such a situation. The German response was equally direct and categorical. They too felt that they could not expose themselves to the loss in such a situation. They pointed out that under such an arrangement they would be carrying 100 per cent of the risk on their intervention in Frankfurt, and also 100 per cent of the risk on our intervention in New York. Under such circumstances, they might just as well be using us as their agent to intervene in New York. So why go to all the trouble of drawing on the swap line? The only way out, according to the Germans, was to agree to an equitable sharing of the burden so that, in the event of major exchange rate movements while parities remained unchanged, both parties to the swap would share both losses and profits on a 50-50 basis. In fact, this is the same formula that the Germans proposed, and which we finally accepted, last year to settle a $50 million swap drawing left outstanding after closure of the gold window in August 1971.

So far as I could gather, the German Federal Bank is quite firm on this point and has the full support of its other Common Market partners to whom their proposal for loss sharing has been communicated. In view of the existing impasse on the matter, any early activation of the swap lines is unlikely. However, the question of increasing the size of the

lines is separable from that of activation, and it would be worthwhile to have the increases in place pending the time at which agreement can be reached on the revaluation clause.

In reply to a question by the Chairman, Mr. Coombs said he did not have a specific proposal with respect to an expansion of the swap network to lay before the Committee at this time. As he had indicated, his discussions thus far had been exploratory in nature and the parties to them, including himself, had limited themselves to comments on general orders of magnitude.

By unanimous vote, the System open market transactions in foreign currencies during the period March 20 through April 16, 1973, were approved, ratified, and confirmed.

Mr. Coombs then noted that eight System drawings on the swap line with National Bank of Belgium, totaling $325 million, would mature for the seventh or eighth time in the period from May 2 through May 23, 1973. Also, three System drawings of Swiss francs--two totaling $565 million on the Swiss National Bank and one of $600 million on the Bank for International Settlements--would mature for the seventh time in the period from May 9 through May 16. The extent to which those drawings could be paid off before maturity would depend on

market developments in the interim, and he would recommend that they be renewed if necessary. Since all three of the swap lines involved had been in continuous use for more than one year, specific authorization by the Committee was required for the renewals.

By unanimous vote, renewal for further periods of three months of the eight System swap drawings on the National Bank of Belgium maturing in the period May 2-23, 1973, was authorized.

By unanimous vote, renewal for further periods of three months of the two System swap drawings on the Swiss National Bank and the one drawing on the Bank for International Settlements maturing in the period May 9-16, 1973, was authorized.

Mr. Bryant then made the following statement:

One month has gone by since the final crisis-generated meeting of finance ministers and central bank governors was held in Paris on March 16. With that much distance between us and the tumultuous period of the first quarter, I thought it might be useful today to try to take stock in a summary fashion of where the international monetary situation now stands, and where things may be going in the months ahead.

One widely shared reaction to the events of the last month is a sense of relief that exchange markets have been relatively calm and free from the turmoil of late January, February, and early March. At the last Paris conference, one European official who was particularly weary of attending round-the-clock meetings is supposed to have said that "The most urgent aspect

of international monetary reform is to return to a system of fixed weekends and free evenings, with very wide bands around them." It would certainly be premature to claim that this reform was actually accomplished in the last 4 weeks, but--compared with February and early March--there has been measurable progress. Exchange markets have been relatively subdued. Rates have not fluctuated widely, and--with the constructive exception of Japan--official intervention has been limited. As the 4-week period progressed, volume seemed to pick up (though remaining considerably below the norms prevailing prior to the crises) and bid-ask spreads were narrowing back towards more normal levels.

One month's evidence provides no basis for reaching strong conclusions. The present tranquil period could end rather abruptly at any time. About all one can say with confidence is that--so far--the <u>proximate</u> objective that governments were seeking in March has been achieved. That proximate objective was an end to the disorder and severe uncertainty that prevailed in exchange markets during the crisis period.

The current period of managed flexibility in exchange rates is often described as a "transitional period." But what sort of an international monetary system are we transiting towards? If one takes stock of where governments' views seem to stand today on the question of longer-run reform, the positions of most countries seem tentative. I might almost use the word "hesitant." It is true, as Governor Daane reported to you in connection with the last C-20 meeting, that wide political support can be mustered in favor of the phrase "stable but adjustable par values." But if one looks mainly at what governments are doing and seem to be planning, instead of what they are saying at a political level, it is rather easy to get the impression that there is little sense of urgency about terminating the current period of transitional floating. In some cases, such as statements last week by German and Italian officials, even what governments are saying supports this impression.

It is true that the C-20 ministers at their last meeting instructed their deputies to intensify their work. Two technical working groups have been set up. The deputies are to meet for longer periods. And in

May the deputies are to begin discussion of a document--to be called a "draft outline" of reform--that might be presented to ministers for approval at the September Nairobi meeting.

Ministers will probably agree on some statement or document in Nairobi, if only because it would appear politically unseemly to have expended a great deal of effort on an exercise only to report that they could not yet agree. But judging from what can be seen of governments' positions at this point in time, we should not be surprised if the document or communique agreed to at Nairobi turns out to be rather long on rhetoric and rather short on real substance. In particular, it is not too difficult to imagine the major reform issues connected with the exchange-rate regime being left still essentially unresolved at Nairobi, with the result that we might still be telling ourselves next October that we would be operating for some extended time in a so-called "transitional period." In the meantime, of course, de facto evolution of the exchange-rate regime may well continue--for example, modifications in the membership or operating procedures of the joint EC float.

