

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 26, 1970, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Francis
Mr. Hickman
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Sherrill
Mr. Swan
Mr. Morris, Alternate for Mr. Heflin

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

Messrs. Eastburn and Coldwell, Presidents of the Federal Reserve Banks of Philadelphia and Dallas, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Kenyon and Molony, Assistant Secretaries
Mr. Hexter, Assistant General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Craven, Gramley, Hersey, Hocter, Jones, Parthemos, and Solomon, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Bernard, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Cardon, Assistant to the Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors

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Messrs. Wernick and Williams, Advisers,
Division of Research and Statistics,
Board of Governors
Mr. Keir, Associate Adviser, Division of
Research and Statistics, Board of
Governors
Mr. Baker, Economist, Government Finance
Section, Division of Research and
Statistics, Board of Governors
Miss Ormsby, Special Assistant, Office of the
Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant,
Office of the Secretary, Board of Governors

Messrs. Black, Fossum, and Baughman, First Vice
Presidents, Federal Reserve Banks of Richmond,
Atlanta, and Chicago, respectively
Messrs. Eisenmenger, Link, Taylor, and Tow,
Senior Vice Presidents, Federal Reserve
Banks of Boston, New York, Atlanta, and
Kansas City, respectively
Messrs. Bodner, Scheld, and Green, Vice
Presidents, Federal Reserve Banks of New
York, Chicago, and Dallas, respectively
Messrs. Gustus and Kareken, Economic Advisers,
Federal Reserve Banks of Philadelphia and
Minneapolis, respectively
Mr. Sandberg, Securities Trading Officer,
Federal Reserve Bank of New York

By unanimous vote, the minutes of
actions taken at the meeting of the
Federal Open Market Committee held on
May 5, 1970, were approved.

The memorandum of discussion for the
meeting of the Federal Open Market Commit-
tee held on May 5, 1970, was accepted.

Before this meeting there had been distributed to the members
of the Committee a report from the Special Manager of the System Open
Market Account on foreign exchange market conditions and on Open
Market Account and Treasury operations in foreign currencies for the

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period May 5 through 20, 1970, and a supplemental report covering the period May 21 through 25, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner said the private gold market had seen a flurry of activity at the beginning of this period as a result of the heightened tensions in the Middle and Far East, and the price in London moved up to a high of \$36.24 in fairly active trading. The market subsequently quieted down, however, and since mid-month the price had been below \$36.00. On the official side there had been no transactions of any consequence and the Stabilization Fund's gold holdings remained at over \$500 million. He should perhaps note, however, that the Treasury's final arrangements for cleaning up the Dutch and Belgian swap drawings involved use of a total of \$20 million of Special Drawing Rights, the first use of SDR's by the United States.

The foreign exchange markets had been rather more active and unsettled in the last few weeks than at any time this year, Mr. Bodner reported. However, the general pattern of orderly trading still prevailed in most currencies and European concerns about the health of the U.S. economy did not seem to have seriously affected the exchange markets. Sterling had fallen rather sharply to very close to par and, indeed, would have gone below par at the end of last week had it not been for firm support by the Bank of England. The weakness in sterling was accounted for by a number of factors, including the tapering off of the seasonal strength in

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the overseas sterling area and somewhat poorer trade results in the United Kingdom itself. The main sources of the pressure, however, were a sharp rise in Euro-dollar rates at a time when interest rates in the United Kingdom were somewhat easier and, of course, the uncertainties introduced by the setting of the election date for June 18. There had been some modest pressure in the forward market, with a little precautionary selling of sterling, and that contributed to the selling of spot sterling. All of those factors had combined to put some modest pressure on sterling and no doubt some weakness would continue to be seen between now and election time. Nevertheless, although the wage pressures continued to build, there was no reason at this point to think the British would be in serious trouble in the near future. However, it was quite possible that the British would have to reactivate their swap line to help tide them over the pre-election period.

As Mr. Coombs had reported at the last meeting, Mr. Bodner continued, the Italian lira had been looking a bit healthier and the Italians were making reserve gains over and above their new borrowings in foreign markets. Consequently, they had been able to pay off another \$400 million in swap drawings from the System--\$200 million on May 19 and \$200 million today--leaving just \$200 million outstanding. However, in the last week the lira had come under renewed pressure and had required regular modest support by the Bank of Italy. Increasing labor strikes, particularly one-day strikes, the uncertainties generated by the forthcoming regional and local

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elections in Italy, and a sharp break in the Italian bond market had combined to put pressure on the lira. In addition to supporting the exchange rate, the Italians were forced once again to come in to support the bond market, although they hoped to be able to withdraw from that market fairly quickly.

Mr. Bodner remarked that the other side of the coin was the picture in the Canadian dollar market. The Bank of Canada had continued to take in very large amounts of dollars with the rate at the ceiling, and there were widespread rumors of at least a widening of the margins to the full 1 per cent permitted by the International Monetary Fund--and even, possibly, a revaluation. Canadian reserve gains so far this year had approached \$1.2 billion, thanks in part to a very sharp bulge in exports following the settlement of the nickel and steel strikes in Canada in late 1969 and unexpectedly large shipments of wheat and barley. In addition, Canadian interest rates had been highly competitive and had pulled in funds from the United States. As the Committee was no doubt aware, the Bank of Canada acted to reduce the interest rate incentive by cutting its discount rate to 7-1/2 per cent. Nevertheless, funds had continued to move into Canada, especially with the increasing rumors of an exchange rate adjustment. The Bank of Canada had now begun to try to head off some of that speculative activity by operating in the forward market to reduce the premium

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on the forward Canadian dollar and at the same time to push forward some of their potential reserve gains. Those operations began in a modest way on Friday (May 22) and continued yesterday. It was still too early to tell how effective they would be, but the Canadians were satisfied with the initial results.

Elsewhere the exchange markets had been generally quiet, Mr. Bodner continued. Earlier in the month the Swiss had taken in \$250 million. That led directly to a System swap drawing of \$200 million, since the inflow put the Swiss uncovered dollar position at over \$800 million--a level which the National Bank found uncomfortable. Since that infusion of liquidity into the Swiss market, however, the franc had been somewhat easier and no further operations had been necessary. Similarly, the Germans took in \$200 million on one day in mid-month, but the rate had held below the ceiling since then.

Finally, Mr. Bodner remarked, he should say a word about the Euro-dollar market, where rates had moved up quite sharply to about 9-1/4 per cent for most intermediate maturities. The rise in the rate reflected renewed bidding from U.S. banks, the draw-down by the Italian electricity authority of its \$400 million Euro-borrowing, and some bidding by German and Japanese banks. As he indicated earlier, those developments put some pressure on sterling and no doubt contributed to the easier tone of the Swiss

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franc and French franc. They had not caused any serious problems, however, and today there was some easing in demands.

By unanimous vote, the System open market transactions in foreign currencies during the period May 5 through 25, 1970, were approved, ratified, and confirmed.

At the Chairman's invitation, Mr. Hayes commented briefly on the meeting he had recently attended in Basle. He reported that it had been an unusually quiet meeting, since no acute exchange problems currently existed, but that universal concern had been apparent about inflation and high interest rates. After summarizing the comments at the meeting on the situation in various individual countries, Mr. Hayes noted that there had also been discussion of the prospects for greater monetary cooperation within the Common Market. He regarded the issue as largely academic, at least for the present, because of the wide differences of view existing among member countries.

Mr. Solomon then presented the following statement on international developments:

At the moment, members of the Committee are no doubt preoccupied with pressures in financial markets. My presentation today looks beyond these immediate pressures to the period, which may be close, when U.S. short-term rates will have declined again and funds will be moving back to the Euro-dollar market, with adverse effects on the balance of payments.

In the February 10 chart show we projected an underlying liquidity deficit for 1970 of about \$4 billion, reflecting an improvement in the current account of the balance of payments and a deterioration of the capital account. The results so far this year are not much out

of line with the February projection. We should note, however, that preliminary indicators show rather heavy deficits for April and early May. In any event, whatever the size of the liquidity deficit this year, any net repayment of Euro-dollar borrowings by U.S. banks will make the official settlements deficit that much larger.

