MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, May 20, 1975, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Baughman
Mr. Bucher
Mr. Coldwell
Mr. Eastburn
Mr. Holland
Mr. MacLaury
Mr. Mayo
Mr. Mitchell
Mr. Wallich

Messrs. Balles, Black, Francis, and Winn, Alternate Members of the Federal Open Market Committee

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

Mr. Broida, Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist

Mr. Sternlight, Deputy Manager for Domestic Operations
Mr. Pardee, Deputy Manager for Foreign Operations

Mr. Rippey,[1/] Assistant to the Board of Governors

Chairman Burns noted that by letter dated April 11, 1975, Chairman Patman of the Subcommittee on Domestic Monetary Policy

---

1/ Left meeting at point indicated.

of the House Committee on Banking, Currency and Housing had requested the FOMC memoranda of discussion for the years 1971-74, inclusive. By letter dated April 18 he (Chairman Burns) had responded that that request would be considered by the FOMC at today's meeting. On May 9 the staff had distributed materials relating to the request, including copies of the two letters he had mentioned, a memorandum from Messrs. O'Connell and Broida, and a brief memorandum from himself suggesting that the Committee resist the request.[1/]

The Committee then engaged in an extended discussion of the issues involved in Mr. Patman's request. It developed that, with the exception of Governor Bucher, all members were of the view that the considerations in favor of complying with the request were outweighed by those against doing so. Particular stress was placed on the arguments that premature release of the memoranda of discussion would result in a destructive diminution of candor in the Committee's deliberations, would create difficulties in connection with information involving foreign central banks and governments, and would require the Committee to consider whether preparation of the memoranda should be terminated despite their usefulness to the Committee and ultimately to economic historians.

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

Mr. Bucher expressed the view that the Federal Reserve should do everything possible to counter the frequent charge that it was unduly secretive and that it should, on its own initiative, reduce the lag with which the FOMC memoranda of discussion were made public from the present length--five years after the close of the calendar year in which the meetings occurred--to one year. Other members, while not in favor of complying with the request, suggested that the Committee review the question of the length of this lag at an appropriate time.

It was agreed during the discussion that the staff should explore the possibility of lengthening the policy records, which were published with a 45-day lag, to include additional information on the reasoning entering into the Committee's decisions on domestic policy.

> With Mr. Bucher dissenting, the Committee decided to decline to comply with the request of April 11, 1975, from Congressman Wright Patman, Chairman of the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Currency and Housing, for the memoranda of discussion at FOMC meetings in the years 1971-74, inclusive.

Secretary's note: On June 3, 1975, the following letter was sent to Congressman Patman over the signature of Chairman Burns:

Dear Mr. Chairman:

Your request for the memoranda of discussion for meetings of the Federal Open Market Committee ("FOMC") in the years 1971-74, inclusive, has been considered carefully by the Committee. In this connection, the FOMC has given full and deliberate consideration to the oversight responsibility that the Congress in general and your Subcommittee in particular have with respect to its functions and operations.

I might note at the outset that, apart from the memoranda which you request, there are three regularly available sources of information about the operations of the FOMC. One consists of weekly statistical releases published by the Board, which promptly and fully disclose the results of the Committee's open market operations. The most important of such weekly releases are the Federal Reserve Statement (H.4.1), the Weekly Summary of Banking and Credit Measures (H.9), and Money Stock Measures (H.6).

A second source is the record of policy actions, which is prepared pursuant to a requirement of the Federal Reserve Act. These policy records disclose the Committee's intentions with respect to open market policy, as reflected in the actions reported. They include all votes, by name, cast by members of the Committee in connection with the determination of open market policies; the reasons underlying the policy actions, including descriptions of then-current and prospective economic developments and of conditions in domestic and international financial markets; and statements of the reasons for any dissenting votes.

A third source, the minutes of actions, indicates all votes taken by the FOMC--including those relating to procedural matters as well as those relating to policy questions. The minute entries for policy actions are made available for public inspection on the same schedule as the policy records; the minute entries for most other actions are made available promptly after the meeting.

To this copious body of information concerning the operations of the FOMC, the memoranda of discussion add essentially one further type of material: reports of the deliberations through which the Committee reaches its decisions on policy and procedural matters. As you are aware, there is no legal requirement that such memoranda of FOMC meetings be prepared. However, they have proved valuable to the FOMC and its staff in connection with the ongoing work of the Committee, and we believe they constitute a useful historical record. For these reasons, they are maintained by the Committee and made available to the public after a time lag determined by the FOMC.

The memoranda of discussion reflect the unfettered, spontaneous expressions of FOMC member views and opinions. Some of these expressions may be put forth primarily to elicit discussion and clarification of issues rather than as statements of firmly held views. Some may turn out to be inconclusive with respect to the FOMC's ultimate decisions, and others at odds with those decisions. All such expressions do, however, contribute to the decisional process.

The informal "give and take" debate at FOMC meetings, as substantially reflected in the memoranda of discussion, involves the decision-making process utilized by the legislative, executive, and judicial branches of our Government since the founding of the Republic. Each branch of Government daily encounters the situation where individual opinions and advice, expressed and conveyed in the decision-making process, are re-thought, altered, or reversed on the hearing of opinions and views of other participants. Premature public exposure of such deliberations, whether involving legislative, executive, judicial, or administrative bodies, preceding as they do the official decisions and actions of such bodies, would quickly and certainly make such decisional process sterile. If the FOMC memoranda of discussion were to be released prematurely, the Committee would be faced with the choice of permitting a destructive diminution of candor in its deliberations or of preserving the members' ability to speak their minds freely and fully by terminating the preparation of such memoranda. Neither alternative would be in the public interest.

In addition, the matters commonly discussed at FOMC meetings include ongoing or prospective transactions in foreign exchange markets, the premature disclosure of which could have both immediate and longer-term adverse impact on international flows of funds. Moreover, references are frequently made to highly sensitive matters involving, or statements by or about, foreign central banks and governments. Clearly, continued FOMC access to such important and relevant communications must not be jeopardized by even a suggestion of untimely dissemination.

In view of these considerations, the Committee has concluded that it must respectfully decline to comply with your request for the 1971-74 memoranda of discussion.

The Committee's decision, premised in major part on its need to preserve the practice of free and uninhibited member contribution to discussions, reflects a legal position the concept of which was reaffirmed by the United States Supreme Court as recently as one month ago in the case of NLRB v. Sears, Roebuck, & Co., 95 S Ct. 1504, 1516 (1975). Justice White, speaking for the Court with respect to the need to protect the decision-making processes of government agencies, cited the Court's earlier position that "...experience teaches that those who expect public dissemination of their remarks may well temper candor with a concern for appearances...to the detriment of the decision-making process."

As Chairman of the Federal Open Market Committee I endorse whole-heartedly the foregoing principle.

Chairman Burns then noted that a suit against the Federal Open Market Committee had been brought in U.S. District Court.[1/] He asked Mr. O'Connell to comment.

1/ The Committee had been informed of this suit by a memorandum from Messrs. O'Connell and Hawke, dated May 16, 1975, and entitled "Freedom of Information Act suit against Federal Open Market Committee." A copy of this memorandum has been placed in the Committee's files.

Mr. O'Connell said the suit grew out of the request, of which he had advised the Committee at its meeting on March 18, 1975, for the memoranda of discussion and policy records for the FOMC meetings held in January and February 1975. As the members would recall, the request was made under the Freedom of Information Act by the Institute for Public Interest Representation of the Georgetown University Law Center. In accordance with the discussion and decisions at that meeting, the Secretary had denied the request for the memoranda of discussion and had advised the requesting party of the time schedule on which the policy records were available; and Mr. Holland, acting under delegated authority, had denied an appeal received subsequently. In his suit plaintiff asked the Court (1) to order the Committee to make the January and February memoranda of discussion, or nonexempt portions thereof, promptly available, and (2) to declare invalid the provision of the Committee's Rules Regarding the Availability of Information in so far as it authorizes any deferment in the publication of the policy records or other nonexempt FOMC records, including nonexempt portions of the requested memoranda of discussion. Federal Reserve staff members were working with the Department of Justice to prepare the Committee's defense.

Following his remarks, Mr. O'Connell responded to questions.

Chairman Burns noted that at its previous meeting the Committee had asked the Subcommittee on the Directive to review means of handling the various numerical specifications in the policy record. He invited Mr. Holland to comment.

Mr. Holland observed that the Subcommittee's recommendations were contained in a memorandum dated May 19, 1975, copies of which would be available shortly.[1/] Briefly, it was suggested that the Committee should eventually incorporate the short- and longer-range specifications in the last and next to the last paragraphs of the directive, respectively. For the time being, however, it would be appropriate to cite the specifications in the text of the policy record--as was done in the draft record for the April meeting--rather than in the directive.

Mr. Holland then summarized the reasons for the Subcommittee's recommendations. He noted in this connection that so long as the Committee was in the present experimental stage with respect to the development and use of quantitative specifications, it was desirable to proceed in a flexible manner.

There was general agreement with the recommendation that, for the time being, the specifications should be handled as they had been in the draft policy record for April.

The Chairman then described certain changes in procedure he planned to introduce in today's meeting in the interest of expediting consideration of the Committee's business.

1/ The memorandum in question was distributed later during the meeting. A copy has been placed in the Committee's files.

Mr. Rippey then left the meeting and the following entered:

Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. Axilrod, Economist (Domestic Finance)
Mr. Gramley, Economist (Domestic Business)
Mr. Solomon, Economist (International Finance)
Messrs. Boehne, Bryant, Davis, Green, Kareken, Reynolds, and Scheld, Associate Economists

Mr. Coyne, Assistant to the Board of Governors
Mr. Keir, Adviser, Division of Research and Statistics, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Messrs. Eisenmenger, Parthemos, Jordan, and Doll, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, St. Louis, and Kansas City, respectively
Messrs. Hocter and Brandt, Vice Presidents, Federal Reserve Banks of Cleveland and Atlanta, respectively
Mr. Keran, Director of Research, Federal Reserve Bank of San Francisco
Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York

By unanimous vote, the Committee ratified the action taken by members on April 17, 1975, revising the procedures for allocation of securities in the System Open Market Account to read as follows, effective May 1, 1975:

1. Securities in the System Open Market Account shall be reallocated at least once each year as determined by the Board's Division of Federal Reserve Bank Operations and the Manager of the System Open Market Account for the purpose of settling Interdistrict clearings and approximately equalizing for each Federal Reserve Bank the ratio of gold certificate holdings to Federal Reserve notes outstanding.

2. Until the next reallocation, the Account shall be apportioned on the basis of the ratios determined in Paragraph 1.

3. Profits and losses on the sale of securities from the Account shall be allocated on the day of delivery of the securities sold on the basis of each Bank's current holdings at the opening of business on that day.

> By unanimous vote, the Committee ratified the action taken by members on April 30, 1975, increasing from $3 billion to $4 billion the limit specified in paragraph 1(a) of the Authorization for Domestic Open Market Operations on changes between meetings in System Account holdings of U.S. Government and Federal agency securities, effective April 30, 1975, through the close of business May 20, 1975.

In connection with the foregoing action, Mr. Sternlight noted that the increase in the leeway had been needed in the recent period because a rise to record levels in the Treasury's balances at the Reserve Banks had necessitated large-scale purchases of securities by the Desk to supply reserves. Looking ahead over the next several weeks, it appeared that a sharp rundown in the Treasury's balances would necessitate large-scale operations to absorb reserves. Although not all of those operations would involve outright sales of securities, he recommended that the leeway be kept at $4 billion for another 4 weeks in order to provide flexibility.

