

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 Monday and Tuesday, April 15-16, 1974, beginning at 4:00 p.m. on Monday.

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

Mr. Eastburn, President of the Federal Reserve  
Bank of Philadelphia

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

Mr. Holmes, Manager, System Open Market  
Account

Mr. Coyne, Assistant to the Board of  
Governors  
Mr. O'Brien, Special Assistant to the  
Board of Governors  
Mr. McWhirter<sup>1/</sup>, Associate Director,  
Division of Federal Reserve Bank  
Operations, Board of Governors  
Mr. Keir, Adviser, 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

Messrs. Leonard and Williams, First Vice  
Presidents, Federal Reserve Banks of  
St. Louis and San Francisco, respectively  
Messrs. Boehne, Scheld, and Sims, Senior Vice  
Presidents, Federal Reserve Banks of  
Philadelphia, Chicago, and San Francisco,  
respectively  
Messrs. Willey, Jordan, and Green, Vice  
Presidents, Federal Reserve Banks of  
New York, St. Louis, and Dallas,  
respectively  
Mr. Poole, Adviser, Federal Reserve Bank  
of Boston  
Mr. Duprey, Senior Economist, Federal  
Reserve Bank of Minneapolis  
Mr. Gillum, Economist, Federal Reserve Bank  
of Philadelphia

By unanimous vote, the minutes  
of actions taken at the meeting of  
the Federal Open Market Committee  
held on March 18-19, 1974, were  
approved.

The memorandum of discussion  
for the meeting of the Federal Open  
Market Committee held on March 18-19,  
1974, was accepted.

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1/ Entered meeting at point indicated.

Mr. McWhirter, Associate Director of the Board's Division of Federal Reserve Bank Operations, entered the meeting.

Chairman Burns noted that a report of examination of the System Open Market Account, dated April 10, 1974, had been distributed to the Committee on April 11. He asked Mr. McWhirter to comment.

Mr. McWhirter observed that the examination of the System Account, including foreign currency operations, had been made as at the close of business March 8, 1974. In contrast to the situation at the time of the previous examination, in July 1973, no out-of-balance conditions were found. No errors had been made in the accounts since the first of the year; an error that had occurred in December had been discovered and corrected by the Bank well before the examination started. In his opinion, the new computer systems that had been installed, the new computer programs in use, and the attention of management were entirely adequate.

The reports of audit of the System Open Market Account and of foreign currency operations, made by the Board's Division of Federal Reserve Bank Operations as at the close of business March 8, 1974, were accepted.

Mr. McWhirter left the meeting at this point.

Chairman Burns noted that at its previous meeting the Committee had considered a recommendation by the Manager, contained in his memorandum of March 15, 1974, that the System begin submitting noncompetitive bids in rolling over official account holdings of Treasury bills in regular bill auctions. A decision had been deferred pending the development of certain additional information, and a new memorandum from the Manager had been distributed on April 9, 1974.<sup>1/</sup> He asked Mr. Holmes to comment.

Mr. Holmes said he hoped the new memorandum circulated last week answered the questions that had been raised by some Committee members in the earlier discussion. As reported in the memorandum, an analysis of the bill auctions over a 3-month period-- from December 1973 through February 1974--indicated that, on the average, System bids for 3-month bills were priced at the equivalent of .003 of a percentage point above the average bids of all other competitive bidders; for 6-month bills the corresponding figure was .001 of a percentage point. It seemed to him that those results indicated that a shift to a noncompetitive bidding basis, under which official tenders in an auction would be awarded at the average price, would have very little effect on the auctions.

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<sup>1/</sup> A copy of the new memorandum, dated April 8, 1974, and entitled "Proposal to bid for Treasury bills on a noncompetitive basis," has been placed in the Committee's files.

Mr. Holmes noted that the procedures he proposed also would call for the Treasury to announce, in advance of each bill auction, the total amount of official holdings of maturing bills--by the System, Treasury investment accounts, and foreign official accounts--that would be eligible for noncompetitive roll-over. As he had mentioned at the previous meeting and in his latest memorandum, it was possible that such announcements would have some effect on the average prices received by the Treasury in individual auctions; in particular, dealers might tend to bid more aggressively for the remaining supply when official holdings were relatively large and less aggressively when they were relatively small. Over time, however, such effects should balance out.

As indicated in his latest memorandum, Mr. Holmes continued, he recommended that the Committee approve the proposals contained in his memorandum of March 15. The Treasury had agreed to those proposals and was prepared to make the change promptly if the Committee approved them. The Treasury presumably would publish an explanation of the new procedure in one of its regular bulletins; he would expect to work with Treasury personnel and with Board staff on the text of the explanation.

Mr. Brimmer observed that he had been among those at the previous meeting who had raised questions about the likely effects

on prices of a shift to noncompetitive tenders for official accounts. He had expected the effects to be in the direction reported in Mr. Holmes' memorandum but had thought they would be larger. In any case, he was now prepared to approve the proposals.

Mr. Coldwell remarked that, despite the findings reported by Mr. Holmes, he still had some concerns about the proposal. If the Committee were inclined to approve it he would suggest that it do so for a trial period of, say, 6 months. The Manager might then report on how well the new bidding method was working and the Committee could decide whether or not to continue it.

Mr. Hayes asked the Manager whether he considered 6 months a desirable period for the purpose Mr. Coldwell had suggested.

Mr. Holmes replied that if there were problems with the approach--and he was not aware of any at present--they were likely to emerge long before 6 months had elapsed.

Mr. Brimmer expressed a similar view. He added that, once the new approach was announced, market participants would have a right to expect that it would be continued unless serious problems developed. He favored proceeding on the assumption that the approach would work rather than viewing it as experimental. In particular, he was opposed to the suggestion of a trial period.

