

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 21, 1974, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Black
Mr. Brimmer
Mr. Bucher
Mr. Clay
Mr. Holland
Mr. Kimbrel
Mr. Mitchell
Mr. Sheehan
Mr. Wallich
Mr. Winn

Messrs. Coldwell, MacLaury, Mayo, and Morris,
Alternate Members of the Federal Open
Market Committee

Messrs. Bales and Francis, Presidents of
the Federal Reserve Banks of San Francisco
and St. Louis, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. Nicoll, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Brandt, Bryant, Davis, Doll, Gramley,
Hocter, Parthemos, Pierce, and Reynolds,
Associate Economists

Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market
Account

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Mr. Melnicoff, Managing Director for
Operations and Supervision, Board
of Governors
Mr. Chase, Adviser to the Board of
Governors
Mr. Coyne, Assistant to the Board of
Governors
Mr. Wonnacott, Associate Director,
Division of International Finance,
Board of Governors
Messrs. Keir and Williams, Advisers,
Division of Research and Statistics,
Board of Governors
Mr. Gemmill, Adviser, Division of
International Finance, Board of
Governors
Mr. Struble, Senior Economist, Division
of Research and Statistics, Board of
Governors
Miss Pruitt, Economist, Open Market Secretariat,
Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant,
Board of Governors

Mr. Willes, First Vice President, Federal Reserve
Bank of Philadelphia
Messrs. Eisenmenger, Boehne, Scheld, and
Sims, Senior Vice Presidents, Federal
Reserve Banks of Boston, Philadelphia,
Chicago, and San Francisco,
respectively
Messrs. Jordan and Green, Vice Presidents,
Federal Reserve Banks of St. Louis and
Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve
Bank of Minneapolis
Mr. Cooper, Assistant Vice President, Federal
Reserve Bank of New York

Chairman Burns noted that Mr. Brimmer had recently submitted his resignation as a member of the Board of Governors, effective August 31, 1974, at which time he would join the faculty of Harvard University's Graduate School of Business Administration. Mr. Brimmer's letter to the President had included the following observations:

In leaving the Board, I would like to stress that I am not resigning because of any policy disagreements with my colleagues on the Board. I have found my service both exhilarating and highly satisfying. To serve as a Member of this Board is truly a rare--and perhaps unique--privilege. The strategic importance of the Federal Reserve's role in national economic policy is self-evident. During my years on the Board, there has been almost a complete change in membership, but the spirit of nonpartisan cooperation and commitment to the furtherance of the nation's interest on the part of Members has not changed at all. And in carrying out the assignment given to us by the Congress, we have had the dedicated and impartial support of what I believe is the best professional staff in the Federal Government. I am especially indebted to a number of its individual members for support over the years.

The Chairman remarked that he had found those comments highly gratifying. Everyone in the System could be proud of the dedication Mr. Brimmer had displayed during his period of public service and of the distinction accorded him by his appointment to Harvard. On behalf of everyone present, he wanted to thank Mr. Brimmer and extend best wishes to him.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on April 15-16, 1974, were approved.

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The memorandum of discussion for the meeting of the Federal Open Market Committee held on April 15-16, 1974, 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 period April 16 through May 15, 1974, and a supplemental report covering the period May 16 through 20, 1974. Copies of these reports have been placed in the files of the Committee.

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

For most of the period since the last meeting of the Committee the dollar remained under pressure. As more detailed balance of payments figures have become available, the reasons for the steady slide of the dollar since last January have become somewhat clearer. The main trouble has apparently come from bank lending where loans and various placements abroad have risen by the remarkable figure of over \$6 billion between February and April. Other major categories in the balance of payments, such as trade and long-term capital investment, also deteriorated. Meanwhile, the German trade figures have continued to show exceptional strength, while the British, Japanese, and probably others have been over-financing their payments deficits, partly by recourse to U.S. bank credit. As dollar rates have steadily eroded since last February, the leads and lags and other forms of speculation have inevitably turned against us. Watergate continues to have a severely

depressing effect, and from time to time it has become the dominant factor in the market. This convergence of adverse influences has overwhelmed the benefits we had hoped to get from rising short-term interest rates here.

In this unpleasant situation, we have been forced to pursue a sort of rearguard action, limiting our intervention to instances in which unduly sharp declines of dollar rates were threatening to create disorderly market conditions. Since the last meeting of the Committee we have been particularly cautious, intervening to the extent of no more than \$40 million while allowing the dollar rate against the mark to weaken further. Last week that rate fell to a level somewhat more than 20 per cent below the January peak. During the last 2 weeks or so, however, we became increasingly concerned that we could be getting dangerously close to the kind of psychological situation in the market that had triggered the sudden flight from the dollar last July. So, on the weekend preceding the last BIS meeting, I had long discussions with the new President of the Swiss National Bank and the head of the Foreign Department of the German Federal Bank. These talks led to agreement on the desirability of coordinated intervention not only by the German Federal Bank and the Federal Reserve, but also by the Swiss National Bank, acting on its own, if dollar rates should decline further to dangerously low levels against the mark and the Swiss franc. Last Tuesday, as I was flying back from Europe, the dollar moved down close to the levels at which such coordinated intervention would have taken place. But then, a report of the intervention plan suddenly appeared on the ticker and the dollar rebounded sharply. We continue to get a free ride out of this report and others suggesting that we are secretly intervening. The dollar is currently trading about 4 per cent above the lows reached a week ago without any actual intervention by the Swiss, Germans, or ourselves.

It seems to me that the favorable market reaction to leakage of the intervention plan underlines the importance of broadening out somewhat our intervention to currencies other than the mark. If the dollar slumps back--and the latest weekly balance of payments figures are hardly encouraging--I am hopeful that the Swiss National Bank will remain prepared to buy dollars outright in moderate amounts, while the Federal Reserve

and the German Federal Bank operate in marks. I can see still further advantages to be gained from simultaneous, although perhaps only symbolic, intervention in Japanese yen. The Bank of Japan might be prepared to see us draw small amounts on the Japanese swap line on the basis of the same 50-50 profit and loss sharing arrangement that we have with the German Federal Bank. If so, I hope that the Committee would have no objection to a pilot operation on this basis if market developments should suggest that it would be helpful.

By unanimous vote, the System open market transactions in foreign currencies during the period April 16 through May 20, 1974, were approved, ratified, and confirmed.

Mr. Coombs then noted that eight System swap drawings on the German Federal Bank, totaling \$251.3 million, would mature for the first time in the period May 28 through June 26, 1974. He would recommend the renewal of those drawings at maturity.

Renewal of System drawings on the German Federal Bank maturing in the period May 28 through June 26, 1974, was noted without objection.

Secretary's note: Prior to this meeting two reports by Governor Brimmer, on the eleventh annual meeting of Governors of Central Banks of the Western Hemisphere and on his visit to Trinidad and Tobago, and a report by Governor Wallich on the May meeting of the C-20 Deputies, were distributed to the Committee. Copies of these reports are appended to this memorandum as Attachments A, B, and C, respectively. Also appended, as Attachment D, is a report on developments at the May Basle meeting, at which the System was represented by Chairman Burns, Governor Sheehan, and Mr. Coombs.

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 presented the following statement:

Data becoming available since the last Committee meeting appear to confirm the expected bottoming out in aggregate economic activity. Nonfarm payroll employment rose in April, and the February and March figures were both revised up substantially. Employment in manufacturing increased in April for the first time in 5 months, mainly reflecting the recall of auto workers.

While there has been some strengthening in labor demand, the April decline in the unemployment rate to 5.0 per cent was mainly the consequence of a reduction in the labor force.

As you know, there was a sharp drop in the average workweek in manufacturing in April. However, this appears to have reflected principally the occurrence of Good Friday during the survey week, and this fact was taken into account in the estimate that industrial production rose 0.4 per cent in April. In the main, the gain was related--directly or indirectly--to increased auto assemblies, but production of business equipment did move up by 1/2 per cent, and the March figure for this category was revised up to show a rise of that magnitude also.

Apart from these April developments in industrial production and employment, the information coming in over this past month has been on the discouraging side. The decline in real GNP during the first quarter now reported by the Bureau of Economic Analysis is a little larger than had earlier been estimated. However, the downward revision was principally in inventory investment, and the statistics for this sector of GNP may be misleading. Net exports were revised up, while the estimate of domestic final purchases was not changed much.

Thus far in the second quarter, consumer spending has remained in the doldrums. Outside of autos, retail sales in April were sluggish, and the improvement in auto sales since the end of the oil embargo has been weak. Sales of small cars have been particularly disappointing. For domestic-type small cars, we had expected sales to be limited by production capabilities until late this year. Instead, unit sales have been

generally declining since January, and inventories have built up to rather ample levels. Unit sales of imports declined further in April and are now one-fourth below the level early this year.

In the housing market, too, the additional strength we had been looking for over the spring and summer months is being called into question. True, housing starts rose in April, but permits declined, and the trend in starts and permits over the past 7 months has been basically flat.

Savings flows to nonbank intermediaries, moreover, deteriorated somewhat more than we had expected in April, and deposit experience in early May at both New York City mutual savings banks and California savings and loan associations appears to have been quite unfavorable. The Administration's new housing program will add support to the housing market later this year and on into 1975. But the outlook for savings flows has worsened enough so that, on balance, the prospects for housing do not seem materially stronger now than a month ago.

One of the principal underpinnings of the recovery the Board staff has been projecting, as you know, is the projected continuation of growth in business fixed investment outlays. Indicators of activity in this sector are hard for me to interpret. The March-April rise in business equipment production was encouraging; so also was the sustaiment of expenditure anticipations in the latest McGraw-Hill survey. Unfilled orders, moreover, are still mounting, and there are qualitative reports in the red book^{1/} of continued strength in capital outlays. But there are some worrisome signs of prospective weakness, too. Construction contracts for commercial and industrial floor space in the first quarter were 17 per cent below the third quarter of 1973--a decline that is probably attributable mainly to the effect of the oil shortage on commercial building. And new orders for nondefense capital goods in real terms have shown little, if any, increase over recent months.

On the price side, the drop in farm and food prices has provided some relief from the rapid rise in prices of nonfood commodities and services. As you know, the

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

April rise in the over-all wholesale price index was the smallest since last October. Since mid-April, there has been some decline also in prices of sensitive industrial materials, particularly metals and textiles. BLS will release figures this morning showing a 0.6 per cent rise in the consumer price index in April--the smallest increase since December--as food prices were off 0.4 per cent on the month.

A disappointing feature of recent wage-price experience has been the uptick in the trend of wage rate increases in recent months. The first-quarter rate of rise in average hourly earnings reported a month ago seemed too low to be true, and it was. Statistics for February and March were both revised up, and the April rise was the largest so far this year. The annual rate of increase in the average hourly earnings index over the last 3 months now measures 7-1/2 per cent.

Taking recent developments into account, our staff has shaded downward its projection of real GNP growth for the year ahead, and shaded up once again its estimate of the rate of price increase. The lower estimates of real growth reflect principally a judgment that earlier projections of consumer auto buying were over-optimistic. We have not yet been led to alter materially our projection of continued expansion in business fixed investment.

The over-all contours of our projection through mid-1975 are thus not greatly different from what they were a month ago. Real GNP expansion is expected to be moderate, the unemployment rate is projected to rise, and the rate of inflation is projected to taper off, but mainly because of an expected slowdown in the rise of food and fuel prices.

Let me note in closing that our GNP projection makes no allowance for the effects of uncertainties arising from recent signs of instability in financial markets. There are reports that commercial paper of less than highest quality has become difficult to sell, that some banks other than Franklin National are facing significant liquidity pressures, and that some nonfinancial borrowers--particularly, the REIT's--are having trouble securing borrowed funds. But we do not know whether expenditure plans of businesses or consumers are being

curtailed, or if so, by how much. We do feel, however, that the threat of financial instability represents a negative factor with potentially strong implications for real economic expansion. At this juncture, the risks of real GNP growth falling short of our projection are, in my judgment, considerably greater than the risks of an over-run.

Mr. Brimmer said that, in connection with a speech on public utility financing he would be making at a meeting of the Wharton School Club tomorrow, he had asked economists at the twelve Reserve Banks to obtain certain information from utilities in their areas. The results lent support to Mr. Gramley's concluding comment about possible difficulties in financial markets.

As he would indicate in his speech, Mr. Brimmer observed, many utilities were not able to maintain the 2-to-1 ratio of earnings to interest costs which most investors preferred, and bond rating services had lowered the ratings of debt issued by a large number of public utilities so far this year. In fact, through May 13 the rating services had announced as many reductions or suspensions of public utility ratings as in all of 1972 and 1973. Although most public utility commissions permitted automatic rate adjustments for increased costs of fuel and purchased electricity, the commissions were not accelerating the process of granting general rate increases. The resulting impairment of earning ability was increasing the utilities' difficulty in raising funds. Their financing problem would be

compounded by the substantial volume of low-coupon bonds that would mature later in 1974 and especially in 1975.

However, Mr. Brimmer continued, there was one optimistic note in the survey. Although a news report had suggested that the recent appeal by Consolidated Edison of New York for emergency State assistance was just the first in a series of such appeals by utilities, from the information supplied by nearly 100 public utilities in the Reserve Banks' survey, it appeared that most utilities would not need to seek State aid.

Mr. Wallich remarked that it was quite difficult for utilities to maintain a 2-to-1 interest coverage ratio when long-term interest rates were around 9 per cent. Unfortunately, rating services did not take that factor into account.

Mr. Hayes noted that the Board staff projected a rise of 5.2 per cent in the GNP implicit deflator in the second quarter of 1975. He wondered whether that projection was not on the optimistic side; the outlook for productivity increases was not good in light of the sluggishness of the recovery, and the rate of advance in employee compensation was somewhat disturbing. Projections made at the New York Bank suggested that the rise in the deflator would be roughly one percentage point higher than the Board staff's forecast.

Mr. Gramley noted that the Board staff's projection allowed for an increase in productivity from the second quarter of 1974 to the second quarter of 1975 of about 2 per cent. While that estimate might be high, in his judgment it was reasonable. The staff had assumed that there would be a movement back toward the trend rate of growth in productivity once the decline in economic activity stopped, even though subsequent growth was slow.

Mr. Bucher noted that the staff estimate of real GNP in the second quarter of 1974 had been revised down from \$834.9 billion to \$831.2 billion. He asked if that reflected the downward adjustment of projected automobile sales.

Mr. Gramley replied that the revision of the second-quarter GNP figures was a consequence of the greater-than-expected decline in the first-quarter level of output; the change from the first to the second quarter shown in the most recent projection was little different from that of 5 weeks ago. The staff's downward adjustment in projected sales of automobiles mainly affected the GNP projections for the third and fourth quarters. Earlier projections had incorporated a substantial rise in auto sales in the fourth quarter, by which time production capacity for small cars would have been expanded considerably. However, the assumption that the ability to produce small cars would be a major constraint on auto sales had proved to be incorrect.

Mr. Bucher then asked how much effect the Administration's new housing program had had on the staff projection of housing starts.

Mr. Gramley replied that it was difficult to quantify the impact precisely. Staff projections had originally allowed for the introduction of additional housing initiatives. The new Administration program would in itself probably result in somewhere between 125,000 and 150,000 additional housing starts, on balance, in fiscal 1975. However, since that effect was likely to be offset to some extent by the greater-than-anticipated deterioration in savings flows, the staff projection of housing starts had not been increased by that much.

Mr. Black said he was puzzled by the continuing strong demand for raw materials, both in the United States and abroad. That demand might be attributable to fears of continued shortages, to anticipation of price increases, or possibly to business optimism about the economic outlook. He would like to have the staff's views on the question.