After some discussion it was agreed that the course recommended by Mr. Sternlight was a reasonable one.

By unanimous vote, the Committee decided to maintain the dollar limit specified in paragraph 1(a) of the Authorization for Domestic Open Market Operations at $4 billion for the period through the close of business June 17, 1975.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on April 14-15, 1975, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on March 18, 1975, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period April 15 through May 14, 1975, and a supplemental report covering the period May 15 through 19, 1975. Copies of these reports have been placed in the files of the Committee.

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

After the last meeting, the dollar at first remained buoyant on expectations of a further firming of interest rates here and on expectations of good United States trade figures for March. The cumulative rise of the dollar from its January-February lows at one point reached 5 per cent against the German mark and 7-1/2 per cent against the Swiss franc. As it turned out, our trade figures were even better than expected, at a surplus of nearly $1.4 billion for the month. Nevertheless, Germany's trade figures were also somewhat better than expected. Also, German interest rates firmed and, as the U.S. Treasury began to scale down its expected borrowing needs, U.S. interest rates settled back somewhat. The dollar thus began to drift lower in late April and early May.

Initially, this easing of dollar rates was taken in stride. Dealers grew disappointed, however, over the renewed signs of dollar weakness in the face of such a clear improvement in the U.S. competitive position, and bearish sentiment soon resurfaced. European traders in particular remain of the view that our fiscal policy will be entirely too stimulative and that Congress will force the Federal Reserve also into an excessively expansionary stance, providing the basis for another round of inflation once the economy picks up. European governments, by contrast, are seen as more willing to accept high, and even rising, unemployment levels in order to scale down their rates of inflation and improve their international competitive positions.

With confidence still shaky, the dollar has tended to suffer from cross currents in other markets. Sterling has come under heavy selling pressure in recent weeks, and some portion of the flows out of that currency has gone directly, or indirectly through dollars, into Continental currencies, bidding the latter up generally. The French franc was in particularly strong demand, for reasons of its own, and on several days its rise also evoked a sympathetic rise in other Continental currencies.

In the nervous atmosphere which developed, the dollar suffered a particularly sharp sell-off last Tuesday following the Cambodian seizure of a U.S. merchant ship. The military challenge was handled with dispatch by the U.S. Government, and the dollar quickly recovered. This recovery was short-lived, however, as exchange traders were still concerned over the liquidity of New York banks, should New York City be declared bankrupt, and dollar rates were marked down by 1/2 per cent or so following the cuts in discount and prime rates in the United States. Consequently, the dollar closed the period some 1-1/2 to 4 per cent below late April highs against Continental European currencies. In the judgment of many European officials, the dollar remains unrealistically low against several of those currencies, and I share that view.

With so many shifts in expectations over currency relationships under way, a number of central banks intervened forcefully and in size during the period, including the Bank of England, the Bank of Canada, the Bank of France, the Swiss National Bank, and the Bank of Italy. In dollar terms, the combined total of central bank intervention during the period amounted to $3.0 billion, which compares with some of the heaviest months under the Bretton Woods System.

As for our operations, we were frustrated by the fact that the currency in which we are most effective, the German mark, was at or near the bottom of the EC snake throughout the period. This made the German Federal Bank reluctant--at times highly so--to have us operate forcefully in their currency, even though we leaned more heavily than usual on intervention in Dutch guilders and Belgian francs, which were near the top of the snake. We intervened on 7 days during the period, for $88 million equivalent of marks, $29 million equivalent of guilders, and $4 million equivalent of Belgian francs. I nevertheless believe that a more forceful approach on our part at important junctures could have avoided much of the deterioration of market atmosphere which has occurred in recent weeks.

Otherwise, at times of dollar buoyancy, we chipped away at our swap debt. We repaid a further $155 million worth of swap drawings. New drawings during the period of $74 million leave us with outstanding total drawings of $681 million, down $82 million from the last meeting.

In response to a question by Chairman Burns, Mr. Pardee explained that by describing the dollar as buoyant for a time after the last meeting, he meant that any downward pressures on the dollar were met with resistance in the market and did not lead to cumulative declines. At the same time, the dollar was less than strong.

Mr. Coldwell asked what the purpose of more forceful intervention in the recent period would have been.

Mr. Pardee responded that bearish sentiment had resurfaced in the market and the dollar had weakened even though, in his judgment, the fundamentals of the situation suggested that it should have been much stronger. During the preceding week, several developments--including the flows out of sterling, the relative decline in interest rates here, the concern over the financial condition of New York City, and the Mayaguez incident--simultaneously exerted downward pressure on the dollar. The Mayaguez affair, although it did not affect the domestic market, had a substantial effect in the markets abroad; large sales of dollars originating in Europe were reported. It would have been desirable to deal with that situation in a more forceful way, but other central banks, especially the German Federal Bank, were not persuaded that more forceful operations should be undertaken at that time.

Mr. Coldwell asked whether the market could have been described as disorderly.

Mr. Pardee replied that on one day the dollar dropped more than 1-1/2 per cent against major currencies. A movement of that size could lead to disorderly conditions, although that term could not be defined precisely.

Mr. Wallich remarked that he would regard a decline of 1-1/2 per cent on a single day as distinctly disorderly.

In response to a question by Chairman Burns, Mr. Pardee noted that the Foreign Currency Directive provided for intervention to aid in avoiding disorderly conditions in exchange markets and also to temper and smooth out abrupt changes in exchange rates. The Mayaguez incident had a profound effect at a time when there were other bearish influences in the market, and he would have preferred to move against the decline in the dollar at once rather than to allow it to cumulate, as it did for a time. However, the dollar strengthened again after prompt military action by the United States resolved the situation.

Chairman Burns said he would question whether intervention would have been justified in the absence of prompt action by the U.S. Government.

Mr. Wallich commented that in a situation such as that created by the seizure of the Mayaguez, it was appropriate for financial action to support political action of the country. The Government should act as one.

Chairman Burns remarked that the financial action might be appropriate once the political action had been taken.

Mr. Mitchell said he was sympathetic to Mr. Pardee's view; he thought that it was wise to try to anticipate difficulties. The question in his mind, however, was whether the Manager should consult with the Committee or with some member of the Committee on the question of what, if any, action would be appropriate in such circumstances.

Mr. Hayes observed that in his view the actions of the Manager were clearly consistent with the Foreign Currency Directive.

Mr. Mitchell commented that a judgment on that issue depended on one's interpretation of "abrupt changes." That ought to be defined more precisely in the Foreign Currency Directive.

Mr. Hayes remarked that he thought there was an understanding among the major central banks that a movement in rates of as much as 1-1/2 per cent was too abrupt.

Mr. Wallich said the Europeans had agreed that a movement of 1 per cent constituted a kind of guideline indicating a need for firm intervention. The Federal Reserve had listened sympathetically to that view, and whether or not it had actually agreed, he believed it was a reasonable position.

Chairman Burns said he agreed with Mr. Wallich.

Mr. Mitchell observed that he was troubled because he was not sure that the Committee was sufficiently aware of the circumstances--in a quantitative sense--that indicated the need for intervention. That situation could be remedied in either of two ways: when similar situations arose, the Manager could consult with the Chairman, who might then choose to consult with the

Committee; or the Foreign Currency Directive could specify numerical guidelines. The general guidelines in the present directive were ratified in March of each year without discussion, but they had been formulated before exchange rates were freed to float.

Mr. Hayes remarked that the Manager's daily report to the Subcommittee provided a full description of foreign exchange operations.

Chairman Burns agreed and observed that those reports would have formed the basis for objections, had there been any at the time. Nevertheless, the Committee might now wish to incorporate some numerical guidelines in the Foreign Currency Directive. If the Committee chose to do that, it should not go too far in limiting the Manager's scope to conduct operations. The Account Management had performed extremely well.

In response to questions, Mr. Pardee observed that at present operations on any given day were conducted with certain dollar limits in mind--although developments during the day might cause those limits to be raised--and the maximum amount of intervention in each foreign currency had to be negotiated with the central bank in question. Early in the day the Desk informed members of the Board staff of any plans for operations, and through the rest of the day it maintained almost hourly communications with the Board staff. At any time that the Desk expected to operate on a scale in excess of about $20 million, it sought the views of members of the Subcommittee. Thus, the Desk was already operating under certain informal numerical guidelines, and he would have no problem if guidelines were established that required consultation with the Subcommittee or the full Committee under specified circumstances. It should be recognized, however, that market developments often required that decisions concerning intervention be made quickly.

Mr. Coldwell remarked that he would like to have a better understanding of the purposes of intervention and the particular circumstances that made it desirable.

Mr. Bucher observed that it might be desirable to establish a subcommittee to review the foreign currency instruments and to make recommendations to the Committee.

Mr. Wallich commented that he and members of the staff had been engaged in such a review for some time, and establishment of a subcommittee might be desirable at this point.

Mr. Mitchell remarked that the subject of intervention in the foreign exchange markets was beginning to attract the attention of members of the Congress, which ought to be taken into account in reviewing the instruments.

Chairman Burns noted that he had received a letter from Congressman Reuss concerning foreign exchange operations; he had not yet answered the letter, but he had had some conversations with the Congressman on the subject. He agreed that it would be desirable to establish a subcommittee to take a careful look at the foreign currency instruments and to recommend any changes that might appear appropriate. He would appoint such a subcommittee.

Mr. MacLaury observed--with reference to the letter mentioned by the Chairman--that in testimony before Congressman Reuss' Committee, the Secretary of the Treasury had suggested that the System intervened only for the purpose of countering disorderly market conditions. In his view, that interpretation should not be allowed to stand on the record as the only purpose of intervention; the language of the Foreign Currency Directive made clear that the purposes were broader. And having himself been involved in the System's foreign exchange operations some time ago, he would note that the existing guidelines required the Manager to exercise considerable judgment. While the Committee might choose to change the guidelines, it should not circumscribe day-to-day operations too closely or second guess the Manager in his conduct of those operations.

Secretary's note: On June 24 Chairman Burns designated Messrs. Debs, MacLaury, and Wallich (Chairman) as members of the Subcommittee on Foreign Currency Instruments.

By unanimous vote, the System open market transactions in foreign currencies during the period April 15 through May 19, 1975, were approved, ratified, and confirmed.

Secretary's note: A report by Mr. Wallich on the May Basle meeting and a report by Mr. Solomon on meetings of Working Party 3 and Group of Ten Deputies on May 14-15, 1975, which were distributed during this meeting, are appended to this memorandum as Attachments A and B, respectively.

Mr. Pardee then observed that negotiations were continuing between the Treasury and the Belgians over the System's swap drawings that had been outstanding for so long. The Treasury's latest proposal had been received by the Belgians with disappointment, and they had not yet made a formal response.

In reply to questions, Mr. Pardee remarked that the Desk could encourage the Belgians to make an early response. The proposal made by the Treasury in effect was the same one that had been made in November 1973; from the Treasury's point of view, matters of principle were involved.