Mr. Hayes proposed that the Manager simply be asked to inform the Committee promptly if any problems arose.

Mr. Coldwell said he thought the Committee should review the approach after some specific period--he had used 6 months only as an example--on the basis of a report by the Manager on how well it was working.

The Chairman suggested that if the Committee approved the Manager's recommendations it should do so on the understanding that Mr. Holmes would submit a formal report on how well the approach was working at any time he felt able to do so but not later than 6 months from now.

There was general agreement with the Chairman's suggestion.

Mr. Mitchell asked whether it was likely, under the proposed approach, that any one dealer would bid successfully for the bulk of the bills available to the public in auctions when official holdings of maturing bills were very large.

Mr. Holmes said he thought that was quite unlikely. In any case, the Treasury had the right to reject any tenders, and it now followed a rule of thumb under which no bidder would be awarded more than 25 per cent of the issues offered in an auction.

Mr. Wallich referred to Mr. Holmes' comment that under the new approach dealers might bid more or less aggressively, depending

on whether official holdings of maturing bills were relatively large or small. He agreed that the effects should balance out over time in terms of a simple average of the average prices in successive auctions. It might be worth noting, however, that the prices would tend to be more favorable to the Treasury when the volume of bills bid for by the public was small and less favorable when that volume was large. On a weighted average basis, therefore, there would be a small net disadvantage to the Treasury.

After further discussion, the Committee agreed that the recommendations set forth in the Manager's memorandum of March 15, 1974, should be approved, subject to the understanding suggested by the Chairman that within 6 months Mr. Holmes would submit a formal report on how well the approach was working.

By unanimous vote, the Committee approved the recommendations contained in a memorandum from the System Account Manager dated March 15, 1974, entitled "Proposal to bid for Treasury bills on a noncompetitive basis."

The Chairman suggested that the Committee turn to the question of the kinds of information on longer-run targets that should be included in the policy records. In the discussion last December the Committee had agreed, after extensive debate, to publish its short-run ranges of tolerance in quantitative form and to describe its longer-run targets in qualitative terms. The

first policy record prepared on the new basis--for the meeting held in January--would be published in about a week. It could be argued that any further discussion of the matter today would be premature, since it had been the sense of the December discussion that the Committee should proceed cautiously--taking an initial step with respect to the short-run targets and then, after some experience had been gained, considering whether to take a further step with respect to the longer-run targets. However, the question had been raised in a proper manner and was now before the Committee.

Chairman Burns noted that a staff memorandum containing background material, including a listing of four alternative courses that might be followed at this point, had been distributed.<sup>1/</sup> While

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<sup>1/</sup> A copy of this memorandum, dated April 3, 1974, and entitled "Background material for contemplated discussion of desirability of publishing longer-run targets in policy record," has been placed in the Committee's files. The four alternative courses suggested for Committee consideration were as follows:

1. Holding to the decision taken in December, in the expectation that the whole subject of publication of target information will be reviewed after some experience is accumulated under the procedures agreed upon then. . . .It could be argued in support of this alternative that there have been no developments since December to cause the Committee to reverse a considered decision.

2. Setting aside the December decision, and agreeing that longer-run targets, as well as short-run ranges of tolerance, shall be published in numerical form in policy  
(Footnote continued on next page)

the members were, of course, free to comment on any of the four possible courses, he would suggest that they focus mainly on alternatives 1 and 3.

The Chairman then invited Mr. Eastburn to open the discussion.

Mr. Eastburn said he would speak to the two alternatives the Chairman had mentioned. While he personally would be inclined to publish the longer-run targets in quantitative form, he was not sure about the possible effects of such a course and accordingly concurred in the view that the Committee should move cautiously. Since the January policy record had not yet been published, the

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records beginning, say, with that for the February meeting. Adoption of this alternative presumably would be on the grounds that the December decision was a mistaken one.

3. Holding to the December decision, but agreeing not to exclude directives calling for growth in monetary aggregates over the months ahead at "faster (slower)" or "somewhat faster (slower)" rates than experienced in some specified past period. . . . It could be argued that this alternative would reduce the risks of undesirable market effects to an acceptable level, since it would not involve explicit or implicit disclosure of the precise numerical targets or even the identity of the target measures, and since the period to which the targets applied would be stated in general terms ("over the months ahead"). At the same time, the language would give at least some general impression, albeit imprecise, of the direction and broad thrust of monetary objectives.

4. Proceeding as in (3), but also agreeing not to exclude directives calling for growth in monetary aggregates at rates "about the same as" those in some historical period. This alternative would be somewhat more forthcoming about the nature of the longer-run targets. On the other hand, the language could be interpreted more precisely than that under (3), and therefore would involve greater risks of undesirable market effects.

members had not had an opportunity to observe the reaction in financial markets to the disclosure of the short-run ranges of tolerance. They had, however, had an opportunity to review a draft of that policy record and to observe how the citation of the short-run targets would appear in context. In his judgment, the public was likely to be confused by a series of records in which varying--sometimes widely varying--short-run targets were associated with directives calling for "moderate" growth in the monetary aggregates. He thought it would be appropriate for the Committee to remedy that situation at an early point, rather than let such confusion accumulate.

In sum, Mr. Eastburn continued, he favored alternative 3 over 1. The analysis in the paper prepared at the Philadelphia Bank,<sup>1/</sup> which the members had received, supported going at least as far as alternative 3; as the paper indicated, that would represent not a new step but rather a return to a trend that had been interrupted last year. The main point, in his view, was that the Public Information Act required the Committee to make at least the degree of disclosure that would be involved under 3. He might note that alternative 4, while somewhat more venturesome, also had

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<sup>1/</sup> This paper, prepared by Gary P. Gillum and entitled "The place of the long-run targets in the policy record," was distributed on April 9, 1974. A copy has been placed in the Committee's files.

precedents in drafts submitted by the staff. If the Committee pursued the alternative 3 course for, say, 3 months without encountering difficulties, it could proceed to take another cautious step toward further disclosure.