The first question one may ask is, why do we care if the official settlements deficit is large? On the one hand, we can recognize that there is considerable scope for a sizable deficit on official settlements this year, after two years of surplus. The first quarter has already produced a recorded deficit in the magnitude of about \$3 billion--not at an annual rate. Up to now the surpluses corresponding to U.S. deficits have accrued mainly to countries that either are prepared to hold dollars--Canada and Japan--or have debts to repay--France and the United Kingdom. A number of other foreign monetary authorities are short of dollars and would welcome additional holdings. Furthermore, our gold reserves have increased, we have about \$900 million of SDR's, and a reserve position in the Fund of well over \$2-1/2 billion. Nevertheless, while there may not be any immediate problem, good reasons exist to limit the outflow of dollars. A large return flow of dollars to Europe would tend to undermine the efforts of European central banks to control inflation and would be resented, just as, last year, there was resentment over the upward pressures the United States was putting on European money markets. In addition, a massive and apparently prolonged deficit--reflected in a big reduction in U.S. reserves or a big increase in foreign official dollar holdings--would no doubt reflect on the status of the dollar and have a deeply disturbing effect on the international monetary system. It would also jeopardize the future of the SDR system. Thus, it is not a matter of indifference to the United States how large the official settlements deficit turns out to be this year and next.

For most components of the balance of payments, there is little that can be done in the short run. It is hoped that the trade surplus will continue to improve in response to the cooling off here, while abroad demands are strong and prices are rising rather rapidly. The trade statistics for April--to be announced today--show a surplus at an annual rate of \$2.2 billion--about the same as for the first quarter. As to foreign purchases of U.S. stocks, one can only hope that neither uncertainties regarding political and economic developments in the United States nor the troubles of Investors Overseas Services will do more than interrupt what appeared to be, in 1968-69, a basic shift in preferences by foreign investors toward acquisition of U.S. equities.

As for U.S. private capital, there is considerable leeway in the existing restraint programs administered by the Commerce Department and the Federal Reserve. No significant relaxation of these programs has been made this year.

This brings us to a major swing item in the balance of payments--the flow of Euro-dollars between American banks and their branches.

From mid-December to last week, U.S. banks repaid about \$2 billion to their branches. This figure overestimates--perhaps by \$700 million--the reflow of dollars to the rest of the world, since to that extent official funds were switched from foreign branches of American banks to head offices.

It is understandable that in the first quarter of this year banks were repaying Euro-dollar funds. Regulation Q ceilings were advanced, short-term market rates came down here, and banks increased their recourse to sales of commercial paper. Meanwhile, monetary restraint was intensified in Europe. In the past six weeks, U.S. rates have risen again and, on balance, American banks have not made further Euro-dollar repayments. It seems likely, however, that our short-term rates will turn down again before long. As this happens, European rates are unlikely to follow very far, and U.S. banks will once again have an incentive to repay Euro-dollar liabilities to their branches.

This incentive to repay high cost Euro-dollar borrowings is tempered by the feature of the marginal reserve requirement that provides that banks will lose their reserve-free base to the extent that their liabilities fall below the level of May 1969.

If and when U.S. short-term rates ease off, we should expect the few banks that are still well above their reserve-free bases, by an aggregate amount of about \$1-1/2 billion, to come down to those levels. The big question is, will the banks act to hold on to the rest of their Euro-dollar borrowings in order to preserve this reserve-free money? If banks were to decide that the reserve-free base is not worth preserving, there would be a potential reflow of several billions of dollars out of the \$11.1 billion of reserve-free bases.

The individual banks that are calculating the value of preserving the base need to try to estimate their future need for funds. If they expect to have to call on the Euro-dollar market again before too long, it is worth some short-run sacrifice to save the reserve requirement in the future. No doubt the upturn in short-term rates in the last six weeks has helped in this respect--by demonstrating to the banks that they cannot count on not needing to tap the Euro-dollar market.

For the future, the Federal Reserve's policy with respect to Regulation Q will have a significant influence on bank behavior with respect to Euro-dollars. If, for example, Q ceilings were altered in a way that led banks to feel confident that there would not again be a squeeze such as they experienced in 1966 and 1969, they would place considerably less value on keeping their reserve-free base. From the point of view of the balance of payments alone, a case could perhaps be made against relaxing Regulation Q ceilings at all. If domestic considerations call for a change in these ceilings, it would be desirable to leave banks uncertain regarding their freedom from Q ceilings in the future.

Federal Reserve action regarding bank-related commercial paper would also have an effect on bank willingness to hold on to Euro-dollars. The imposition of a reserve requirement on commercial paper would make Euro-dollars relatively more attractive. Perhaps there are other measures worth considering. The Board's staff is studying the matter.

Apart from consideration of specific measures that the System might adopt as a way of protecting the balance of payments, I would in conclusion bring to the Committee's attention once again the rather obvious point that, when doubt exists as to whether and how far monetary policy should be eased, balance of payments considerations weigh in on the side of caution.

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 May 5 through 20, 1970, and a supplemental report covering the period May 21 through 25, 1970. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Holmes commented as follows:

An atmosphere of abject gloom and despair continued to pervade the securities markets over most of the period since the Committee last met. Stock prices plummeted to

new lows, while yields on corporate and municipal bonds rose above the peaks reached late in 1969. The market for Government securities attempted to stabilize on occasion, but the effort appeared to be half-hearted at best and very short-lived. The markets generally tended to ignore indications of a slowing economy, focusing instead on evidence of continued inflation and on what many participants considered to be a lack of direction in national policy. There was cynicism about fiscal policy; uncertainty over the future course of monetary policy; concern over Southeast Asia and the Middle East, over domestic unrest, and over the general state of health of financial markets; and growing fear about the ability of the money and capital markets to meet the public and private demands for funds expected in the second half of the year. As is often the case, the financial community may have talked itself into a more pessimistic state of mind than is warranted by the circumstances. The best medicine would be some relatively good news from Southeast Asia or on the domestic inflationary front. Lacking that, and even better in connection with some favorable news, some more basic change may be required in national policy--in fiscal policy and/or by adoption of some form of income-price policy along the lines suggested by the Chairman and Vice-Chairman of this Committee. Meanwhile, the markets are vulnerable to any sudden shock and official assurances that all is well, or will soon be, appear to be doing more harm than good.

While the Treasury bill market has benefited from an improved technical position and from investor concern for liquidity and safety, rates have moved erratically over the period--particularly for longer-dated bills. Given all the uncertainties, dealers are generally unwilling to build up inventories and are trying to protect themselves by widening trading spreads and by exacting a higher underwriting spread in the regular Treasury bill auctions. In the regular Treasury bill auction held a week ago bidding was more normal than in the preceding two auctions, and rates generally tended to stabilize. By Friday, however, dealers began to focus on the fact that, in addition to the regular weekly auction yesterday, they would have to bid on 9-month and 1-year bills today; and

rates backed up sharply. In yesterday's auction, average rates of 7.13 and 7.36 per cent were established for three- and six-month bills, respectively, down 4 and 14 basis points from the high rates set in the near-disorderly auction just prior to the last meeting of the Committee, but well above the low points reached about May 8. As the blue book^{1/} indicates, one would normally expect a seasonal decline in bill rates between now and the end of June, and given the technical position of the bill market such a decline might result from even a modest increase in demand. But given the market's mounting concern over the size of the Treasury's cash needs in July and August--most of which is expected to be met by sales of tax-anticipation bills--rates may continue to move erratically.

I am sure that the Committee needs no detailed account of the outcome of the Treasury's May refinancing, which has been covered in detail in the written reports to the Committee. It was touch and go on the \$3-1/2 billion cash portion of the financing, with the outcome in doubt until the very last minute. The need to allot 100 per cent of subscription--many market participants had expected only a 50 to 60 per cent allotment at worst--left subscribers, of course, with more of the 18-month note than they wanted. With the new issue being pressed on the market in early trading on Friday, May 8, Treasury support of the market was required--including the purchase of \$130 million of the when-issued securities on a go-around conducted at the Trading Desk at 9:30 a.m., a half hour before the market normally begins to trade. All in all, Treasury trust accounts acquired nearly \$300 million of the 7-3/4's of 1971 and the 8's of 1977, mainly the former. Fortunately for the Treasury's cash position, however, the refunding portion of the financing turned out better than anticipated, with \$1 billion more cash raised than had been expected.