Mr. Gramley replied that, in his judgment, the most important factor in current demand for raw materials was the severe shortage of such materials; business firms needed to replenish inventories in order to maintain production schedules. Anticipation

of price increases probably ranked second. There was little evidence that businessmen generally expected activity to expand more rapidly than the staff's projections suggested. The comments presented in the red book seemed consistent with that interpretation.

Mr. MacLaury said he agreed with Mr. Gramley's judgment that the risk of a shortfall in real GNP from the staff's projection was considerably greater than the risk of an over-run. To a large extent the April gains in such indicators as industrial production, personal income, employment, and retail sales appeared to reflect the strength in output and sales of automobiles. However, the weekly rate of automobile sales had fluctuated widely in April and early May. That made him skeptical about the extent to which autos could be expected to contribute to the strength of the recovery. Moreover, business fixed investment was being counted on to provide a major element of strength in coming quarters, but most leading indicators of business investment appeared to be either stable or declining.

Furthermore, Mr. MacLaury remarked, he had been concerned for several months about the strength of real consumption expenditures, which were also a key element in projections of economic recovery. In that connection, he noted that the discrepancy between the projections yielded by the Board's econometric model and the

judgmental projections presented in the green book^{1/} were unusually large at present. For example, the judgmental projections showed an increase of about \$20 billion in real GNP from the first quarter of 1974 to the second quarter of 1975, whereas the model yielded a rise of \$2 billion. Similarly, the judgmental projections for personal consumption expenditures and residential construction, when deflated, indicated a growth of \$15 billion over that period, in comparison to a rise of about \$2 billion in the model forecast. A large part of those differences appeared to be attributable to the allowance in the model for a sizable impact on personal consumption of the wealth erosion resulting from declining values of stocks and bonds. The staff evidently had discounted that effect in its judgmental forecast.

Mr. Gramley observed that the staff had carefully reviewed results of the econometric model before making its judgmental projection. As Mr. MacLaury had noted, the projections of consumption expenditures yielded by the model were more pessimistic; for example, the model forecast a saving rate of around 7 per cent at the end of the projection period, compared with a rate somewhat above 6 per cent shown in the judgmental projection. The staff

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

had decided to modify the model forecast for two reasons. First, it seemed likely that the model overstated the wealth effect on consumption in the present period. Secondly, it seemed reasonable to assume that, at a time when there was an extraordinary increase in one specific component of the price index, namely petroleum products, consumers would reduce their rate of saving somewhat in order to maintain their living standards. However, he believed that in the case of both consumption expenditures and business fixed investment, the probability was greater that the staff had overestimated, rather than underestimated, the strength of recovery.

Mr. Kimbrel noted that the rate of savings flows at non-bank thrift institutions had been slowing markedly, with consequent impacts on housing activity. However, some Sixth District thrift institutions recently had been investing a large volume of funds at current high interest rates in the Federal funds market rather than using those funds to make mortgage loans. He wondered whether thrift institutions in other Districts also had become large sellers of Federal funds.

Mr. Partee replied that he had heard of such instances. The Federal Home Loan Bank Board was concerned about the situation and had imposed a very high interest rate on their shortest-term advances to savings and loan institutions. They were also monitoring

associations, as the Federal Reserve System monitors banks, to ensure that they did not use Federal Home Loan Bank advances to make Federal funds sales. It should be noted, however, that such sales of Federal funds did not necessarily mean that the thrift institutions were withholding funds from the mortgage market. Savings and loan associations had made a large volume of commitments over the winter months that would not result in loan closings until late spring and summer, and many no doubt had funds available temporarily which could be placed in the Federal funds market. As a result of recent changes in FHLBB regulations, the associations could count the sums so invested as part of their liquidity reserves. The Federal Reserve System first permitted savings and loan associations to sell Federal funds in 1970, but relatively few did so until the regulation relating to liquidity reserves was changed.

The Chairman asked if data were available on sales of Federal funds by savings and loan associations.

Mr. Axilrod replied that, in connection with a study of the Federal funds market, the staff had tabulated sales of Federal funds by type of seller for the week after the April tax date. He did not have the figures at hand but would supply them later in the meeting. Similar data were not available on a continuing basis at present, but the staff had been exploring the possibility

of developing a regular series with the staff of the Federal Home Loan Bank Board.

Mr. Kimbrel then remarked that his staff had made a telephone survey of Sixth District businessmen to determine their attitudes about increasing inventories and whether they were motivated primarily by anticipation of further price increases. Almost without exception, scarcity of materials was given as the primary motivating factor. Limited availability of storage space, as well as the high cost of storage, insurance, taxes, and interest payments, made it impractical for them to increase inventories for other purposes.

Mr. Mitchell noted that final takings by consumers in real terms had been declining for more than a year. He wondered whether the staff believed the increase from a year ago in the dollar volume of inventories that businesses were now financing reflected a significantly higher physical volume of inventories or a lower physical volume at higher prices.

In reply, Mr. Gramley said he was reasonably certain that the real level of inventories currently was higher than a year ago. In the first quarter of 1973 the increase in inventories was about \$5 billion; he believed the final figure for the first quarter of 1974 would be higher than that, and the staff was projecting a

still higher rate of accumulation in the second quarter. In his opinion, however, the primary explanation of the current large financing demand lay not so much in a substantial rise in the rate of inventory accumulation as in increased prices, the uneven distribution of profits by industry, and the decline in profits--after adjustment for inventory profits--in the first quarter.

Mr. Partee said he thought there was little doubt that the level of real inventories was higher now than a year ago. That view was confirmed by a staff study in which real inventory changes were estimated by relating series from the industrial production index to deflated sales data. The study indicated a rather steady accumulation, in physical terms, of both materials and consumer goods inventories over the last 2 years, but no particular acceleration in the rate of advance. The result, however, was that firms were financing a larger physical volume of stocks at substantially higher price levels.

Mr. Mitchell asked if those findings were consistent with the decline in the physical volume of consumer purchases.

Mr. Partee replied that the lower level of real consumer takings was offset by increases in the real volume of exports and of business purchases of plant and equipment, and, until recently, in construction expenditures. The ratio of inventories to sales, in book value terms, was relatively low.

Mr. Gramley agreed, noting that the inventory-sales ratio had been declining during the first quarter, and was now around 1.5 per cent--an historically low figure. He added that it was necessary in interpreting the recent expansion of business credit demands to consider the behavior of profits. For domestic non-financial corporations, profits after taxes and the inventory valuation adjustment declined from an \$82 billion annual rate in the third quarter of 1973 to a \$78-1/2 billion rate in the fourth quarter, and then to \$71-1/2 billion in the first quarter of 1974. If rough estimates for profits of oil refiners were subtracted, the figures for domestic non-financial corporations would decline from \$72-1/2 billion in the fourth quarter to \$62-1/2 billion in the first quarter. That very substantial decline in profits, in the face of increasing inventory prices, was a major factor in the growth of business loan demands.

Mr. Francis reported that businessmen in the Eighth District, aside from those in industries affected by the oil shortage, reported that they were proceeding full steam ahead with respect to both production and capital expenditures. Even some in industries which had been hindered by the oil shortage indicated that activity was beginning to pick up. Some District automobile dealers were now reducing the inventories of large, late-model used cars which they

had accumulated during the winter; some dealers expected to have waiting lists for delivery of big cars by mid-summer, as a result of overreaction by producers in cutting back on output of such cars. That situation would probably be corrected when the new models came out in the fall.

It seemed to him, Mr. Francis continued, that conditions in the Eighth District were consistent with recent national data suggesting more strength in housing starts and domestic automobile production, as well as a lower rate of unemployment. Indeed, he thought the latest projection of real GNP might be too low to be consistent with current data.

Mr. Coldwell observed that comments from Reserve Bank directors and businessmen indicated that manufacturers in the Eleventh District also were producing close to capacity. The oil industry in particular was working at forced draft. However, oil well casing had become a limiting factor in drilling activity. For example, one producer had mentioned to him that he had 200 wells to be drilled, of which about half were development wells, but he could not get casing pipe.

In response to a question from the Chairman, Mr. Coldwell said he did not know how much casing pipe was being exported at present. However, even though the entire output of one large

Texas steel company had been converted into casing pipe, the price of used casing had quadrupled in the last 40 days. Thus, producers were faced with rapidly rising costs as well as with problems of availability of materials, and both factors were contributing to the strong demand for business loans.

Mr. Brimmer observed that he had made some inquiries about export of oil field equipment in connection with a study being done by the National Advisory Council. It was his impression that the volume of such exports was not large and that exports were not a major cause of the domestic shortage.

Mr. Winn commented that an overly narrow focus on short-run developments could give a misleading impression of the condition of the economy. If the present long-range plans of some industries were realized, the economy could be considerably stronger than now anticipated. For example, the automobile industry was projecting output of 17 to 18 million units in 1980, and that implied strong demands for steel and other materials over the intervening period.

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 16 through May 15, 1974, and a supplemental report covering the period May 16 through 20, 1974. Copies of both reports have been placed in the files of the Committee.

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

The period since the Committee last met was not a particularly easy one for open market operations and the Trading Desk. A need to supply a very large volume of reserves, brought about by changes in market factors and a sharp rise in required reserves, fell afoul of a technical shortage of Treasury and agency securities in the market, competition from foreign buyers, and extraordinary pressures in the money market as a feeling of malaise spread throughout the financial markets generally. After the first 2 weeks of the period, banks appeared to be generally reluctant to borrow at the discount window, perhaps reflecting a desire to keep their borrowing records clear, as System policy appeared to them to be tougher--and perhaps likely to be kept in place longer--than had been expected only a short time ago.

Early in the period after the Committee last met, the monetary aggregates appeared to be coming in much stronger than had been desired at the last meeting, and the Desk moved promptly to a more reluctant supply of reserves, anticipating that the Federal funds rate would move to the upper 10-3/4 per cent end of the tolerance range, and then, when the Committee concurred with the Chairman's recommendation on April 24, to 11 per cent. A prompt move was considered appropriate not only because of the strength of the aggregates, but also in order to establish new levels in the money market before the Treasury had to announce the terms of its refunding on May 1.

As you all know, despite the provision of a large volume of reserves through open market operations, the Federal funds rate has generally persisted at a higher level than desired for the past 2 weeks or so. This resulted in another inter-meeting move last Friday when the Committee took note of Desk difficulties and set a ceiling guideline for the Federal funds rate at 11-1/4 per cent.

Despite the technical shortage of securities, the Desk was able to make net outright acquisitions of about \$1.8 billion in Treasury bills, coupon issues,

and Federal agency issues, with about one-third coming from foreign official sources. In addition, over \$14 billion of repurchase agreements were made, including a substantial volume for a full week's maturity. As you know, it has long been System practice to permit dealers to withdraw RP's before maturity if they so desire, and a large number of such early terminations occurred because of the public demand for high quality Treasury and agency issues.

Early in the period, as System pressure on the money market was being increased, there was a sharp rise in market interest rates in all maturities and in all instruments, as described in the written reports to the Committee. The 3-month Treasury bill rate reached an all-time auction high of 9.04 per cent on May 6. Since then rates have been moving down, particularly in the Treasury area, where the 3-month bill was trading below 8 per cent late last week. Rates backed up again, however, in yesterday's regular Treasury bill auction, where average rates of 8.20 and 8.44 per cent were established for 3- and 6-month bills, up 15 and 36 basis points from rates established in the auction just preceding the last Committee meeting. Incidentally, no special problems developed in the new system of Federal Reserve bidding in Treasury auctions, although with all the turbulence that was going on it is admittedly hard to tell what the facts really are.

Despite the erratic behavior of interest rates, the Treasury refunding, which was generously priced, was quite successful. The 4-1/4 year, 8-3/4 per cent notes, which were the first to be auctioned, drew an unusual amount of noncompetitive tenders, and this helped to whet professional interest in the subsequent offerings. The two notes are now selling at premiums over the auction price, while the bond is trading close to the auction price.

Looking ahead, there still appears to be the likelihood of strong demand for bank credit from nonbank financial institutions as well as from commercial and industrial borrowers. Inflationary fears are still strong, and as market rates remain high, disintermediation will remain a problem. Further moves toward quality instruments on the part of investors also appear to be

in the cards, meaning higher rates and/or reduced availability for lesser-known (or lesser-regarded) names--and this includes both banks and nonbanks. The Franklin National episode cast a chill over the markets. So far, there appear to have been no widespread repercussions, but this is obviously an area that will bear close watching. Since it now appears that Franklin's borrowing at the discount window will have to be both large and extended, account should be made of the unusual nature of this supply of reserves in the conduct of open market operations, just as was done in the Commonwealth of Detroit case.

While there are risks that other institutions may become subject to the kinds of pressures experienced by Franklin, I suspect that in the longer run the Franklin episode may have some salutary effects. This experience may well force some of the other aggressive banks around the country to rethink their over-reliance on liability management, their aggressive approach in seeking out loans, their overcommitment position, and their investment policies. If they do--and they certainly should be encouraged to do so--we may well end up with a sounder banking system.

Finally, I should note that we recently added two new dealers to the list with which the Desk trades. One is DLJ Securities, a subsidiary of Donaldson, Lufkin, and Jenrette--a stock market and investment firm. The second new dealer is First Pennco Securities--a subsidiary of the holding company of First Pennsylvania Bank and Trust Co. This brings the number of dealers with whom we do business back to the previous high of 25.

Chairman Burns referred to Mr. Holmes' comments about the Franklin National Bank situation and suggested that the members defer any questions they might have on that subject. Following the FOMC meeting he planned to call a brief meeting of the Board members and Reserve Bank Presidents to review certain matters, and questions relating to Franklin National could be discussed then.

Mr. Black noted that there recently had been an encouraging slowdown in the growth rates of the monetary aggregates. He asked whether Mr. Holmes thought that development reflected a lagged response to earlier increases in short-term interest rates, or whether it was a temporary consequence of the technical problems the Desk had encountered in supplying reserves.

In reply, Mr. Holmes said Mr. Axilrod might be in a better position to answer that question, although he would hazard the view that there was little or no relationship in the short run between the kinds of technical problems experienced in the recent period and the growth rates of the aggregates. He might note, incidentally, that the main difficulty had not been in supplying reserves, but in holding the Federal funds rate down to the desired level without supplying an unduly large volume of reserves. The money market had come under pressure because of a shift in bank preferences away from borrowing at the discount window, and it had not been feasible to compensate for the effects of that change in attitudes through open market operations.

Mr. Axilrod expressed the view that the recent reductions in the growth rates of the aggregates were mainly a consequence of earlier increases in short-term market rates and, to some extent, of the tailing off in May of Federal income tax refund payments.

He agreed with Mr. Holmes that the technical problems facing the Desk recently had had virtually no effects on the aggregates. If the Desk had supplied more nonborrowed reserves during the brief period in question, the Federal funds rate would have been somewhat lower. However, because member banks would have borrowed even less than they in fact did in the period, total reserves--and the monetary aggregates--would have been little different. Changes in non-borrowed reserves, and associated changes in short-term interest rates, affect the monetary aggregates only with some lag.

Mr. Coldwell asked whether the Desk might have purchased coupon issues more actively than it had in supplying reserves during the recent period.

Mr. Holmes noted that the Desk had bought some coupon issues from foreign accounts early in the period and that it had purchased a rather sizable volume of agency issues on three occasions. It had, of course, appeared undesirable to buy longer-term Treasury issues during much of the period because of the Treasury refunding then in process. At present, some dealers had again moved to a short over-all position in Government securities; they had no inventory at all.