The last topic to which I would like to turn is the U.S. balance of payments. If we take stock of the prospects here, how optimistic can we be that adjustment on the needed scale is finally under way?

The first thing to note is that over the last 2 years since 1970 we have seen a very large devaluation of the dollar. The yen-dollar exchange rate has changed by more than a third. The Deutschemark is now some 30 per cent more expensive in terms of the dollar. Even on a weighted average basis against the rest of the world as a whole, there has been an effective devaluation of the dollar on the order of 16 to 17 per cent.

These large exchange rate changes cannot help but have very considerable effects on our international transactions, even though the size and timing of the effects cannot be calculated with any precision. At exchange rates in the neighborhood of those now prevailing, therefore, we now have better cause than at any time in recent memory to be optimistic about the underlying trends in the U.S. balance of payments and in the payments balances of the other major industrial countries.

For the U.S. trade balance, the staff at the Board foresees a likely continuation of large deficits (perhaps even a worsening) for the next few months. This is in large part because of the initial perverse effects on the value of imports of higher import prices due to the most recent devaluation. But we believe it is reasonable to expect the deficit to begin falling fairly sharply in the second half of the year. In addition to the cumulating net favorable effects of both currency realignments, which are expected to be very substantial in the second half, cyclical influences will on balance be less adverse than in 1972. We think it is plausible to expect the trade balance to move into actual surplus sometime during the course of 1974. By 1975, the surplus could become as substantial as several billions of dollars.

We also think there is a good chance that this improvement in the trade balance will be largely carried through into an improvement in the basic balance.

Of course, for this cheerful view of things to come about, there will have to be sufficient restraint on domestic inflation to prevent an erosion of the competitive gains brought about by the devaluations and to ensure that resources actually are made available for increased exports and for import substitution. There also has to be a willingness on the part of surplus countries to accept a worsening in their trade balances and over-all balances of payments.

Although I do believe that a great deal of adjustment is now constructively built into the pipeline, it would be wrong to leave the impression that everything is likely to be smooth sailing from here on into port. The deficit on current account and long-term capital for the full year 1973--the basic deficit--is likely to be of the same order of magnitude as last year, in the $8 billion to $10 billion range. Though this deficit will be adjusting, it can only do so slowly. In the meantime, the deficit has to be financed--one way or another.

Exchange markets are thus likely to be very nervous about the evolution of the U.S. balance of payments. Each new piece of information--for example, each release of the monthly trade figures--is likely to be seized on, and no doubt overinterpreted. Moreover, the situation is particularly delicate because

> the markets know that governments are not formally in agreement as to the guidelines and traffic regulations that are supposed to govern the operation of the exchange and monetary system during this period.
>
> It would therefore only be prudent to expect occasional flare-ups and periods of unsettlement in the months ahead. Seen in this perspective, the relative calm in exchange markets in the last 4 weeks probably is too good to last.
>
> Though periods of unsettlement may well come, we need not--it seems to me--be unduly apprehensive about riding out any such storms on the basis of the present exchange-rate arrangements. Movements in the rates can be allowed to absorb the greater part of any pressure that does develop, with official intervention being available for use, if necessary, to prevent markets from becoming genuinely disorderly. What likelihood there is of flare-ups and unsettlement should be declining over time _pari passu_ with the underlying basic adjustment. It is this trend of underlying adjustment that makes it seem reasonable to hope for continued progress toward a system of weekends and evenings that are, if not fixed, then at least infrequently adjusted because of being troubled by exchange crises.

Chairman Burns remarked that he had found Mr. Bryant's report useful and interesting.

Mr. Daane expressed a similar view. He was glad that Mr. Bryant had added a caveat near the end of his remarks to the effect that the sailing was not likely to be entirely smooth from here on. While it was true that exchange markets had been calm since March 16 and that the volume of transactions had grown as traders learned to adapt to the new conditions, a disturbance could arise at any moment--perhaps as a result of a shock from an unexpected quarter, as had been the

case in February. He wondered whether attitudes had not become a bit too relaxed recently, particularly among the governments that seemed to have no great sense of urgency about the need for monetary reform. He would be interested in Mr. Coombs' view on that point.

Mr. Coombs said he thought the present calm in exchange markets could be attributed primarily to fatigue on the part of participants after all the earlier tumult and to the absence of any seriously disturbing events in the news. That situation could not be considered normal, and the new arrangements could be challenged at any moment.

Mr. Coombs added that he would like to emphasize a point he had made in his prepared statement--that the extent to which the exchange rates were floating could be easily exaggerated, given the fixed rates among European currencies, the "dirtiness" of the Japanese float, and the likelihood that African, Middle Eastern, and Asian countries would decide to maintain fixed rate relationships with Europe in the event the dollar floated downward. In his judgment the situation toward which the markets were drifting--in which the dollar would be the only cleanly floating major currency--foreshadowed continuing uncertainty and even distrust of the ultimate value of the dollar, and perhaps also of its value in the short and intermediate term.