Open market operations over the period faced the delicate and unhappy task of trying to restore some degree of order to the market for Treasury securities at a time when bank credit and the money supply appeared to be growing more rapidly than the Committee desired.

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

There has been a fair amount of confusion about the nature and extent of System support of the Treasury financing. It should be made clear that at no time during the period did the System purchase rights or when-issued securities, although--as I mentioned at the last meeting--we were prepared to do so if necessary. Our support was confined to the massive purchase of Treasury bills reported at the last meeting; and I might note in passing that, while the emergency action of the Committee to suspend the \$2 billion leeway until today was not needed, there was only \$27 million left of the leeway by the close of business on May 5.

Despite the fact that System bill purchases lightened dealer portfolios markedly, and bill rates temporarily declined sharply, the market was apprehensive lest the System turn into an aggressive seller of bills in the May 13 statement week in order to recapture the reserves supplied by bill purchases in the previous week. While we did indeed supply more reserves in the week ended May 6 than we would have in the absence of the Treasury financing, the market generally tended to exaggerate the over-supply. Roughly \$700 million of the daily average of \$1,170 million reserves supplied by System operations was needed to offset reserves drained by market factors and by required reserves. And, in any event, we were able in the May 13 statement week to get the reserve situation back under control while avoiding any general operations to absorb reserves in the market. This happy event was partly planned but mainly the result of good luck. On the planned side, the Treasury had earlier agreed to run its balance with the Reserve Banks on the high side, and in addition we were fortunate enough to be able to sell Treasury bills in some volume directly to foreign accounts. By the May 20 statement week the System had turned into a modest supplier of reserves. On May 18, after payment date for the new Treasury issues, the System made its first purchases of coupon securities in half a year, buying \$113 million in a market go-around, including \$75 million of the issues involved in the Treasury financing. While this particular operation served to reduce the continued overhang of Treasury coupon issues in the market, it was consistent with our basic reserve objectives and reflected the availability of coupon issues relative to Treasury bills.

While I believe market participants are a shade less concerned that increased System attention to monetary and credit aggregates will be to the exclusion

of any attention to money market conditions or to interest rates, an atmosphere of skepticism remains. In particular there is a strong fear that, now the Treasury financing is out of the way, the System may tighten up money market conditions once again in order to restrain further expansion of bank credit and the money supply. Consequently, every move made by the Trading Desk is subject to especially close scrutiny, and the risk of over-interpretation of anything we do has probably never been greater. This attitude, together with the general state of market uncertainty, cautions us to approach day-to-day operations with as much flexibility as we can muster. I might note in passing that even a very modest go-around to sell very short bills last Thursday raised a fair amount of market concern.

Turning to the aggregates, it appears that both money supply and bank credit have been rising faster in May than the Committee desired and are likely to exceed the 4 per cent target over the second quarter as a whole, according to current projections. How much weight we should put on the projections is still hard to determine. I find it interesting, but not particularly illuminating, that the New York Bank's second-quarter projections for both money supply and the adjusted credit proxy, particularly the latter, are weaker now than they were three weeks ago--suggesting that we have made some modest progress towards getting back to the target path. This would be somewhat reassuring were it not for the fact that Board staff projections have moved in precisely the opposite direction and are now much stronger than three weeks ago.

In any event, the growth in money supply clearly registered in April and May indicates that firmer money market conditions than were feasible over the Treasury financing period will probably be required if the Committee wants to work back towards the 4 per cent target for the second quarter as a whole. Given the unsettled near-crisis state of the financial markets, we at the Trading Desk very much need a clearcut view of the intensity with which the Committee wants to resist what is apparently a greater demand for money and credit than had earlier been anticipated or felt desirable. In general, alternative A of the directive drafts^{1/} as presented in the blue book

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

would call for more resistance, while alternative B would accept a 6 to 6-1/2 per cent growth rate for money supply and bank credit for the second quarter. Both versions include a proviso calling for the modification of operations as needed to moderate excessive pressures in financial markets and it would be most helpful to have the Committee's views on how that proviso should be interpreted.

Mr. Mitchell remarked that he thought the Desk had done an excellent job in a very difficult situation during the past three weeks.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period May 5 through 25, 1970, were approved, ratified, and confirmed.

The Chairman then called for the staff economic and financial reports, supplementing the written reports that had been distributed prior to the meeting, copies of which have been placed in the files of the Committee.

Mr. Partee made the following statement concerning economic developments:

It is even more difficult today than it was three weeks ago to reach a judgment, with any confidence, about the course of economic activity over the months ahead. The business statistics, though a little weaker in some areas, are on balance not significantly worse--or better--than had been assumed in staff projections for the Committee. Inventory investment has been sharply curtailed, industrial production relatively well maintained, and personal income bolstered by large additions resulting from the increases, with retroactive features, in social security and Federal pay. This would imply the probability of a bottoming out soon in the business decline, with

moderate economic recovery the likely prospect for the remainder of the year. Unemployment would probably rise moderately further, since the recovery initially is expected to remain below our growth potential, but, by the same token, demand pressures as a factor in inflation would remain in abeyance.

The financial underpinnings for this relatively optimistic projection, however, have grown increasingly suspect in recent weeks. The stock market has declined sharply further, with the New York Stock Exchange composite off now by 24 per cent just since the beginning of April and by 38 per cent from the late 1968 high. This is by far the largest and longest decline of the postwar period. Long-term interest rates have rebounded to earlier peaks, with the Aaa new-issue corporate rate again above 9 per cent and the Bond Buyer's municipal index for the first time above 7 per cent. And rumors of impending financial distress involving both financial and nonfinancial businesses are growing; in a few instances, there is evidence that such rumors may be true. In such an environment, one wonders what may be happening to the strength of future spending and investment plans.

The main potential hazard to the economy, of course, does not lie in the decline that has taken place in paper values, massive as it is, or in the possibility of a few failures or corporate reorganizations. Stock market values do not appear to be particularly important sources of financing for goods expenditures, and financial failures are to be expected from time to time in a risk-taking economy. But these developments both reflect, and add fuel to, a sharply deteriorating public psychology. This is reflected in some of the District reports contained in the new red book^{1/} prepared for the Committee, and it is very evident in the meetings of business and financial people that one attends. There is deep concern with the performance of the economy, exhibiting at the same time the continuation of strong inflationary pressures, rising unemployment, and falling profits and financial asset values. There is underlying concern, also, about the increasing questioning of the social and moral values of our society, and of the quality of life that it produces.

^{1/} The report, "Current Economic Conditions by District," prepared for the Committee by the staff.

Under the circumstances, the sharp decline in the market is widely taken as an index of the trouble we are in, and a flurry of failures now among larger business and financial firms, should it occur, would tend to confirm the worst of these fears. In short, for the first time in my experience, there appears to be some possibility of a crisis of confidence in the viability of our economy. The odds still seem high that anything like this will be averted, and a dramatic improvement in the military situation in Southeast Asia might still do wonders for public psychology. But the very fact that we have reached the point where a confidence crisis seems conceivable must have, unless the trend is quickly reversed, major implications for the economic outlook.

As I pointed out to the Committee last time, the Board's econometric model assigns a significant weight to the value of financial asset holdings as a marginal determinant of spending. The main effect shows up in consumption within a quarter or two, although business fixed investment is influenced later on and there are important secondary effects on inventories and incomes. Taking account of the decline in stock prices that had occurred through last Friday, and assuming that there is neither a further decline nor a recovery, the model would forecast consumption expenditures, by the fourth quarter, \$10 billion lower than otherwise; and a GNP down \$19 billion in current dollars, and \$13 billion in real terms, from what it would be in the absence of the stock price decline. This model projected the course of consumption expenditures very well in the stock market declines of 1957-58 and 1966, but it underestimated spending somewhat following the 1962 market break, when there was little subsequent weakening in the economy. I should point out that the model is, of course, based on average postwar experience, whereas the current market decline has been of considerably larger than average dimensions.