Mr. Coldwell asked whether dealers might not have been invited to round up customer paper.

Mr. Holmes replied that, while that technique was simple to apply in the case of RP's, it was much more difficult for purchases of coupon issues. An attempt to employ it in the latter case was likely to result in undesirably large changes in interest rates.

Mr. Axilrod observed that he was now able to provide the information on Federal funds sales by savings and loan associations he had mentioned earlier. The information was in the form of daily-average sales of Federal funds during the survey week, which ended April 24, to 45 of the 46 banks that were most active in buying such funds. During the week in question, daily-average sales to those banks by savings and loan associations were about \$3 billion, and sales by the Home Loan Banks and the Home Loan Bank Board were \$1.2 billion. The sum of \$4.2 billion accounted for a little more than 10 per cent of total acquisitions of Federal funds by the 45 banks during the survey week. Of the \$3 billion of Federal funds sold by S&L's, \$440 million matured in 30 days or more. Although he was not certain, he believed that practically all of the associations' holdings in the funds market could be counted as part of their liquidity reserves. To the extent that was so, those holdings were substitutes for holdings of other liquid assets, such as CD's and Treasury bills.

Chairman Burns said it would be desirable to remove any uncertainty about the extent to which S&L investments in the funds market simply substituted for other liquid asset holdings. It might well be that the attraction of an 11 per cent return on Federal funds was keeping those institutions from making a significantly larger volume of mortgage loans.

Mr. Partee noted that the Home Loan Bank Board had just recently changed its rules to require an S&L with excess liquidity reserves to reduce those reserves before it would be permitted to increase its borrowings from a Home Loan Bank.

Mr. Keir added that the Home Loan Banks were about to raise the rate they paid on deposits held with them by member associations. Since the new rate would be made competitive with rates available on money market instruments, it was likely that some liquid asset balances of S&L's which had been shifted to market instruments in order to maximize interest returns would now be shifted back to the Home Loan Banks. Such a reflow would reduce the need for the Home Loan Banks to borrow in the market.

In reply to a question by Mr. Francis, Mr. Axilrod said he had no information on the volume of CD holdings by savings and loan associations.

Chairman Burns remarked that it would be useful to explore possible means of obtaining such information. More generally, he

thought the figures Mr. Axilrod had cited today should be brought to the attention of senior officials of the Department of Housing and Urban Development and the Home Loan Bank Board, and their meaning fully explored with the staffs of those two agencies.

Mr. Winn observed that State usury laws were having the effect of diverting funds away from local housing markets. He had heard reports of flows to Guam and other distant places of funds that would have gone into domestic mortgages in the absence of usury laws.

Chairman Burns remarked that high interest rates could serve a useful function if they stimulated action with respect to such laws.

Mr. MacLaury said he wanted to raise a question, on procedural grounds, about the increase in the ceiling on the Federal funds rate which the members had agreed upon last Friday. When circumstances such as those that developed in the recent period prevented the Desk from keeping the funds rate within the specified range of tolerance, the Committee could either widen the tolerance range or simply accept the fact of a miss and leave the range unchanged. He thought last Friday's increase in the funds rate ceiling would be interpreted by the public as a policy move, whereas--in his view, at least--a policy move of that kind was not called for, in

light of the downward revisions in the estimated growth rates of the aggregates. If similar circumstances should develop in the future--that is, if the Desk again found itself constrained by the state of securities markets from taking the actions needed to keep the funds rate within its specified range--he hoped the Committee would follow the alternative course of simply accepting the miss.

Chairman Burns expressed the view that Mr. MacLaury was raising a question about the Committee's judgment rather than about procedures, since there did not appear to have been any impropriety with respect to the procedures followed.

Mr. MacLaury indicated that he obviously had not meant to imply impropriety. If Friday's increase in the funds rate ceiling was a policy decision taken in light of developments in the aggregates, he would limit himself to the observation that he disagreed with the Committee's judgment.

The Chairman remarked that he could not say what particular considerations motivated individual members of the Committee to agree last Friday to the proposed change in the guideline for the funds rate. It seemed clear, however, that the proper procedure was followed and that a policy decision--whether sound or unsound--was made.

Mr. Wallich asked whether it would be correct to say that the funds rate had exceeded its upper limit in the recent period as a consequence of temporary technical factors in the market rather than as a result of a change in the underlying relationship between the funds rate and the rates of growth in the aggregates.

Mr. Holmes expressed the view that technical factors were the main source of the problem. In part, however, it might have been due to a mis-estimate of the underlying relationship.

Mr. Axilrod noted that the specifications for the various alternative policy courses discussed in the blue book^{1/} implied a staff judgment that there had been some change in the underlying relationship. Specifically, the particular alternative that retained the Committee's earlier longer-run growth path for M₁ had associated with it a higher range for the Federal funds rate than had been shown in the previous blue book.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period April 16 through May 20, 1974, were approved, ratified, and confirmed.

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

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

I would like to highlight for the Committee some of the implications of changes that seem to be emerging in the relationships among the monetary aggregates. One key development is that growth in M_2 and M_3 is being restrained more promptly and in greater magnitude than growth in M_1 , if experience of recent weeks is any indication.

Time deposits other than large negotiable CD's issued by weekly reporting banks appear to be growing at about two-thirds of the pace prevailing in the fourth and first quarters. And there appears to be virtually no growth if the figures are taken to exclude all time deposits of \$100,000 or more, which are exempt from Regulation Q ceilings. At nonbank thrift institutions, deposit growth from the end of March to the end of April was at a 2-1/2 per cent annual rate, less than one-third the pace of the fourth and first quarters; and experience in early May continues to be unfavorable.

With high market interest rates assumed to be a continuing attraction for savers--as a hedge against erosion of savings from inflation--we foresee little pick-up in growth rates of these types of time and savings deposits. Thus, under current money market conditions, M_2 and M_3 are expected to slow to growth rates of 6-3/4 and 5-3/4 per cent, respectively, over the second and third quarters. These growth rates are 4 and 6 percentage points, respectively, slower than average growth in the three calendar years 1971-73. In comparison, M_1 growth in the second and third quarters under current money market conditions is projected to be only a little less than 1 percentage point slower than in 1971-73.

This restraint on M_2 and M_3 has been accompanied by considerable tightening of lending terms in the mortgage market and at banks. Since the last FOMC meeting, home mortgage rates have risen about 1/2 of a percentage point and the prime loan rate has risen 1-1/2 percentage points. With very little net new

deposit money available at existing Regulation Q ceiling rates, banks and thrift institutions have had to turn increasingly to high-cost funds. As you know, banks have relied very heavily on large CD's, and thrift institutions have sharply increased their borrowing, mainly from the Home Loan Banks in the case of S&L's.

At the same time as M_2 and M_3 have come under restraint, bank credit growth has accelerated--spurred by expansion in business loans and financed by CD's. As open markets have become more resistant to risky borrowers--such as REIT's, some finance companies, and some public utilities--many of these have been forced to turn to banks. We are not able to quantify the extent to which banks have been used as a last resort of financing for necessitous borrowers. I doubt that it is yet an extremely important factor in bank credit expansion, but it is probably making some contribution.

These various emerging relationships suggest that the Committee--in addition to its usual stress on M_1 --might wish to give a little more weight to M_2 and M_3 now, since they seem to be the variables currently most sensitive to tightening operations. On the other hand, bank credit expansion has been quite rapid. We expect growth to slow as banks and investors both become more cautious in the CD market. However, as monetary restraint continues, banks may have to assume an increasing role as last-resort lenders to firms which cannot obtain financing elsewhere to honor their commitments. Nonetheless, the current high bank lending rate should work to encourage these and other borrowers to scale down their activities.

Mr. Brimmer noted that, as the Board members knew, a few days ago he had asked the staff to review year-end figures for the 50 largest banks in the country, to determine the extent to which they were relying on "purchased money"--that is, Euro-dollar borrowings, Federal funds purchases, and large-denomination CD's--to support their footings. He believed the results had a direct

bearing on some of the points made by Mr. Holmes and Mr. Axilrod in their reports today. For most of the 50 banks, purchased money constituted one-fourth or less of their total assets. For several banks, however, the figure exceeded one-third, and for a few it was in excess of 40 per cent. Some of the banks relying most heavily on purchased money were among those about which questions were being asked in financial markets.

As Mr. Axilrod had indicated, Mr. Brimmer continued, banks might have to play an increasing role as lenders to risky borrowers who were unable to obtain financing elsewhere to honor their commitments. It seemed clear that some of the banks which were likely to be an important source of funds for such necessitous borrowers were themselves in a difficult position. It was worth keeping that fact in mind in considering the possible need over the months ahead for the System to provide a backstop for some financial institutions.

Mr. Morris said he was disturbed by the latest upward revision in the money stock series, particularly since it was beginning to appear that the estimating procedures used had a systematic downward bias. He would find it helpful to have a staff paper describing the estimating procedures currently employed and discussing the reasons for the errors.

Chairman Burns commented that the reasons for the errors were readily explained--except for four call-report dates per year, data were not available for deposits at nonmember banks. Current figures had to be estimated, and--as in all such cases--the estimating techniques were subject to error. It was true that the errors had been in one direction for some time. The remedy, however, was not to attempt to refine the estimating techniques but to get current data on nonmember bank deposits. Efforts to that end were being made, and he hoped they would prove successful.

Mr. Willes referred to Mr. Axilrod's suggestion that under present circumstances the Committee might want to give increased weight to M_2 and M_3 , for which the slowing of growth had been more marked than in the case of M_1 . It was not clear to him whether Mr. Axilrod was suggesting that M_2 and M_3 were now more appropriate targets for monetary policy than was M_1 . As he (Mr. Willes) understood it, the greater slackening in M_2 and M_3 recently was primarily a consequence of the workings of Regulation Q; investors, attracted by the high rates available on market instruments, were shifting funds out of time and savings deposits subject to rate ceilings.

In reply, Mr. Axilrod said his point was that a given growth rate in M_1 was now associated with higher market interest rates than previously; and, as Mr. Willes had indicated, because

of the resulting shifts out of time deposits at banks and nonbank thrift institutions, the given M_1 growth rate was accompanied by a lower rate of growth in M_2 and M_3 . In effect, the restraint on M_2 and M_3 growth was being imposed by tightening credit conditions, which was the transmission mechanism for monetary policy.

Mr. Francis remarked that the reasons for the behavior of M_2 and M_3 argued, if anything, for giving them less rather than more weight in deciding on policy. The Committee should be alert to the possibility that runoffs in time and savings deposits might lead to accelerated growth in M_1 .

Mr. MacLaury said he did not believe that the Committee should pay more attention to M_2 and M_3 simply because its policies seemed to be having a more rapid effect on those series than on M_1 . The relative weight placed on different monetary aggregates should depend on their inherent usefulness as targets for policy.

Mr. Mitchell asked if Mr. MacLaury meant to imply that the Committee should focus exclusively on M_1 .

Mr. MacLaury said he did not. He was arguing against changing the relative emphasis on the series, not for placing exclusive emphasis on any one.

Mr. Axilrod observed that the Committee had tended to attach some weight to both M_1 and M_2 . One could draw either of two conclusions

from the fact that growth had slowed in M_2 relative to M_1 . One was the conclusion Mr. Francis had reached. The other, which he had offered for Committee consideration, was that the acceptable rate of growth in M_1 was greater than otherwise because the slower growth in time and savings deposits--that is, in near-money--was providing some offset.

Mr. Wallich said he had some questions about the meaning that should be attached to particular rates of growth in M_1 . First, according to the staff's projections, the rate of increase in nominal GNP would exceed 8 per cent in every quarter from the current quarter through the second quarter of 1975. If the rate of expansion in M_1 over that period were roughly 6 per cent, a rise in velocity at a rate above 2 per cent--which he understood was usually taken as the trend rate--would be implied. He would be interested in the staff's observations on that point. Secondly, he wondered how the relationship between a 6 per cent growth rate in M_1 and the projected rate of price advance compared with the corresponding relationship in a year such as 1969, when M_1 grew only about half as rapidly and prices were rising less than at present. Finally, he noted from the supplement to the green book that the demand deposit ownership survey had revealed an unusually large shift of deposits in the first quarter of 1974 from the business sector to the household sector. Such shifts raised the

question of which price index was appropriate for deflating money supply figures. He recognized that those questions were too complex for immediate response, but he would be grateful for any light the staff could throw on them at this point.

Mr. Axilrod said he might note with respect to the third question that the ownership survey figures on demand deposits by sector were highly volatile and were subject to error as a result of technical problems. While he had been surprised by the magnitude of the first-quarter shift of deposits to households, some shift of that kind was consistent with the explanation the staff had developed for the substantial increase in the money supply in February and March. As the Committee would recall, the staff had attributed part of that increase to the large volume of Federal income tax refunds being made then.

Mr. Partee observed with respect to Mr. Wallich's first question that by almost anyone's calculation the rate of increase in velocity implied over coming quarters would exceed the trend rate. The Board's staff had only recently found some evidence of a secular trend in velocity independent of interest rates. Assuming that there was some small upward trend, the staff believed that a 6 per cent growth rate in M_1 over the projection period would be consistent with a continued upward movement

in interest rates. In that connection, it might be noted that in real terms the money supply was declining.

Mr. Gramley added that comparisons of growth rates in the money supply and nominal GNP could give misleading impressions about the likely pressure on interest rates unless account was taken of the extent to which the rise in nominal GNP reflected an increase in real GNP as opposed to an advance in prices. The theoretical argument for expecting a secular uptrend in velocity unrelated to interest rates involved the presumption that the income elasticity of the demand for money was less than unity. But the income measure used in that argument was real income. In other words, in a period in which prices were advancing but real income was stable, theory would predict a rise in the demand for money proportionate to the rise in prices. In the staff's current GNP projections, much more of the rise in nominal GNP was expected to reflect price advances than gains in real output. Accordingly, any given increase in velocity over the projection period would produce more upward pressure on interest rates than it would have under the circumstances that existed in, say, the 1950's.

Mr. Axilrod said he might note one special factor underlying the rather sizable rise in velocity over the second and third quarters implied even by the set of staff projections

of M_1 that assumed no change in money market conditions. Because interest rates were believed to affect money demand with a lag, the increases of the past 2 months were expected to result in a willingness to reduce money holdings relative to income during coming months. After several months, that lagged effect would end and a more normal relationship would be restored.

Chairman Burns observed that the Committee was about ready for its deliberations on monetary policy. He was sure that the members had considered the question of policy with special care in preparing for this meeting. He could state his own views quite briefly: he thought conditions were at a stage at which the System's primary objective should be to regain money market stability, and he doubted that the Committee should focus on the monetary aggregates to the usual degree at this time. Before the discussion proceeded, it might be helpful to the Committee to have the policy recommendations of its senior economist.

Mr. Partee expressed the view that the Committee's primary concern at this time should be with the state of financial markets. That would not be so if something extraordinary appeared to be happening in the real economy. However, as Mr. Gramley had indicated in his report earlier today, the course of events was rather close to expectations--excluding any effects flowing from

unstable financial markets, for which no allowance had been made in the projections. The economy might now appear to be a bit weaker than earlier projections had suggested, but the difference was not great.