Chairman Burns suggested that the Committee debate the merits of publishing longer-run targets as a policy matter without raising the legal issue. Few of the members were well qualified to discuss that issue, and the Committee's attorneys had concluded on the basis of extensive studies that the requirements of the Public Information Act depended on determinations that were within the province of the Committee.

Mr. Kimbrel observed that he was inclined toward alternative 3, and would hope that the Committee could develop somewhat more precise interpretations of the kinds of phrases it used in the directive. He would be interested, however, in knowing whether the Chairman thought that alternative would create any difficulties for him in his capacity as System spokesman before Congressional committees and elsewhere.

Chairman Burns replied that he would not anticipate any such difficulties.

Mr. Brimmer remarked that alternative 3 did not go as far toward disclosure as he had advocated late last year as a member

of the subcommittee on policy records. It was a step in the right direction, however, and he would favor it over alternative 1 if the Committee were making its initial decision today. He would be concerned, however, about changing procedures only a short time after those agreed upon in December had been implemented.

The Chairman observed that the question raised by Mr. Brimmer was a troublesome one to which the Committee might want to return later in its discussion.

Mr. Hayes said that among the several alternatives he preferred 3 to 1 and 4 to 3. His first choice, however would be alternative 2--to publish the longer-run targets. He was not particularly concerned about the risk that the release of 6-month targets 3 months after the meeting would have undesired market effects, since he believed that market participants would readily understand that the targets were subject to change at every meeting. Moreover, publishing the longer-run targets would have the advantage of providing a much better perspective for the short-run ranges of tolerance. In general, he believed the best course for the Committee was to publish as much information as it could about its objectives, in an effort to avoid biased interpretations. He was not persuaded that the decision taken in December--to provide quantitative information only on the short-run targets--was really the more cautious approach;

caution might well call for releasing the longer-run targets in quantitative form.

Mr. Mayo said he favored alternative 1, which called for holding to the December decision at this time. As the members would recall, he had originally expressed a preference for publishing the longer-run targets but not the short-run ranges of tolerance. The Committee had debated the subject at great length in December; it had made a decision; and to his knowledge there had been no developments since then to warrant reopening the issue. He would see no advantages in incorporating in the policy records for the January and February meetings quantitative information on the longer-run targets adopted then, as if the Committee had known in January and February that those figures would be published. He had no objections to alternative 4, and could accept it as a second choice. He preferred alternative 1, however, simply on the grounds that it was not good management for the Committee to reopen a settled matter in the absence of new developments.

Mr. MacLaury expressed the view that in attempting to choose among the four alternatives listed in the staff's memorandum the Committee was continuing to focus on the wrong issue. In his judgment, the issue of the public's right to know--and of the benefits the Committee would derive from improved public knowledge--

arose primarily in connection with information on the Committee's policy-making procedures rather than on the targets it happened to adopt at particular meetings. That was why he was inclined to place great stress on what would be said at the time the January policy record was published. A full explanation should be made of the Committee's procedures, including the role played by the longer-run targets, even if the Committee preferred not to reveal the specific targets during the period to which they applied.

Mr. MacLaury added that, within the frame of reference provided by the four alternatives, he favored alternative 4. He would view that course as reverting to a procedure the Committee had followed in the past. He saw little risk and some gain in such a course.

Chairman Burns said he would not consider the adoption of alternative 4 as reverting to a prior procedure. The Committee might have employed that alternative in some isolated instance, but it had never made a deliberate judgment regarding its general desirability.

In response to a question, Mr. Eastburn said the review made at the Philadelphia Bank indicated that the Committee had adopted directives of the type mentioned in alternative 3 on a number of occasions. From time to time draft directives along

the lines indicated in alternative 4 had been included among those suggested by the staff, but he believed they had not been adopted by the Committee.

Mr. Williams said that he, along with his colleagues at the San Francisco Bank, believed that alternative 2 represented the best course. He considered it highly important that the public be given as much information as possible about monetary policy, and he would recommend publication in the policy record of the longer-run targets with a 6-month lag and the short-run targets with a 3-month lag. He felt that publication of the short-run targets alone might be highly misleading to the public. If alternative 2 was not accepted by the Committee, he would support alternative 3.

Mr. Morris observed that he also favored alternative 2. In his judgment, publication of the short-run ranges of tolerance would lead inevitably to pressures for publication of the longer-run targets, for two reasons. First, the short-run ranges would not be comprehensible to the public unless they were placed in the context of the longer-run targets. Over the past 9 months or so the Committee had adopted 2-month ranges for  $M_1$  that spread from a lower limit of zero in one instance to an upper limit of 9-1/2 per cent in another case; to publish such information outside the framework provided by the long-run targets would lead to a great

deal of confusion. Secondly, misses necessarily were much greater for the short-run than for the longer-run targets, and to publish only the former would be to give a highly inaccurate impression of the Committee's ability to achieve its objectives.

Rather than responding to such pressures later, Mr. Morris continued, he thought it would be better for the Committee to publish the longer-run targets on its own initiative at the outset. He agreed with Mr. Hayes that it was unrealistic to expect publication of the longer-run targets in the policy record to have adverse effects on the money market. To participants in that market, a policy record issued with a 90-day lag was an historical document of no great relevance to the way in which they managed their positions. Of much more immediate concern to market participants were the current movements in the Federal funds rate; they were aware of the significance of that rate under the Committee's present procedures, and they watched closely for movements outside the latest range of fluctuation that might signal a change in policy. Over the next week or so, for example, market participants would be waiting to see whether the Desk permitted the funds rate to move above 10-1/4 per cent without intervening. No sophisticated money market operator was likely to base his actions on information in a 90-day old policy record when he had a current measure available within a week after the meeting.