The staff projection presented in the green book^{1/} does not make specific allowance for this possible stock market effect, although we do provide for a relatively high personal savings rate and for a gradual leveling off in business plant and equipment expenditures on

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

other grounds. We will attempt a careful examination of the plausibility of significant weakness in both areas in the chart show planned for the next meeting of the Committee. Meanwhile, we will be watching for signs that secondary effects of the financial market reverses are beginning to appear.

So far, consumption appears to be holding up well. Retail sales, according to the preliminary report, increased about 1-1/2 per cent in April, which would be a comparatively strong showing, and the weekly data thus far in May suggest that sales are holding at about the April level. Domestic new car sales in the first 20 days of May were at a 7.5 million rate, which is a little higher than in the first quarter, although a sales contest for General Motors dealers appears to have affected the most recent 10-day results. The expectation has been for a rise in retail sales, of course, in view of the large additions to the income stream that were paid out in April and early May. On this basis, we have continued our earlier projection of a relatively strong showing in consumer expenditures for the second quarter.

Our current projections, on the other hand, now call for some moderation in the uptrend in business fixed investment. A small further rise is still expected in the aggregate of such spending for the second and third quarters, followed by a leveling off in the fourth, but the increase for the year as a whole has been cut back to 6 per cent from the 8 per cent gain shown in earlier projections. Such an adjustment seems warranted on the basis of the continued flatness in new orders for machinery and equipment, and by the further decline in manufacturers' new capital appropriations reported by the National Industrial Conference Board survey for the first quarter. I am also informed, on a confidential and highly judgmental basis, that early returns from manufacturers in the current Commerce-SEC survey suggest a downward adjustment of 3 to 4 percentage points in planned capital outlays for the year from the 10 per cent gain indicated by the previous survey.

The leveling off in capital spending represents the principal change we have made in our current projection, and accounts for the more modest recovery in real GNP now expected in the second half of the year. This projection, I believe, is a reasonable one, assuming that confidence and spending plans have not been seriously eroded by

financial market developments. The problem is that it seems quite possible that such an erosion is occurring, and that the performance of the economy may therefore fall significantly short of our projections. For this reason, and because there is at present some possibility of real financial distress, I would urge that the Committee's policy for the time being be one of deliberate, accomodative monetary growth. A further increase in interest rates, as well as the indication that markets may be tightening, should be resisted strongly until we can get a better fix on what the problems of the financial markets may mean for the course of business activity.

Mr. Axilrod made the following statement concerning financial developments:

At this point in time, with respect to financial variables, the critical question for the FOMC to consider is whether to adjust upwards the growth rate it is willing to see for monetary aggregates. As the documentation presented to the Committee makes clear, the growth rates for both money supply and bank credit are currently running above what the Committee earlier contemplated. So the practical question is whether, or to what extent, the FOMC should attempt to adjust its reserve policy so as to move these aggregates back toward the moderate growth path previously desired.

Consideration of this question requires some analysis of why the monetary aggregates have been behaving as they have. One reason has to do with the large credit demands on longer-term markets. Since the last meeting of the Committee, long-term interest rates have moved around 20 to 25 basis points higher, as a result of the continued heavy private and Governmental financing demands in combination with a variety of expectational jolts. Municipal as well as corporate and Treasury bond yields have now moved above their late 1969 highs. The pressure on long-term markets both affected and was intensified by the Treasury's mid-May refunding. While more cash was raised through the Treasury refunding than was expected, it was not without its difficult moments and not without some cost in terms of reserves supplied through open market operations.

A second reason for the greater rise in monetary aggregates is partly related to the first. There has been, I believe, an attempt on the part of the public to improve their liquidity. This has occurred for a number of reasons. Consumers may be uncertain about future income prospects--not to mention their eroding wealth positions as stock prices plummet--and as a result may be attempting to increase their saving in the form of liquid assets, such as deposits and savings and loan shares. Moreover, security markets, and particularly the stock market, are in a state of considerable apprehension because of uncertainties about future economic developments as well as about the fabric of society. Under the circumstances, investors have probably moved, at least temporarily, into cash and very short-dated debt instruments.

A third reason for the greater rise in monetary aggregates, particularly the money supply, has to do with price increases. If there has indeed been an upward shift in cash balance demands, the growth in money supply thus far this year--at about a 6 per cent annual rate--has been very little more than the minimum necessary to permit any increase at all in the real value of cash balances, since the GNP price deflator has risen at a rate of more than 5 per cent. And it is presumably the real, and not the dollar, value of cash balances which is relevant to the public when cash is being held for precautionary or similar purposes. I am not saying--it should be clear--that money supply ought to grow more just because the price level is rising more rapidly. What I am saying is that if the public has shifted to wanting to hold, and not spend, more cash in relation to GNP, then this desired cash has to be considered in constant-price terms. If the outstanding money supply is not permitted to rise sufficiently, interest rates or stock yields will rise as the public sells earning assets to seek, insofar as it proves possible, the real cash balances it wants to hold.

Back of these various reasons given for the greater growth in monetary aggregates is the basic presupposition that the nation's liquidity was severely constrained in 1969 and that some effort is now being made, and should be made, to restore it. The liquidity data available are consistent with this hypothesis, even after allowance is made for the secular downward movement in holdings of

cash and liquidity in the post-World War II years. For example, from the first quarter of 1969 to the first quarter of 1970, corporate liquidity ratios have dropped about 5 percentage points, a drop greater than that which occurred between the third quarters of 1965 and 1966, the previous period of severe monetary restraint--and a drop greater than appears consistent with the normal downward trend of the past several years.

As to institutional liquidity, there was, of course, a very sharp decline in the liquidity of banks and savings and loan associations in the course of 1969 and through the first two months of 1970. Since then there has been some improvement, but the position of commercial banks still appears to be about as strained as in the second half of 1966, and savings and loan associations and mutual savings banks still appear to be considerably worse off than in that period--although for S&L's regulatory efforts to make them more content with a reduced level of liquidity have of course been made. These rough aggregate liquidity measures do not, of course, indicate anything about potential trouble spots for individual business firms or financial institutions, including stock houses, except insofar as a sustained strain on liquidity generally increases the probability of particular trouble spots developing.

The liquidity strains of the last half of 1966 were eased in the first half of 1967, and this easing was accompanied by a shift to a 6-1/2 per cent annual rate of growth in the money supply and a 10 per cent growth rate in bank credit, from a period of virtually no change in money during the last half of 1966. I happen to believe that the System's policy in the first half of 1967 was right. The problems that subsequently developed seem to me to have been the result of sustaining the rapid money and bank credit growth over the next 18 months against the background of a dilatory and uncertain fiscal policy.

I believe it would be prudent in the current period to permit a growth in money similar to that of the first half of 1967 in order to help ease the liquidity and other financial market strains now evident in the economy. This should not, of course, be construed as suggesting that the FOMC should continue on such a growth path over a very sustained period. But I would not tighten money markets between now and the next meeting of the Committee in an effort to move back onto the aggregate path adopted at the previous meeting. Rather, one approach over the next few weeks would be to keep the Federal funds rate

at around an 8 to 8-1/8 per cent rate, or even to shade the funds rate lower if that proved necessary to permit at least a seasonal decline in the bill rates and an associated easing in financial market tensions generally. It is possible, but not certain, that more of an expansion in money and bank credit might then ensue over the short run than targeted in either alternative A or B; but the extent to which the Manager permits this to happen would be made to depend on market conditions and with the understanding that the aggregates should not, if at all possible, exceed the levels now projected for June and more desirably might be somewhat lower. A generous interpretation of alternative B might be consistent with this approach--that is, an interpretation that permitted a modest easing of money market conditions over the short run.