Chairman Burns remarked that, before calling for Committee discussion of current monetary policy, he might note again his view that the present was a critically important juncture for policy. The Committee's broad objective was clear: on the one hand, it should avoid adding fuel to the inflation; on the other hand, it should take no steps that would tend to bring on an early recession. If there were a recession, the deficit in the Federal budget could easily rise from recent levels in the neighborhood of $20 billion to $40 or $50 billion, and monetary policy--whatever its stance in the interim--would inevitably move in the direction of ease. He believed that whatever mistakes the Committee might have made in 1972 had been reasonably well corrected, although admittedly that was a matter of judgment. In any case, it was important to look to the future rather than to the immediate situation or to the past.

The Chairman then asked Mr. Partee for his recommendations on policy.

Mr. Partee remarked that the Chairman had made one of the principal points he had planned to put to the Committee. The recent past and present were characterized by strong inflationary pressures and rapid economic expansion, but the outlook was increasingly taking on a cyclical aspect suggesting a slowdown

ahead--very possibly within the next year. Accordingly, and in view of the lags in the operation of monetary policy, it was highly important to avoid overreacting to immediate developments.

Mr. Partee added that in his judgment the longer-run targets the Committee had agreed upon at its last meeting--indexed by an annual rate of growth of 5 to 5-1/2 per cent for M_1 in the second and third quarters combined--were about right; he saw no grounds for urging that the Committee adopt some significantly different targets. Accordingly, he would endorse the stance of alternative B of the draft directives. In that connection, it was worth noting that since last October, when the Committee began to consider its longer-run objectives for M_1 and M_2 more formally, the cumulative expansion in the level of the money stock had been about on target. Thus, starting in October, the targets--or the mid-points of the target ranges--set by the Committee for 6-month growth rates in M_1 were successively 6, 5-1/2, and 5-1/4 per cent. Actual growth had put M_1 well above the longer-run target path in December, but the money stock came back on path in January and had fallen somewhat below it in March. That experience suggested to him that in choosing its short-run operating ranges for the monetary aggregates the Committee no longer had any reason to skew the ranges toward the low side of its longer-run target, as it had done at several recent meetings; the ranges shown in the blue book under alternative B would seem to be appropriate. Rather, if the Committee wished to

guard against the appearance of undue ease, the appropriate change in the B specifications would be to increase the lower limit of the range of tolerance shown for the Federal funds rate. He would not be opposed to an increase of a quarter of a point in that lower limit, to 6-3/4 per cent, from the 6-1/2 per cent specified.

Chairman Burns then called for a general discussion of monetary policy and the directive.

Mr. Mitchell concurred in Mr. Partee's view that no change should be made in the Committee's longer-run objectives at this point. For the short run--say, the next 60 or 90 days--he thought the broad objective should be to discourage any speculative attitudes and actions by businessmen with respect to investments in inventories and capital equipment. The Board of Governors had a broader array of instruments that might be brought to bear in working toward that objective, but he thought the Committee could help by avoiding any suggestions of easing. Accordingly, he agreed with Mr. Partee that it would be desirable to set the lower limit for the funds rate above the 6-1/2 per cent level associated with alternative B; a 7 per cent lower limit would be acceptable to him. He did not believe that System operations could have much impact on the growth rate of M_1 during the next month or so, but they certainly could prevent the funds rate from

declining to a level that would be prejudicial to the short-run objective he had described.

With respect to the operational paragraph of the directive, Mr. Mitchell noted that alternative B called for bank reserve and money market conditions consistent with "moderate" growth in monetary aggregates over the months ahead, and alternative C called for conditions consistent with "modest" growth. He was not sure he fully understood the intended difference between those two words, but he would be inclined to use the C language.

As far as the discount rate was concerned, Mr. Mitchell continued, he thought the chances were small that an increase at this point would yield any significant benefit other than reducing the subsidy element in the present rate. For that reason, he would not be inclined to make a change at the moment.

Mr. Hayes said he shared Mr. Mitchell's view that it would be undesirable for the System to give the impression that it was easing policy. In that connection, he was concerned that the Committee might be tending toward an unduly mechanistic approach to policy formulation. The general stance and posture of the System was of major importance at a time like the present, when the economy was approaching, if not actually experiencing, a boom and when inflation was by far the biggest danger. Under such circumstances, it was particularly important that the Committee

hold the line and not be led into easing money market conditions because of a change in the growth rates of the monetary aggregates that might well prove temporary. It was, of course, desirable to take account of lags and to look to possible future effects of present actions. In that process, however, there was a risk of introducing so much sophistication that the most important immediate considerations were overlooked.

Mr. Hayes observed that much firmer wage and price controls were needed. As had often been noted, however, controls were not of much use in the absence of appropriate fundamental policies, and in the present situation monetary policy was one of the fundamentals.

Mr. Hayes remarked that he was not disturbed by the slow growth of M_1 in the first quarter, especially in view of the generous growth over the past year and the projections, for whatever value they might have, of renewed substantial growth in the coming months. Meanwhile, the explosive expansion of bank credit should give the Committee pause, even after taking account of the special factors that had been discussed today. Total credit flows were very large and liquidity in general was at a high level.

Mr. Hayes observed that in its policy considerations the Committee would want to keep in mind that the Treasury refunding to be announced around April 25 would introduce an even keel

element. As Mr. Holmes had noted, it was not clear at this juncture how important even keel considerations would be.