Mr. Wallich said the main difficulty involved the allocation of a certain portion of the loss on the drawings. No doubt existed about those portions that were attributable to a formal action to revalue the Belgian franc and to two formal actions to devalue the dollar. Since the last formal devaluation, however, the dollar had depreciated further, causing an additional loss; the Belgians believed that that portion of the loss should be borne by the United States, whereas the Treasury took the position that it should be shared on a 50-50 basis. As he saw it, after allocation of the portions of the loss attributable to the three formal changes in exchange rates, Belgium owed the United States a certain number of dollars, which it had, and the United States owed Belgium a certain number of francs, which it did not have and would have to buy; the question simply was whether Belgium would return the dollars and the United States would return the francs. If he were an impartial observer, he would be inclined to think that by insisting on 50-50 sharing, the United States was trying to avoid paying its debts. Although he had not communicated his view to the Treasury, the Manager had made the same point in working with the Treasury on the proposal to the Belgians.

Mr. Holland observed that if the United States was unwilling to accept the loss resulting from any depreciation of the dollar between the time of a drawing and its repayment, the swap network would be dealt a serious blow. He noted that in the first instance the loss would fall on the Federal Reserve, not on the Treasury.

Mr. MacLaury remarked that, not having followed the negotiations, he was uncertain about the interpretation of the Treasury's position. However, it was possible that the unwillingness to accept the loss might undermine the swap network.

Chairman Burns asked Mr. Wallich to pursue the matter further with the Treasury and to report the results to the Committee.

Mr. Wallich commented that the Belgians might not be too unhappy if the Treasury did not agree to change its position, because they were holding covered dollars whereas liquidation of the debt might result in their acquiring uncovered dollars after a period of time. Also, the System might get a chance to buy the Belgian francs in the market in order to repay the drawing, although the prospects of doing that did not look very good at the moment.

Mr. Pardee then reported that nine drawings on the German Federal Bank, totaling about $142 million, would mature in the period from May 27 through June 19, 1975; three of the drawings, totaling nearly $45 million, were second renewals and the other six were first renewals. In the recent period, no drawing in German marks had had to be renewed for a second time, and on the basis of the regular program of purchasing marks, he hoped that the three drawings in question would be liquidated before their maturity dates. He would recommend renewal of all these drawings, if necessary. In addition, he would recommend renewal of two drawings on the Netherlands Bank, totaling $19 million, that would mature for the first time on June 3 and June 27.

Renewal for further periods of 3 months of System drawings on the German Federal Bank and the Netherlands Bank, maturing in the period from May 27 to June 27, 1975, was noted without objection.

Chairman Burns then called for the staff report on the domestic economic and financial situation, supplementing the written reports that had been distributed prior to the meeting. Copies of the written reports have been placed in the files of the Committee.

Mr. Gramley made the following statement:

> Signs have multiplied over the past month that the recession of 1974-75 has about reached its trough. Inventory liquidation in March was huge--approaching $30 billion, at annual rates, in GNP terms. That will probably be the largest monthly decline of this recession. From here on out, movement towards a more moderate rate of inventory liquidation should be adding to production and employment, and April figures suggest that this may already be happening.
>
> Total nonfarm employment (the establishment series) declined only 50,000 last month, and almost half of the 172 reporting industries showed increases. Moreover, the length of the workweek in manufacturing--a fairly reliable leading indicator--rose by 0.2 hours, after six successive monthly declines. The drop in industrial production last month amounted to only 0.4 per cent, or less than half the March decline, and manufacturing output fell by even less than the total. There were scattered increases in production among the nondurable goods industries--such as textiles, apparel, and rubber--that probably reflect the need to replenish inventories of particular commodities.
>
> The purchasing agents reports for April were also heartening: the percentage of companies reporting increased orders and production both rose substantially. Furthermore, initial claims for unemployment insurance have continued trending down.
>
> All of these signs--emerging at a time when fiscal stimulants are adding powerfully to disposable income--make it seem very likely that the trough in business activity is near at hand, if not already past. This is, I believe, the story told also by the qualitative comments in this month's red book.[1/]

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

Recent incoming statistics raise some troubling questions, however, about the near-term strength of the forces of recovery. Developments with regard to auto sales, housing activity, and business capital spending are turning out on the disappointing side.

In the auto market, sales this spring have been below staff projections, and even further below the major auto manufacturers' expectations. U.S. production of new cars last month rose to a 6.3 million annual rate, and by early May assemblies were up to a 7.0 million rate. With sales at less than a 6 million annual rate since early March, dealer inventories--particularly of small cars--have been rising again. Cutbacks in production schedules totaling 30,000 units have already been announced for the second quarter, and additional reductions seem almost inevitable--if not during this quarter, then in the early part of the third quarter. Thus, the automotive sector shows no signs yet of coming out of its depression.

For housing, on the other hand, signs of a stirring have begun to be visible--after a long and cold winter. Sales of new single-family homes rose in March to their best level since last September, and we hear reports that sales continued to pick up in April--perhaps reflecting in part the housing tax credit. The starts and permits figures for April are, however, a bit of a puzzle. Starts rose a disappointing 2 per cent, while permits were up 27 per cent. Permits are not always a reliable lead indicator of starts, however. So while it seems fair to conclude that a recovery in housing is at long last under way, the strength of the rebound in homebuilding remains very much in doubt.

As for business fixed capital spending, one could not realistically have expected any near-term strength to develop as yet; this sector of demand, after all, typically lags in the initial phase of a cyclical upswing. However, the advance indicators of business capital expenditures have been weaker than we had counted on. New orders for nondefense capital goods have continued to fall rapidly; in March, these orders in real terms were 37 per cent below their peak last July. Moreover, construction contract awards for commercial and industrial buildings--the floor space series--dropped further in March to only about one-half of their level a year earlier. True, the latest McGraw-Hill survey, like the last Commerce Department survey, suggests that plans for future capital expenditures are not being cut back further. On the other hand, our staff tally here at the Board of publicly announced cancellations and postponements shows a substantial rise in April among industrial firms. On balance, further retrenchment in real business fixed investment outlays over the remainder of 1975 seems very likely, and this will probably be accompanied by a substantial liquidation of inventories in the capital-goods sector.

These disappointing recent trends in autos, housing, and business fixed capital have led the staff to review its GNP forecast for this and the next four quarters, and to trim marginally the strength of the projected recovery in real economic activity. The biggest adjustment was in housing, where we now project the annual rate of starts to rise to only around 1-1/2 million units by the end of this year. Over all, however, our staff view of the outlook has not changed much from what it was a month ago. For example, the real GNP expansion projected for fiscal 1976 is now 5.1 per cent instead of 5.7; the unemployment rate is still projected to rise above 9 per cent, and to remain above 9 per cent through mid-1976; and the rate of inflation is still projected to wind down to around 4-1/2 per cent by the second quarter of next year.

A few months ago, the projection of a further substantial moderation in price pressures seemed quite optimistic, even to the staff, but recent developments on the price front have made it appear more realistic. Wholesale prices of both consumer and producer finished goods have begun in the past several months to reflect more fully the easing of pressures that occurred first in sensitive raw materials, and later in intermediate materials, components, and supplies. At the retail level, price changes in March showed improvement even in the service area. The most encouraging development of all, however, is the slowdown in the pace of wage increases--to an annual rate of 6-3/4 per cent in the first 4 months of this year, compared with figures in the 9 to 10 per cent range in the first three quarters of 1974. If productivity begins to improve as it usually does in a period of economic recovery, the annual rate of increase of unit labor costs may soon be declining to a 3 to 4 per cent range--the lowest rate since late 1972.

In closing, let me note that the over-all outlook for economic activity and prices between now and mid-1976--as the staff sees it--is, in my view, disconcerting. Although significant further moderation is expected in the rate of price increase, only a little progress is anticipated in reducing the tremendous gap that has opened up between actual and potential output and in bringing down the rate of unemployment. Private demands for goods and services are expected to remain moderate for a number of reasons. They include the fact that lending policies of major financial institutions still appear to be very cautious; that confidence of businesses and consumers has been shaken by the steepness and severity of the recession; that some of our major cities are in financial trouble; that the housing industry is still plagued by a sizable stock of houses for sale, by continued problems in the supply of construction funds for multi-family dwellings, and by a cost-price structure that puts an acceptable house out of the reach of many families; that the auto industry may also be suffering long-run damage from high unit prices, as well as from fears of yet higher costs of gasoline; and that the electric utilities have canceled or postponed enormous amounts of planned expenditures for new plant and equipment.

It is, of course, true that forecasters often underestimate the strength of recuperative forces when the economy is at the bottom of a recession. That may be true again. However, there is such a large amount of slack in the economy now that real growth would have to exceed our projection by a wide margin, and for an extended period, before excess aggregate demand once again emerged as a significant problem.

Chairman Burns observed that it would be desirable if Committee members' comments on the economic situation and outlook emphasized any points on which they differed significantly from Mr. Gramley's analysis.

Mr. Mayo commented that in general he agreed with Mr. Gramley's analysis, and yet his own assessment of the economic outlook differed somewhat from the projections presented in the green book.[1] Having in mind recent developments affecting housing, capital goods, and inventories, he would have made larger downward revisions in the projected recovery in the third and fourth quarters of this year. In his view, the staff projections for those quarters were too optimistic.

Mr. Gramley observed that he also felt that the staff projections overestimated the strength that was likely to emerge in the third quarter of this year. For that quarter, the staff had allowed for an inventory reduction of about $1 to $1-1/2 billion in the automobile sector, and that figure might be too low. In addition, the third-quarter projection of domestic auto sales--at a 6.6 million annual rate--might prove to be too optimistic; it reflected an assumption that sales would be stimulated somewhat by expectations of price increases on the 1976 models. During the next month the staff would undertake a major review of its projection--and extend it in time--in preparation for a chart show to be presented at the June meeting. Some indication of the response of consumption expenditures to the tax rebate--which would be a decisive factor in third-quarter developments--should become available within the next few weeks.

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

Mr. Black remarked that, like Mr. Mayo, he was in agreement with Mr. Gramley's analysis, but he thought the prospects were for a somewhat stronger recovery later this year than had been projected by the staff. One possibility was that a larger-than-expected liquidation of inventories would result in better conditions in capital markets than generally anticipated, and such improvement together with the investment tax credit might bring about an earlier and faster recovery in business fixed investment than had been projected--particularly in view of the large number of projects that had been postponed. In this connection, he noted the statement of the president of a large construction firm to the effect that in this recession the design and engineering work required for new plants had been continued, so that an economic upturn could be followed promptly by the start of construction on many facilities.

In response, Mr. Gramley said it was possible that business fixed investment would recover earlier and faster than now projected by the staff, but he would continue to have doubts until new orders for capital goods began to show some strength and construction contract awards turned up. Developments of the kind suggested by Mr. Black were likely to be reflected in such advance indicators of business capital spending.

Mr. Hayes observed that he too agreed with Mr. Gramley's analysis of the economic situation and outlook, and with the projection that the pace of recovery in real economic activity would not be strong. Unlike Mr. Gramley, however, he did not find that disappointing; a slow recovery would provide the setting for a lasting reduction in the rate of inflation, such as had occurred in the late 1950's and early 1960's.

Mr. Gramley commented that the recovery projected by the staff was slower than the typical recovery in the postwar period. Simulations using the econometric model suggested that a considerably faster rate of expansion could be stimulated without having a significant effect on the rate of increase in prices--that a considerably more rapid rate of increase in real GNP would still be consistent with a further winding down of inflationary pressures.