Mr. Wallich said he thought it would be premature at this time to release additional information on the longer-run targets, and accordingly he favored alternative 1. He realized that there were considerations on the other side; for example, the disclosure that the Committee was aiming for relatively low 6-month growth rates in the monetary aggregates could contribute to the abatement of inflationary expectations. Information on the longer-run objectives was likely to be misleading, however, because--given the little that was known about the relationships involved--those objectives often would not be achieved. The alternative 3 formulation--in which desired growth rates would be described in the directive as faster or slower than growth rates in some historical period--would not be meaningful at present for another reason: such statements would refer to growth rates in nominal terms, whereas in a time of inflation the meaningful rates would be those formulated in real terms.

Mr. Holland expressed a preference for alternative 3. While he agreed that at this early date the Committee should not overturn the decision it had made in December, he would not consider adopting alternative 3 as a reversal of the December decision. He had arrived at one further conclusion on reading the Philadelphia Bank's paper: at times when the 2-month ranges of tolerance for

the monetary aggregates were considerably above or below the corresponding 6-month targets, the staff might offer draft directives for Committee consideration that referred to desired growth rates "over the quarters ahead" rather than "over the months ahead."

Mr. Black said his conclusion was similar to Mr. Holland's, except that he would prefer to use the phrase "over the next two quarters" on a regular basis in the directive, to make it clear that the longer-run targets applied to a 6-month period. With that modification, he favored alternative 3. It was important, in his judgment, to give some indication of the nature of the longer-run targets to avoid misleading the public. Just as data on System security purchases were subject to misinterpretation in the absence of information on other factors affecting reserves, so would be figures on the short-run tolerance ranges in the absence of any indication of the nature of the longer-run objectives.

Mr. Bucher remarked that he enthusiastically endorsed Mr. Morris' comments; like the latter, he favored alternative 2.

Mr. Mitchell observed that he had acquiesced in the present procedure not because he was worried about the market effects of disclosing the longer-run targets--he was not at all concerned on that score--but because he was reluctant to make a public record of the difficulties the System encountered in achieving such targets.

He thought the Committee should be quite specific in its internal deliberations, and he hoped the day would come when its aim was so improved that it could afford to be specific in its published record. At this point, however, he favored alternative 1.

Chairman Burns said he would state his own position and then call for a poll of members' preferences among the four alternatives. After pondering the question closely for a long time, he was of the view that it would be a mistake for the Committee to change its December decision at present. In a memorandum to the Committee last November he had concluded with the following observations: "It would be best--at least in the immediate future--to formulate any statements in the policy record regarding longer-run targets in qualitative terms, whether or not quantitative information is included on short-run operating ranges. Some experimentation along these lines will be needed, and it should be allowed to evolve. We need to improve our policy records, but we also need to move cautiously. Let us not attempt to do more at this time than we can properly assimilate." He had heard nothing in today's discussion to cause him to modify that view. Mr. Morris might be entirely right in suggesting that the Committee would decide to change its procedures relatively soon; indeed, he (the Chairman) might well be urging a change in a few months. He

would expect, however, that any change would be made as a result of the members' convictions, and not in response to pressure. He saw no harm in waiting a few months to see how the present procedures worked out.

The Chairman then called for indications of preferences among the several alternatives.

Including Committee members and Reserve Bank Presidents not currently serving, the preferences were as follows: alternative 1, 5; alternative 2, 7; alternative 3, 5; and alternative 4, 2. Of the 12 Committee members, 4 favored each of the first three alternatives and none favored alternative 4.

The Committee then engaged in further discussion, focusing primarily on alternatives 1 and 3. In a final poll, 6 members indicated that they preferred alternative 1, 5 favored alternative 3, and 1 abstained.

Chairman Burns observed that on the basis of those preferences, no change would be made at present in the procedures that had been agreed upon in December with respect to information to be published on longer-run targets. The Committee would review the question again in a few months, after some experience under those procedures had been gained.

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 from March 19 through April 10, 1974, and a supplemental report covering the period April 11 through 15, 1974. Copies of these reports have been placed in the files of the Committee.

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

Since the last meeting the dollar has undergone a series of severe speculative attacks, which resulted in a further decline against major currencies. The dollar/German mark exchange rate was again the bellwether. By March 19, when the period began, the dollar had slipped 9-1/2 per cent below its peak in January of this year, as the exchange market gained the impression that the German government was either prepared to revalue the mark once more or would at least welcome a further sharp appreciation. Between March 19 and the bottom of the decline on March 28 and 29, the dollar fell another 5-1/2 per cent, and we sold \$193 million equivalent of marks and the German Federal Bank purchased \$118 million to cushion and smooth the decline. The dollar was also supported by the tightening of money markets here and some easing abroad, by Chairman Burns' testimony before the House Subcommittee on International Finance, and by denials of any intention to revalue issued by German authorities. Since bottoming out, the dollar has improved 2-1/4 per cent, with only \$12 million intervention by us and none by the German Federal Bank.

During these speculative attacks, the dollar suffered a generalized depreciation as other major currencies moved up in sympathy with the mark, including some currencies with serious underlying problems, such as sterling, the French franc, and the yen. Except for making very minor sales from Treasury and System balances of French and Belgian francs, we did not intervene to stop the dollar's decline against those other currencies. This was mainly because we were lacking a policy decision on handling the revaluation clause under the relevant swap agreements.