In addition to the problem of financial market tensions, there is another reason for encouraging moderation of market interest rate pressures over the next few weeks, even at the cost of a little more expansion in the aggregates than may be desired over the longer run. I would suspect that the real rate of return on capital is now declining, as indicated in part by the current and expected reduced rate of corporate profits. Ordinarily one would expect long-term market interest rates to decline in reflection of a reduced real return on capital. That long-term market interest rates have been rising is under these conditions an anomaly--an anomaly that cannot be explained, I suspect, by rising inflationary expectations, and an anomaly that could, if continued, lead to monetary restraint that is excessive for current economic conditions.

Chairman Burns said it might be useful at this point to remind everyone present of the need to preserve the confidentiality of the Committee's discussions. The Committee's record had been very good in that respect, but it would be well to be especially careful at present in view of the sensitive conditions prevailing in financial markets.

At the Chairman's suggestion the Committee then engaged in a general discussion of the economic and financial situation and

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outlook. Among the subjects considered were the nature and implications of recent changes in liquidity positions and desires, recent and prospective savings flows to nonbank thrift institutions and their implications for housing activity, the effect of strikes on business activity in individual industries and in the economy as a whole, and the outlook for the balance of payments.

With respect to the general economic outlook, Mr. Hickman remarked that, although recent evidence indicated that the economic contraction had continued in April and probably in May, there were signs that the stage had been set for renewed expansion in real activity during the second half of the year, along the lines suggested by the Board staff's projections. A similar assessment had been reached by the group of Fourth District business economists meeting at his Bank on May 15. These economists also were optimistic about improvements in the price situation.

Mr. Hayes observed that recent economic statistics seemed a bit weaker. However, he still saw no evidence of an accelerating downturn and thought that, on balance, the chances of a serious recession were small. On the price issue, businessmen in his district--and he himself--were very discouraged, in contrast to the optimism reported by Mr. Hickman. The decline in stock prices obviously was a source of concern, with consequences for business that were hard to predict. He suspected, however, that the overall effect would be limited. He was, of course, highly concerned

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about existing conditions in financial markets generally, and thought it was clear that those conditions had to be a major factor in the Committee's policy decision today.

Mr. Baughman remarked that the expectations for economic activity of Seventh District economists also tended to resemble those of the Board's staff, as they had for some time. However, the views of businessmen--which had been more optimistic earlier--had shifted, and now were in line with or more pessimistic than those of the economists.

Mr. Francis commented that appropriate policy actions taken in 1969 had inevitably resulted in some cutbacks in production and other well-publicized developments that had disturbed many people. Nevertheless, over-all activity continued at a near-record level and declines in the past six or nine months had been modest compared with those in the postwar recessions.

Mr. Coldwell observed that on some counts--particularly the cutback in business capital spending plans--the longer-run outlook might be said to have improved recently. In his judgment, however, the over-riding consideration at the moment was the crisis of confidence reflected in the decline of common stock prices. He thought the existing psychology was a result of a variety of factors, including events in Cambodia, evidence of persisting inflation, weakness in the economy, and--to some extent--the System's recent shift toward increased emphasis on the monetary aggregates and

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reduced emphasis on money market conditions. The Committee's task now was to provide a background of stability. In general, he concurred in Mr. Axilrod's prescription for policy.

Mr. Kimbrel agreed that confidence was at a low ebb, but he thought that perhaps was traceable more to the price situation than to indications of economic weakness. He wondered whether the current anxiety over developments in the stock market was not exaggerated. In any case, he thought the System might make its best contribution to public confidence by demonstrating its own confidence in the aggregative targets it had set forth in January and February--targets which he still considered appropriate for the longer run. He recognized that the Desk had to have flexibility to deal with current pressures and that it would not be feasible to move back abruptly to the target path of moderate growth in the aggregates, but he hoped those targets would be kept in mind.

Mr. Morris remarked that the sharp decline in security values could have a substantial impact on spending, and called into question other kinds of evidence suggesting that economic activity would turn up as projected.

Mr. Daane commented that the overtones of financial crisis were sufficiently pervasive already to be affecting prospects for the projected rise in real activity in the second half, and if the crisis atmosphere were to deepen the outlook would be materially

affected. In his judgment the Committee's present problem clearly was that of devising ways and means for coping with the emerging financial crisis.

Mr. Swan agreed that the deterioration in psychology appeared to be running considerably ahead of the deterioration in economic activity. Like others, he was concerned about existing conditions in financial markets and thought the System had to do what it could in that area. At the same time, it was worth noting that the problem of inflation was still one of the major sources of uncertainty. Continued advances in prices and perhaps unsophisticated interpretations of recent fiscal policy developments were creating widespread interest in direct wage and price controls. That interest was reaching almost compelling proportions among the public generally and on the part of a great many businessmen.

Messrs. Hayes and Baughman also reported growing interest in their Districts in some form of wage and price controls.

Chairman Burns said that he would agree with much of what had been said about the respective states of business psychology and present economic conditions and the apparent inconsistencies between the two. He thought it would be a mistake, however, to take too much comfort from the indications that the economy had deteriorated less than business psychology; it should be remembered that, to an important extent, the state of psychology today would shape the state of the economy tomorrow.

The Chairman noted that in recent meetings of the Committee a good deal had been said about the threats of recession and inflation. It had been generally recognized that threats of both types existed, although the members had differed in the way they assessed their relative importance. Recession and inflation were, of course, traditional concepts in business cycle theory. But there was a third traditional concept to which, fortunately, it had been unnecessary to pay much attention in the postwar period--the concept of financial crisis. He thought the atmosphere was now one of near-crisis--if in fact a crisis was not already at hand--and that the problems of inflation and recession had to be judged against the background of a possible crisis.

The essential characteristic of a financial crisis, the Chairman continued, was that for any of a large number of reasons people became concerned about the future and sought to get into a liquid position. Normally businesses sought to maximize profits; at other times they concentrated instead on maintaining solvency and their goal became a strong, or relatively strong, liquidity position. It was an atmosphere of this second sort with which the Committee now had to deal.

It was his basic view, Chairman Burns commented, that, if the President were in a position to tell the nation that the Cambodian operation had been successfully completed and that troops were being withdrawn ahead of schedule, the effect on financial

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markets would be electrifying; the present atmosphere of gloom would vanish. He believed that such an announcement would be forthcoming, although probably not in the immediate future. In the meantime, the System had to play the traditional role of a central bank in circumstances such as those now prevailing--by acting as a lender of last resort, by maintaining orderly markets, by keeping interest rates from rising and, if possible, by moderating interest rates somewhat.

The Chairman noted that in recent months the Committee had moved toward increased emphasis on the monetary aggregates in formulating policy. He thought that move had been a constructive one, and that such emphasis remained appropriate--for "normal" times. However, these were not normal times. In view of the current rapid deterioration of business psychology and the possible consequences for the economy and for society, it was necessary temporarily to put aside the objective of moderate growth in the monetary aggregates and to undertake the classical functions of a central bank when a crisis existed--or was near at hand, or seemed to be approaching--however the members chose to describe the present situation.

In sum, Chairman Burns said, he thought that the real economy was basically sound but that it was not likely to remain so unless the deterioration of business psychology was corrected. The basic

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cure probably would have to come from a source other than the Federal Reserve--such as a Presidential statement on Southeast Asia. In the meantime, the Federal Reserve was in a position to make a significant contribution by attending to the liquidity needs of the economy.

Chairman Burns then called for the go-around of comments and views on monetary policy. With respect to the second paragraph of the directive, he noted that in addition to alternatives A and B proposed by the staff there had been distributed other proposals by Messrs. Hayes, Daane, and Mitchell, as well as a modified version of Mr. Hayes' proposal which had been labeled "alternative E."^{1/}

Mr. Hayes began the go-around with the comment that he agreed with the general tenor of the Chairman's observations. He then proceeded with the following statement:

The basic economic situation has not changed appreciably since our last meeting, although most recent statistics suggest if anything a little more weakness than had been expected. Certainly there is no indication of an accelerated decline. Renewed expansion around the middle of the year still seems probable--with, however, a continued updrift in unemployment. The spirit of great uneasiness pervading the financial markets and the country generally represents an intangible factor that is hard to evaluate but could be important. On the other hand, I have the feeling that the current unease is a good deal more acute in financial markets than among businessmen generally.