Chairman Burns remarked that comparison of the speed of the recovery that might now be in the making with the pace of past recoveries could be misleading; it would be better to compare the current projections with those made at about the time of the earlier lower turning points. Economists characteristically had underestimated the speed of recovery; when economic activity was still declining, one often could see nothing but weakness and had difficulty in identifying sources of strength, but once the upturn did occur, momentum developed within the private sector. At present there was no way of telling whether that historical experience would be repeated. The current weakness evident in the planning or contract stage of business capital spending provided one argument against it. Historically, the contract or new order stage of capital spending had led in business cycle recoveries. He could recall only two exceptions to that rule: one occurred in 1914, when the economy was pulled out of a rather deep recession by the export orders provoked by the outbreak of the war; the other was in 1933, when the recovery was led by consumption while investment lagged. At the moment it was necessary to look mainly to the consumption sector for sources of strength in the recovery process, and as Mr. Gramley had indicated, some evidence ought to be available within a month.

Mr. Coldwell remarked that he was sympathetic to Mr. Hayes' view concerning the desirability of a slow recovery. However, there was a risk that Congress would not be inclined to accept the levels of unemployment being projected and might respond by enacting excessively expansive measures.

Mr. Hayes agreed that a substantial risk of such a response existed, but he hoped that any new measures that might be enacted would focus on the structural problems of employment rather than on aggregate demand.

Chairman Burns observed that in their budgetary planning the Budget Committees of the Congress were assuming a mid-1976 unemployment rate of about 7-1/2 per cent. It was significant that any Congressional committee was willing to tolerate a rate that high over so long a period.

Mr. Holland said he agreed with much of the staff analysis, but there were two areas in which his own thinking differed appreciably. In his view--perhaps reflecting intuition as much as analysis--expansion in consumption expenditures was likely to be a little stronger than projected by the staff; consumer caution and saving proclivity might be altered as the feeling grew that there was a bottom to the recession and that some things were getting better instead of worse. He also thought that the Mayaguez incident had had a perceptible influence on the average person's impression of the way things were going in this country, and such influences could help tilt confidence about the future and the willingness to make expenditures and commitments. Thus, he foresaw a stronger rise in final sales arising from greater expansion in consumption expenditures, although he recognized that the greater strength could be offset by a larger liquidation of inventories--either of consumption goods or unsold new houses.

The second area of difference, Mr. Holland continued, had to do with fiscal policy in the first part of next year. The staff had assumed a continuation into next year of this year's one-time reductions in taxes and, therefore, had projected significantly higher budget deficits than were being contemplated by the Congressional Budget Committees. Given the mood that now seemed to be spreading in Congress, he would like to withhold judgment a while longer as to whether fiscal policy would be as expansive as the staff had projected.

Mr. Gramley remarked that the staff had assumed that the income tax reductions on 1975 liabilities and the investment tax credit would be permanent.

Mr. Winn observed that he was in general agreement with the staff analysis, but the possibility of aborting the recovery might be increasing rather than decreasing. It was disturbing that some savings and loan associations had started to raise mortgage rates in response to just a little firming in the demand for mortgages.

Chairman Burns commented that the recent rise in mortgage rates was a lagged response to the earlier rise in market yields on long-term bonds; he would expect that mortgage rates would turn down again in response to the decline in bond yields that had occurred over recent weeks. Still, the rise in rates was surprising in view of the huge inflows of funds to the savings and loan associations.

Mr. Francis remarked that both savings and loan associations and banks had indicated that large deposits--on the order of $40,000 at one time--were flowing into passbook accounts. The institutions considered such deposits to be hot money, and that no doubt influenced their behavior with respect to mortgages.

Mr. Morris remarked that he was encouraged that the discussion was focused on long-term prospects for economic activity. One thing on which members of the Subcommittee on the Directive had been able to agree during the course of a meeting on the preceding day--when weaknesses in Committee procedures had been discussed--was that deliberations tended to focus too much on the very near term and too little on the appropriate long-term strategy; the last Subcommittee on the Directive had emphasized the same point. The need to focus on the longer term was particularly critical now that the Chairman had the task of reporting to the Congress quarterly on the Committee's longer-term targets.

Mr. Morris observed that in his view acceptance of the staff projection led to the conclusion that the policy course being pursued by the Committee could not be defended before the Congress or the American people. Growth in real GNP of 5 per cent over the four quarters to the second quarter of next year, as projected, was not acceptable, and that slow a recovery could not be justified in the interest of dampening inflationary pressures.

Continuing, Mr. Morris said he could sympathize with the position of not accepting the course of economic activity suggested by the judgmental projections unless and until some confirmation was provided by current economic indicators and, consequently, of holding to a strategy of relatively moderate growth in the money supply until such time as evidence indicated the need for a change. That was an entirely logical and valid strategy for the Committee to adhere to, although it might cause some problems with Congress later on. In any case, it would be useful to have a full discussion of longer-term strategy, and it might be useful if the chart show at the June meeting was formulated in a way to foster such a discussion.

Chairman Burns remarked that the unemployment rates projected by the Board staff and by other economists in and out of Government made him very uncomfortable, but he did not think that much more could be done than was being done at the present time. First, as members of the Committee knew, he attached little importance to M_1; he believed that M_5 was a much better indicator of what was happening to the money supply, and it had been growing at an annual rate of about 9 per cent. Secondly, he attached far more importance to the willingness to use the existing stock of money--the income velocity--than to the stock itself, no matter how measured. Business cycle experience strongly supported that position; in the first year of economic recovery, the increase in velocity was very much larger than the increase in the stock of money.

The Chairman added that if the Committee now embarked on a course of significantly faster growth in the money stock, long-term interest rates would be adversely affected. The business and financial community would interpret such a policy as laying the basis for a new wave of inflation superimposed on the inflation that was still running its course at a fairly rapid rate. The resulting rise in long-term interest rates could abort the recovery in economic activity.

Mr. Wallich observed that a year ago business capital investment had been considered an element of great strength in the economic situation, and it had been widely thought that despite the decline in activity such investment would be fairly well maintained because of the shortages that had been evident. Now, cutbacks had been made in expenditures, although capacity limitations were just as obvious as before, even if the levels of output were somewhat further below capacity. In some cases, cutbacks had been made in expenditure programs that clearly should proceed. The utilities, for example, had inadequate reserve capacity, which they would surely take steps to remedy if they could find the money. Consequently, he was led to think that the capital spending situation might look worse than it really was and that a snapback in expenditures would develop once the demand situation seemed to be improving and money was becoming available at reasonable rates. Businesses needed the capacity. Spending programs had been interrupted, and it was plausible for them to get back on track when the economy was seen to be improving.

Mr. Baughman remarked that he personally agreed with the staff analysis of the economic situation. At the last meeting of the board of the Dallas Bank, however, the directors were of the opinion that the outlook had changed; they were less sure that recovery would develop fairly promptly and strongly. It was against that background that they had recommended a reduction in the discount rate.

Chairman Burns asked whether the change in view might be explained in the following way: the Eleventh District had been a rapidly growing region--with a lower unemployment rate than in the rest of the country--and the recession had come late and was just beginning to be felt in that part of the country even though the forces of recovery were beginning to be felt in other parts of the country.

Mr. Baughman said he believed that that was the explanation. He would add that two of the directors--one in manufacturing and one in retailing--had reported that their purchasing agents saw more evidence of softness or of less strength in prices than had been expected. Accordingly, the purchasing agents were suggesting lower financing needs for additions to inventories than they had been estimating earlier.

Mr. Baughman remarked that the liquidity demands of financial institutions had already been noted, and he thought the problem warranted further comment. It seemed to him--both from the behavior and the statements of managers of such institutions--that they would continue to acquire short- and intermediate-term Government securities in substantial volume before they would begin aggressively to seek business loans and consumer and mortgage loans. They appeared to be sensitive to examiner criticism of their loan portfolios. As had been noted, the rise in mortgage rates in the current environment was surprising. All of this raised a question in his mind whether the System could do anything that would hasten the satisfaction of the demand for additional liquidity on the part of the financial institutions. It seemed to him that serious consideration ought to be given to the possibility of another reduction in reserve requirements. That way of injecting reserves might have more impact than other methods on management attitudes in the financial institutions. He doubted that jawboning would be useful now.

Chairman Burns commented that the large banks, at least, were concerned over the attitude of the SEC toward new capital issues, and they were feeling constrained. It was a difficult problem that Mr. Mitchell and he were working on. A few weeks ago he had been optimistic about the outcome, but he no longer felt confident.

Mr. Mitchell observed that at a meeting of the Board of Governors yesterday the U.S. foreign trade situation and outlook had been discussed at some length. The staff had supported its projection of deterioration in the trade balance over the rest of this year, but he continued to feel that the projection was wrong. If the dollar was undervalued at present and efforts to change attitudes toward it were unsuccessful, imports and exports were bound to be affected. That could be a source of strength in the economy that was not reflected in the staff projection.

Chairman Burns remarked that he had been analyzing additional information on U.S. exports that he had requested from the staff, and he too had doubts about the staff analysis. Exports had been strong, and although he had not yet completed his study, he would guess that they would be a source of strength in the months ahead.

Mr. Mitchell then noted that there had been a remarkable run-up in common stock prices recently and that in the past the wealth effect of changes in stock prices had received a lot of attention as an influence on consumer attitudes and expenditures. He asked Mr. Gramley why he had not mentioned the role of stock prices in this period.

Mr. Gramley replied that the staff had been influenced by the Board's econometric model, which suggested that changes in wealth had significant effects on consumption. For the period ahead the model suggested much less strength in consumption expenditures than did the judgmental projection, in part because of the substantial decline in real wealth over recent years and in part because of the way that the tax rebates and reductions were handled in the model. The staff was inclined to believe that consumer buying would be stronger than the model suggested.

Mr. Mitchell commented that although the run-up in stock prices had been substantial for so short a period, it nevertheless was possible that the effect on consumption would be limited because many holders of stock had not yet recovered their positions.

Chairman Burns remarked that the rise in stock prices had had some effect on the business community; new stock issues were rising, even though modestly.

Mr. Kimbrel--noting Mr. Baughman's remarks concerning the liquidity demands of financial institutions--said both commercial banks and savings and loan associations in his District were still rebuilding their liquidity, and some measures to improve the availability of reserves would be welcome and might have some psychological effects. With regard to the economic outlook, he was less optimistic about prospects for consumption expenditures than was the staff. One reason was that supplemental unemployment benefits for General Motors workers in Atlanta had been running out, and such benefits for each worker had amounted to about $100 per week, or $5,000 during 1974. A member of his staff had estimated that similar reductions in benefits on a nationwide basis would take away about $1 billion, at an annual rate, from income available for spending.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period April 15 through May 14, 1975, and a supplemental report covering the period May 15 through 19, 1975. Copies of both reports have been placed in the files of the Committee.

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

> In promoting the Committee's aim of somewhat more rapid growth in monetary aggregates, Desk operations since the last meeting have achieved a modest easing of money market conditions. After starting with a funds rate objective around 5-1/2 per cent, the Desk soon began moving toward the 5-1/4 per cent midpoint of the Committee's range--and then to the 5 to 5-1/4 per cent area--as aggregates were turning out well

within the desired range for M_1 and below target for M_2. The move was made cautiously, to avoid exaggerated market effects during a period of heavy Treasury financing.

As in other recent months, the pattern of day-to-day operations was dominated by the need to offset the impact of huge swings in the Treasury balance at the Reserve Banks. These swings not only required massive operations, but also probably impeded at times the achievement of Committee objectives, making it a bit more difficult to produce desired money market conditions.