The dollar's decline since January has reflected some important outflows. The heavy outflows of bank-reported capital, as evidenced by the \$2 billion additional claims on foreigners reported in February by United States banks, and the \$1-1/2 billion in loans to foreigners reported on an accumulated weekly basis during March, may be in part a one-time adjustment to the lifting of capital controls in January, but they are no doubt in large part the result of intense competition among U.S. banks in seeking foreign business. The greatly enlarged payments this month to oil-exporting countries could put further pressure on the dollar, as a substantial part of these flows is channeled into short-term deposits in the Euro-dollar market, thus creating the risk of arbitrage flows to foreign money market centers.

In general, we continue to be faced with a volatile and potentially turbulent exchange market situation, with our main hope perhaps residing in the possibility that firm credit and interest rate conditions will prevail on this side of the Atlantic.

In reply to a question by Mr. Black, Mr. Willey said that oil company payments were scattered throughout the month. However, they tended to peak around mid-month--payments today and tomorrow would probably be the largest in April--and to rise again toward month end. Payments in subsequent months would remain heavy, although perhaps not quite so heavy as those in April.

Mr. Coldwell noted that the Bank of Italy had been intervening in the foreign exchange markets on a substantial scale but had not drawn on the swap line with the System. He asked what other resources were available to the Italians.

Mr. Willey replied that the Bank of Italy had financed their exchange market intervention in part through drawings of about \$1.9 billion on other European central banks under the EEC agreement; they still had about \$500 million available under that agreement. The Italians also had been borrowing in the Euro-dollar market on a rather large scale. Apart from the swap line with the System, they had an agreement with the International Monetary Fund under which they could draw \$1.2 billion.

Mr. Holland asked whether there had been indications of imminent drawings on the swap lines with the System by the Bank of Italy or other central banks in the network.

Mr. Willey replied that he was not aware of any such indications. Of course, when the swap line with the Bank of Italy was enlarged earlier in the year it was clear that they contemplated the possibility of drawing at some point.

By unanimous vote, the System open market transactions in foreign currencies during the period March 19 through April 15, 1974, were approved, ratified, and confirmed.

Mr. Willey then noted that six System drawings on the National Bank of Belgium, totaling \$230 million, and one drawing each on the Swiss National Bank and the Bank for International Settlements, of \$371 million and \$600 million, respectively, would mature for the eleventh time in the period from May 2 through May 15. He recommended that those drawings be renewed. Since all three swap lines had been in continuous use for more than a year, express approval by the Committee was required for their renewal.

By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium, the Swiss National Bank, and the Bank for International Settlements, maturing in the period May 2-15, 1974, was authorized.

Secretary's note: Prior to this meeting notes by Mr. Wallich, summarizing developments at the March meeting of the C-20 Deputies and the April Basle meeting, were distributed to the Committee. Copies of these notes are appended to this memorandum as Attachments A and B, respectively.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of System Open Market Account covering domestic open market operations for the period from March 19 through April 10, 1974, and a supplemental report covering the period April 11 through 15, 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:

System open market operations over the period since the Committee last met were devoted to an increasingly begrudging supply of reserves to the banking system as the monetary aggregates proved strong and bank credit showed explosive growth. The more restrictive System approach, in an atmosphere of accelerated loan demand and intensified inflation, resulted in sharp increases in interest rates throughout the maturity spectrum. For a time, near-chaotic conditions prevailed in the capital markets, where a heavy volume of new issues met increasing investor resistance, and market underwriters sustained substantial capital losses. By the close of the period, however, after rates had adjusted substantially upward, the markets had regained some semblance of stability, although an underlying atmosphere of uncertainty prevailed.

In today's regular Treasury bill auction, I expect that average rates of about 8.05 and 7.88 per cent were established for 3- and 6-month bills. These are substantially below the recent highs--by 50 basis points or more--with the 3-month bill declining at least 30 basis points today alone. This reflects the very sharp rally that has taken place in the bill market as scarcities have developed.

Given Committee instructions at the last meeting and the indicated strength of the monetary aggregates, the Desk moved promptly after the meeting to establish a more restrictive stance in advance of the Treasury's cash financing, which was announced on March 20. The financing involved the auction of \$2-1/2 billion June tax-anticipation bills on March 26 and \$1-1/2 billion 8 per cent 2-year notes on March 28. The bill auction involved a larger addition to market supply than had been anticipated, thus adding to the then-upward pressure on short-term interest rates. The note auction was aided by heavy buying by small investors, but a total of only \$1.7 billion bids were received by the Treasury and some tenders had to be awarded at the minimum acceptable price at a yield of 8.13 per cent, compared to the average of 8.08 per cent.

Looking ahead, the Treasury will announce the terms of its May financing on May 1. This financing involves a refunding of about \$5-1/2 billion of publicly held securities maturing on May 15. Given the still uncertain state of the market, this may prove to be a major undertaking. In order to reduce market pressures, it would seem desirable for the Treasury to pay off some of this maturing debt, but there is some uncertainty about the strength of the Treasury's cash balance in mid-May, and it will need more cash towards the end of the month or in early June. And, by the end of the June, there could be some debt ceiling problems for the Treasury, too, unless new legislation can be enacted. In any event, I would plan to roll over the System's holding of \$1.3 billion of the maturing issues into whatever new issues the Treasury offers in a proportion related to expected public subscriptions.

Last Friday, it was learned that  $M_1$  is now expected to be above the upper end of the Committee's range of tolerance for March-April. The Desk accordingly on Friday planned a still more restrictive approach to reserve supply, expecting that the Federal funds rate will average 10 per cent or more. In this statement week, the Federal funds rate has been running close to 10-1/4 per cent--it hit 10-1/2 per cent at one point today, even though we did a fair amount of repurchase agreements--but other money and capital market rates have tended to stabilize or improve. Should the Committee decide tomorrow on a policy that involves a more restrictive stance, I think it important that this policy be effected promptly in order to establish a new set of money market conditions in advance of the Treasury's refunding.