In the present explosively inflationary situation, Mr. Hayes continued, he would like to see the longer-run target for M_1 reduced another notch, to a 4-1/2 to 5 per cent range, and he thought the Committee should seek a much more moderate rate of expansion in bank credit than that of recent months. He favored shorter-run target ranges for the monetary aggregates between those shown in the blue book for alternatives B and C, including an April-May range for the M_1 growth rate of 3 to 6 per cent. He had been pleased to see the lower limit of the range for the Federal funds rate raised from 6-3/4 to 7 per cent last week, and now he would suggest increasing the upper limit by a quarter of a point also; in other words, he favored a 7 to 7-3/4 per cent funds rate range. For the directive, he liked the language of alternative C.

Turning to the discount rate, Mr. Hayes said he was inclined to agree with Messrs. Balles and Brimmer that a half-point increase would have a rather mild impact on financial markets, in light of the period for which the discount rate had lagged market rates and the size of the spread. He recognized the unusual circumstances underlying the Board's reluctance to approve a rate increase, but he thought that reluctance should not be carried to

the point of immobilizing this important policy instrument at a time like the present. Finally, as he had indicated on several past occasions, he would like to see the remaining Regulation Q ceilings on large-denomination CD's removed, perhaps with an accompanying action to impose marginal reserve requirements on increases in outstanding CD's above some base.

Mr. Brimmer said he concurred in Mr. Partee's views with respect to both the economic outlook and the desirability of adopting the alternative B longer-run targets and short-run operating ranges for the monetary aggregates. He also agreed with those who thought that inflation represented the greatest present danger. As he had indicated earlier, however, he believed that a distinction should be made at this point between the tasks of various policy-making groups. Within the System, he thought that, in achieving any additional restraint that might be needed, greater reliance should now be placed on the various instruments available to the Board; the Committee's task should be primarily one of avoiding slippage.

Like Mr. Hayes, Mr. Brimmer continued, he had been pleased by last week's increase in the lower limit of the funds rate range. Today he would prefer to have the lower limit set at 6-3/4 or 7 per cent rather than at 6-1/2 per cent, and if

some increase in the upper limit was needed that also would be agreeable to him. But he would not want the Committee to shift to a more restrictive stance with respect to the provision of reserves.

Mr. Balles remarked that he had great sympathy for those staff members who had the job of trying to attain the longer-run targets and the short-run objectives set by the Committee. However, in light of the overshoots in the monetary aggregates that occurred in the second half of 1972 and the undershoots of the first quarter of 1973, he wondered whether it might not be desirable for the Committee to undertake another basic examination of the problem of targets. Specifically, he understood that the staffs at the Board and the New York Bank were now evaluating the experiment with RPD's begun in early 1972. Depending on the outcome of that evaluation, the Committee might want to consider appointing a new subcommittee to study ways of controlling the aggregates and such matters as the optimum time horizon for the operating directives. He had no preconceived notions as to whether such other measures as nonborrowed reserves and the monetary base would make good operating targets, but the pros and cons of alternative measures might be compared to those of RPD's when the evaluation of the latter was completed. In

general, he believed the Committee still had a long way to go in perfecting its approach to operations.

Turning to current policy, Mr. Balles said he had concluded with the benefit of hindsight that the Committee had missed the boat last year, to use Mr. Brimmer's term, by permitting the monetary aggregates to expand too rapidly. He would not want to compound the problem now by going too far in the direction of restraint. It was important to move in an orderly fashion onto the longer-run growth path for M_1 that the Committee had decided upon at its previous meeting. Also, he agreed with those who believed that signs of money market easing should be avoided at present, in view of the explosive inflationary pressures now prevailing. Thus, he also would like to see the lower limit of the funds rate constraint set at 6-3/4 per cent, and possibly even 7 per cent.

With respect to directive language, Mr. Balles observed that, like Mr. Mitchell, he was not sure he understood the significance of the terms "moderate" and "modest" growth in the aggregates, as used in alternatives B and C, respectively. If the choice for the operational paragraph were limited to those two alternatives, he would choose C. However, he preferred more specific language, such as that of the directives

issued at other recent meetings. In those directives the growth rates desired had been described in relation to the rates prevailing in some past period.

Mr. Coldwell remarked that, with prices moving up rapidly and with advances in wage rates also threatening to accelerate, he had some question about the desirability of relying heavily on M_1 as an index of the stance of monetary policy. He was especially concerned about the rapid advance in bank credit, and as implied by the question he had raised earlier today, he was dubious about the validity of recent monthly figures on M_1. His inclination would be to give less weight to monthly data on M_1, although the quarterly M_1 figures appeared to be coming out reasonably well.

Mr. Coldwell observed that he favored the language of alternative C for the directive. While he thought there was a case for shifting the specifications associated with that alternative slightly in the direction of those of B, such a procedure might constitute overly fine tuning. He would, however, lower the upper limit of the range shown under C for the Federal funds rate from 8 to 7-3/4 per cent, so that the range would be 6-3/4 to 7-3/4 per cent.

With respect to the discount rate, Mr. Coldwell said he recognized the problems facing the Board in considering the

increases recommended by the Reserve Banks. In his judgment, however, other problems were posed for monetary policy by the retention of the existing 5-1/2 per cent discount rate, and he hoped that the Board would take early action on the proposals for an increase.