From April 15 to May 5 the Treasury balance at the Reserve Banks rose a monumental $8.7 billion. Largely to cope with this, the System added nearly $3 billion to its outright holdings during this period (including $1.1 billion of Treasury coupon issues), while holdings of securities under repurchase agreements were up $5.6 billion from April 15 to April 30. By May 19 the Treasury balance had receded from its $9.8 billion peak to about $7.9 billion. The System added about $950 million more to outright holdings, almost all in bills, while holdings under RP's were down by some $1.1 billion from the end of April.

The Account Management thus used most of the additional $1 billion leeway for change in outright holdings voted by the Committee on April 30. In the weeks ahead, it is estimated that the Treasury balance will run down perhaps as sharply as it rose earlier, producing an enormous reserve bulge by early June. Our staff is projecting free reserves of around $5 billion by the week of June 11. While part, perhaps even most, of the needed reserve-draining job can be accomplished through matched sale-purchase transactions, which do not exhaust the leeway set by the Committee, I welcome the greater operational flexibility now provided by retaining a $4 billion leeway limit until the next meeting.

The credit markets have been fairly buoyant in the recent period--at least since May 1, when the Treasury announced, along with its financing terms, that its cash needs through June 30 would be $5 billion less than anticipated earlier. Dealers and various trading accounts scurried to cover short positions, pushing up prices and giving a good reception to the Treasury's 3-1/4-, 7-, and 30-year issues. Market perception of somewhat more comfortable reserve availability also strengthened prices. By the time the Treasury's 2-year issue was auctioned, last Wednesday, rates had declined to a point where investors became hesitant, and distribution of that issue has lagged, even in the wake of the latest discount rate reduction and further evidence of a slightly easier System stance. Currently, dealer inventories of Treasury coupon issues maturing in over a year are around $2.2 billion, up from $1.5 billion on April 15 and a small net short position on May 6, just before the recent note and bond auctions. The current inventory can probably be worked down without too much difficulty if the funds rate stays around its recent level. The System, it may be noted, is not in a position to buy for several weeks in view of the projected reserve bulge ahead.

Bill rates have come down in the past few weeks, with 3- and 6-month bills auctioned yesterday at about 5.12 and 5.41 per cent, down from 5.54 and 5.84 per cent the day before the last meeting. With a steady funds rate, bill rates may remain around their recent levels, although System sales or run-offs of bills to offset the drop in Treasury balances could exert some upward pressure.

An exception to the generally improved credit market atmosphere in recent weeks is the market for New York City securities, which has virtually closed for all but small transactions in the past few days.

At the last meeting, the Committee approved the Manager's recommendation of a higher charge for lending securities. This was implemented on April 16. Since then, the Desk has made a daily average of $77 million in securities loans, compared with $87 million from January through mid-April. We have not yet implemented the procedure for lending against cash during the day, with securities collateral to be received by the end of the day. The delay reflects technical problems in the plan to debit temporarily the borrower's reserve account by double the amount of securities to be borrowed. We now feel it is preferable to debit the reserve account by the value of the securities (with appropriate margins), and then charge a penalty interest rate in the event that securities do not come in by the end of the day. We plan to describe this procedure in a memorandum to the Committee, and if there is no objection from the Committee we would be prepared to start the new procedure shortly afterward.

Secretary's note: In a memorandum to the Committee dated June 2, 1975, a copy of which is appended to this memorandum as Attachment C, the Deputy Manager for Domestic Operations described the procedures for lending securities against cash that the Account Management planned to put into effect, provided there were no objections from Committee members. No objections were received, and the new procedures were scheduled to be put into effect by mid-June.

By unanimous vote, the System open market transactions in Government securities, agency obligations, and bankers' acceptances during the period April 15 through May 19, 1975, were approved, ratified, and confirmed.

Mr. Axilrod made the following statement on prospective financial relationships:

All of the alternatives[1/] presented for Committee consideration today envisage relatively rapid rates of growth in the money supply during May and June. This mainly reflects our view that tax rebate checks will, to a considerable extent, lodge temporarily in demand accounts, as was apparently the case with tax refund checks in February and March. As the public--with some lag--spends these funds, repays debts, or invests in other assets, demand deposit balances would, of course, tend to be reduced later on. From this factor alone, the rate of money growth should tend to drop off substantially in the summer, given current money market conditions. Nevertheless, we project an increase in the narrow money supply in the third quarter on the order of a 7 per cent annual rate, due to the expected strength of transactions demands for cash in light of the projected rise of nominal GNP growth to over a 10 per cent annual rate.

The staff now expects less interest rate pressure over the near term than it had earlier, given growth in the monetary aggregates. The GNP projection is a little weaker now than it was at the time of the last

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

meeting. Moreover, data on the monetary aggregates have been coming in on the weak side of staff forecasts over the past few weeks. A lesser demand for M_1 may also be indicated by the quarterly benchmark revision that reduced estimated M_1 growth in the first quarter by about 1 percentage point. However, M_2 and M_3 were not revised in any significant way, as time deposits were strengthened a little, so that the new figures might also be interpreted as providing additional evidence of the public's marked preference for interest-earning deposits relative to cash during that period.

It still appears likely that interest rates will have to rise--at least by late summer--in order to restrain monetary growth rates, given the continuing expansion in GNP that is projected. But the extent of a turnaround in interest rates, when it comes, could be less dramatic than earlier thought--particularly in longer-term markets.

Long-term market interest rates, mortgage market rates, and the prime loan rate all remain high relative to short-term rates--despite the very recent rally in the bond market and the further downward tick in prime loan rates. Bond markets have clearly been affected by the heavy volume of security offerings. The mortgage and bank loan markets, however, have been influenced mainly by lender reluctance to seek loans aggressively; rather, lenders have felt an even more urgent need to rebuild liquidity positions. In addition, these quasi-administered markets may have been influenced by the view that interest rates are likely to turn up soon and that there is little to be gained by encouraging additional business by reducing current lending rates further.

Given the steepness of the yield curve and improved institutional liquidity positions, bond markets and institutional lenders may become somewhat more accommodative of borrowers over the next month or so, if the money market remains relatively comfortable and if the market questions further its earlier attitudes regarding upward interest rate expectations. In this context, it may be useful for the System to continue purchasing some Treasury coupon issues in periods of reserve need as a means of encouraging continued stability in bond markets and by extension, I believe, in mortgage markets.

The Chairman then called for a discussion of monetary policy and the Committee's policy directive and suggested that initially the members focus on the broad direction of policy without reference to numerical specifications.

Mr. Hayes commented that the current economic and financial setting seemed to justify a policy of no change. As had been noted earlier, recovery in business activity appeared to be on the way, although its pace remained uncertain and might prove to be gradual and sluggish; the rate of inflation had been receding, and might well continue to do so in view of the prospect for prolonged slack in the economy; growth in the aggregates had been stronger for several months; fiscal stimulus was strong and was likely to remain so; and the position of the dollar in the exchange markets was a cause for concern and caution. While he was not impervious to the political and social disadvantages of the economic slack and was in favor of action to reduce it, he would not attempt to do so by deliberately fostering a rapid surge in growth of the aggregates. Looking backward, however, growth in the aggregates over a considerable period had been fairly slow, and there was room for reasonably strong growth for a few months.

In defining a policy of no change, Mr. Hayes said, he would stress money market conditions, maintaining about the current Federal funds rate. To achieve that, he would have a broadly tolerant attitude toward the behavior of the aggregates in the short run. Accordingly, he would favor rather wide 2-month ranges of tolerance for the aggregates, so that the Manager would not have to move the funds rate substantially unless growth in the aggregates appeared to be much weaker or stronger than projected currently. It was important to avoid a substantial run-up in interest rates, which could damage the recovery. It was important also to avoid a further decline in rates--which, in addition to weakening the dollar in the exchange markets, could create false expectations of further aggressive easing and could pose serious political problems later in the year if conditions forced a major reversal in rates. In view of the recent reduction in the discount rate to 6 per cent, he would not favor any further change at this time. And he would be wary of any change in reserve requirements, because he feared such a move would be misinterpreted as a sign of further aggressive ease.

Mr. Morris observed that he believed the course of policy over the recent months had been about right. Assuming that the projections for growth in the aggregates over the May-June period proved to be correct, he would argue that policy had been producing financial flows within the appropriate ranges. In light of the uncertainties concerning current projections of economic activity, however, he held a strong conviction that another period of shortfalls in monetary growth had to be avoided. The Committee could guard against the possibility of shortfalls in the weeks ahead by specifying a range for the Federal funds rate that was wider than that suggested by the staff and by instructing the Manager to move the rate promptly if it appeared that growth in the aggregates was falling below the specified ranges.

Mr. Morris added that at this time he was not eager to see a further decline in short-term interest rates--assuming that the desired rates of growth in the aggregates could be achieved without exerting downward pressure on rates--because of the formidable political problems that would be encountered in moving rates up again next year. However, shortfalls in the aggregates would indicate that the staff projections of growth in real GNP were too high. In addition, they would damage the credibility of and confidence in the Federal Reserve System.

Mr. Mitchell remarked that he was not unhappy about the recent course of monetary policy, but he would like to make the yield curve even steeper than it was in order to increase the pressure on those investors who thought they could afford to remain in short-term investments. Given enough time, the present course of policy could exert such pressure on investors--especially on the savings and loan associations--but he was not sure that the Committee could afford to wait. He wondered whether wider fluctuations in the funds rate--around the same central tendency that the System would aim for in any case--would introduce enough interest rate risk to discourage investors from maintaining very short positions.

Concerning the business situation, Mr. Mitchell said he was not satisfied with current prospects. In particular, the staff projections for housing activity continued to be more optimistic than he thought was justified by the facts at hand. Mortgage rates had to decline somewhat, and while flows of funds into the thrift institutions were large enough to bring that about in time, he would like to see the decline occur more promptly. For that reason, he would favor a somewhat easier posture for monetary policy.

Mr. Kimbrel commented that he believed the recent course of monetary policy had been about right. Recovery in business activity appeared to be under way, although it was progressing slowly. He considered a slow recovery desirable, but like others, he was not so sure that it would be acceptable for very long. The result might be a more expansive fiscal policy, which he would find disturbing. While considerable progress had been made in reducing the rate of inflation, current and projected rates were still high by historical standards. Accordingly, he favored maintaining about the current policy posture.

Mr. Eastburn remarked that in light of the Committee's agreement on 12-month targets for growth in certain of the aggregates, consideration might be given to the path to be followed over that period. He would prefer to pursue a strategy of "front-loading"--achieving more rapid rates of growth early in the period than later on--because the economy would be weak early in the period and would need the stimulus whereas it would be stronger later on. Moreover, there was some urgency to achieve more rapid rates of growth in the near term because of the recent shortfalls. Like Mr. Morris, he believed that it was important to avoid shortfalls in the period ahead and that the Manager should move the funds rate promptly if it appeared that growth in the aggregates was falling below the specified ranges. At the same time, any marked increase in growth rates should be avoided.

Mr. Francis said he agreed with the staff view that the recession had about reached its trough, and business people with whom he talked were generally more optimistic about the outlook than they had been a while ago. He also agreed that the recovery was likely to be slow, because activity in housing and in the automobile industry would not pick up as rapidly as in earlier business recoveries. For the same reason, the unemployment rate would not decline as quickly as desired, but he was not sure that monetary policy could do much to stimulate activity in the lagging industries.

Mr. Francis observed that he disagreed with Mr. Eastburn's suggestion for a strategy of front-loading. The Committee should attempt to maintain growth rates of the aggregates within the longer-run ranges agreed upon and avoid being in a position later on of attempting to slow monetary growth at a time when interest rates were firming. He would give primary emphasis to the aggregates and less attention to interest rates. In particular, he would widen the range of tolerance for fluctuations in the funds rate.