At the same time, Mr. Partee continued, there had been unusual developments in financial markets which appeared to require the Committee's attention. Market conditions were more sensitive than they had been in a long time. According to reports from commercial paper dealers--the staff had been in touch with most such dealers--paper that was not of prime grade was just not selling, even though the quoted price spreads against prime paper had been increased substantially. Questions were being raised in the market not only about the paper of nonbank issuers but also about the paper of some bank holding companies. Some concern was being expressed about the soundness of some banks, and large investors appeared to be backing away from CD's of banks outside the major money centers. Common stock prices had been declining; yesterday, the averages reached their lowest point in the latest downtrend. Stocks traded on the American Exchange, which were on average more speculative than those traded on the New York Exchange, had been particularly weak; that also indicated a preference for quality securities over issues that had any tinge of speculation

attached. And, as the members knew, the REIT's were having a difficult time not only in the commercial paper market but also in holding their bank lines of credit together and generally in keeping their heads above water.

There was no doubt, Mr. Partee observed, that the sensitive state of the markets was largely a consequence of loose financial practices. There had been overuse of the commercial paper market, overextension of credit by banks, and overdependence on very short-term sources of funds. But the financial conditions prevailing were also partly a consequence of the monetary policy the System had been following; were it not for the tensions and the high cost of borrowing that policy had produced, the problems would not seem as great as they did at this point. As Mr. Gramley had suggested, if the situation went out of control and some serious financial constrictions developed, there was a possibility that economic conditions could change materially for the worse. While the staff was not predicting such a development, it nevertheless was a distinct possibility. In view of the unmistakable signs of unease in financial markets, and in view of the marked tightening of money market conditions that had occurred over recent months, he would recommend that the Committee focus at this time on a stabilization of money market conditions, and that it formulate its directive in money market terms. He might note that that was a course which he had not often suggested to the Committee.

Mr. Mitchell observed that monetary policy was at a crossroads. If the Committee sought more restraint, it would soon be confronted with the need to let up; if it held steady, it might be able to maintain the present posture long enough for it to be effective. The present course of policy, which he had not been enthusiastic about initially, was producing results. Although those results were painful for some people, it was important to maintain about the existing degree of pressure. Because he believed it would be dangerous--and, in the long run, counterproductive--to increase the pressure, he would favor maintaining about the prevailing money market conditions.

Mr. Holland remarked that he, like Mr. Mitchell, believed that financial markets and institutions had reached a state of sensitivity that counseled maintenance of steady money market conditions over the period until the next meeting of the Committee. Moreover, such an objective in the short run would not be antithetical to the Committee's longer-run objectives for monetary policy. Through the whole financial system--including other kinds of institutions as well as banks--lending policies were being tightened, which was part of the working of a tightening of monetary policy. Growth in the monetary aggregates now appeared to be slowing. Setting aside April, growth in M_1 , M_2 , and the credit

proxy from May to September--according to staff projections-- would be almost precisely at the rates that the Committee, at its last meeting, had adopted for the second and third quarters combined. To his mind, that represented an appropriate policy posture that could be maintained for a time; it took due account of the slowing of growth in M_2 and M_3 and the consequences for residential construction activity. Further tightening in an effort to offset the earlier bulge in monetary growth would be inappropriate. In the past, the System often had overstayed monetary restraint a bit and thus engaged in a bit of overkill. To press further now would run that risk.

Concerning the directive, Mr. Holland said, it would be appropriate to couch the operational paragraph in terms of money market conditions, using the variant for alternative A^{1/} shown in the blue book, and it was also appropriate to describe prevailing money market conditions as "restrictive," as was done in that paragraph. He would widen the short-run ranges of tolerance for the aggregates by one percentage point in each direction in order to increase the chances that the Federal funds rate could be held within the specified range. While the funds rate range specified under A was 10 to 12 per cent, it would be desirable for the Manager to operate around 11 per cent unless the May-June growth rates for

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

the aggregates appeared to be outside the widened ranges. And, it would be consistent with those operating tactics that no longer-run targets be adopted at this meeting.

Chairman Burns said he believed that prevailing money market conditions could best be described by a Federal funds rate range of 11 to 11-1/2 per cent. He asked Mr. Holmes if that was correct.

Mr. Holmes agreed, noting that the rate had been in that range over the preceding 2 weeks.

Mr. Willes commented that this was the third meeting of the Committee that he had attended during the past 3 years. On each of the three occasions, it appeared that the rate of inflation and the economic situation as a whole made it desirable to reduce the rate of growth in the monetary aggregates. In each instance, however, there seemed to be some special factor in the situation that cautioned against doing so. He had an uneasy feeling that the frequency of such occasions explained the somewhat excessive rate of monetary growth over the past 3 years and contributed to the rate of inflation.

Continuing, Mr. Willes remarked that it was in extraordinary times that it was most important to maintain the focus on the longer-run targets for monetary growth and to endeavor,

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even at some risk, to avoid allowing temporary pressures to distract the Committee from those targets. An attempt to keep money market conditions under control, and adoption of a directive couched in those terms, could lead to an undue focus on money market conditions that would create difficulties at a later time. Consequently, he hoped that the Committee would not go too far in focusing on its concern about developments in the money market. The point of view at the Philadelphia Bank was that a change in Regulation Q and some other measures could relieve some of the immediate pressures in the market. Moreover, it was impressive that the markets had been able to assimilate developments like those involving the Franklin National Bank. Altogether, he would favor an attempt to stay on target with respect to the monetary aggregates, and he would be willing to accept an increase in money market rates, if that should be necessary.

Chairman Burns remarked that Regulation Q ceilings surely would not be changed in the next few weeks, and the Committee had to arrive at a policy decision for the 4-week period until the next meeting.

Mr. Francis observed that his position was very similar to the one that had just been expressed by Mr. Willes. The current

situation in financial markets resulted at least in part from almost 3-1/2 years of excessive monetary expansion, and if the Committee delayed in attempting to bring the aggregates under control, it would face even more severe problems a few weeks or months ahead. He would prefer to move gently in the direction of getting the aggregates back on target, giving less emphasis to market interest rates. Particular problems that arose could be dealt with on an individual basis. Hopefully, the inflation problem would begin to improve within a relatively short period of time, bringing about a change in the whole market situation. Action to begin to moderate the inflation was inevitable, in his view, and he would hope to avoid a delay that would merely make the problem more difficult.

Chairman Burns commented that interest rates had moved up sharply and financial markets might be described as bordering on disorder. In conversations with business and financial people during the past few days, since returning from abroad, he had found more concern than he had encountered for many years. While he believed that there was general agreement within the Committee about the longer-run or intermediate-term objectives of policy, he also believed that it was necessary to pause and allow the markets to absorb what had already occurred. That was the meaning

of his earlier statement; it was the meaning also of the statements made by Mr. Partee and others. For the present, he thought it would be dangerous not to pause.

Mr. Wallich remarked that there was reason to be concerned about the state of financial markets and to pay more attention to the markets now than at other times. That could lead to insufficient restraint; it was possible that recent market developments resulted not from a period of strong monetary restraint but from inflation, and it might be that progress against inflation could not be made without great risks and serious repercussions in the markets. However, he thought that was the less likely case. The trend of real balances and the rise in the velocity of money suggested increasing tightness. The maintenance of prevailing money market conditions, in addition to being necessary because of the state of the markets, might be appropriate anti-inflationary policy. Accordingly, unless taking full account of the market situation would result in very high rates of growth in M_1 --which he did not believe would be the case--he would focus on the markets now rather than on the behavior of the aggregates.

Mr. Kimbrel observed that continuing inflation was of such concern to people in his District that even those who were particularly affected by monetary restraint regarded present monetary

policy as reasonable. He believed that the present course of policy was correct, and he hoped that the Committee would continue on that course and maintain the pressure. He would accept, although reluctantly, a further increase in short-term interest rates over the next 4 weeks, consistent with a Federal funds rate around 12 per cent under alternative B, unless growth in the aggregates weakened. He would not push rates up but would allow them to be determined by the behavior of the aggregates. He would not favor lowering the funds rate target at this time, because it might be misinterpreted as a shift in policy; in his view, such a shift now would be premature.

Mr. Coldwell remarked that he also was concerned about the state of the markets, and he was particularly concerned about the position of some banks. While he would not like the Committee to be diverted from its primary objective, he could accept a pause. He would couch the directive in terms of money market conditions, specifying a somewhat wider range for the funds rate, because he believed that some of the problems of today would no longer exist by the time of the next meeting. If interest rates had reached their peaks and tendencies for a decline in rates developed, he would not want to resist those tendencies and attempt to maintain the funds rate at a particular level. On the other

hand, if upward pressures intensified, rates could be allowed to move up slightly. He preferred the specifications of alternative B, with a range of 10 to 12-1/2 per cent for the funds rate.

Mr. Balles observed that the Committee was faced with a severe dilemma. As had been noted, financial markets were in a sensitive state and some financial institutions were having difficulty in issuing paper. However--recalling the Chairman's Congressional testimony of several months ago, to the effect that inflation and high interest rates went hand-in-hand--he concluded that inflation was the main cause of the current strains in financial markets. The question was how to break the vicious cycle.

Continuing, Mr. Balles remarked that on his recent trip to the Far East he had been impressed by developments in Australia. Monetary expansion over the past year had been faster there than in the United States, and the problem of inflation had been more severe. Now, however, the monetary authorities had taken the bull by the horns; they had programmed zero growth in M_1 for this year. Costs of short-term money to business were in a range of 20 to 25 per cent. Such a policy, he might note, was being pursued by a labor government, and the government had just been reelected despite the extremely high short-term interest rates. Whether any lessons relevant to the United States could be drawn from the Australian

experience was uncertain, but in any event, the policy being pursued had not brought about a collapse of the financial system.

Mr. Balles said he was encouraged by the progress that had been made recently in slowing growth in the aggregates to about the rates that had long been the targets. He would hate to lose the momentum that had been achieved, except for what might be a necessary pause. Unless growth in the aggregates were brought back to the desired path, the problem of inflation would not be solved. He noted that even under alternative C, which specified an M_1 growth rate of $4\frac{3}{4}$ per cent over the second and third quarters from the upward revised level for March, the rate of growth from January to September of this year would be about 6 per cent. Measured on the basis of quarterly averages, growth to the third quarter of this year either from the third quarter of last year or from the first quarter of this year would also be at a rate of about 6 per cent. Any higher rate, if continued for very long, would slow down the effort to break the inflationary psychology and expectations and would reduce the chances of success. Consequently, he would strongly favor alternative C were it not for the sensitive state of financial markets. With some reluctance, he would moderate his position in light of the state of the markets, if it were understood that a different policy course would be pursued only for the period until the next meeting.

Chairman Burns remarked that the period might prove to be even shorter. The Committee might find it desirable or necessary to modify its instructions to the Manager before the next meeting.

Mr. Black said he agreed with much of what had been said by Chairman Burns and Messrs. Mitchell, Holland, and Wallich. As far as the financial markets were concerned, a critical stage may well have been reached. The policy that the Committee had been pursuing had resulted in a serious attrition in the economy's liquidity in relation to the rise in prices and nominal GNP. As he viewed the markets, the System's function as lender of last resort could very well override any policy decision arrived at today, whether that decision placed major emphasis on the aggregates or on money market conditions. Concerning inflation, there was no way that the pressures could be dissipated entirely any time soon. If by the end of the year the rate of price rise could be brought down below that in most other leading industrial nations--perhaps within a range of 5 to 7 per cent--a great deal would have been accomplished. Altogether, therefore, he favored alternative A, but with a Federal funds rate ceiling of 11-3/4 per cent rather than 12 per cent, and he favored the directive couched in terms of money market conditions. Growth in the aggregates was beginning to show some response to earlier policy moves, and it was necessary now to pause in order to take stock of lagged effects on money and credit growth and to provide some reassurance to the market.

Mr. Mayo observed that the Committee had achieved a desirable degree of restraint through allowing the Federal funds rate to rise to its present level. However, to allow the rate to rise further--except for a day or two as a result of temporary developments in the market--would be to run a real risk of playing the game of brinkmanship. He would not want to overstay what, in his view, had been a successful policy so far. He believed in attempting to control inflation as much as anyone, but the Committee was dealing with questions of confidence in the banking system and with a fragile financial structure.

Consequently, Mr. Mayo said, he strongly favored alternative A. He would accept Mr. Holland's suggestion to widen the short-run ranges of tolerance for the aggregates. He also would accept the 6-1/4 per cent target for growth in M_1 over the second and third quarters. In his view, the decline in the rate of growth in M_1 from 8.9 per cent in the fourth quarter of last year to 7.1 per cent in the first quarter, followed by projected declines to 6.7 and 5.6 per cent in the second and third quarters, was reasonable and would make a very acceptable record. Finally, with respect to the language of the directive, he would accept the money market variant for A shown in the blue book, but he would amend it to give emphasis to his desire to avoid any further

tightening of money market conditions. Thus, it would say, ". . .the Committee seeks to maintain about the prevailing restrictive money market conditions without further tightening, provided that the monetary aggregates appear to be growing at rates within the specified ranges of tolerance."

Mr. Hayes commented that he agreed with the position that had been expressed by Chairman Burns, Mr. Mitchell, and others--namely, that primary emphasis should be placed on money market conditions at this time. He took that position even though he was deeply concerned about inflation and wished to control growth in the aggregates in order to reduce inflationary pressures. Growth in the aggregates had been too fast for a long time, and he was not tremendously optimistic about the prospects for either slowing down monetary growth or for controlling inflation. However, in the present circumstances of sensitive financial markets, the only sensible policy was to hold the line and maintain about the prevailing money market conditions. He favored a narrow range for the funds rate--namely, 11 to 11-3/4 per cent. He suggested an upper limit of 11-3/4 per cent because the rate had been as high as 11-1/2 per cent for a time, but he could accept a range of 11 to 11-1/2 per cent.

With respect to the directive, Mr. Hayes said he would not want to loosen any more than he would want to tighten money market conditions, and therefore, he preferred the language for the operational paragraph without the additional words suggested by Mr. Mayo. He disagreed with the staff suggestion to delete the words "international and domestic" in the reference to "financial market developments." He would retain those words in view of the delicate state of the markets at this time. And in the third of the general paragraphs, he would take note of the present state of financial markets by inserting the clause, "and conditions in financial markets have been uneasy," following the statement on private short-term interest rates.

Mr. Holmes remarked that a minor technical problem often arose that made it desirable from his point of view to retain the separate references to domestic and international financial developments. A large flow of dollars into the hands of foreign central banks, creating a need to invest the funds, might occur at a time when the supply of securities available in the market was inadequate. He would interpret the directive language to mean that the Desk might supply securities to the foreign central banks and try to offset the reserve effects afterwards. Thus, he would not deviate from the reserve and money market objectives specified by the Committee except for an extremely short period of time.

Chairman Burns commented that he believed the Manager would have authority to operate in that manner in any case. Nevertheless, in view of the nervous condition of the Euro-dollar market, it would be desirable to retain the words in question in order to demonstrate awareness of international monetary conditions on the part of the Committee. However, he would reverse the order, referring to domestic before international developments.

Mr. Brimmer said he would prefer to shift the emphasis a bit by saying, "while taking account of developments in domestic and international financial markets." Concerning the operational implications, he asked whether, in the event of a large increase in borrowings at the discount window, the Committee would expect the Desk to fully offset the borrowings or allow them to result in some increase in reserves. During the Penn Central difficulties in 1970, the borrowings had been allowed to affect reserve growth from June into September. He had been assuming that this time the borrowings would be fully offset in terms of their effects on reserves.

Chairman Burns said that would be the normal expectation; it should be assumed at present that the reserve effect of such borrowings would be fully offset, although there might be some differences in timing. If market conditions became disorderly, however, that assumption might have to be set aside.

Chairman Burns then asked first, whether there were any objections to adding to the third of the general paragraphs of the directive the reference to uneasy conditions in financial markets, as had been suggested by Mr. Hayes, and second, whether there were any objections to revising the operational paragraph of the directive to say, ". . .while taking account of developments in domestic and international financial markets."