^{1/} These additional alternatives are shown in Attachment B to this memorandum.

Meanwhile, we are confronted with a continuing upward spiral of wages and prices, and little progress on this front seems likely over the coming months. Expectations of further inflation are widespread and deeply imbedded. Efforts to improve our trade balance are being largely frustrated by persistent inflation.

I feel much troubled over the outlook for the Federal budget. A number of developments could produce a deficit for fiscal 1971 well above the latest official estimate, and this at a time when monetary policy needs a strong fiscal ally. The prospective heavy volume of Treasury borrowing in the second half of calendar 1970 will complicate our task of maintaining moderate expansion of the monetary aggregates, which already show signs of excessive growth in the current quarter. The credibility of our anti-inflation effort might be further jeopardized if we were to publish increases at annual rates of 6 per cent or more in the money supply over an extended period.

I would favor retaining a growth rate of roughly 4 per cent for the money supply as the longer-run objective of policy, bank credit being a less useful target under present circumstances. I therefore reject the idea of actively seeking more liberal growth rates as suggested by alternative B of the directive drafts. At the same time, however, I am acutely aware that the current state of the financial markets means that attempting to get back to appropriate growth rates in a short period of time might prove disastrous for financial markets and for interest rates. I would be willing to accept a temporary expansion in growth rates of the monetary aggregates to the extent that this is required to avoid further pressures in financial markets. In other times, the current low state of confidence and the fears of a liquidity crisis might suggest a very liberal approach on the part of the Desk. But in the present setting, with much of that lack of confidence attributable to defeatism on the whole anti-inflation campaign, the Manager will have to walk a thin line between equally dangerous hazards. I have given the Secretary suggested language for a variation on directive A, and have asked him to circulate it. The Secretary has distributed a further modification of this directive, labeled alternative E, and I find this quite acceptable. I would also suggest a small change of wording in the first paragraph, in recognition of the fact that growth of the money supply in May is apparently rapid.

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After discussion of Mr. Hayes' final point, it was agreed that the statement in question should be revised to read "... in May... the money supply appears to be expanding rapidly."

Mr. Francis remarked that, as the Committee knew, he had been deeply concerned about the risk that the monetary aggregates would expand at a rate that would delay the cure of inflation. Although he continued to be concerned on that score he was impressed by the Chairman's analysis of the situation. Accordingly, for the directive he was prepared to support alternative E, which he understood would permit whatever rate of expansion was necessary to cope with the immediate situation. However, he looked forward to the time when it would be possible to return to the Committee's longer-run objectives for the aggregates.

Mr. Kimbrel said that he, too, would like to return to the longer-run objectives when possible, but would favor alternative E today in view of the Chairman's statement and other comments.

Mr. Eastburn said that alternative E also seemed appropriate to him. However, he hoped the Manager would keep the Committee's longer-run objectives in view to the extent possible while coping with the immediate situation in the market. That seemed to be particularly desirable when one looked ahead to the problems the Committee might be facing in the latter part of the year. Given the lags in monetary policy, the Committee might want to be

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pursuing a fairly restrictive policy then, but even keel considerations were likely to be in effect about half the time.

Mr. Hickman said he concurred in Mr. Eastburn's comments. It seemed clear that the Committee could not return now to its earlier target path of 4 per cent annual rates of growth in bank credit and the money supply for the second quarter, given the reserve injections already made in connection with the Treasury financing, the conditions prevailing in financial markets, and the fact that a failure to meet the large liquidity demands of the public could cause an undesirable contraction of business and consumer spending. While he did not like the wording of the staff's alternative B, he thought the target growth rates for the aggregates associated with that alternative were more appropriate to the current situation. Because of the crisis atmosphere existing, he would view upward deviations from those targets as more acceptable in the period until the next meeting than was normally the case. He would not, however, want to depart from the longer-run target paths for an extended period and hoped that, by the time of the next meeting, the pressures in financial markets would have been greatly reduced. On balance, he favored alternative E for the directive.

Mr. Sherrill also found alternative E acceptable. He thought the Chairman's description of the prevailing situation was

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accurate. There was little doubt that the Committee was faced with a crisis--in confidence if not in any more fundamental sense--but he believed that it would be relatively short-lived; it was likely that the situation would be calmed by an announcement of the conclusion of U.S. operations in Cambodia, and perhaps also by the beginning of summer vacations at the nation's colleges.

Meanwhile, Mr. Sherrill said, it was essential to avoid further deterioration of conditions in financial markets. He considered that to be of great importance because he agreed with Chairman Burns that the state of psychology during this crisis period could have significant implications for the real economy over the longer run.

Mr. Brimmer remarked that he did not share the view that the present situation was one of crisis; if he did, he would favor more drastic policy measures than contemplated by alternative E. In his judgment it was correct to say that financial markets were under considerable strain. He agreed that the System should do what it could to moderate the strain. At the same time, it should keep an eye on its longer-run targets for bank credit and the money supply--and, more fundamentally, on its goal of bringing about some reduction in the rate of inflation.

In effect, Mr. Brimmer continued, the Committee was being temporarily diverted from its desired course by the need to cope

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with the immediate situation. He thought the directive should convey the impression that that development was the consequence of unfortunate happenstance. Specifically, he would propose a modified version of alternative E in which the opening sentence was divided into two, reading as follows: "To implement this policy, the Committee desires to see only a moderate growth in money and bank credit over the months ahead. However, it recognizes that current market uncertainties and liquidity strains make it necessary to accommodate--temporarily-- somewhat larger growth rates in the near term than would be desirable in the longer run." The concluding sentence would be identical to that of alternative E.

Mr. Maisel remarked that the Committee was properly dividing the issue facing it into two parts--relating, respectively, to its general policy posture and to the kind of provisos it should add. Unlike Mr. Brimmer, he would consider it improper to suggest that the Committee intended to deviate only temporarily from its earlier targets. Indeed, he thought alternative E, even before Mr. Brimmer's proposed modifications, went too far in that direction, and that the staff's alternative B was better in that respect.

What was called for today, Mr. Maisel continued, was not an authorization for the Manager to deviate temporarily from earlier targets but an instruction to the Manager for the next four weeks to

seek more rapid growth in the aggregates. At the previous meeting he had favored somewhat higher target growth rates than were in fact selected, in order to compensate for the unduly low levels that had resulted from the negative growth rates for most of the aggregates in the past year. Now there were two additional reasons for favoring more rapid growth. First was the increased demand for liquidity. In his judgment, the accommodation of shifts in the liquidity function was a basic responsibility of the Committee--not something it should be willing to do only temporarily or grudgingly. Secondly, although the staff had not changed substantially its point estimates of GNP in coming quarters, the probabilities of sizable downward deviations from those estimates had greatly increased. On that account also the Committee should be prepared to seek somewhat higher growth rates in the aggregates, as called for by alternative B.

The remaining question concerned the Manager's mode of operations under such a directive, Mr. Maisel said. Obviously the Manager should be very cautious if he thought it was necessary to lower total reserves in order to bring the annual rate of growth in M_1 in the third quarter down to the 5 per cent target specified under alternative B. Operations should be conducted very carefully and flexibly vis-a-vis market conditions, rate movements, and the impact on the market's view of Federal Reserve targets.

Mr. Maisel observed that such caution was particularly necessary since the most recent estimates of the aggregates were suspect. He would not feel unduly alarmed if the levels of the aggregates were somewhat above the targets in June. However, while the alternative B targets should be treated as minimums, he hoped that they would not be exceeded by more than half the difference between the June and July targets under that alternative.

On that basis, Mr. Maisel concluded, he would have no objection to replacing the second sentence of alternative B with the second sentence of alternative E, which began "Open market operations until the next meeting of the Committee...."

Mr. Daane observed that he had arrived at his preferences for the directive against the background of his disquiet regarding the financial situation. If he were acting on his own he would favor a directive of the sort he had had distributed before the meeting--calling for moderation of existing pressures on the money market whatever the implications for the aggregates. However, in light of the views of other Committee members concerning the aggregates, he was prepared to accept alternative E with certain modifications.