Mr. Holland remarked that, in view of the lags with which monetary policy affected business activity, decisions taken today concerning the aggregates essentially would influence the shape of the recovery later in the year. It was obvious that the Committee needed to aim for a policy that would produce recovery without renewing inflationary pressures. Fiscal policy was helping now, as it would not later on: the tax refunds and rebates were creating a bulge in fiscal stimulus that, in turn, was creating a bulge in monetary stimulus. The System should accommodate, rather than resist, the bulge in the aggregates, recognizing it as temporary and as a degree of front-loading within the framework of the Committee's longer-run objectives.

Chairman Burns commented that Mr. Holland's concept of front-loading appeared to differ from Mr. Eastburn's: the former was accommodative while the latter was deliberate.

Mr. Eastburn remarked that he wished to see a faster rate of growth early in the period to which the Committee's longer-term growth rates applied, but he was not concerned whether the faster rate came about because of the tax refunds and rebates or for other reasons.

Continuing, Mr. Holland said he felt some satisfaction that the faster rates of monetary growth could be achieved through an accommodative rather than an aggressive policy. The recent improvement in financial markets--in particular, the rally that had turned interest rates down again--was encouraging; if financial markets remained reasonably quiet, as he hoped they would, confidence would benefit. According to the blue book,[1/] that was a reasonable expectation, in view of the expected bulge in the growth of the aggregates, assuming the Committee pursued an accommodative policy.

Mr. Winn observed that he was reasonably satisfied with the current stance of monetary policy, although in considering what was appropriate, he had questions about two issues. First were the financial problems of New York City. Second were the public analysis and comment of Federal Reserve policy calling attention to the prospects for increases in interest rates later on; if he were an investor, he would be inclined to be invested in short-term securities.

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

Mr. Clay remarked that in view of the current weakness in the economy, uncertainty about the vigor of the anticipated recovery, sluggish monetary growth since the beginning of the year and, in his view, uncertain effects of the tax rebates on monetary growth, he favored a moderately stimulative monetary policy for the next few months. At this time, he would attempt to maintain stable money market conditions, which would make an important contribution to confidence, and to achieve that objective, he would temporarily accept wide short-run ranges of tolerance for the monetary aggregates.

Mr. Wallich commented that the main question before the Committee was whether to pursue a strategy of front-loading growth in the money supply, but he would view the issue from a long perspective. If the Committee wished to wring inflationary pressures from the economy during only one cycle of recession and recovery, the present level and projected growth of the money supply were about right. Achievement of that objective would take a long time, and it was uncertain that the Congress would find it acceptable. The alternative was to risk the revival of a degree of inflationary pressures in pursuit of a more rapid recovery this time and hope that such pressures could be eliminated altogether in the next cycle. The latter strategy raised the question--much debated by economists--of the extent of the current shortfall in the money supply from the growth path required to achieve the desired rate of recovery. His inclination was against the strategy of front-loading, on the grounds that pressures for monetary expansion were likely to develop later on and it would be desirable to have some flexibility to yield to a degree. If the System expanded the money supply more rapidly now, it would be compelled to resist the pressures rigidly later on. Therefore, his preference was to continue policy on its present course.

Mr. Mayo observed that in his view monetary policy over the past few months had been satisfactory both in its design and in its execution by the Desk. Nevertheless, banks remained reluctant to expand credit, although in the Chicago District, they were buying Government securities; they were almost obsessed by a desire to restore their liquidity positions. Therefore, he favored a further reduction in reserve requirements. Moreover, he believed in lower requirements as a matter of principle, and it might be quite a while before the Board had another opportunity to take such action.

Continuing, Mr. Mayo said it seemed to him that at the moment continued recession remained a greater risk than renewal of inflationary pressures--although the inflation problem was by no means remote. He would point out, therefore, that even under the most liberal of the three alternatives presented in the blue book the rate of expansion in M_1 in the May-June period would bring growth over the year ending in June 1975 to only 4 per cent, which he regarded as very modest; the volume of reserves created had been very modest. Accordingly, a posture of a little more ease would be compatible with developments over the past year as well as with the Committee's longer-term goals. While avoiding actions that could be misinterpreted as an effort to push interest rates down, he would pursue a more accommodative policy in the period ahead, during which the volume of Treasury financing would be less than it had been recently and the tax rebates would be tending to raise the growth rates of the monetary aggregates. As in the past, he would advocate a wider range of tolerance for the Federal funds rate.

The meeting then recessed. It reconvened at 2:45 p.m. with the same attendance.

Mr. Bucher remarked that he now felt somewhat less anxious about the situation than he had for some time in the past. The point had been reached where little could be gained by aggressive moves toward greater ease in monetary policy. Financial markets had improved in the past few weeks and liquidity had been increasing to a point that would accommodate economic growth. Nevertheless, he remained concerned about the financial environment for two main reasons. As noted earlier, investors preferred short-term instruments, which no doubt reflected uncertainty and also an expectation on their part that interest rates would rise. Like Mr. Mitchell, he was concerned in particular about developments in the mortgage market; the recent rise in rates reflected, among other things, depositors' preference for passbook accounts over longer-term certificates. His second main reason for concern was the financial problems of New York City and the possibility that their effects would spill over into other financial markets.

Continuing, Mr. Bucher observed that he would welcome a slight easing, should that develop, but he would not pursue it aggressively. Also, he agreed with Mr. Morris that a particular effort should be made to avoid a shortfall in growth of the aggregates in the period immediately ahead, that a wider range be specified for the Federal funds rate, and that the Manager be instructed to move the rate down promptly if it appeared that growth of the aggregates was falling below the specified ranges. Finally, his concern about the condition of financial markets would lead him to make every effort to avoid an upward movement in interest rates, a development that would tend to confirm expectations of some investors that rates--particularly long-term rates--would increase in the near term.

In response to the Chairman's request for his advice to the Committee, Mr. Partee said the main point he would make concerned the confidence one might have in assessing the meaning and consequences of near-term movements in interest rates versus those in the aggregates. As had been noted, financial markets were sensitive--both because of the problems of New York City and because of investor anticipations of higher interest rates--so that any upward movement in rates would be a major event in the market, tending to confirm the judgments of those who had remained invested in short-term instruments. Although increases in interest rates would no doubt have to be accepted sooner or later in response to economic recovery, it seemed premature now to register that kind of confirmation of higher rates to come when the recovery in activity had not yet commenced.

On the other hand, Mr. Partee continued, the staff felt considerable uncertainty about the near-term projections of the aggregates, because disbursement of tax rebates would amount to billions of dollars in the May-June period. The staff had assumed that a substantial portion of the rebates temporarily would be reflected in M_1, but no one could know how long those cash balances would remain or what the ultimate distribution of the proceeds between spending and saving would prove to be. Consequently, it would be exceedingly difficult to appraise the significance of substantial monetary growth or of the lack of it in the May-June period. In the period immediately ahead, therefore, the Committee might wish to emphasize interest rates more and the aggregates less than usual; it was a situation in which the operational paragraph of the directive for the time being might best be cast in terms of money market conditions.

Mr. Black remarked that he was in general agreement with Mr. Partee's views. He saw no reason to change the long-run objectives agreed upon at the last meeting, and any of the three alternatives in the blue book could lead to those objectives, although by different routes. His own preference for growth rates over the second and third quarters were about in line with the projections under alternative B. For the May-June period, he could accept the entire ranges encompassed by the three alternatives, because the spreads were relatively narrow and because this was a time to depart from the usual practice and to give more emphasis to money market conditions. It was important to avoid a backing-up of interest rates right now, which would interfere with the recent improvement in the tone of money and capital markets. At the same time, he would not want to discourage any downward movement in rates that might develop naturally. In sum, he would emphasize money market conditions, aiming for just a little more ease. Finally, if domestic and foreign markets continued to improve, a further quarter-of-a-point reduction in the discount rate might be appropriate in order to bring it more closely in line with market interest rates.

Mr. Balles commented that in setting 12-month objectives for certain of the aggregates in response to the Concurrent Resolution of the Congress, the Committee was sailing on uncharted seas, and like Mr. Eastburn, he believed that the path toward achievement of those long-term objectives was important. With respect to the economic outlook, the view at the San Francisco Bank was in essential agreement with that of the Board staff; his staff also saw signs of a near-term bottoming out of the decline in activity. However, most directors of the Bank remained more pessimistic than he or his staff about the timing and vigor of the upturn. Trends from one industry to another were mixed, and some of the directors could not yet see the light at the end of the tunnel.

Continuing, Mr. Balles observed that for some months he had been concerned that the dramatic decline in short-term interest rates overstated the degree of availability of bank credit to private borrowers. Many banks in the Twelfth District were still very cautious in their loan policies and were more inclined to place funds in Government securities or even in the Federal funds market than in loans. Like others, therefore, he would be uneasy about anything that would bring about a rise in interest rates in the near term, prior to confirmation that economic activity had in fact turned up. Given the lags in the effects of policy, therefore, he would lean moderately in the direction of front-loading of growth in the monetary aggregates. For the period immediately ahead, he would resolve doubts on the side of ease.

Mr. MacLaury said he had a hunch that the staff projections of real GNP would prove to be low; like Mr. Holland, he thought that consumption expenditures might be stronger than projected. Nevertheless, he continued to believe that the 12-month targets adopted at the last meeting were too low. Despite his preference for a higher target, however, he did not favor a strategy of front-loading. He felt that for the period until the next meeting, it would be appropriate to maintain existing money market conditions.

Continuing, Mr. MacLaury remarked that he was disturbed by what he perceived as a lack of clarity in the Committee's methodology. While the Committee now was publicly announcing its longer-term targets, he had less confidence than before in his understanding of the path by which those objectives were to be achieved. He realized that views differed on the importance that should be attached to the long-run targets, but it seemed strange for the blue book to state that all of the three alternatives it presented were generally consistent with the 12-month ranges. He believed that it made a difference whether the Committee embarked on the path indicated by the high alternative or on that indicated by the low alternative. Whenever the time was available, Committee discussion of the link between the short-run and longer-run ranges for the aggregates would be desirable.

Mr. MacLaury added that another problem that ought to be discussed was the implication that benchmark revisions in the money supply statistics had for the Committee's targets. At present, the targeted growth rates were retained despite revision in the base from which growth was being measured.

Mr. Coldwell commented that, as he had said earlier, persistence of an unemployment rate as high as that projected by the staff would risk an excessively stimulative fiscal policy response by Congress. He did not like the prospect of an unemployment rate above 9 per cent through June 1976, and he thought Congress would like such a development even less. Still, he was reasonably well satisfied with the present posture of monetary policy; he would suggest, however, that the Committee err on the side of ease.

Chairman Burns remarked that the Committee might now turn its attention to the directive and to the numerical specifications. First, he thought it would be undesirable to reopen the debate on long-term targets. That was not a question that should be debated at every meeting; now and then, strong and decisive reasons might exist for reappraising those targets even though a clear-cut decision had been reached a month earlier, but he did not think that was the case today. At the next meeting, moreover, the staff would present a chart show, and the Committee would need to consider the longer-term targets in preparation for the next presentation to a Congressional oversight committee--the House Banking Committee--so he would suggest that the Committee not review them today.