No objections were raised to either suggestion.

Mr. Sheehan observed that he endorsed the policy position that had been expressed by Chairman Burns and Mr. Mitchell and that had been supported by others. He would favor a range of 11 to 11-1/2 per cent for the Federal funds rate, but he would not like the rate to go any higher than it had been in recent days and would prefer to see it hover around 11 per cent.

Mr. Clay commented that he continued to believe the primary goal of monetary policy must be to reduce the rate of inflation if money market conditions were to be brought back to any degree of normality. The alternative, should the monetary aggregates not be brought under control, would be an accelerating intensification of the problems confronting financial markets today. Accordingly, further slowing in the growth rates of M_1 and M_2 and a substantial reduction in the growth rate of the bank credit proxy

were required. In his opinion, growth in the aggregates as indexed by a target of growth in M_1 at a 5 per cent rate over the second and third quarters would be consistent with that objective. To achieve such a slowing in the aggregates, money market conditions would need to be tightened, with a range of 11-1/2 to 13-1/2 per cent specified for the Federal funds rate. In view of the current sensitive financial markets, however, he did not intend that the Committee use a sledge hammer to crack the financial peanut; it had to try to get at the nut over a period of time. He believed that the Manager was capable of judging the condition of the financial markets from day to day and could achieve the objective without disturbing financial markets unduly. Therefore, the Committee should retain the goal that it had had for some time, but it should switch to the money market directive to work toward that goal on a day-to-day basis.

Continuing, Mr. Clay said the actions taken by the System in the case of the Franklin National Bank had done a great deal to improve confidence in the financial markets. All over the country, banks that had been emphasizing liability management were beginning to examine their current positions seriously, and that would bring them back from the outer edges of liability management. They knew that in an emergency they would be likely to run into problems,

but they had the confidence that they would be able to see them through. Therefore, any actions in the period immediately ahead that could lead people to conclude that the Committee was giving up its longer-run objectives would be a great mistake and would increase the difficulty of getting the situation back under control. Bearing in mind that the Committee was not giving up its objectives, he could support the position taken by the Chairman and others.

Mr. Brimmer remarked that, like the Chairman and others, he believed that this was a time to pause. The fragility of the financial system should not be overlooked. As he had noted earlier, some of the largest banks in the country were in an exposed position with respect to the extent that they were relying on purchased money, and some of them might soon have to turn to the Reserve Banks for assistance. An additional indication of the problem was provided by a recent holding company case, in which the argument had been advanced that a proposal for an acquisition should be approved because the lead bank in the holding company was in such an exposed position that disapproval would rock the markets.

Mr. Brimmer said he favored alternative A. He believed that a ceiling of 11-1/2 per cent for the Federal funds rate would provide the Desk with enough leeway. And while he would prefer that the Desk offset additions to reserves arising from borrowings,

he recognized that the need to give attention to developments in financial markets might mean that that would not be fully accomplished in the short run.

Mr. Morris observed that the case for a pause at this juncture was very strong. That there were strains on the financial system at present was obvious, but the ability to forecast the possible consequences of those strains was very limited not only because the rise in short-term interest rates had been so sharp but because rates had moved into new high ground. No prior experience existed by which to judge the ability of the financial system to adapt to current rates. Therefore, the prudent course would be to hold steady for a month, so that the Committee would be in a better position to assess the consequences of the actions it had already taken.

Mr. Morris said he found reassuring the staff projections indicating that maintenance of prevailing money market conditions was not likely to produce a sharp expansion in the aggregates. If developments over the next 4 weeks suggested that those projections were wrong and that maintenance of prevailing money market conditions was in fact producing excessive growth in the aggregates, the Committee would have to reexamine the situation. At that time, however, four more weeks of experience would be available in assessing the nature

of the strains on the system. Consequently, he believed that a money market directive, with a Federal funds rate range of 11 to 11-1/2 per cent, was appropriate on a temporary basis.

Mr. MacLaury remarked that he had no difficulty in accepting a pause at this time, because he believed that the risks with respect to the real economy were on the side of weakness. Because of the sensitive state of financial markets, moreover, he would not want to see the funds rate move higher. Holding the rate in a range of 11 to 11-1/2 per cent would be satisfactory to him.

Mr. Bucher commented that he endorsed the Chairman's recommendation for a pause at this time. Like Mr. Holland, he would widen the short-run ranges of tolerance for the aggregates; he would suggest a range of 4 to 8 per cent for M_1 .

The Chairman said he thought, on the basis of the discussion, that the following suggestions might be acceptable to the Committee. He proposed that the Committee adopt a directive consisting of the staff's draft of the general paragraphs as amended earlier, and an operational paragraph couched in terms of money market conditions, 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 restrictive money market conditions, provided that the

monetary aggregates appear to be growing at rates within the specified ranges of tolerance." It would be understood that that directive would be interpreted in accordance with the following specifications. The longer-run targets--namely, the annual rates of growth for the second and third quarters combined--would be those shown under alternative B: 5-1/2, 6, and 12 per cent for M_1 , M_2 , and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the May-June period would be 13 to 20 per cent for RPD's, 3 to 7 per cent for M_1 , and 4-1/2 to 7-1/2 per cent for M_2 . The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 11 to 11-1/2 per cent. He asked whether the members concurred in those suggestions.

After discussion, the Committee agreed that the directive language and specifications suggested by the Chairman were appropriate.

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--which had declined appreciably in the first quarter--is likely to change little in the current quarter and that price increases are continuing exceptionally large. In April industrial production and manufacturing employment expanded somewhat, after having declined for 4 months. The unemployment rate edged down to 5 per cent, as the civilian labor force declined. Wholesale prices of farm and food products declined substantially further, but increases among industrial commodities again were widespread and extraordinarily large. The advance in wage rates has accelerated somewhat in recent months, and unit labor costs have been rising at a fast pace.

In April and early May the dollar depreciated further against leading foreign currencies, and the balance of payments remained in deficit on the official settlements basis. Rising import costs for petroleum and other products contributed to a sizable deficit in U.S. foreign trade in March.

Growth in the narrowly defined money stock slackened somewhat in April from the rapid pace in the preceding 2 months, and the more broadly defined money stock continued to expand moderately. Deposit experience at nonbank thrift institutions deteriorated sharply. Business short-term credit demands remained exceptionally strong. These demands were concentrated in banks, and to help finance loan growth, banks issued a record amount of large-denomination CD's and continued to borrow in the commercial paper and Euro-dollar markets. Private short-term market interest rates have risen sharply further in recent weeks and conditions in financial markets have been uneasy. Treasury bill rates also rose in late April and early May, but have declined markedly in recent days. Long-term rates have continued upward. Effective April 25, Federal Reserve discount rates were raised one-half point to 8 per cent.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, supporting a resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

To implement this policy, while taking account of developments in domestic and international finance markets, the Committee seeks to maintain about the prevailing restrictive money market conditions, provided that the monetary aggregates appear to be growing at rates within the specified 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 F.

5/21/74

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It was agreed that the next meeting of the Committee would be held on June 18, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Zaida
Secretary

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

ATTACHMENT A

Office Correspondence

Date May 13, 1974

To Board of Governors

Subject: Eleventh Meeting of Governors
of Central Banks of the Western
Hemisphere.

From Andrew F. Brimmer

The eleventh annual meeting of Governors of Central Banks of the Western Hemisphere was held in Caracas, Venezuela, April 29-30, 1974. It was followed by a meeting of the Assembly of the Center for Latin American Monetary Studies (CEMLA) and by the eighteenth meeting of Governors of the Latin American Central Banks. An account of the CEMLA Assembly and of the Latin American meeting is presented in Appendix A.

Twenty six central banks were represented at the hemispheric meeting, sixteen of them by their President or other chief executive officer. In addition, Panama, where there is no central bank, was represented by the Chairman of the National Banking Commission, who is also Minister of Finance and Economic Planning. The Federal Reserve delegation, which I headed, included Presidents Hayes and Kimbrel, of the Federal Reserve Banks of New York and Atlanta, respectively, Mr. Pardee, Vice President of the Federal Reserve Bank of New York, and Mr. Maroni, Senior Economist in the Board's Division of International Finance.^{1/}

Three topics were on the agenda of the meeting: (1) central bank mechanisms to channel credit; (2) the recent experience with floating exchange rates; and (3) the impact of the world demand-supply situation for petroleum on the economies and balances of payments of the countries of the Western Hemisphere. For each topic, there was a formal paper, followed by two prepared comments. The floor was then open for a general discussion. It was my responsibility to present the main paper on the petroleum problem. A copy of my paper is attached.

1/ This report is largely based on Mr. Maroni's notes.

In general, the discussions were useful and interesting. The participants were frank in sharing their experiences, though I sensed a definite reluctance to speak on the petroleum question on the part of many of the representatives from countries entirely dependent on imports for their petroleum supplies. It appears that they were afraid to ruffle the feelings of the petroleum exporting countries of the region -- and particularly those of the host country, Venezuela -- if they drew attention to the harm which is being done to them by the higher price of petroleum. It is likely that the petroleum importing countries of the region are counting heavily on the goodwill of their more fortunate neighbors to induce the latter to recycle a portion of their surplus petroleum earnings directly or indirectly to them, thereby alleviating their difficulties. The petroleum importing countries of the region may also be unwilling to speak up on the impact of the higher petroleum prices because they hope to be able, some day, to raise the prices of their own exports.

The Petroleum Problem

The presentation which I made on the petroleum question was well received. Several of the participants said that they were glad that the question was being discussed unemotionally and purely from the point of view of the financial and economic realities which a higher price of petroleum entails -- whatever its precise level. Some of the participants told me privately outside the meeting room that they were pleased that an impartial analysis of the facts had been presented by our delegation, since this was not a very popular approach to the question in the region. President Hayes

made a useful contribution to our presentation by amplifying and making more explicit my prepared remarks on some of the financial strains likely to arise in the markets as the surplus earnings of the petroleum exporting countries are recycled, and this too was favorably commented on by the participants. A detailed account of the comments made by the participants on the petroleum problem is presented in Appendix B.

Floating Exchange Rates

The main paper on floating exchange rates was presented by the Bank of Canada, which was represented by Mr. Robert Johnstone, Adviser. Mr. Johnstone contended that the fears expressed before 1973 by the critics of a move to floating exchange rates have not been realized. He noted that international trade had not been disrupted and instead had continued to grow in 1973, that the fluctuations in exchange rates which have occurred since the beginning of 1973 were by and large in appropriate directions and helped to redress the persistent imbalance in the payments position of major countries rather than being perverse as some feared, and that the adoption of floating rates had not been accompanied by attempts to escape from the responsibility of cooperating in seeking solutions to international monetary and payments problems or to escape from a disciplined management of domestic policies. He conceded that one year was too short a period to reach definitive conclusions and that the story might have been different if many countries had been faced with problems of faltering demand and unemployment instead of unusual strength in demand. But as things turned out, he felt that floating, on the whole, had worked well. He gave

a favorable account of Canada's experience with floating rates since 1970. While he warned that this was not necessarily applicable to other countries and that he was not preaching the merits of floating rates for all countries at all times, his own preference for such a policy -- not unexpectedly -- was unmistakable.

The prepared comments were made by the representatives of Uruguay and Jamaica, who took issue with the main Canadian contention. Both said that the trade expansion of 1973 was motivated by boom conditions which were so strong that they could not have been outweighed by uncertainties generated by floating rates. The Uruguayan representative also pointed out that the move to floating rates reflected a lack of monetary discipline and that the will to negotiate a comprehensive reform of the international monetary system had waned in recent months. The Jamaican representative expressed the view that the magnitude of the exchange rate movements in 1973 was, at times, questionable and in some cases in the wrong direction. He noted that the conditions of 1973 required anti-inflationary policies and that this more than offset any temptation to relax internal financial discipline that floating might otherwise have fostered.

The representatives of Uruguay and Jamaica assessed floating rates primarily from the standpoint of the developing countries. Not surprisingly, they expressed unhappiness with the present arrangements and stressed the problems and difficulties which these arrangements are causing them. Among the problems cited were the lack of a forward market in the developing countries, the instability of exchange rates between the

currencies of neighboring developing countries which use different intervention currencies (e.g. Jamaica is tied to the dollar while the other commonwealth Caribbean countries continue to be tied to sterling), the variability of the real value of reserves and of export earnings, the complications arising for a developing country whose currency is pegged to a floating intervention currency because its exchange rate vis-à-vis other currencies moves without regard for the state of its own balance of payments, and the reduced need to create SDRs because the currencies of the major countries are floating, at a time when the developing countries need more liquidity rather than less because their currencies are pegged to floating intervention currencies.

In the ensuing discussion, Mr. Cano, President of the Central Bank of Chile, expressed a preference for frequent rate adjustments for countries experiencing chronic inflation; Mr. Barreto, President of the Central Bank of Peru, pointed out how difficult it was to tell whether floating intensified an internal disequilibrium or resulted from it; and Mr. Uribe, the Bank of Mexico's Manager for Economic Policy and Research, explained that the fixity of the peso-dollar rate was a cardinal element of policy which the Mexican authorities had decided not to alter in 1973 in the belief that other means could be used to deal with the problem.

I commented that the world was really on a mixed system of fixed and floating rates and that floating was subject to various degrees of intervention. I spoke briefly about U.S. intervention, and President Hayes amplified my remarks on this point. I noted that the depreciation of the dollar in the March-July 1973 period had added substantially to domestic

inflationary pressures and that the need to coordinate monetary policies among countries was not diminished by floating.

I emphasized that, while the U.S. money markets were more open now than they had ever been, following the elimination of capital controls, it should not be concluded that the U.S. authorities would allow their influence over domestic interest rates to be diminished.

The discussion made it clear that the developing countries would prefer a greater degree of stability among major currencies than has prevailed in the last twelve or fifteen months. The Uruguayan delegate in particular spoke of the need for intervention in exchange markets and urged the prompt adoption of guidelines for this purpose. However, there appeared to be a general recognition that an improved adjustment process among the industrialized countries would be beneficial to the developing countries and a readiness to put up with some of the inconveniences of floating if this would help to establish conditions under which the transfer of real resources from the developed countries to the developing countries would not be jeopardized every time that a balance of payments adjustment is needed by the former.

The Transfer of Real Resources

Indeed, the transfer of real resources to the developing countries appeared to be uppermost in the minds of the participants. During the discussion on the petroleum question, several of them commented that the increase in petroleum prices was causing great uncertainty as to the intentions of a number of developed countries regarding their foreign assistance

commitments. No one explicitly cited the United States in this connection, but the Congressional action last winter rejecting Administration proposals to replenish the resources of IDA (the World Bank's soft loan affiliate) was clearly on their minds. One participant -- Mr. Paulo Pereira Lira, President of the Central Bank of Brazil -- went so far as to say that the real crisis was not the petroleum crisis but the crisis of the transfer of real resources. Another -- Mr. Alfredo Phillips, of the Bank of Mexico -- commented that no political will to proceed with the transfer of real resources to the developing countries was apparent. Mr. Phillips stressed that the developing countries needed to convince the developed countries that it would be in the interest of all concerned to establish reliable mechanisms to transfer real resources to the developing countries.