Mr. Robertson observed that he was in agreement with most of the comments on policy others had made today. As had often been painfully true during his tenure with the Federal Reserve, inflation was the number one problem in the domestic economy. In contrast to the situation not long ago, demand-pull was now an important element in the inflation, and there was no question but that the economy was in a state of boom. While some of the current strength of demand could be attributed to temporary factors, as had been noted today, he did not anticipate a substantial abatement of demand pressures in the next few months.

Facing that prospect, Mr. Robertson continued, it was more important than ever that the growth of the monetary aggregates be kept moderate relative to GNP. He was not concerned about the recent low growth rates of the aggregates; indeed, those growth rates could turn out to have offered a constructive and well-timed check on what appeared to be increasing inflationary expectations.

Mr. Robertson observed that he was greatly concerned about the recent outsized rates of growth in bank credit. The chief cause of the rapid growth was obvious; it was due in large part to the upsurge in bank issuance of large-denomination CD's, stimulated by the strong demand for bank loans. He doubted that it would be in the public interest to permit that surge to go on much longer. If Regulation Q ceilings were not to be used to curb the surge--and he presumed they would not be--the proper instrument for further restraint in that area was not general-purpose open market operations but rather Board disciplinary action aimed directly at the big CD's, such as a substantial increase in reserve requirements on CD's. In any event, it seemed ridiculous to him to retain Q ceilings on longer-term CD's while having no ceilings on short-term instruments.

Mr. Robertson remarked that he preferred the language of alternative C and the accompanying specifications, except that he would reduce the upper limit of the range for the Federal funds rate from 8 to at least 7-3/4 and perhaps to 7-1/2 per cent. To set the upper limit at 8 per cent would, in his judgment, represent a panic reaction. For the lower limit, he would prefer 7 per cent. It was important to avoid any indication whatsoever of an easing of policy, since the psychological

attitudes of the public were influenced to an important extent by actions of the System and the assessments of those actions published by commentators.

While carrying out such a policy, Mr. Robertson continued, the System should carefully observe the patterns of response and be attentive to possible side effects of an adverse kind. At the same time, if monetary policy was to do its job, it would have to hold to its objectives with determination. One advantage in maintaining a firm stance in monetary policy--and fiscal policy as well--was that it might eventually permit the elimination of the control programs. A great danger in such programs was that once in place they were very hard to eliminate; indeed, there was a tendency for controls to proliferate. At that stage, much of what had been gained over the years could be destroyed.

Mr. MacLaury remarked that one question facing the Committee at this juncture was whether to accept at face value the figures portraying a slow average rate of growth in the monetary aggregates since the beginning of the year or those indicating a very rapid growth rate in real economic activity over the same period. He was inclined to place credence in the measures of business activity and to discount the money stock numbers as distorted. He could not explain why the figures on money

growth rates were so low, but he thought they would snap back--much as they had in December.

A second question, Mr. MacLaury continued, concerned the proper role of monetary policy in countering the present overheating in the economy. Like some others, he was concerned about the risks of overreacting to the present situation--of missing the boat a second time, as it passed in the opposite direction. On balance, he favored alternative B, except that he would modify the specifications to retain the present 7 to 7-1/2 per cent range for the Federal funds rate.

Mr. Francis said the historical record of the relationship between growth rates of money and production supported the view that it would not be desirable for the low monetary growth of the last few months to persist for very long. Monetary growth had been too rapid in 1973 and a gradual winding down was needed, but the restraint should not be overdone. However, the average rates of increase over periods beginning last September or last November were not far off target, and in view of the large overhang of Treasury deposits and the potential for international reflows there were reasons to believe that the unduly slow growth of the past couple of months would not persist.

On balance, Mr. Francis observed, he favored the long- and short-run specifications for the aggregates shown under alternative B; the alternative C growth rates if attained immediately might

involve too quick slowing. For the funds rate he would favor a lower limit of 7 per cent and an upper limit of 7-3/4 or even 8 per cent. He agreed with Mr. Balles that the wording of the draft operational paragraphs of the directive was undesirably qualitative, and that more quantitative language would be preferable.

Mr. Kimbrel said he thought it was desirable to maintain about the present degree of restraint, given the rate of price advance and the persistence of inflationary expectations. Observers in the financial community apparently had been impressed with the System's recent record of slowing down the growth rate of the monetary aggregates. He hoped the gains that had been made in improving public confidence would not be dissipated.

In short, Mr. Kimbrel continued, he would favor long-term growth targets for the monetary aggregates and short-run operating constraints much like the present ones. If he had a choice, he would select the specifications of alternative B--except for the funds rate range--and the directive language of alternative C. For the weekly average funds rate, he would set a floor of 7 per cent, mainly to avoid any impression of slippage in the degree of restraint. He favored a ceiling of 7-3/4 per cent, not to indicate an intention to press for more restraint but simply to provide additional latitude in case of need. He would also like

to endorse Mr. Robertson's hope that monetary and fiscal policies would be of a kind that would permit the eventual elimination of controls.

Mr. Sheehan said he thought that the recent moderate rate of growth in inventories was not due to better inventory management. Rather, it reflected the inability of businesses to catch up with rising sales.