The past period has been one of turbulence in the money and capital markets. Loan demand pressure has made banks aggressive sellers of CD's, and rates have risen by as much as 1-1/2 percentage points. The prime rate is quite generally at 10 per cent--and, as you know, one North Carolina bank raised its prime rate to 10-1/4 per cent today. The extent of the demand for business loans had not been anticipated by the banks and the fervent hope now is that it was a

short-run bulge involving a shift from commercial paper, special inventory financing, a spate of foreign borrowing, and perhaps some anticipatory demand.

Bond dealers, particularly in the corporate and municipal sectors, went through a trying period, although as noted earlier, the markets had settled down last week, and at the higher yield levels funds were moving smoothly through the capital markets. A heavy volume of financing lies ahead, however, and there is an underlying note of uncertainty that could again rise to the surface. Despite all the cries of distress, most market participants applaud what they consider to be a vigorous anti-inflationary campaign by the Federal Reserve. I'm sure they recognize the basic fact that unless inflation is gotten under control, the future of the capital markets is bleak indeed.

Chairman Burns asked what groups Mr. Holmes had in mind in his comment that most market participants applauded the System's anti-inflationary efforts.

Mr. Holmes replied that he was thinking of most dealers in Government securities, the major banks, the more thoughtful dealers in corporate and municipal securities, and perhaps even some stock-brokers. The dealers were, of course, extremely unhappy about the short-run impact of rising interest rates on their capital positions; he was describing their more general philosophical attitude.

Mr. Brimmer said he would be interested in Mr. Holmes' views on the extent to which recent foreign borrowing at U.S. banks reflected the ending of the VFCR program or other special factors.

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Chairman Burns asked in that connection whether the recent foreign borrowing had been primarily by banks.

In response, Mr. Holmes said he thought the bulk of the foreign borrowing had been by banks. There also had been a substantial volume of borrowing by foreign governments, both in Europe and elsewhere. In general, he would attribute the rise in foreign borrowing to a combination of factors, including the ending of capital controls, the desire of New York banks to reestablish their competitive positions in markets abroad, and a real demand for dollars abroad for purposes of balance of payments financing.

In reply to questions by Mr. Holland, Mr. Holmes said the recent decline in bill rates was a consequence of scarcity conditions that developed in the bill market, and was not reflected in corresponding declines in other short-term interest rates. Dealers had reduced their positions in bills because of high carrying costs, and when demands developed from foreign sources and from domestic investors interested in short-maturity instruments, bill rates declined substantially, following their earlier substantial rise. Bill rates might remain around their current levels temporarily, partly because of reinvestment demands that could be expected later this week when the Treasury paid off maturing tax-anticipation bills. He would be surprised, however, if bill rates remained near those levels for long, given present rates on Federal funds and CD's.

Mr. Sheehan asked whether the staffs at the Board and the New York Bank were in general agreement with respect to their projections of the monetary aggregates.

Mr. Holmes replied that the two sets of projections were relatively close for the April-May period. For the second quarter as a whole, however, the New York Bank projections were somewhat higher than those of the Board staff.

Mr. Eastburn asked how Mr. Holmes thought the markets might react to a half-point increase in the discount rate.

Chairman Burns remarked that he might inform the Committee at this point that the Board had acted earlier today to disapprove increases in the discount rate--from 7-1/2 to 8 per cent--that had been proposed by two Reserve Banks. A key paragraph in the Board's letter to those Banks read as follows: "The Board members felt that an increase in the discount rate at this time would be taken as a signal that the System wanted to reinforce its firming actions and, given the sensitive condition of financial markets, such an increase might well trigger further large advances in market and bank lending rates. In the Board's judgment the current economic and financial evidence did not call for a strong signaling action at this time. However, the Board will remain alert to the desirability of an early discount rate action."

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The Chairman added that he would like to remind everyone present that information concerning Reserve Bank proposals for changes in the discount rate and the Board's responses was to be held in strict confidence. He then suggested that Mr. Holmes reply to Mr. Eastburn's inquiry.

Mr. Holmes said he thought a discount rate increase would be interpreted by the market as confirmation of a strong anti-inflationary stance by the System. The impact on short-term rates was unlikely to be as drastic as it might have been a week or 10 days ago, when the markets had not been in good shape. However, he thought there would be some impact. He was not persuaded that rates had stabilized as yet; strong technical forces were helping market conditions at the moment, but they would not last indefinitely. Moreover, the Treasury's large May refunding would put some pressure on the market. A slackening of loan demand would help a great deal; demand appeared to have slackened in New York last week, but one should not read too much into one week's figures.

The Chairman remarked that in the Committee's policy discussion tomorrow the members might want to offer any views they had about the desirability of an increase in the discount rate, and also about the desirability of another possible action--an increase in marginal reserve requirements on large-denomination CD's. The

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Treasury's financing calendar offered some constraints on the timing of such actions, on which Mr. Axilrod might comment at this point.

Mr. Axilrod observed that, as Mr. Holmes had indicated, the Treasury would announce on May 1 the terms on which it would refund the \$5-1/2 billion of securities maturing on May 15. That was a sizable financing, and as the members knew, market conditions were quite sensitive. In his judgment, Tuesday, April 23 would be about the latest date before the financing at which a discount rate increase should be announced; that would allow one full week for markets to settle down before the Treasury's advisory committees made their recommendations for the financing. If the discount rate were to be increased after the financing, it might be well to wait at least until the May 15 settlement date--and perhaps a little longer--in view of the possible difficulties of distributing the sizable volume of new issues that would be involved.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period March 19 through April 15, 1974, were approved, ratified, and confirmed.