In this connection, Mr. Victor Bruce, President of the Central Bank of Trinidad and Tobago, told me in a private conversation that the developing countries were waiting for the United States to make a definite statement, one way or the other, on the proposal to link the issuance of SDRs and the extension of development assistance. He said that, if the link proposed was definitely out of the question this should be made known, and if the United States really favored a reliable method to transfer real resources to the developing countries, it would be helpful to know what plan the United States had in mind. One participant told Mr. Maroni that the statement on the link proposal made by Chairman Burns at a meeting of the Committee of 20 last July had been discounted by some

Latin Americans who interpreted the fact that the statement was made by Chairman Burns rather than by Secretary Shultz as a maneuver which left the Secretary uncommitted on the issue -- and therefore free to endorse the link later if that proved to be politically desirable.

The Channeling of Bank Credit

Ten Governors commented on the channeling of bank credit, most of them to outline the experience of their own country. The principal analytical comment was made by Mr. Manuel Uribe, of the Bank of Mexico, who recognized the difficulties inherent in a system of selective credit controls, but stressed the need to employ such controls in the face of the serious imperfections with which the price mechanism operates in the developing countries and the difficult problems associated with the use of interest rates as a means of allocating resources in such countries. Mr. Uribe suggested that there was a need to assess the effects of such controls on the structure of production, the level of prices and the distribution of income, and to analyze their implications for the composition of bank assets, the relative economic position of various sectors of the economy, and the flow of savings to the banking system and to the securities markets.

I expressed the hope that CEMLA would undertake an analytical study of the problems raised in this connection, and in particular that it would attempt to assess the effectiveness of the many different mechanisms in use in the countries of the Hemisphere. I added that, in my opinion, CEMLA should not hesitate to assess also the techniques used

in the United States to channel credit in desired directions. I pointed out that it would be helpful to us to have an objective dispassionate view of the merits of interest rate ceilings, for example.

The discussion on the channeling of credit was based on a survey of the techniques in use in the Hemisphere, undertaken by CEMLA following a suggestion which I made at last year's meeting. The CEMLA survey disclosed an enormous variety of techniques being applied, but CEMLA had not, so far, attempted any evaluation of their effectiveness.

The International Financial Posture of Venezuela

Before the meeting got underway, the participants heard a speech by Mr. Hector Hurtado, the new Minister of Finance of Venezuela, who outlined his country's financial views. He began by deploring the lack of progress on the reform of the international monetary system and the attempt of some developed countries to blame this -- and the world economic crisis itself -- on the recent increases in petroleum prices. He then assumed the attitude of championing the interests of the developing countries, while offering to help solve the financial problems of the world in a multilateral manner and in cooperation with the international institutions.

He stressed the adverse effects of the recent uncertainties on the transfer of real resources to the developing countries and the lack of political will in the industrialized countries to adopt new arrangements and rules of international financial conduct, and he described the petroleum problem as one of balance of payments adjustment to a new and irreversible situation as regards petroleum prices. He proclaimed a need for "fairer"

prices for all raw materials and urged that closer ties be established among raw material producing countries to achieve this result. He complained that the profits of the large international oil companies were intolerably large and not in accord with the efficiency and the welfare of the world community.

He listed the steps taken by Venezuela to recycle part of its petroleum earnings, and announced the creation of a Venezuelan Investment Fund -- which, incidentally, will be headed by Mr. Benito Losada, a former President of the Central Bank, who is well known to several Board Members. This fund will undertake (among other things) the direct financing of development projects in other countries, as well as to purchase bonds and loan participations from international institutions.

He expressed support for the proposal of the Managing Director of the IMF to create a special oil facility in the IMF, but he warned that this facility must give priority to the needs of the developing countries, through rules of eligibility to borrow and a schedule of amounts which may be borrowed designed so as to prevent the developed countries from capturing the lion's share of the available resources.

Policy Statement by the New President of Venezuela

While the meeting was in progress, the new President of Venezuela -- who took office in March -- made an important policy speech in which he announced a series of economic and financial measures, including the nationalization of the iron ore concessions and of a supermarket chain owned by a Rockefeller enterprise, and the requirement that many foreign firms divest

themselves of substantial shares of their Venezuelan holdings. These measures are causing much concern among American businessmen operating in Venezuela.

It is clear that the new position of wealth in which Venezuela finds itself is enabling it to be far more independent of foreign capital than it has been up to now. The acquisition of business interests now held by foreigners is, of course, one way to recycle a part of Venezuela's petroleum earnings.

Other measures announced by the President include a rather sweeping increase in wages -- while prices remain frozen -- a cut in the maximum interest rates on consumer installment credit, and higher taxes on the oil companies. I should add that there are persistent rumors that the Venezuelan currency will soon be appreciated. However, the Finance Minister has denied that this was in prospect.

Concluding Comments

My experience at this meeting, as at the one held a year ago, is that these sessions are very useful -- not only for the opportunity to exchange ideas and learn one another's points of view -- but also in establishing a rapport with the central bankers of the area. Because of the relatively frequent changes in the top positions of many of the area's central banks, these personal contacts must constantly be renewed. By participating at the highest possible level, we give concrete evidence that our expressions of concern for the area and of interest in its problems are genuine, and we strengthen the efforts of the U.S. Government to develop closer and more mature relations with the other countries of the Hemisphere.

The next meeting will be held in Panama, approximately a year from now. An agenda committee to prepare for that meeting has been named, consisting of the Central Banks of Chile and Jamaica and the National Banking Commission of Panama.

Appendix A

Meeting of CEMLA Assembly

and Meeting of

Governors of The Latin American Central Banks

Following the meeting of Governors of Central Banks of the Hemisphere, two other central bank meetings took place.

CEMLA Assembly

The Assembly of members of the Center for Latin American Monetary Studies, known as CEMLA for its Spanish language initials, met on May 1. CEMLA has 22 Central Banks as voting members, and 4 more -- including the Federal Reserve System -- as non-voting members. Another 18 institutions also participate as non-voting members.

The Assembly heard a detailed presentation by CEMLA's new Director, Mr. Adolfo Diz, of a program to institute major changes in the orientation and structure of the institution, aimed at strengthening its training, research, publication and information activities. The Assembly voted unanimously to endorse this program and approved a plan to increase and restructure the dues schedule so as to provide the financing which the program will require.

The Assembly also voted to admit two new voting members, the Central Bank of Guyana and the National Banking Commission of Panama.

Latin American Governors Meeting

The eighteenth meeting of the Governors of the Latin American Central Banks, which we were invited to attend as observers, was held on May 2. This meeting was conducted along lines similar to the hemispheric

meeting which preceded it. The agenda covered (a) techniques to promote exports, (b) central bank capability and effectiveness in managing money supply, and (c) reports by the three Latin American Executive Directors in the IMF.

Before considering the items on the agenda, the meeting, acting on a suggestion of the Venezuelan Finance Minister, set up a working group, consisting of representatives from four Central Banks plus the three IMF Executive Directors, to make recommendations on the ways in which the Venezuelan contribution to the proposed IMF oil facility might be made available in order to ensure that the facility would give priority access to its resources to the developing countries. Because of lack of time, the working group made only a quick study of the matter and did not come up with detailed proposals before the meeting adjourned. But by requesting the recommendations of such a group, the Venezuelan authorities strengthened their posture as defender of the interests of the developing countries.

The discussion on export promotion brought out the fact that a number of countries are running afoul of the U.S. anti-dumping law and that the U.S. has imposed countervailing duties against some of the affected products. The participants expressed concern over this situation, and warned each other that export promotion devices should be reviewed to stay clear of such difficulties. The discussion also brought out the feeling, on the part of a number of participants, that existing facilities to finance Latin American exports are inadequate. The Argentine and Mexican representatives suggested the use of IBRD and IDB guarantees to permit more extensive discounting of export paper in foreign markets.

The main paper on the management of money supply, presented by the Central Bank of Nicaragua, argued that the central banks of developing countries have no control over money supply, whether it be on the magnitude of the changes or on their direction, and that money supply is determined by decisions made by the public, largely independently of the actions of the Central Bank. The Nicaraguan representative admitted that this thesis was based on the Nicaraguan experience and that it was influenced by the fact that the Nicaraguan economy is open to international influences, has long enjoyed a stable exchange rate with few if any exchange restrictions, and is largely agricultural. But he claimed that it was applicable to other developing countries. The reasoning was involved and the meaning was not always entirely clear, but it appeared that the key element of the analysis was that changes in the balance of payments automatically absorbed any change in money supply that did not correspond to the domestic demand for money and thereby nullified the power of the central bank to control it. The paper suggested that, rather than attempting to affect the supply of money, central banks should seek to influence the factors which determine the demand for money, particularly credit expansion. The paper also suggested that the concept of money be broadened so as to include all liquid assets, "including obligations of any nature of bank and non-bank financial intermediaries."

In his prepared comment, Mr. Cano, President of the Central Bank of Chile, agreed that, in an open economy with a fixed exchange rate, the effectiveness of monetary policy was limited, but he suggested that the central bank did have control over the nominal amount of money supply. He pointed out that discrepancies between the amount of money created, in

nominal terms, and the amount demanded by the public would have repercussions on the level of domestic prices, interest rates, and international reserves, but he argued that the Central Bank had means to deal with this situation, including the power to alter the exchange rate, or to impose exchange restrictions. He added that the speed with which these repercussions would occur would depend on the ease with which the public had access to credit, and he said that this was the reason why domestic credit expansion, rather than money supply, was the key variable for monetary policy. He noted that, since central banks in developing countries could not use open market operations to influence credit expansion, they often resorted instead to direct or selective measures of credit regulation. He agreed that it was desirable to broaden the analysis of the demand for liquid assets so as to include all obligations of the financial intermediaries, but noted that, since non-bank financial intermediaries are not regulated by the Central Bank, there was no need to include their obligations in the definition of money.

Mr. Victor Bruce, President of the Central Bank of Trinidad and Tobago, also presented a prepared comment. He reviewed the analysis which has led central bankers to focus on money supply in their attempt to influence the level of economic activity, and some of the reasons why this analysis has been questioned. He agreed that the wider definition of money suggested by the Central Bank of Nicaragua had merit. He stressed the limitations of the instruments of monetary policy in the developing countries, and the difficulty of controlling the influence on the money supply of the net foreign assets and the government deficit. He commented

that the Nicaraguan paper in effect called for a reassessment of the approach to monetary policy and he expressed sympathy for this view.

In the ensuing discussion, the representatives of Peru, Mexico, and Argentina reviewed the experience of their country with their respective monetary management techniques. Mr. Barreto (Peru) and Mr. Uribe (Mexico) felt that their country's experience showed that money supply could be controlled. Mr. Gomez Morales (Argentina), for his part, said that monetary policy was a consequence of overall economic policy and that monetary management was useless unless it was incorporated in a comprehensive economic program.

The final session of the meeting was devoted to reports by the three Latin American Executive Directors in the IMF. Mr. Alexander Kafka (Brazil) reviewed the status of the C-20 negotiations. Mr. Carlos Massad (Chile) reported on the problem of formulating guidelines for a system of floating exchange rates. Mr. Guillermo Bueso (Honduras) discussed the progress being made toward establishing an IMF oil facility. This led to comments by Mr. Ricardo Ariazú, Alternate Executive Director in the IMF (Argentina), concerning the forthcoming review of IMF quotas. Mr. Ariazú pointed out that the Latin American countries are losing ground economically relative to the rest of the world, and warned that the area might experience adverse consequences from this in the quota review.

The next meeting of Governors of the Latin American Central Banks will be held in Mexico City in September, the week before the annual IMF/IBRD meetings.

Appendix B

Latin American and Caribbean Comments
on Petroleum Problem at the
Meeting of Central Bank Governors

Ten participants commented on my presentation: Four of them represented oil exporting countries; three more were from countries which are nearly self sufficient in oil; one was from a country with some crude oil production; only two represented countries with no crude oil production.

Mr. Pereira Lira, President of the Central Bank of Brazil,^{1/} said that he was glad to hear that the effects of the increase in petroleum prices on the industrialized countries were not as bad as had been feared at first. He noted that, for the first time, the developed countries were feeling the economic pressures usually felt by the developing countries. He agreed with me that it was now essential to reevaluate the traditional views on the balance of payments and to learn to accept large trade or current account deficits.

He recognized that the petroleum importing countries would suffer a loss of welfare and said that the problem for these countries was to find a way to absorb this loss without having to suffer a lower rate of economic growth. He concurred in what I had to say about the dangers of stimulating demand in the present circumstances.

He played down the problems associated with the recycling of the surplus earnings of the petroleum exporting countries. He said that the Euro-currency markets were accustomed to handling short-term liabilities and

^{1/} Brazil produces only about 25 per cent of its petroleum needs.

extending long term credits and that the bankers operating in these markets should be able to cope with this problem in the future. He noted also that the petroleum exporting countries had expressed a willingness to recycle and that this should allay the fears of those worrying about balance of payments equilibrium. He suggested that the amount of recycling and the terms under which it might take place could be dealt with in later discussions. He pointed out that the proposed IMF oil facility would help and that some developing countries -- notably Brazil -- had ample reserves to tide them over the initial period -- although this was not the case for the developing countries as a group. He said that the developed countries had an important role to play in channeling funds to the developing countries and that the problems of the latter would be greatly eased if the former would only increase their level of official development assistance in accordance with the targets sanctioned by the United Nations -- so as to bring it to 7/10 of 1 per cent of GNP.

He placed the additional import cost for Brazil in 1974 as a result of the increased oil import bill at about \$2 billion. He said that the Brazilian authorities were hoping that this would not have unduly large adverse effects on other imports and that the rate of growth of GNP would not suffer much.

He concluded that the real crisis for the developing countries was that of the transfer of real resources which is endangered by the uncertainties stemming from the higher oil prices.

Mr. Espinosa, General Manager of the Central Bank of Ecuador,^{1/} took exception to my having stated that the petroleum situation stemmed

^{1/} An oil exporting country.

from a unilateral action by the oil producing countries. He said that there was nothing new or unusual about acting unilaterally and that developed countries acted this way often. He cited the unilateral declaration of inconvertibility of the dollar and the unilateral decision to float currencies hitherto considered firmly anchored. He said that it was not fair to single out the oil producing countries for criticism on this score.

He defended the decision to raise oil prices, noting that it reflected changes in market conditions, that the oil producers were facing ever higher prices for their imports, that luxury consumption and wasteful uses of oil had to be curbed, and that the oil companies were earning intolerably high profits. He suggested that the increase in oil prices had opened the door to increases in other prices which, he said, had long been held too low.

He expressed confidence in the recycling decisions of the oil producing countries and in the ability of the consuming countries as a group to recapture the additional cost of oil imports, and voiced optimism in the ability of the world to handle the problem through cooperative action.

Mr. Barreto, President of the Central Reserve Bank of Peru,^{1/} said that the oil crisis made it possible to appreciate more clearly the crisis of the world economy and of the monetary system. He took the position that both stemmed from the inflation which has been allowed to

^{1/} Peru produces about 70 per cent of its oil needs.

persist for so long in so many important countries. He added that the maldistribution of world liquidity had made matters worse and helped to perpetuate the disequilibrium. He urged a redistribution of world liquidity and the adoption of coordinated policies to prevent it from again becoming maldistributed. He suggested that the redistribution of liquidity being accomplished through the increase in oil prices presented a unique opportunity to apply these principles.

Mr. Branda, Vice President of the Central Bank of Uruguay,^{1/} noted that his country had little access to additional financing and that petroleum imports would reach \$170 million, or 35 per cent of total imports, in 1974. He said that this percentage had never exceeded 15 per cent in the past, and that it would take a tripling of meat exports -- the country's principal export -- to pay for such a large jump in oil import costs. He said that such an increase in meat exports was not feasible. He also said that the higher cost of oil would intensify inflationary pressures in Uruguay by an estimated 5 per cent.