In general, Mr. Sheehan continued, he concurred in the remarks Mr. Brimmer had made this morning except for the latter's suggestion that the Committee had "missed the boat" last year.

Chairman Burns said he was not sure he had understood that comment of Mr. Brimmer's. He asked if the latter would explain his meaning.

Mr. Brimmer replied that his position, basically, was that action by the Committee at this time could not be expected to have much effect on the rate of inflation in the near term, but that some of the excess demand evident today would not have emerged if the System had applied monetary restraint a bit more vigorously in 1972.

Mr. Sheehan remarked that he, personally, had no regrets over the System's policy course in 1972, for two reasons. First, there had been grounds for concern about the level of unemployment throughout much of the year; as he recalled the figures, the

unemployment rate did not move below 5.5 per cent until November. He was not aware of any projections which foresaw the ebullience that developed in the fourth quarter of 1972 and the first quarter of 1973. Secondly, if the Committee had tightened policy last fall to the degree some members had favored, the prime rate undoubtedly would have moved up much more than it did and Congress would very likely have passed legislation calling for interest rate controls.

In reviewing the draft directives, Mr. Sheehan continued, he had been struck by the fact that the statements in the general paragraphs were concerned exclusively with the past and present. In its deliberations the Committee should be focusing on the future, and it should be recalling the staff projection discussed at the last meeting which suggested that a 4 per cent rate of growth in M_1 would mean a recession in 1974. It was important that the Committee avoid any action today that would precipitate a recession late this year or early next year.

Mr. Sheehan said he would not want the weekly average Federal funds rate to exceed 7-1/2 per cent during the next month. He would be quite willing to set the lower limit on the funds rate above the 6-1/2 per cent level associated with alternative B; a floor between 6-1/2 and 7 per cent would be

acceptable if the Manager felt that the resulting range would not constrain his operations too much. With respect to the operational paragraph, like some others he was not sure what the distinction between "moderate" and "modest" growth in the aggregates was intended to convey; if "modest" meant a continuation of the 2-1/2 per cent M_1 growth rate estimated for the first 4 months of 1973, he would be opposed to its use.

Mr. Black observed that a reading of monetary policy history suggested that the main mistakes had occurred in connection with a stop-and-go approach. Against the background of the disastrous behavior of prices in recent months, there was a strong temptation at present to move toward a degree of restraint that would prove excessive over the longer run. His preference would be to follow a policy course of the kind recommended by Mr. Partee. Specifically, he favored the specifications of alternative B except that the lower limit of the range for the funds rate would be raised from 6-1/2 to 6-3/4 per cent. He hoped the funds rate would not be held close to the 6-3/4 per cent floor for an extended period, but if there were a shortfall in the aggregates he would be prepared to see it go that low.

Mr. Bucher noted that he had read two recently published books concerned with the subject of inflation. One explored, in part, the

premise that inflation was a permanent phenomenon, and it considered at length the means of adjusting to such an environment. The other argued that, given present dominance of certain institutions representing both business and labor, the economic system no longer functions in the way it had in the past and that direct controls offer the only solution to the problem of inflation. He expressed concern about these ways of thinking and joined Mr. Robertson in hoping that direct controls could eventually be eliminated. At the same time, he felt a sense of frustration about the problems of coping with inflation by general stabilization measures. In that connection, he concurred in Mr. Balles' suggestion that the Committee should be searching for ways to improve its tools. Such a search, he thought, should be carried out on a continuing basis.

With respect to current policy, Mr. Bucher said he agreed with Mr. Mitchell and others about the importance of avoiding any impression that the Committee was relaxing its stance. The sharp market reaction to a rather small volume of System bill purchases in early April was an indication of the sensitivity of observers to any easing operations the Federal Reserve might undertake. But the Committee would have to walk a narrow line since, as Mr. Partee had suggested, it was necessary to avoid overdoing restraint.

In summary, Mr. Bucher observed that he favored the longer-run targets for the monetary aggregates shown under alternative B, moving toward a 5 per cent growth rate for M_1. He agreed with those who thought 6-1/2 per cent would be too low as the lower limit for the Federal funds rate, and he would prefer a 6-3/4 per cent floor. As to the upper limit, he hoped it would not be set higher than 7-1/2 per cent. The language of alternative C was acceptable to him for the operational paragraph of the directive. He also was not sure about the significance of the word "modest," but he had no objection to its use so long as the Manager understood the Committee's intent.

Mr. Daane remarked that, like others, he would want to avoid overreacting to recent developments at the current stage of the cycle and, like others, he was equally anxious to avoid adding any fuel to inflationary expectations. He differed somewhat from Mr. Partee's assessment of the probabilities attached to the three alternative contours of economic activity over the rest of the year. While he hoped he was wrong, he would place a somewhat higher probability on the contour involving a bigger boom, followed by more disruptive consequences, than implied by the staff's projections. He did not believe that monetary policy could do much about the size of the bubble he anticipated.