In his judgment, Mr. Daane continued, the need was to issue instructions to the Desk that would permit it to show its hand

in the market in which it operated. He thought that objective could be encompassed within alternative E if the first sentence was revised by deleting the words "only a" before "moderate growth," and the word "somewhat" before "larger growth rates;" and by substituting "temporarily" for "in the second quarter." The sentence would then read, "To implement this policy, the Committee desires to see moderate growth in money and bank credit over the months ahead, but it recognizes that current market uncertainties and liquidity needs require larger growth rates temporarily than would be desirable in the longer run."

Those changes would be helpful, Mr. Daane believed, partly because it was not clear at present how much of an increase in growth rates would be involved in meeting liquidity needs, nor how long the higher growth rates were likely to be required. Also, in the next sentence he would suggest deleting the standard phrase "until the next meeting of the Committee" after the words "open market operations," because the need to moderate pressures might be quite temporary. However, he felt less strongly about that suggestion than about the others.

Mr. Mitchell remarked that the problem the Committee was concerned with might appear to be wholly one of semantics. He thought, however, that there was a more fundamental matter involved--namely, a concern that the Committee might find itself

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backing away from the policy posture it considered best for the long run. The recent success in arresting the inflationary psychology of investors had been a year or so coming, and it would be unfortunate if that gain was now dispelled by an indication to the market that easy money was here again. Thus, the choice of directive language was of some importance from the point of view of the record as well as in connection with instructing the Manager.

Mr. Mitchell observed that he did not like the staff's alternative B but he could accept alternative E, perhaps with some of the amendments that had been suggested. He also had an amendment of his own to propose; he would prefer to say that current market uncertainties and liquidity needs "now entail"--rather than "require"--larger growth rates in the aggregates. He also agreed that the reference to the second quarter in that clause was undesirable because it was not possible to say how long the current difficulties would last.

Mr. Black said he favored alternative E as modified by Mr. Mitchell.

Mr. Tow remarked that he found alternative E acceptable, in part because it made clear that the Committee was maintaining its basic goal of moderate growth in money and bank credit and was deviating from that goal only on a short-term basis. He was

not disturbed by the reference to the second quarter, because it should be obvious that the duration of the current difficulties could not be predicted at this time and because the Committee would be meeting again before the end of the quarter.

It was apparent, Mr. Tow continued, that it would be necessary to pay increased attention to money market conditions in coping with existing strains. He hoped, however, that money market conditions would not be eased--and growth in the aggregates stimulated--any more than necessary, and he assumed that that was the intention underlying the final clause of alternative E. At times in the past when the System was pursuing an expansive policy it had unintentionally let its policy become too expansive, as the cumulative result of actions taken at successive meetings. He thought caution was needed to prevent that from happening again.

Mr. Baughman observed that the general format of several of the proposed directives was to indicate the Committee's allegiance to the longer-term goal of moderate growth in money and bank credit while accepting the need to ease pressures in financial markets in the short run. He thought that posture was appropriate under the circumstances and had no objections to the specific language of alternative E.

Mr. Galusha said alternative E was quite satisfactory. Unlike Mr. Daane, he would not want to delete the word "somewhat" before

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"larger growth rates" or to remove the reference to the second quarter. He noted that today's directive would not be released for 90 days, when the current crisis in financial markets presumably would be a matter of history. If the qualifying terms in question were not included readers at that time might conclude that the Committee had overreacted to the present situation by moving further toward ease than necessary. The Committee had been the target of such criticism in the past--he thought deservedly. He hoped that in dealing with the present temporary situation it would be possible to stay reasonably close to the longer-run goals.

Mr. Swan remarked that the Committee members appeared to be essentially in agreement regarding the basic needs of the present situation. He could accept alternative E for the directive, preferably with the modifications suggested by Messrs. Daane and Mitchell. He thought, however, that the first sentence of E was rather confusing, and that it was likely to be even more confusing when the directive was published in 90 days. It seemed to him that a more straightforward second paragraph was desirable, such as the following:

"To implement this policy, in view of current market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall be conducted with a view to moderating pressures on financial markets, while, to the extent compatible therewith, maintaining bank

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reserves and money market conditions consistent with the Committee's longer run objectives of moderate growth in money and bank credit."

Mr. Coldwell remarked that he had planned to suggest directive language similar to that Mr. Swan had proposed. In his judgment the key question facing the Committee today was whether or not a crisis existed or was approaching. If the answer was affirmative, the central bank's main responsibility was to preserve the stability of financial market conditions, even if that meant giving up longer-run objectives temporarily. In his judgment the prime focus of the directive should be on the objective of moderating financial market pressures, as in the first part of Mr. Swan's proposal, and it might even be desirable to delete for the time being the remaining language concerning longer-run objectives. One other possibility would be to add a proviso clause relating to possible further deterioration in financial markets, but he did not think such a clause was required at present.

Mr. Morris asked how the Manager would interpret the difference between an instruction to operate, on the one hand, "with a view to moderating pressures on financial markets," as in alternative E and Mr. Swan's proposal; and, on the other hand, "with a view to attaining somewhat easier money market conditions," as in the proposal of Mr. Daane's that was distributed before the meeting.

In reply, Mr. Holmes said that he would interpret alternative E and Mr. Swan's language as being consistent with stable money market conditions in the event it proved possible--as he thought it might--to moderate pressures in financial markets without moving the Federal funds rate down below its recent levels around 8 per cent. In contrast, he would interpret Mr. Daane's proposed language as calling for easier money market conditions whether or not easier conditions were required in order to moderate financial market pressures.

Mr. Morris then said he could support alternative E, but he thought that the modifications proposed by Mr. Swan were quite sensible. It was desirable to make clear in the record that the Committee was deviating temporarily from its longer-run objectives in order to deal with the crisis in financial markets, and he considered Mr. Swan's proposal better in that respect.

Mr. Robertson made the following statement:

We are passing through a phase of our cooling-off process that is particularly conducive to exaggerated reactions--and we are certainly seeing some of those around us. Moreover, there is no law that such reactions have to meet our usual standards of consistency. So the stock market can drop under the weight of punctured profit expectations, the bond markets can sag under the cloud of seemingly endless offerings, and both amateur and professional economy-watchers can conclude that the Administration game plan for controlling the inflation is a failure.

To be sure, the feeling that "things are out of control" in this country extends well beyond the economic sphere. What that does to the economic

system is to sap some of its confidence and resilience, making it still more sensitive to shocks. Thus, with hopes reduced and fears heightened, I think it should be no surprise that a rising number of cries for help are being directed at the Federal Reserve.

In this kind of atmosphere, I am convinced that the best prescription for monetary policy is to display a steady hand on the tiller and a cool head at the helm. Dumping reserves into the banking system to try to assuage liquidity fears would be counterproductive, I think, both in the short run and in the somewhat longer run. Its immediate effect could be to make the Federal Reserve also seem panicky; and over the weeks and months ahead it could give rise to expectations of renewed tightness on the assumption that the Fed would try to reel back in the monetary bulge that would be the inevitable consequence of any bail-out operation.

I grant that many of the considerations here are matters of degree. A modest easing up on our part runs less of these risks than would a drastic move. But on balance I favor trying to hold as closely as we reasonably can to a moderate monetary course. This means that I would like the Trading Desk to try to keep edging back toward the moderate growth rates in the aggregates set down in the last blue book and further amplified in the latest blue book in the paragraph associated with alternative A for the directive. I am concerned enough about what the blue book calls "the fragility of market conditions" so that I would not urge any abrupt move in this direction. I would not even want the Manager to be as strenuous in his aggregate-taming efforts as he was during April, following our previous aggregate bulge. In effect, I want him to stop short of efforts that could cause a significant further rise in interest rates. But I would encourage him to press gradually, when and as he can without so elevating interest rates, in the direction of the 7 per cent and 4 per cent annual rates of growth in bank credit and money, respectively, that were targeted for alternative A in the blue book.