Mr. Bruce, President of the Central Bank of Trinidad and Tobago,^{2/} said that his country was a small oil producer and would derive some benefits from the price increase. He agreed that the producing countries must finance the deficits of the consuming countries and he indicated that some recycling proposals by his country were about to be presented to the other countries of the Caribbean area for which Trinidad and Tobago has special responsibilities. He added that his country has offered to purchase IDB bonds and that discussions have begun looking to the purchase of IBRD bonds.

^{1/} There is no crude oil production in Uruguay.

^{2/} An oil exporting country.

Mr. Phillips, the Bank of Mexico's^{1/} Manager for Relations with International Organizations, said that the petroleum problem merely intensified the problem that the world economy was already facing. He said that, in addition to the effects on aggregate demand, employment, and prices, there was a specific effect on the fertilizer industry which would hurt most those least able to afford it. He noted that the search for new energy sources was beyond the reach of many developing countries which cannot afford the high cost investment required. He expressed some misgivings about the ability of many developing countries to tap the financial markets of the world in competition with the developed countries, some of which have already tapped them for what he called astronomical amounts. He complained that the intentions of the developed countries regarding the transfer of real resources were not clear and that there appeared to be no political will to proceed on this matter in those countries. He urged the developing countries to work to convince the developed countries that it would be in the interest of all countries to establish reliable mechanisms to transfer real resources. As for Mexico, he said that it was nearly self sufficient in petroleum and that it hoped to be fully self sufficient soon.

Mr. Gomez Morales, President of the Central Bank of Argentina,^{2/} expressed pleasure that the problem was being discussed realistically as a fact. He agreed that the effects on the balances of payments and on the negotiations for a new financial order in the world were paramount. But he stressed that, in his opinion, the failure of the reform efforts was due to

1/ Mexico produces nearly 90 per cent of its oil needs.

2/ Argentina produces nearly 90 per cent of its oil needs.

a lack of political will, and not to the rise in petroleum prices. He suggested that to finance the oil deficits would merely postpone the day of reckoning for the borrowers and would saddle them with ever increasing interest payments. He indicated that Argentina was nearly self-sufficient in petroleum and that it was making efforts to increase other forms of energy production to fill the gap.

Mr. Silva, First Vice President of the Central Bank of Venezuela,^{1/} noted that the developing countries have long suffered adverse terms of trade and that this had recently begun to change. He viewed the increase in oil prices as a step to redress the relative price position for the producing countries. He pointed out that the Paley Commission, which prepared projections on the need for basic resources in the early 1950s, had grossly underestimated the demand for 1975.

He complained that it was wasteful to use petroleum as fuel when it could be used productively in the petrochemical industry and in many other ways, including the production of proteins. He placed the blame for the world financial crisis on the lack of fiscal discipline in the key currency countries. He added that world inflation and the depreciation of key currencies had reduced the purchasing power of the export earnings of the developing countries in general and of the oil producing countries in particular. This, he said, made it reasonable to raise oil prices. He admitted that the higher oil prices would have an impact on world price levels, but he noted that sharp increases in other commodity prices -- especially wheat, sugar, and soybeans -- were also contributing heavily to the rising trend of world prices.

^{1/} An oil exporting country.

He emphasized Venezuela's cooperative attitude, citing its decision not to cut oil output when other producing countries did. But he failed to mention Venezuela's announcement, last month, of a 7 per cent cut in output to reduce the amount of gas being flared at the wells.

He listed the steps taken by Venezuela to recycle some of its oil export earnings: (a) its efforts to promote the creation of an OPEC development fund; (b) its agreement to IDB and IBRD bond issues in the Venezuelan market; (c) its decision to create and endow a development trust fund in the IDB; (d) its decision to make contributions to three regional development banks -- the Andean Development Corporation, the Central American Bank for Economic Integration, and the Caribbean Development Bank -- (e) its decision to incorporate petroleum in the system of reciprocal credits in use among the member countries of the Latin American Free Trade Association -- in effect deferring payment for petroleum for a number of months beyond the customary payment period; and (f) its decision to earmark 50 per cent of its petroleum revenues for a National Investment Fund, one of whose functions will be to finance development projects in Latin America.

Mr. Mercado, President of the Central Bank of Bolivia^{1/}, said that the countries producing basic commodities other than oil were just as badly affected as the oil producing countries by the chronic deterioration in their terms of trade as their import prices rose without interruption over the years. He said that this condition needed to be corrected and that this was

1/ An oil exporting country.

especially important when they were among the least developed of the developing countries.

I thanked those who had spoken for their comments and I remarked that only one of them represented a country (Uruguay) totally dependent on imports for its oil supplies. I said that, since there were 12 such countries in the region and since the impact of the oil crisis on them was bound to be severe, it would be interesting to hear from a few more representatives of this group of countries.

Only one, Mr. Fernandez, President of the Central Bank of the Dominican Republic,^{1/} responded. He said that his country's oil imports in 1974 would exceed 25 per cent of total imports. He expressed appreciation for my concern over the plight of countries totally dependent on imports for their oil supplies, and for Venezuela's announced intentions to help. He added that his country was benefitting from a rise in the price of its principal export (sugar), and he noted that the price of sugar was responding to the pull of demand rather than to a curtailment of supplies.

1/ The Dominican Republic has no crude oil production.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

ATTACHMENT B

Office Correspondence

Date May 17, 1974

To Board of Governors

Subject: Visit to Trinidad and Tobago

From Andrew F. Brimmer

April 26-28, 1974.

On April 26-28, I visited Trinidad and Tobago, accompanied by Mr. Yves Maroni, of the Board staff.^{1/} I called on the Central Bank, the Ministry of Finance and the local offices of Chase Manhattan Bank and First National City Bank--the two U.S. banks operating in the country. I also met with the managers of all of the banks in a group session at the Central Bank. At the end of my visit, I was invited by the Governor General of Trinidad and Tobago, Sir Ellis Clarke, a former Ambassador to the United States, to call at his residence where we had a long private conversation. I had also a private luncheon at the home of the Deputy Governor of the Central Bank, Mr. Leonard Williams, who was acting Governor in the absence of Governor Victor Bruce.^{2/}

I was warmly received and I believe that my visit did much to strengthen the relations between the Federal Reserve System and the financial community of Trinidad and Tobago. I had been scheduled to make this visit a year ago, but had to cancel it at the last moment because of pressing business in Washington. By rescheduling the visit, I was able to show genuine interest in the country and its problems and to erase any bad feeling which might have been left by my earlier last minute cancellation.

1/ This report is largely based on his notes.

2/ Governor Bruce was out of the country during my visit.

Throughout the visit, I maintained close contacts with the U.S. Embassy and received strong support from Ambassador Lloyd I. Miller and his staff. The Economic officer of the Embassy, Mr. James C. Todd was especially helpful in arranging the schedule of appointments in cooperation with the Central Bank and in handling administrative details. At the start of the visit, I received a useful briefing from Ambassador Miller, Mr. Robert G. Rich, Deputy Chief of Mission, and Mr. Todd. Ambassador Miller accompanied me on my calls at the Central Bank and at the Ministry of Finance and later hosted a reception in my honor at his residence, at which I had a chance to meet a number of American businessmen operating in the country, in particular the representatives of oil companies with refining and offshore drilling facilities.

My conversations covered a wide variety of financial and economic subjects. They are summarized below under topical headings.

The "localization" of foreign banks

In 1967, the Prime Minister of Trinidad and Tobago laid down the policy that foreign banks must transform themselves into local banks within five years. This was understood to require local incorporation with--eventually--at least 51 per cent of the capital locally owned. Since then, Barclays Bank, the Royal Bank of Canada and the Bank of Nova Scotia have become locally incorporated and have begun to issue shares on the local market, and the Canadian Imperial Bank of Commerce is scheduled to follow their lead this year.

First National City Bank of New York has asked to be allowed to continue operating as a branch of the New York entity. In return, it has offered to bring in more capital to conduct its local banking activities than would be required from a locally incorporated institution, and to incorporate locally separate companies to conduct its congeneric activities, including a finance company, a leasing company, and a data processing company. These companies would be joint ventures with local capital and they would be in compliance with the localization policy. This proposal is still under consideration by the Trinidad and Tobago authorities. Chase Manhattan Bank, following the Citibank lead, has submitted an essentially similar proposal.

When I called on him, the Minister of Finance, Mr. G.M. Chambers, expressed satisfaction with the progress made so far in implementing the localization policy. But he did not specifically refer to the proposals made by the American banks. Mr. Williams, Deputy Governor of the Central Bank, told me that the authorities faced a difficult decision in this case. If the American banks' proposal is accepted, this is likely to be coupled with the establishment of special restrictions on their lending to place them on a basis comparable to that in effect for other banks. This is because applicable regulations relate the level of lending to the amount of a bank's capital--a relatively small amount for the banks which have complied with the localization policy, but a much larger one (the capital of the head office, to be precise) for those which continue to operate as branches of a

worldwide concern. Last January, the Minister of Finance asked Parliament to amend the law to require the banks operating as branches of foreign banks to hold "ascribed capital" equal to not less than 5 per cent of their deposit liabilities, such "capital" to be brought in from abroad and to be invested in securities approved by the Central Bank.

The managers of both U.S. banks made it clear that the authorities would not permit the opening of any additional bank offices by foreign banks. Chase Manhattan was allowed to move one of its bank offices from its old location at the Hilton Hotel to the new Holiday Inn, but the Canadian Imperial Bank of Commerce was denied permission to open a bank office in the lobby of a new office building the construction of which it had financed. The site was awarded instead to the Government owned National Commercial Bank.

Competition Among Banks

Barclays Bank has been in the country the longest, has the largest number of banking offices, and the largest amount of deposits--about \$200 million. The two American banks are relative newcomers and have been far more aggressive than the older established institutions. Mr. Ian Dasent, Manager of the Citibank branch, claimed that Barclays Bank earned only \$1.5 million last year with its \$200 million in deposits, but that he was able to earn \$7 million on deposits of only \$60 million.

He gave credit to the Bank of Nova Scotia for opening up the field of consumer credit which the two other Canadian banks and Barclays had ignored until then. He said that Barclays paid 2-1/2 per cent on

savings deposits and refused to pay more because of the large volume of deposits on which a higher rate would apply. He noted that Barclays had an advantage in that it had offices in many areas where there was no other bank. With its low rate on savings deposits, Barclays was able to hold its lending rate down and thus put a squeeze on the other banks which had to pay increasingly higher rates last year to attract funds. Competition raised the rate paid by banks for new funds to levels which left little margin for profit. In the end, there was a gentlemen's agreement among the banks to pay no more than 9-1/2 per cent for funds.*

The Financial Situation

The growth of consumer credit was accompanied by a rapid rise in imports in 1972 and 1973. At the same time, there was a shift in the pattern of financing, as the local importers who, for many years, financed themselves in the United Kingdom, switched to local financing when interest rates in that country rose in the second half of 1972 and in 1973. The domestic credit expansion greatly reduced the excess reserves which the banks had long been accustomed to maintain, and put pressure on local interest rates. International reserves declined under the dual impact of rapidly rising imports and a reduced use of foreign financing for imports. Domestic prices also rose more rapidly.

Early in 1973, the Central Bank raised reserve requirements and introduced restrictions on consumer credit. But it was not until the Government raised relatively large loans abroad in the second half of 1973 that the

* I was told informally that the idea of a ceiling originated with the Central Bank.

decline in reserves was halted. The rise in petroleum prices has since occurred, strengthening the external position of the country, which has a net export surplus in petroleum. Domestic prices, for their part, surged ahead more sharply, partly in response to worldwide price trends, especially as regards foodstuffs. Consumer prices, in particular, rose 23 per cent in 1973.

In many of my conversations, reference was made to the intensifying wage demands which organized labor has been putting forward. Recent contracts have been providing wage increases of 25-40 per cent over a three-year period. A special labor problem is emerging in the form of a drive to unionize bank workers. The recent inflationary upsurge has given the organizers of the bank unionization movement a strong argument to make headway among bank employees.

I wondered why the Trinidad and Tobago dollar remained tied to the pound when the greater part of the country's trade is with the United States. One answer I received was that the currency was overvalued and that the sterling link enabled it to float down against the dollar when sterling floated after June 1972. Another answer was that trade with the other commonwealth Caribbean countries was growing and that these countries, with the exception of Jamaica, were also tied to sterling. Still another answer was that the sterling tie served the country well in view of the arrangements with the U.K. Treasury and the Bank of England, which provides some type of exchange rate guarantee.

International Financial Issues

During my call on the Minister of Finance, the Permanent Secretary of the Ministry, Mr. Frank Rampersad, expressed concern over the outcome of the C-20 discussions. He worried that the result might be the resurgence of the influence of the Group of Ten and the shelving of the proposals to improve the transfer of real resources to the developing countries, including the SDR-aid link proposal.

He also stated that the present system of floating exchange rates was disadvantageous to the developing countries for a number of reasons. One disadvantage was that the system was forcing importers to assume additional costs which intensified inflation. This apparently was a reference not only to the cost of hedging but also to the higher local currency cost of imports denominated in a currency against which the local currency is depreciating. Another disadvantage which Mr. Rampersad cited was that floating rates were accompanied by shortages which did not seem to be explainable by market conditions, but which appeared to occur because importers attempted to time their purchasing so as to benefit from the most favorable exchange rate possible.

Mr. Rampersad also expressed concern over the prospects for new activations of SDRs in a world in which the need for fresh additions to liquidity is diminished because balance of payments equilibrium can be achieved though floating. He agreed that a fixed rate system was a thing of the past, but he wondered whether appropriate guidelines for floating could be agreed upon.

Trinidad and Tobago will have a substantial increase in foreign exchange earnings as a result of the increase in petroleum prices. The Government has recently adopted the tax reference price system to calculate the taxes owed by the petroleum companies. The tax rate for petroleum companies has also been raised from 45 to 47.5 per cent and a throughput tax on refinery operations has been instituted. A number of oil wells, which were uneconomic at the lower price, have been reactivated. While the additional foreign exchange earnings will, in large part, be used to pay for imports--thereby eliminating the deficits of recent years--they are likely to allow also a substantial accumulation of reserves.

I gained the impression that, after the reserves have been rebuilt from what is now a rather low level, the authorities would make some contribution to alleviate the plight of the neighboring Caribbean countries which are entirely dependent on imports for their oil supplies. Indeed, after I left Trinidad, the representative of Trinidad and Tobago at the annual meeting of the Caribbean Development Bank announced that his country intended to set up a special trust fund within the Bank to help the poorer members of the Bank meet the local currency requirements which they must assume under Bank loans, and to assist them in overcoming the balance of payments difficulties stemming from the oil crisis. The amount to be provided was not specified, but was described as "substantial."

Development Policy

I sensed that there is no great interest in developing tourism in the country. The plane on which I traveled to Trinidad landed in Barbados--where most of the passengers got off. Only seven persons continued on to Trinidad, barely 40 minutes away. While we were on the ground in Barbados, several other planes arrived loaded with tourists--including a Boeing 747. By contrast, the airport at Port of Spain, Trinidad, was rather quiet.

This impression was confirmed when I visited the island of Tobago (on a Saturday) and saw some fine beaches and a number of tourist hotels, but few tourists. Further confirmation came in several of my conversations, which made it clear that investments to develop the infrastructure needed to stimulate the growth of a tourist industry were not being especially encouraged. Indeed, tourist income is thought to be rather an unreliable source of income, and the cancellations of airline flights because of the energy crisis were cited as evidence of this.