Mr. Daane observed that he would be inclined to place more emphasis on the possible need for even keel in the coming period than had been suggested in the discussion thus far. In particular, he would not want to prejudge the Treasury's choice from among the financing options available to it, nor to preclude, by System operations, the use of any of those options. He favored the language of alternative B; while the difference between the words "moderate" and "modest" was not necessarily great, the latter term was somewhat ambiguous, whereas the former seemed to convey correctly the Committee's intentions with respect to the desired growth in the monetary aggregates. He also favored the specifications of B, except that he would raise the lower limit of the funds rate range to 6-3/4 or even 7 per cent. According to the blue book, a decline in the funds rate to 6-1/2 per cent was likely to be accompanied by a drop in Treasury bill rates. Such a development, in his judgment, should be avoided, since it would tend to support the views of those who were anticipating an easing of monetary policy and thus strengthen inflationary expectations. He also would be agreeable to raising the upper limit of the funds rate range, perhaps to 7-3/4 per cent.

Mr. Morris noted that he had participated in the daily conference call during the period since the last Committee meeting and had observed from day to day the shortfalls that had

occurred in reserves and monetary aggregates and the tendency for short-term rates to drift down in the face of very strong economic conditions. That response, he believed, had not been anticipated by members of the Committee, and he could conclude only that it was a reflection of an extremely tight monetary policy. If, as he believed, monetary policy operated with a long lag, there would seem to be a clear danger of overshooting the desirable degree of restraint. Now that the funds rate had been worked up to the neighborhood of 7 per cent there was a natural reluctance on the part of Committee members to permit it to move down again. However, he, for one, would not be unhappy to see the funds rate drift down to 6-1/2 per cent if that were necessary to get the monetary aggregates growing at reasonable rates. He was not particularly concerned about the possible reactions of businessmen to a decline in the funds rate since he doubted that most of them paid much attention to that rate. But any possible adverse reactions to a slide in the funds rate to 6-1/2 per cent could be forestalled by increasing the discount rate to 6 per cent at the same time. In sum, he favored the specifications of alternative B, including the 6-1/2 to 7-1/2 per cent range shown for the funds rate.

Mr. Winn observed that he shared Mr. MacLaury's reservations about the credence that could be placed in the recent figures

on the money supply. He suspected that there had been some institutional developments which had resulted in some increase in the stimulus associated with a given growth rate in money. Consequently, he would be inclined to avoid any sense of easing. At the same time, he would not want to move aggressively toward greater restraint.

Chairman Burns said he might mention again his view that the Committee was at a critical point in making policy. He had called attention earlier to the recent sharp divergence in the sentiment and expectations of business managers on the one hand and investors and consumers on the other hand, and he had noted that such divergences could not be expected to persist for long. It was likely that in a few weeks--or, at the most, a few months--the attitudes of consumers and investors would be found to resemble those now held by businessmen, or vice versa. Which way the scissors would close, he could not say. However, because the responses of business managers to current developments traditionally had been slow, and because the sentiments now prevailing among consumers and investors were so strong, he was inclined to think that the shift would occur in business attitudes. Accordingly, he thought caution was indicated at present.

The Chairman remarked that he would not take the time today to offer his diagnosis of how the prevailing attitudes had

come about. He would, however, briefly note his conclusions. One feeling that was now widely held among the American people was that their lives, their opportunities, their fortunes, and their prosperity were being shaped increasingly by the Government. Secondly, people had come to feel increasingly that the confidence they had placed in the ability of the Government to manage the nation's affairs in general and its economic affairs in particular had been misplaced. Trust in Government had declined dangerously. Those developments had increased the weight of the System's obligations. The contribution the Federal Reserve could make to preserving confidence might be modest, but it was nevertheless significant; and to the extent that the System made such a contribution it would be contributing to the quality of the lives of the American people in the years ahead.

With respect to the questions immediately before the Committee, Chairman Burns continued, he might note that those who had spoken on the subject of the directive were closely divided between alternatives B and C for the operational paragraph. A very slight majority had indicated a preference for C. The choice between the words "moderate" and "modest" for describing the desired growth rate of the monetary aggregates was not of great significance for open market operations,

because the Committee had recently been following the useful practice of indicating with some precision just what its directive meant. However, the choice did have some significance for the public, since the two words carried somewhat different connotations. He was inclined to agree with Mr. Daane that the word "modest" was ambiguous and that "moderate" would be better. There were, of course, other possible ways of describing the desired monetary growth, such as "gradual" and "prudent."

In response to the Chairman's question, more members indicated that they favored using the word "moderate" than any of the alternatives mentioned.

Turning to the matter of specifications, Chairman Burns observed that a majority of the members favored the longer-run targets and the short-run operating ranges for the aggregates shown under alternative B in the blue book. However, only one member had expressed a preference for the 6-1/2 to 7-1/2 per cent range for the Federal funds rate associated with that alternative. Taking account of the members' comments and of his own views, he would suggest that the Committee consider a range of 6-7/8 to 7-1/2 per cent for the funds rate.

Mr. Hayes noted that a number of speakers had expressed a preference for a lower limit of 7 per cent, which was about

the average level of the funds rate in recent weeks. He personally would find a 6-7/8 per cent lower limit more acceptable if the upper limit were shaded up to 7-5/8.

Chairman Burns remarked that he had suggested a 6-7/8 per cent lower limit for the funds rate in order to provide some slight leeway on the downside from the recent average rate of 7 per cent. With the upper limit at 7-1/2 per cent, there would be considerably more leeway on the upside.