This seems to me the course of action most likely to harmonize our short-run and long-run objectives. With this view in mind, I would vote in favor of the language of draft alternative A, interpreted along the foregoing lines, or alternative E if interpreted in the same way.

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Chairman Burns observed that all of the members, with the possible exception of Mr. Maisel, apparently were willing to accept some variant of alternative E or Mr. Swan's proposal for the second paragraph of the directive.

Mr. Maisel asked how the Manager would interpret those alternatives.

Mr. Holmes said he saw no operational implications to the differences in language. He thought that both would call for operations to moderate the pressures in financial markets if they continued. On the other hand he assumed that, if the pressures should suddenly disappear, under either directive the Committee would want the Desk to move back toward the longer-run targets for the aggregates associated with alternative A in the blue book.

Mr. Maisel then asked about the speed with which the Manager would propose to move back to the alternative A targets in the event the pressures disappeared. He noted that he would not be prepared to vote favorably on the directives in question if he thought the contemplated move was too rapid.

Mr. Holmes replied that any such move would be quite slow and gradual.

The Chairman asked whether the Manager would attempt to accomplish the move in question by the time of the next meeting if the pressures disappeared, and Mr. Holmes replied in the negative.

Chairman Burns then noted that an amended version of alternative E, reflecting certain of the suggestions made in the go-around, had been worked out. The final sentence was unchanged from the original, and the preceding language read as follows: "To implement this policy, the Committee desires to see moderate growth in money and bank credit over the months ahead. However, it recognizes that current market uncertainties and liquidity strains may now entail larger growth rates than would be desirable in the longer run." He proposed that the Committee members be polled informally on each of the three main possibilities--alternative E in its original form and as amended, and Mr. Swan's proposal.

Following the polls, the Secretary reported that the preferences of members appeared to be about evenly divided between Mr. Swan's proposal and the amended version of alternative E, with the latter favored by Messrs. Hayes, Brimmer, Francis, Hickman, Mitchell, and Robertson. However, all members had indicated that they would find Mr. Swan's proposal acceptable.

The Chairman then suggested that the Committee vote on a directive with a first paragraph consisting of the staff's draft amended in the manner Mr. Hayes had suggested earlier, and Mr. Swan's proposed language for the second paragraph.

By unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute

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transactions in the System Account
in accordance with the following
current economic policy directive:

The information reviewed at this meeting indicates that real economic activity declined more than previously estimated in the first quarter of 1970, but little further change is projected in the second quarter. Prices and costs generally are continuing to rise at a rapid pace, although some components of major price indexes recently have shown moderating tendencies. Since early May most long-term interest rates have remained under upward pressure, partly as a result of continued heavy demands for funds and possible shifts in liquidity preferences, and prices of common stocks have declined further. Attitudes in financial markets generally are being affected by the widespread uncertainties arising from recent international and domestic events, including doubts about the success of the Government's anti-inflationary program. Both bank credit and the money supply rose substantially from March to April on average; in May bank credit appears to be changing little while the money supply appears to be expanding rapidly. The over-all balance of payments continued in considerable deficit in April and early May. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, in view of current market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall be conducted with a view to moderating pressures on financial markets, while, to the extent compatible therewith, maintaining bank reserves and money market conditions consistent with the Committee's longer run objectives of moderate growth in money and bank credit.

Chairman Burns then noted that a memorandum from the directive committee, entitled "Publication of material related to the study of

the directive," had been distributed on April 28, 1970.^{1/} He invited Mr. Maisel to comment.

Mr. Maisel said that, in accordance with the memorandum the Chairman had mentioned, he would recommend that the Open Market Committee approve the publication of the staff papers that had been submitted to the committee on the directive and that constituted appendix D of the committee's report. He would not recommend publishing the report itself or appendixes A, B, and C, the last of which contained the staff recommendations.

Mr. Maisel expressed the view that publication of the staff papers would improve understanding of how the Federal Reserve had operated both in the past and under the current directive. It seemed clear to him that there had been a fair amount of misunderstanding about what had been done and what was being done. The Editorial Committee for the Federal Reserve Bulletin would be responsible for the order and timing of publication of the individual papers and for ensuring that they met the proper standard of competence. It would be made clear that the views expressed were those of the individual authors. He thought that if the papers were published in a careful manner there would be highly positive results, both in making the facts clear and in demonstrating the System's concern over the matters considered.

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

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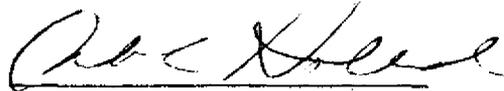
After discussion the Chairman suggested that the Open Market Committee approve the directive committee's recommendations, subject to the understanding that proposals by the Editorial Committee to publish staff papers would be reviewed by the Board and, if the Board's reaction was favorable, by the Open Market Committee.

There was general agreement with the Chairman's suggestion.

In a final observation Chairman Burns said he had found useful the initial issue of the red book and he considered the experiment a success thus far. For later issues he would suggest a somewhat fuller summary at the front. Also, he would suggest that an effort be made to get some information on what might be called the "quality" of consumer purchases. For example, were new car buyers interested in a great deal of optional equipment or were they favoring stripped-down models? Were department store customers tending to shop in the main store or in the basement departments? He had found information of that type quite helpful at times in the past when economic conditions resembled those of today.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, June 23, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.


Secretary

Attachment A

May 25, 1970

Drafts of Current Economic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on May 26, 1970

FIRST PARAGRAPH

The information reviewed at this meeting indicates that real economic activity declined more than previously estimated in the first quarter of 1970, but little further change is projected in the second quarter. Prices and costs generally are continuing to rise at a rapid pace, although some components of major price indexes recently have shown moderating tendencies. Since early May most long-term interest rates have remained under upward pressure, partly as a result of continued heavy demands for funds and possible shifts in liquidity preferences, and prices of common stocks have declined further. Attitudes in financial markets generally are being affected by the widespread uncertainties arising from recent international and domestic events, including doubts about the success of the Government's anti-inflationary program. Both bank credit and the money supply rose substantially from March to April on average; in May bank credit appears to be changing little while the money supply is expanding further. The over-all balance of payments continued in considerable deficit in April and early May. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, the Committee desires to see moderate growth in money and bank credit over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective; provided, however, that operations shall be modified as needed to moderate excessive pressures in financial markets, should they develop.

Alternative B

To implement this policy, the Committee desires to see somewhat greater growth in money and bank credit over the months ahead than previously sought. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective; provided, however, that operations shall be modified if excessive pressures develop in financial markets, or if implementing actions are leading to unduly easy money market conditions.

Members' proposals for second paragraph of current economic policy directive distributed in advance of meeting

Mr. Hayes' proposal:

To implement this policy, the Committee desires to see only a moderate growth in money and bank credit over the months ahead, but it recognizes that current market uncertainties and liquidity needs may require somewhat larger growth rates in the second quarter than would be desirable in the longer run. Open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with the Committee's longer run objectives; provided, however, that somewhat greater growth of money and bank credit may temporarily be accommodated if this proves necessary to avoid excessive pressure in financial markets.

Mr. Daane's proposal:

To implement this policy, the Committee desires to see continued moderate growth in money and bank credit over the months ahead. Under present circumstances in financial markets, however, System open market operations shall be conducted with a view to attaining somewhat easier money market conditions, even if this results, temporarily, in greater than previously desired growth in money and bank credit.

Mr. Mitchell's proposal:

To implement this policy, the Committee recognizes the desirability of accommodating for the time being a somewhat greater growth in money and bank credit than it has previously sought. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective; provided, however, that operations shall be further modified if excessive pressures develop in financial markets or if implementing actions are leading to unduly easy money market conditions.

Modified version of Mr. Hayes' proposal ("Alternative E"):

To implement this policy, the Committee desires to see only a moderate growth in money and bank credit over the months ahead, but it recognizes that current market uncertainties and liquidity needs require somewhat larger growth rates in the second quarter than would be desirable in the longer run. Open market operations until the next meeting of the Committee shall be conducted with a view to moderating pressures on financial markets, while, to the extent compatible therewith, maintaining bank reserves and money market conditions consistent with the Committee's longer run objectives.