Chairman Burns observed that it would be helpful to the Board if, in the time remaining this afternoon, the Reserve Bank

Presidents would offer any views they had on two subjects: the causes of the enormous increase that had taken place during recent weeks and months in bank loans, particularly business loans; and what action, if any, in the way of an admonition to bankers might be desirable on the part of the Board, the Chairman, or the Reserve Bank Presidents.

Mr. Coldwell said he had had an opportunity last week to discuss the sources of loan demand with the presidents of a number of the larger commercial banks in the Eleventh District. It appeared that about half to three-fourths of their loan demand arose because national corporations were drawing on credit lines established earlier--years earlier, in some cases. The draw-downs were for two main purposes: to replace outstanding commercial paper, and to sustain inventory positions at current higher costs. All of the bankers indicated that demands were heavy for real estate as well as for business loans, but that there had not been a major change in the volume of consumer loans. Part of the demand for real estate credit stemmed from the shift in the position of the REIT's; the commercial paper that had been issued by REIT's was fully backed by bank loans or commitments. The bankers were not particularly concerned about the larger REIT's, but they thought some of the smaller units might be over-extended. In the

words of one banker, "We're going to have a work-out operation, but with sufficient time and sufficient inflation, the problem will be taken care of." An additional reason mentioned for the enlarged business borrowing was the desire on the part of some local borrowers to defer planned capital market financing for a period of 3 to 6 months. As to the terms on which the new loans were being made, the bankers uniformly indicated that they were for 90-day periods, with prepayment privileges. They expected, if past experience was a guide, that many of the loans would be repaid within 60 days.

Mr. Morris remarked that the situation in the First District was similar in major respects to that in the Eleventh. First District bankers had been surprised at the high rate at which national corporations were drawing on credit lines; none of those with whom he had talked had anticipated that development. The shift of borrowers from the commercial paper market to banks, which was attributable to the lagged movement of the prime rate, might be slowing now. The heavy volume of bank loans to finance inventories appeared in part to reflect efforts by scarcity-conscious purchasing agents to hoard materials. That disturbed him somewhat; such inventory accumulation now could be followed by a cut-back in purchasing later in the year. There also was heavy foreign borrowing at District banks.

With respect to the Chairman's second question, Mr. Morris continued, he was opposed to moral suasion as a device to control bank lending. That technique could be highly successful in countries, such as Britain and Canada, where the banking system was so highly concentrated that it was possible to meet in one room with the heads of banks accounting for the bulk of the nation's banking business. However, in the United States, where banking was decentralized, moral suasion was much less effective and posed many more problems. He would reserve its use for extreme circumstances.

The Chairman asked whether Mr. Morris considered the recent explosion of bank lending to be troublesome.

Mr. Morris said he thought the rise in the prime rate would tend to moderate the upsurge in foreign lending and the shift in borrowing from the commercial paper market to banks. Relatively, bank lending rates had been quite low for a while, but they were now moving back into parity with competing rates.

Chairman Burns remarked that, if the prime rate were to be relied on to achieve adequate restraint on bank lending, it might have to rise to levels a good deal above any that had been experienced thus far. A question in his mind was whether it might not be better for bankers to ration credit at rates that were not quite so high.

Mr. Morris replied that he was not convinced that the System's past efforts to persuade bankers to ration credit had been very fruitful. Moreover, such a procedure raised problems of bank relations and questions of equity. If he were to indicate to bankers in his District that he was concerned about their lending volume, they were likely to respond that they also were concerned but were faced with a difficult competitive problem. On that score, he might note that representatives of large Chicago banks were currently in Boston, soliciting the business of the local banks' customers.

Mr. Hayes observed that officials of three large New York banks with whom he had talked in recent weeks had explained the surge in loan demands in terms much like those reported by Messrs. Coldwell and Morris. Apparently, the heavy loan demands were not confined to big corporations; they involved practically all commercial borrowers, many of whom were interested primarily in building inventories. As had already been noted, borrowing by foreign banks was adding to the pressure.

Mr. Hayes remarked that he found it difficult to decide whether it was useful to make representations to banks about the volume of lending. He was inclined to share Mr. Morris' view that such a procedure should be employed sparingly. The System's

strong effort last summer might have been helpful, but he was not sure how much difference it had actually made. In any case, an effort to use moral suasion now might be premature. Only 2 months ago money market rates were declining sharply and banks were coming to the view that they had to compete more actively for business. It had not been very long since the System had begun to give clear signals that it was greatly concerned about inflation as opposed to the dangers of recession, and to move too fast on a program of moral suasion was apt to result in confusion. In his judgment, moral suasion would be more productive if it were undertaken after the System had developed a more sustained record of anti-inflationary policy moves.

Mr. Eastburn said he had heard explanations of current loan demand from banks in the Third District that were quite similar to those already described. The strong demand, which had been unexpected, was attributed in good part to business efforts to build inventories to protect against rising prices, including the price increases that were anticipated when controls were discontinued at the end of April. Moreover, because bond rates were rising, business borrowers were not repaying bank loans in the manner typical of a business downswing.

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Chairman Burns remarked that he personally had found it quite difficult to determine the extent to which the increase in needs for inventory financing reflected higher prices on a stable volume of stocks or an increase in the volume of stocks. If a large part of the current business borrowing at banks was accounted for by an effort to expand inventories, the economy might well be headed for difficulties of a kind not seen in the United States since the inventory collapse of 1920.

Mr. Eastburn went on to say that one's views about the desirability of holding conversations with bankers would depend in part on his expectations regarding the future course of business loans. While the urgency of present inventory demands might pass, it was his guess that business loan demands would remain strong and perhaps get stronger. He was inclined to agree with Mr. Hayes that a program of moral suasion would be premature at this point; it would be unfortunate if that device were used now, only to find that it would have been more effective if it had been reserved for later use.