Continuing, the Chairman said there seemed to be a broad consensus within the Committee for maintaining the funds rate at about its current level. Therefore, the Committee might wish to consider directive language that emphasized prevailing money market conditions. The language he would propose for consideration was as follows: "To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to maintain about the prevailing money market conditions over the period immediately ahead, provided that monetary aggregates generally appear to be growing within currently acceptable short-run ranges of tolerance."

With respect to specifications, the Chairman said, he would make some suggestions for consideration by the Committee. He would propose a Federal funds rate range of 4-3/4 to 5-1/2 per cent. That was a narrow range, but he would not wish to see the funds rate move up as high as 5-3/4 per cent, and he believed that that was also the sentiment of other Committee members. For M_1, he would propose a range of 6-1/2 to 9 per cent. In suggesting that range, he was much influenced by the recent publication of the Committee's longer-run objective for growth in M_1--namely, growth within a range of 5 to 7-1/2 per cent over the year from March 1975 to March 1976. He believed that objective was not well understood, and if the Committee decided to adopt a directive that emphasized money market conditions and also specified an upper limit of more than 9 per cent for the M_1 range, many observers would conclude that the Committee had abandoned the announced goal. He could imagine the commentaries that would be written--when the policy record for this meeting was published in about 45 days--to the effect that the Federal Reserve was going wild once again. Therefore, he would not wish to specify an upper limit above 9 per cent; he felt less strongly about the lower limit. He suggested that the members comment briefly on the proposed specifications.

Mr. Hayes asked why adoption of 6-month targets had been discontinued at the time that the Committee had begun to adopt 12-month targets in response to the Concurrent Resolution. He suggested that continuation of the former would give a sense of the desired path toward the longer-term objectives and also would help to provide background for understanding the 2-month ranges.

In response, Chairman Burns remarked that Mr. Hayes had raised a procedural question, which ought to be explored thoroughly. He would suggest it be discussed at the next meeting of the Committee and that Mr. Holland, as Chairman of the Subcommittee on the Directive, begin the discussion.

Mr. Hayes remarked that he did not have strong feelings about the language for the operational paragraph of the directive; perhaps language that emphasized money market conditions, as suggested by the Chairman, would be most appropriate. Concerning specifications, he had no difficulty with those proposed by the Chairman, although--as he had indicated earlier--he would prefer a wider 2-month range for M_1 in order to lessen the chances of triggering movements in the Federal funds rate. He would assume, however, that the Chairman was likely to consult with the Committee during the inter-meeting period if M_1 appeared to be growing at a rate outside the specified range.

Chairman Burns commented that he had had that possibility in mind in suggesting an upper limit for the funds rate of 5-1/2 per cent, rather than 5-3/4 per cent as under alternative B.

Mr. Morris observed that--as he had indicated earlier--he favored a range for the Federal funds rate that was wider than that suggested by the Chairman, with one-half of a percentage point added to the lower end; thus he would specify a range of 4-1/4 to

5-1/2 per cent. His purpose was to put the Manager in a position to respond promptly to shortfalls in growth of the aggregates. He was concerned about the range suggested for M_1 and the reason given for it. The Committee had an obligation to explain to the public the relationship between the 2-month and the 12-month ranges. Thus, he would prefer to specify a May-June range of 7 to 10 per cent for M_1 and to make an effort to explain why that range was believed to be compatible with the Committee's longer-run objectives.

Mr. Baughman commented that the language proposed for the directive was acceptable to him. Concerning specifications, he was in general agreement with Mr. Morris' views. There was nothing to lose and perhaps something to be gained by specifying a lower limit for the funds rate below that suggested by the Chairman; he had a lower limit of 4-1/2 per cent in mind. With respect to the 2-month range for M_1, he had doubts about an upper limit of 9 per cent. It seemed quite possible that the Committee would find itself in a situation of having to choose between the 5-1/2 per cent upper limit for the funds rate and the 9 per cent upper limit for growth in M_1.

Chairman Burns remarked that, on the assumption that nothing unusual happened, his own inclination would be to stop short of a 5-1/2 per cent funds rate and to allow a faster rate of growth in M_1, but he would prefer not to specify an upper limit of more than 9 per cent for the M_1 range. In any case, it would be premature to make any commitments at this time.

Mr. Balles observed that, in light of the apparent consensus for maintaining about prevailing conditions, the language proposed for the operational paragraph of the directive was appropriate. Given his preference to resolve any doubts on the side of ease, he would prefer a lower limit of 4-1/4 per cent for the funds rate, as advocated by Mr. Morris, or 4-1/2 per cent.

Mr. MacLaury said he agreed that the directive language should emphasize money market conditions, and he found the proposed language acceptable. Also, he could accept a range of 4-3/4 to 5-1/2 per cent for the funds rate, although in general he would prefer a wider range. He shared Mr. Morris' view about the need to explain the relationship between the long- and short-run ranges for the aggregates. If the Committee did not have a specific path toward the longer-run objectives, that should be explained. Having said that, he had no difficulty with the 6-1/2 to 9 per cent range for M_1 that the Chairman had suggested.

Mr. Mayo remarked that he favored the emphasis on money market conditions in the operational paragraph of the directive. For the Federal funds rate, he would prefer the wider range of 4-1/4 to 5-1/2 per cent, but he could accept 4-1/2 to 5-1/2 per cent. Like others, he was concerned about the relationship between the long- and short-run ranges for M_1; there would be times when they would appear to be irreconcilable. For the May-June period, he would prefer a range of 7 to 10 per cent.

Mr. Clay observed that a Federal funds rate range of 4-3/4 to 5-1/2 per cent--which he had been prepared to propose himself--was acceptable. For M_1, he preferred a May-June range of 7 to 10 per cent, but he could accept 6-1/2 to 9 per cent. He liked the proposed language for the directive.

Mr. Black remarked that he also liked the language of the directive suggested by the Chairman. For M_1, he preferred a May-June range of 7 to 10 per cent, because he thought the market would react to the downward revision in M_1--reflecting adjustment to new benchmark data--to be made public on Thursday. However, he would not be disturbed by a range of 6-1/2 to 9 per cent. He would prefer a range of 4-1/2 to 5-1/2 per cent for the funds rate; the important point was that the rate not rise above 5-1/2 per cent, and he hoped that it would remain a little below that level.

Mr. Bucher said he favored the directive language of alternative B, although he did not have strong feelings about it. He felt that it would permit declines in short-term interest rates if market forces tended in that direction, whereas the language that emphasized the maintenance of prevailing money market conditions suggested that such declines might be resisted. For the Federal funds rate, he would agree with Mr. Morris' suggestion to widen the range by reducing the lower limit; he could accept either 4-1/4 or 4-1/2 to 5-1/2 per cent. He thought that the upper limit of the M_1 range for the May-June period should be higher than 9 per cent; 10 per cent would be acceptable. He would not allow the 12-month ranges to influence the specifications for the 2-month ranges. He agreed with those who had suggested that the relationship between the two had to be explained to the public.

Mr. Holland remarked that he had been prepared to vote for the language and specifications of alternative B, although his preference had been for an upper limit of 5-1/2 rather than 5-3/4 per cent for the funds rate. Therefore, he could readily accept the range of 4-3/4 to 5-1/2 per cent that the Chairman had proposed. With respect to the directive, he was concerned about the precedent involved in shifting to language that gave more emphasis to money market conditions, but not so much that he could not accept it. He was more seriously troubled, however, by the proposed range for M_1 in the May-June period. There were forces at work--such as the payment of the tax rebates--that might tend to raise the growth rate of M_1 above 9 per cent, and as he had said earlier, he wished to accommodate a temporary bulge in growth arising for that reason. The concentration of the tax rebates in this period was generally known, and it would provide the policy record with as concrete a reason as the Committee might ever have for specification of 2-month ranges that were above the 12-month ranges. Accordingly, he preferred a 2-month range for M_1 that extended from the bottom of alternative C to the top of alternative A--a range of 7 to 10 per cent--with the short-run ranges for M_2 and RPD's adjusted accordingly.

Mr. Wallich observed that he was not happy with the suggestion for a return to directive language that emphasized money market conditions; it would provoke needless discussion. And he would like to see an effort made to reconcile the short-term and longer-term targets; he agreed with Mr. Holland's approach.

Mr. Coldwell commented that he had no objection to the directive language proposed by the Chairman, provided it was interpreted rather broadly. He was concerned, however, about specification of a 9 per cent ceiling for the M_1 range. Also, he preferred a range for the funds rate that was at least 1 percentage point wide. Accordingly, he could accept specifications of 7 to 10 per cent for the M_1 range and 4-1/2 to 5-1/2 per cent for the funds rate range.

Mr. Winn said differences among Committee members might be reconciled by dropping the 2-month ranges of tolerance for the aggregates in this period and at the same time changing the language of the operational paragraph of the directive to call for the maintenance of prevailing money market conditions "provided that growth of the monetary aggregates is more rapid than has occurred on average in recent months." With respect to the funds rate, he preferred a range that was wider than that suggested by the Chairman.

Mr. Eastburn observed that he preferred the directive language of alternative B. For M_1 and the Federal funds rate, he favored ranges of 7 to 10 and 4-1/4 to 5-1/4 per cent, respectively.

Mr. Kimbrel remarked that he had come to the meeting prepared to accept alternative B. However, he considered the directive structured in terms of money market conditions to be desirable at this particular time. With that kind of directive in mind, he would prefer a funds rate range of 4-1/2 to 5-1/2 per cent and the M_1 range of 6-1/2 to 9 per cent suggested by the Chairman.

Mr. Francis commented that he did not like the money market directive. He would add only that he hoped the Committee would not permit so much front-loading of growth in the aggregates in this period that it would be difficult to overcome later on.

Mr. Mitchell commented that he had no problem with the proposed money market directive, even though it might be ideologically inferior. For the short-term ranges, he agreed essentially with Mr. Coldwell except that he would prefer an M_1 range of 6-1/2 to 10 per cent rather than 7 to 10 per cent. However, that did not matter much if the range for the Federal funds rate was 4-1/2 to 5-1/2 per cent. If M_1 appeared to be growing at a rate of less than 6-1/2 per cent, he would like to have another consultation of the Committee before aiming for a Federal funds rate below 4-1/2 per cent. On the other hand, he thought it was quite possible that the growth rate of M_1 in the May-June period would exceed 10 per cent, and he hoped that nevertheless the funds rate would not be moved toward 5-1/2 per cent. He noted the Chairman's earlier remark that his own preference was to stop short of a funds rate of 5-1/2 per cent and to allow a faster rate of growth in M_1.

Chairman Burns then asked Committee members to indicate informally whether they preferred language for the operational paragraph of the directive that emphasized money market conditions, as he had proposed, rather than growth in the aggregates.

A majority indicated that they preferred the language emphasizing money market conditions.

The Chairman observed that there appeared to be agreement on 5-1/2 per cent as the upper limit for the funds rate range. The issue to be decided was between 4-1/2 and 4-3/4 per cent for the lower limit, and he asked the members to indicate informally which of the two figures they preferred.

A majority of the members indicated a preference for 4-1/2 per cent.

Chairman Burns then observed that a majority of the members appeared to prefer an upper limit of 10 per cent for the May-June range of tolerance for M_1. He was particularly concerned that a figure of 10 per cent would be misunderstood--that it would be confused with the longer-term rate of monetary growth that had been proposed by certain economists and politicians. He carried the chief burden of educating the public about the System's objectives--which was a slow and difficult process--and it would be made more difficult for him by specification of an upper limit of 10 per cent. He would suggest that the Committee accept an upper limit of 9-1/2 per cent. The Chairman's suggestion was accepted by the Committee.