Messrs. Daane and Mitchell indicated that they saw no significant advantage to raising the upper limit by 1/8 of a point.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's drafts of the general paragraphs and alternative B for the operational paragraph. It would be understood that that directive would be interpreted in accordance with the specifications shown under alternative B in the blue book, except that the range of tolerance for the daily average Federal funds rate in statement weeks until the next meeting would be 6-7/8 to 7-1/2 per cent.

Mr. Hayes said that, while he planned to vote favorably on the proposed directive, he would do so reluctantly.

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

The information reviewed at this meeting suggests continued rapid growth in real output of goods and services in the first quarter, spurred by an extraordinary increase in consumption expenditures. Over the first 3 months of this year, employment rose strongly but the unemployment rate remained about 5 per cent. The recent advance in wage rates has been more moderate than in the latter part of 1972, but the increase in social security taxes in January added significantly to payroll costs. The rate of increase in prices stepped up very sharply in the first quarter. Prices of foods have continued to rise at wholesale and retail, and in both February and March increases in wholesale prices of industrial commodities were large and widespread. Foreign exchange markets have been relatively quiet since mid-March, and there has been a moderate reflow into dollars. The U.S. merchandise trade balance improved a little in January-February, when both exports and imports were sharply higher than in the fourth quarter of 1972.

Growth in both the narrowly and more broadly defined money stock slowed markedly in the first quarter following a bulge toward the close of last year. However, in the face of strong loan demand--especially from businesses--banks sharply increased their issuance of large-denomination CD's, and the bank credit proxy expanded very rapidly. Short-term market interest rates continued to rise until the beginning of April, but since then some rates--particularly those on Treasury bills--have declined. Rates on long-term market securities have moved down on balance 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 abatement of inflationary

pressures, a more sustainable rate of advance in economic activity, and progress toward equilibrium in the country's balance of payments.

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

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

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, May 15, 1973, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 17, 1973

To Chairman Burns

From Murray S. Wernick MSW

Subject: 1st Quarter Increase in Compensation per Manhour

There was a substantial difference in the rate of increase shown for the index of hourly earnings in manufacturing and compensation per manhour in the industrial sector in the first quarter of this year.[1/] The index of average hourly earnings, which is adjusted for overtime and interindustry shifts, increased by a relatively moderate 5.1 per cent at an annual rate, but the compensation per manhour rose by 12.5 per cent. The two major factors accounted for this difference, as can be seen in the table below are: a) the effects of overtime and of interindustry shifts; b) the increase in social security taxes early in the first quarter.

	1st Q 1973 Per cent increase from previous quarter at annual rates
Index of average hourly earnings in manufacturing--adjusted for overtime and interindustry shifts[2/]	5.1
Average hourly earnings in manufacturing including overtime and interindustry shifts[2/]	8.5
Compensation per manhour in the industrial sector, including fringes, but excluding Social Security taxes	9.5
Compensation per manhour including increase in Social Security taxes	12.5

1/ Greenbook Supplement--April 13, 1973, page C-4, Table 2.

2/ Separate data are not available for the industrial sector, but manufacturing wages account for the bulk of the wages paid in the industrial sector and show approximately the same rates of change.

ATTACHMENT B

April 16, 1973

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on April 16, 1973

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests continued rapid growth in real output of goods and services in the first quarter, spurred by an extraordinary increase in consumption expenditures. Over the first 3 months of this year, employment rose strongly but the unemployment rate remained about 5 per cent. The recent advance in wage rates has been more moderate than in the latter part of 1972, but the increase in social security taxes in January added significantly to payroll costs. The rate of increase in prices stepped up very sharply in the first quarter. Prices of foods have continued to rise at wholesale and retail, and in both February and March increases in wholesale prices of industrial commodities were large and widespread. Foreign exchange markets have been relatively quiet since mid-March, and there has been a moderate reflow into dollars. The U.S. merchandise trade balance improved a little in January-February, when both exports and imports were sharply higher than in the fourth quarter of 1972.

Growth in both the narrowly and more broadly defined money stock slowed markedly in the first quarter following a bulge toward the close of last year. However, in the face of strong loan demand--especially from businesses--banks sharply increased their issuance of large-denomination CD's, and the bank credit proxy expanded very rapidly. Short-term market interest rates continued to rise until the beginning of April, but since then some rates--particularly those on Treasury bills--have declined. Rates on long-term market securities have moved down on balance 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 abatement of inflationary pressures, a more sustainable rate of advance in economic activity, and progress toward equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPHS

Alternative A

To implement this policy, while taking account of forthcoming Treasury financing, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat faster growth in monetary aggregates over the months ahead.

Alternative B

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

Alternative C

To implement this policy, while taking account of forthcoming Treasury financing and possible credit market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with modest growth in monetary aggregates over the months ahead.

ATTACHMENT C

April 17, 1973

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 4/17/73)
A. Longer-run targets (SAAR): (second and third quarters combined)	M_1	5-1/4%
	M_2	5-1/4%
	Proxy	10%
	RPD's	8-3/4%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (April-May average):		10 to 12%
2. Ranges of tolerance for monetary aggregates (April-May average):	M_1	4 to 6%
	M_2	4-1/2 to 6-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		6-7/8 to 7-1/2%
4. Federal funds rate to be moved in an orderly way within range of tolerance		
5. Other considerations: account to be taken of Treasury financing.		

C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.