Not surprisingly, development interest centers around the country's offshore oil and natural gas resources. A few years ago, a plan was drawn up to liquefy the natural gas and to ship it to the United States where it was to be fed (after regassification) into the system supplying the City of Chicago. But this plan has now been shelved. Official policy is to use the gas locally and to develop a petrochemical industry. As a first step, the Government will construct a pipeline to bring the natural gas across Trinidad to a point on the west coast of the island where an industrial area is to be established. I heard some discussion as to whether this site was

the best, but at any rate the Government has already reached agreement with W.R. Grace and Co. to establish a joint venture to build a liquid ammonia plant there.

Trinidad and Tobago welcomes additional foreign private investment, but is increasingly insisting on local participation in major projects. This does not necessarily mean that majority ownership must be in local hands, but where it does not, there is often a requirement that the foreign owners sell a controlling interest to local investors within a set period of time. Because there is not much locally owned private capital, the local investor frequently ends up being the Government.

As other petroleum producing countries, Trinidad and Tobago is attempting to increase its control over this natural resource. Bids were recently requested for oil concessions on the condition that the Government would retain a 35 per cent interest, and that this share would rise to 51 per cent, should petroleum production reach specified levels. The Government is also negotiating with the oil companies operating in the country to obtain a participation in their existing operations.

Concluding Comments

This visit gave me an opportunity not only to renew and broaden contacts with the financial community of another country but also to learn more about its problems, concerns, and attitudes, and their implications for American banks and businesses operating there. It was also

useful in that I found much interest in hearing about conditions in the United States, and genuine appreciation for my responses to the frequent questions asked of me on this subject.

There is much to be said for undertaking visits of this kind to a larger number of countries, both large and small. The greater understanding which comes from personal contacts and the goodwill built up by showing interest in another country can be invaluable assets in a world in which interdependence is growing and the economic and financial problems requiring solution are becoming increasingly complex.

I hope that, as opportunities to travel abroad arise in the future, we will continue to take advantage of them, as we have in the past, to visit other countries so as to become better acquainted with their financial leaders and better informed about their points of view and about matters of interest to them.

ATTACHMENT C

Henry C. Wallich
May 21, 1974

Report on the May 7-10, 1974, meeting of
the CXX Deputies in Paris

At their Paris meeting May 7-10 the Deputies of the Committee of Twenty (the committee established by the IMF to reform the international monetary system) narrowed down some of the issues to be settled at the final meeting of the principals of the Committee in Washington June 11-13. The final document will consist, in all probability, of: (1) "immediate steps" to be taken pending implementation of a long-run reform, of which some might be embodied in IMF amendments requiring action by national legislatures; (2) the broad principles of the long-run reform, hopefully to be endorsed by the Committee as a whole although embodying the record of substantial disagreements and in effect to be put on the shelf; (3) a set of annexes backed only by the "Bureau," spelling out the areas of agreement and disagreement and suggesting alternative solutions.

The "immediate steps" would have to be regarded as the main outcome of the CXX exercise. Their embodiment in IMF amendments, to the extent that it materializes, could be regarded as a significant gesture of national endorsement. The principal "immediate steps" are outlined in this note.

Immediate Steps

A. The high-level Council/Committee. The IMF Executive Directors on May 24 will consider a draft resolution establishing an Interim Committee of the Board of Governors. The Committee could

be converted into a permanent Council by means of an amendment, which would probably closely follow the pattern of the Interim Committee.

The main points to be settled are:

1. The United States has sought to restrict the attendance in the Committee/Council to not more than three persons per IMF Board constituency. Most of the other Deputies argued that attendance should be at least as broad as in the present Committee of Twenty -- 9 or 10 persons per constituency.

2. There was also considerable dispute concerning the Committee's/Council's terms of reference. Some Deputies argued that these terms of reference should be precisely defined and sharply restricted. The United States has advocated broad terms of reference.

B. Floating

1. The Deputies reviewed the IMF Executive Board's consideration of guidelines for floating. (The Executive Board continues to discuss this issue.) The major questions are the following:

- a. To what extent, if any, should the Fund have the right to call upon member countries to resist the appreciation or depreciation of their currencies? If the Fund were to be granted the right to take such initiatives, to what extent would it be required to take into account a country's domestic policy objectives?

- b. To what extent should a country's reserve objective be accepted in overriding the Fund's notion of its appropriate exchange-rate objective?

2. On the proposal for an amendment to the IMF Articles to legalize floating, there was considerable opposition. It is likely that such opposition would remain even if the amendment were to cover only an interim period prior to the full reform of the international monetary system. Legalization of floating is of particular interest to the United States, because without it a country that for reasons of domestic policy or for lack of reserves is unable to establish a fixed rate could be penalized by the Fund.

C. Current account restrictions

1. There was some support for a pledge by countries not to impose current account restrictions for balance-of-payments purposes during a specified period without the approval of the IMF. But there was concern expressed over impinging on the role of GATT. Many representatives from developing countries also stated an unwillingness to be covered by such a pledge -- under present GATT arrangements they receive special treatment.

2. There was even less support for a permanent amendment to the IMF Articles on the same subject.

D. Gold

1. Efforts were made to water down the text concerning gold in the present draft of the "interim steps" which now reads "arrangements for gold will be internationally agreed in the Fund in the light of the objective that the SDR should become the principal reserve asset of the reformed system." The objective of these efforts apparently

was to make the statement more consistent with possible unilateral steps on gold by individual countries or groups of countries. These efforts did not meet with success, but may be repeated at the next meeting.

2. Various technical provisions concerning gold were discussed that would lend themselves to embodiment in an amendment.

3. The Italian representative proposed an amendment that would empower the Fund to issue SDR's in exchange for gold or foreign exchange. After brief discussion, this was left for further consideration by the IMF Executive Board.

E. Special interests of the developing countries

1. The representatives of the developing countries continued to plead for a link. Their principal spokesman continued to declare that the LDC will not approve any package of amendments that does not include the establishment of a link. The U.S. is the principal forceful opponent of the link.

2. The Deputies moved closer to an endorsement of the establishment by the Fund of an "Extended Fund Facility," i.e., a longer term loan window; such a facility would not require an amendment to the IMF Articles.

3. The CXX Report will call for the establishment of a joint Fund/Bank study which is "to carry forward the study of the broad question of the transfer of real resources to developing

countries and to recommend measures to be adopted in order to implement its conclusions." The G-24 countries (representing the LDC's) made specific, elaborate proposals concerning the structure of such a study group.

F. Adjustment

Surveillance of the adjustment process during the interim period, including the experimental use of reserve indicators, will be endorsed. There was, however, some resistance to the endorsement of reserve indicators in whatever form.

G. Only quite general language covering the surveillance of international liquidity and official currency holdings will be employed, covering a lack of more detailed agreement.

H. The SDR

1. There was little further discussion of the basket valuation of the SDR. This matter can be settled by the Executive Board of the IMF. The U.S. has argued for treating the initial decision as provisional only.

2. The interest rate on the SDR was not discussed.

* * *

Very few of the finance ministers of the leading countries who initiated the CXX discussion will be present at the final meeting. There will have been changes in the U.S., Germany, France, U.K., Japan, Italy, and elsewhere. This reduced identification with the CXX exercise leaves little prospect for broadening the areas of agreement at the final meeting.

ATTACHMENT D

June 6, 1974

B.I.S. MEETING OF MAY 13, 1974

(Attended by Chairman Burns, Governor Sheehan, and Mr. Coombs)

At the Governors' meetings on Monday afternoon and evening, the main focus of interest was on the Italian situation, where reserve drains continue to run to roughly \$1 billion per month. So far, the deficit has been largely financed by Italian official borrowing abroad in the amount of \$10 billion, of which nearly \$2 billion has been derived from short-term EC credit facilities and the rest from medium-term Eurodollar borrowing. This has confronted both Italy and its EC partners with the harsh dilemma of choosing between new official credits to Italy or allowing the Italian Government to impose import restraints which would have to go far beyond the import deposit measure recently introduced. There were many indications at the meeting that Italy's EC partners have reluctantly decided to accept the second alternative.

At the Monday afternoon meeting, Governor Carli noted that the Treasury budget deficit being financed by the Bank of Italy amounted to about the same figure as the current account balance of payments deficit. He reported that a policy decision had been taken to cut back the Treasury deficit financed by the Bank of Italy to manageable proportions through (a) additional taxation, and (b) diversion of private credit to the Treasury at the expense of private investment. The recent import deposit measure was primarily directed

at absorbing monetary demand and in conjunction with other policy measures to be announced would cut real economic growth to zero in 1974. He foresaw a severe cut in imports as a result of the Italian Government's program and urged that the rest of the world should accept the inevitable consequences.

Chairman Burns supported Governor Carli's policy prescription and there were no dissenting voices save those of Emminger and Gilbert. Emminger, reflecting judgments made in the EC Monetary Commission, urged that greater emphasis be placed on cutting Government expenditure and Carli replied that naturally he would also prefer this route to the extent feasible. Meanwhile, however, the Italian Treasury was about to issue new short-term paper carrying a rate of 14 percent while also increasing Social Security contributions. Gilbert asked why some decline in the lira rate would not provide a preferable means of adjusting the trade balance. Carli replied that this issue had been thoroughly discussed with the IMF, which had given its blessing to the Italian Government's decision to hold the rate at its current level. He was fearful that the inflationary consequences of a further depreciation of the lira would nullify any possible trade improvement. More fundamentally, he felt that a lira depreciation would do nothing to bring the monetary aggregates under control, which was his primary objective. The issue of Italian trade restraints again came up at the Monday evening dinner, at which time Governor Wormser strongly

depreciated proposals emanating elsewhere in the Common Market for either a severely deflationary Italian policy, depreciation of the lira, or both.

Governor Richardson reported that the monetary restraints applied in Britain last December had brought about a significant slowing down of the monetary aggregates. Against this background, the Bank of England had recently found it possible to permit some easing of interest rates and the uncovered interest rate differential in favor of sterling was now reduced to 1.5 percent as compared to 5 percent in March. Recent British balance of payments figures suggested a considerable narrowing of the non-oil deficit, but he noted that the overall British balance of payments figures had been benefiting from large trade credits provided by the oil producers. As these credits came due during the summer months, new strains on sterling would occur.

President Klasen reported that Bundesbank reserves had risen by \$2 billion in March and April. The Bundesbank had not taken action to absorb the liquidity effects of these reserve increases, with the result that interest rates in Germany had declined.

President Leutwiler similarly reported an easing of credit terms in Switzerland, brought about by a partial release of commercial bank reserves, plus dollar swaps with the Swiss commercial banks.

Governor Sasaki reported that the rate of inflation in Japan seemed to be slowing down, partly owing to tight monetary restraint. Business activity was being similarly dampened by restrictive credit policy. On the other hand, the recent 30 percent increase in wages was expected to rekindle the fires of inflation. He therefore anticipated that monetary policy would remain tight and the Japanese economy would somehow have to accept the fact that the days of rapid growth were over and to adjust to the new situation. He noted that continuing Japanese payments deficits were being covered by heavy short-term borrowing abroad and that Japan was temporarily benefiting from trade credit extended by oil producers, which was cushioning the full impact of the oil price increases.

Chairman Burns noted that a new development in the United States had been the emergence of a clear awareness on the part of the public that inflation was the nation's number one economic problem. He described the public response to the restrictive policy being followed by the Federal Reserve as broadly favorable. He reaffirmed the determination of the System to do its utmost to check the growth of inflationary psychology, and indicated that only a modest rate of growth in real economic demands could be tolerated over the second half of the year. While the U.S. inflation was attributable to many causes, a large share of the responsibility could be assigned to the loose

fiscal policy of recent years. In that connection, he was encouraged by the improved prospects in the Congress for legislation that would place a ceiling on Federal Government expenditures. He also hoped that a good harvest and slower economic growth abroad would help moderate domestic inflationary pressures.

With respect to the weakness in the U.S. dollar since early 1974--after the remarkable recovery of the preceding half-year-- Chairman Burns pointed to the huge bulge in U.S. bank lending overseas that followed the termination of capital controls at the end of January, and expressed the view that the United States might better have phased out such controls rather than canceling them abruptly. In his judgment, the dollar was currently undervalued. He noted that, apart from oil imports, the U.S. trade position was continuing to improve.

Chairman Burns referred with regret to the failure of the oil-consuming countries to organize effective resistance to the monopoly-price tactics of OPEC. He expressed the view that the problem created by the level to which oil prices had been raised was unmanageable, and that to focus on the recycling of funds flowing to the oil-producers was to avoid the real problem.

On the subject of joint resistance by oil-consuming countries, the Chairman was challenged by Governor Wormser, who pointed to the inability of countries without oil resources of their own to endure

a shut-down of oil imports for more than a few weeks' time. Wormser also suggested that the sharp rise of oil prices had been triggered at least in part by Arab discontent with inflation and currency depreciation in the oil-consuming countries, and that unless inflation was brought under control oil prices were more likely to rise further than to decline. In rebuttal, Chairman Burns recalled that the United States had offered to share its oil resources and its advanced nuclear technology with other countries but that there had been no takers. He observed that OPEC's actions, which were unprecedented in economic history, required unusual countermeasures. He stressed the difference between the increase in oil prices and rises in prices of goods trading in relatively free markets, such as farm products and industrial raw materials, and noted that food and other wholesale prices were now peaking or declining.

Regarding Franklin National, Chairman Burns expressed the view that the situation would be brought under control and the international repercussions minimized.

ATTACHMENT E

May 21, 1974

Drafts of Domestic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on May 21, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services--which had declined appreciably in the first quarter--is likely to change little in the current quarter and that price increases are continuing exceptionally large. In April industrial production and manufacturing employment expanded somewhat, after having declined for 4 months. The unemployment rate edged down to 5 per cent, as the civilian labor force declined. Wholesale prices of farm and food products declined substantially further, but increases among industrial commodities again were widespread and extraordinarily large. The advance in wage rates has accelerated somewhat in recent months, and unit labor costs have been rising at a fast pace.

In April and early May the dollar depreciated further against leading foreign currencies, and the balance of payments remained in deficit on the official settlements basis. Rising import costs for petroleum and other products contributed to a sizable deficit in U.S. foreign trade in March.

Growth in the narrowly defined money stock slackened somewhat in April from the rapid pace in the preceding 2 months, and the more broadly defined money stock continued to expand moderately. Deposit experience at nonbank thrift institutions deteriorated sharply. Business short-term credit demands remained exceptionally strong. These demands were concentrated in banks, and to help finance loan growth, banks issued a record amount of large-denomination CD's and continued to borrow in the commercial paper and Euro-dollar markets. Private short-term market interest rates have risen sharply further in recent weeks, Treasury bill rates also rose in late April and early May, but have declined markedly in recent days. Long-term rates have continued upward. Effective April 25, Federal Reserve discount rates were raised one-half point to 8 per cent.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, supporting a resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

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

Alternative B

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

Alternative C

To implement this policy, while taking careful account of financial market developments, the Committee seeks to achieve bank reserve and money market conditions that would slow appreciably the growth in monetary aggregates over the months ahead.

ATTACHMENT F

May 21, 1974

Points for FOMC guidance to Manager
in implementation of directive

Specifications
(as agreed, 5/21/74)

- A. Longer-run targets (SAAR):
(second and third quarters combined)
- | | | |
|--|----------------|--------|
| | M ₁ | 5-1/2% |
| | M ₂ | 6% |
| | Proxy | 12% |
- B. Short-run operating constraints
1. Range of tolerance for RPD growth rate (May-June average): 13 to 20%
 2. Ranges of tolerance for monetary aggregates (May-June average):

	M ₁	3 to 7%
	M ₂	4-1/2 to 7-1/2%
 3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings): 11 to 11-1/2%
 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 to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.