With respect to the lower limit, the Chairman said the members appeared to be evenly divided between 6-1/2 and 7 per cent. He called for an informal poll of preferences between those two figures.

A majority of the members indicated that they preferred 7 per cent for the lower limit of the range of tolerance for M_1.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs and the operational paragraph the Committee had agreed upon earlier. It would be understood that the directive would be interpreted in accordance with the following specifications. The ranges of tolerance for growth rates in the May-June period would be 1-1/2 to 4 per cent for RPD's, 7 to 9-1/2 per cent for

M_1, and 9 to 11-1/2 per cent for M_2. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 4-1/2 to 5-1/2 per cent.

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

The information reviewed at this meeting suggests that real output of goods and services--after having fallen sharply for two quarters--is declining much less rapidly in the current quarter. In April the pace of the decline in industrial production moderated considerably further, and total employment rose. However, the unemployment rate increased again, from 8.7 to 8.9 per cent, as the civilian labor force increased considerably. Average wholesale prices of industrial commodities changed little in April, as in March; prices of farm and food products rose sharply, following several months of large decreases. The advance in average wage rates so far this year has been considerably less rapid than the increase during the second half of 1974.

The foreign exchange value of the dollar has declined somewhat since mid-April, but it is still above the low of early March. U.S. imports fell sharply in the first quarter, and the foreign trade balance was in substantial surplus, in contrast to the deficits of preceding quarters. Net outflows of funds through banks were large in the first quarter, as loans to foreigners continued to increase while liabilities to foreigners declined.

Both M_1 and M_2 grew moderately in April, but M_3 grew more rapidly as inflows of deposits to nonbank thrift institutions remained substantial. Business demands for short-term credit remained weak, both at banks and in the commercial paper market, while demands in the long-term market continued strong. Since mid-April short-term market interest rates have declined somewhat. Most longer-term yields have changed little on balance, and mortgage rates have risen. Federal Reserve discount rates were reduced from 6-1/4 to 6 per cent in mid-May.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments.

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to maintain about the prevailing money market conditions over the period immediately ahead, provided that monetary aggregates generally appear to be growing within currently acceptable short-run ranges of tolerance.

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

It was agreed that the next meeting of the Committee would be held on Monday and Tuesday, June 16 and 17, 1975.

Thereupon the meeting adjourned.

Arthur L. Broida

Secretary

ATTACHMENT A

May 20, 1975
Henry C. Wallich

Report on BIS meeting - May 12, 1975

At the Governors meeting (G-10 group) varied views were expressed about the progress of national economies. The French representative noted with satisfaction the success of French anti-inflationary policies and the improvement in France's trade balance, to which he attributed the return of the French franc to approximately its year-ago relationship with the DMark. No details were given concerning France's proposed re-entry into the Snake.

British presentation dealt with the difficulties that Britain has encountered but saw hope thanks to the tighter budget, and the slower rate of growth of the money supply. The current account, it was noted, had improved considerably even taking account of the dock strike.

At the dinner meeting (G-10 and other visiting governors) there was a further discussion of anti-cyclical policy with varied views being expressed.

At a combined meeting of the EEC and G-10 governors, the attitude of the central bankers with respect to arrangements concerning gold was discussed. Expressions of views at this meeting remained rather tentative. No effort was made to arrive at any common view, or even detailed discussion of many particular points. No report was prepared, but a verbal report is to be rendered by Governor Hoffmeyer to the EEC ministers.

A discussion of the Belgian swap repayment took place between Messrs. deStrycker, Janson, and Hayvaert, and Mr. Holmes, Miss Green, and myself.

ATTACHMENT B

Robert Solomon
May 20, 1975

Report on Meetings of Working Party 3 and Group of Ten Deputies, May 14-15, 1975

Working Party 3

The discussion focused on the evolution of and prospects for the current account balances of the OECD countries and on recent movements of exchange rates.

The current deficit of the OECD countries is apparently turning out to be much smaller in the first half of this year as compared with 1974 and with the forecasts that were made a few months ago. For 1975 as a whole, the OECD current account deficit is now forecast at $24 billion, compared with almost $35 billion in 1974; in the first six months of 1975, the deficit is likely to be less than half that for the year. Among the explanations for the smaller aggregate deficit of OECD countries are the following:

1. The OPEC surplus is smaller as the result of reduced oil exports, some reduction in oil prices, and perhaps larger imports than had been expected.

2. The recession in industrial countries has reduced both the quantities and prices of their imports from non-OPEC developing countries. In due course, this could be reflected in a lower demand for OECD exports by LDC's. This year, the LDC deficit has increased above

what it was in 1974, when it had already risen sharply because of the advance in oil prices. While the imports of OECD countries, which have been falling with the recession, are expected to turn around in the second half of 1975, a sharp rebound is not expected. Thus some LDC's may face severe financing problems.

The improved current balance of the OECD as a whole still leaves substantial disequilibria, actual or potential, among OECD countries. Although Germany's current account surplus is expected to fall off, it will still remain large. The striking improvement in Italy's current account position (from an $8 billion deficit in 1974 to $3 billion at an annual rate in the first half of 1975) is the result of some increase in exports of manufactured goods but also of a substantial drop in imports. Italy's GNP is expected to be 3 percent lower in 1975 than in 1974. Britain's current account has also improved strikingly in recent months and the British, like the Italian, authorities are hoping that the main stimulus to demand will come from exports. This aim is consistent with that of the German authorities who hope to avoid an export-led expansion. Up to now, however, the stimulative measures adopted in Germany have not shown significant results.

Japan too has reduced its current account deficit, to almost zero, despite its heavy oil imports. Once again the explanation is severe recession. Now that the spring wage round is over, with favorable results by Japanese standards, the members of the working party urged that Japan adopt more expansionary domestic policies. This advice seemed to be welcomed by the Japanese Finance Ministry officials at the meeting.

The "other OECD" countries (including Spain, Turkey, Greece, Scandinavia other than Sweden, Australia, New Zealand) are not sharing the improved current account positions shown by the larger countries, for a number of reasons. Some of the countries are affected by the fall in raw material prices. Others are experiencing a reduction in receipts from emigrant workers, some of whom are returning home from the more industrialized countries. And tourist receipts have fallen off. Thus some of these countries may experience difficulties in financing current account deficits that are relatively very large.

The strengthening of the dollar (until a few days before the meeting) was generally welcomed and was ascribed to a narrowing of interest rate differentials in recent months, as U.S. rates stabilized and rates in other countries came down.

The British representatives stated that the depreciation of the pound (a fall of 3-1/2 percent in the effective rate in the past three weeks) did not seem to be a result of switches by OPEC countries out of sterling. They expressed the hope that the rate of inflation would fall to 12 percent this year. It was pointed out that the reduction in the trade-weighted exchange rate of the pound over the past year--about 10 percent--is roughly equal to the excess of Britain's inflation rate over the average of that of other major countries.

Group of Ten Deputies

The Deputies took up the three major issues that will face the IMF Interim Committee when it meets in June: the distribution of IMF quota increases among the major countries, the role of gold, and the future exchange rate regime. No progress was made in narrowing the differences that have prevailed in debate on these matters in the Executive Board of the Fund.

ATTACHMENT C

June 2, 1975

TO: Federal Open Market Committee

Subject: Lending of Securities fr< System Account Portfol:

FROM: Peter D. Sternlight

At the April 15, 1975 meeting of the Committee, the Manager of the System Open Market Account recommended a procedural change in the System's lending facility to make the facility more effective in minimizing delivery failures in the Government securities market. Under existing arrangements, loaned securities are not delivered to the borrower until the collateral (in the form of other Government securities of at least equal market value) is actually received by the Reserve Bank. To expedite delivery of the loaned securities, it was proposed that upon the Desk's agreement to grant the loan request the borrower be sent the securities against a charge to the reserve account of the borrower or the borrower's clearing bank. Later that day, when the Reserve Bank receives the collateral, the charge to the reserve account would be reversed.

Initially, we were planning in connection with the modified lending procedure to charge the reserve account a sum equal to twice the par value of the borrowed securities. The effect of this approach was to provide a significant penalty to the dealer in the event (which we would expect to be quite rare) that there was a failure to deliver collateral in the form of securities that same day. Discussion with dealers and their clearing banks have revealed some difficulties with this approach because of the "double debiting" of reserve accounts during the day. Not only did the dealers express concern about this procedure, but also the clearing banks felt that such an arrangement would result in their extending sizable unsecured loans to non-bank dealers, a practice not permitted by prevailing lending policies of these banks. In view of these considerations, the Account Management now proposes to lend securities against a charge to the reserve account of the borrower (or the borrower's clearing bank) equal to the market value of the loaned securities, plus a moderate margin, but levy a 6 percent per annum penalty should a dealer fail to deliver the promised collateral. The penalty would be in addition to the basic lending charge of 1 1/2 percent, and would retain the strong incentive for dealers to make timely delivery of collateral that was implicit in the initial form of our proposal. Beyond the rate penalty, repeated instances of not delivering collateral would result in the suspension of a dealer's borrowing privilege for a period of time.

If there is no objection from the Committee, the Desk plans to implement the new procedure within about one week.

ATTACHMENT D

May 19, 1975

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on May 20, 1975

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services--after having fallen sharply for two quarters--is declining much less rapidly in the current quarter. In April the pace of the decline in industrial production moderated considerably further, and total employment rose. However, the unemployment rate increased again, from 8.7 to 8.9 per cent, as the civilian labor force increased considerably. Average wholesale prices of industrial commodities changed little in April, as in March; prices of farm and food products rose sharply, following several months of large decreases. The advance in average wage rates so far this year has been considerably less rapid than the increase during the second half of 1974.

The foreign exchange value of the dollar has declined somewhat since mid-April, but it is still above the low of early March. U.S. imports fell sharply in the first quarter, and the foreign trade balance was in substantial surplus, in contrast to the deficits of preceding quarters. Net outflows of funds through banks were large in the first quarter, as loans to foreigners continued to increase while liabilities to foreigners declined.

Both M_1 and M_2 grew moderately in April, but M_3 grew more rapidly as inflows of deposits to nonbank thrift institutions remained substantial. Business demands for short-term credit remained weak, both at banks and in the commercial paper market, while demands in the long-term market continued strong. Since mid-April short-term market interest rates have declined somewhat. Most longer-term yields have changed little on balance, and mortgage rates have risen. Federal Reserve discount rates were reduced from 6-1/4 to 6 per cent in mid-May.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with more rapid growth in monetary aggregates over the months ahead than has occurred on average in recent months.

Alternative B

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

Alternative C

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

ATTACHMENT E

May 20, 1975

Points for FOMC guidance to Manager in implementation of directive		Specifications
A. Desired longer-run growth rate ranges (as agreed, 4/15/75): (March '75 to March '76)	M_1	5 to 7-1/2%
	M_2	8-1/2 to 10-1/2%
	M_3	10 to 12%
	Proxy	6-1/2 to 9-1/2%
B. Short-run operating constraints (as agreed, 5/20/75):		
1. Range of tolerance for RPD growth rate (May-June average):		1-1/2 to 4%
2. Ranges of tolerance for monetary aggregates (May-June average):	M_1	7 to 9-1/2%
	M_2	9 to 11-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		4-1/2 to 5-1/2%
4. Federal funds rate to be moved in an orderly way within range of toleration.		

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

C. If it appears that the Committee's various operating constraints are proving 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 instructi