Mr. Hayes said he might note that the surge in loan demand had been unexpected in New York also. He had heard some suggestions that it represented a temporary bulge, attributable to some special factors that had not yet been recognized. While he suspected that

the bulge was not temporary, he thought it would be well to wait for evidence on that point before reacting.

Mr. Kimbrel noted that the recent rate of increase in business loans in the Sixth District had been below the national average rate. Nevertheless, District bankers were explaining loan demands in the same terms as others had mentioned--including shifts by borrowers from the commercial paper market to banks, the desire to defer capital market financing, and the need to finance the higher costs of inventories, although not necessarily enlarged physical stocks. While the volume of new consumer loans was down, outstandings were rising because of an increase in delinquencies and a slowing of repayments--developments which he found rather disturbing. Large Chicago banks were soliciting business in his District also, and they were being joined in that activity by some New York and Boston banks.

Mr. Kimbrel said he would have no reservations about using moral suasion in the effort to slow bank lending. However, he agreed with those who thought that its use might be a little premature at this point; it would be better to wait a bit to see if demand remained strong.

Mr. Leonard observed that the situation in the Eighth District was basically the same as that described for other Districts. The

increase in loan demand was rather broadly based, and at least some St. Louis banks had attributed it in part to growing needs for inventory financing. Construction activity recently had risen considerably throughout the District, but the extent to which that rise had contributed to the increase in loan demand was not clear. People at the St. Louis Bank had not been as surprised by the rise in business loans as others evidently were; for some time they had thought that the underlying economic situation was stronger than some analysts were suggesting, and they interpreted the strength of loan demand as confirmation of that view. He might note that some States in the District had usury laws limiting the rate of interest that could be charged, and that in two States loans to corporations were not exempted. In those States large commercial banks had to acquire funds in the national money market at rates as high as, or higher than, they were allowed to charge their customers.

Mr. Mayo expressed the view that the time was rapidly approaching when the Chairman might find it desirable to express the System's concern about the rate of increase in bank loans, perhaps in the course of Congressional testimony. If loan demand remained strong, he thought it might then be necessary for the Reserve Bank Presidents to begin discussing the situation with

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individual bankers, even though he shared the disinclination some others had expressed toward that approach. He agreed with Mr. Hayes, however, that moral suasion tended to lose its effectiveness when used too often.

Mr. Winn said he had heard reports of a sharp increase in business demands for warehouse space, which tended to confirm other indications of a widespread desire to increase inventories. In his judgment, however, the rise in loan demand could not be attributed simply to inventory financing needs; to an important extent it also reflected a deterioration of working capital positions and growing problems of collecting on receivables.

Mr. Winn added that banks appeared to be confused about the status of the "two-tier" prime rate. One major bank in the Fourth District had announced that, because of the rise in the costs of funds, it was rationing loans to small businesses and on home mortgages--the categories to which the lower prime rate applied--but not loans on which it could charge the higher rate.

Chairman Burns observed that any confusion about the two-tier prime rate would not last very long since the Economic Stabilization Act, under which the Committee on Interest and

Dividends had been established, was expected to expire at the end of the month.

Mr. Winn then said he was disturbed about another recent banking development. It appeared that some banks, in an effort to improve their figures on earnings per share, were following such practices as reducing their reserves against losses on loans. Officials at one of the large bank auditing firms had advised him recently that his firm was quite concerned about those practices. He thought the System should watch that situation closely.

Thereupon the meeting recessed until 9:30 a.m. the following morning, Tuesday, April 16, 1974. Committee attendance was the same as on Monday evening. Staff attendance was the same as on Monday except that Messrs. Coyne and Gillum were absent, and the following were present:

Messrs. Gramley and Reynolds, Associate Economists

Mr. Wernick, Adviser, Division of Research and Statistics, Board of Governors

Mr. Pizer, Adviser, Division of International Finance, Board of Governors

Mr. Struble, Senior Economist, Division of Research and Statistics, Board of Governors

Ms. Tschinkel, Manager, Securities Department, Federal Reserve Bank of New York

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

Mr. Partee made the following introductory comments:

In the 4 weeks since the last Committee meeting, the staff has had a chance to evaluate more carefully the probable impact on the economy of the lifting of the oil embargo. In addition, the sharp upsurge in interest rates has caused us to reevaluate our expectations for financial market flows and for conditions in the mortgage and housing market. Since the implications of these latter developments bear most importantly on the outlook for early 1975, we have taken this opportunity also to extend our projection through the middle of next year.

The staff forecast resulting from our review has already been presented to you in the green book.<sup>1/</sup> Our purpose today, therefore, is to highlight the most significant aspects of the revised projection, and to discuss possible differences in economic results that might be fostered by alternative monetary policy assumptions.

As to the monetary and fiscal policy assumptions underlying the projection, we assumed first that the controls program will terminate at the end of this month and that there will be no reimposition during the forecast period. Given the substantial relaxation of controls already effected, we expect only a small additional impact on prices, except in the health care field.

Second, we have assumed a Federal budget that is somewhat more expansive over the next fiscal year than

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

that proposed last January by the Administration. On a unified budget basis, projected total outlays are somewhat lower than in the budget message, due mainly to prospective offshore oil sales, which are recorded as negative expenditures. But expenditures on a national income accounts basis are larger--due to an expanded public employment program, the extension of unemployment insurance benefits to a full year's coverage, and the payment this summer of a retro-active Federal pay raise. Moreover, we have assumed that the proposal to reduce personal tax withholding schedules will pass and that there will be no special tax imposed on the oil industry. The result is a small projected budget deficit for fiscal 1975, in full employment terms, as compared with a small surplus in fiscal 1974.

Third, we have assumed continuation of a monetary policy keyed to a 5-3/4 per cent growth path in the narrow money supply. This requires first a period of somewhat slower growth, in order to make up for the overshoot of recent months, and then a return to the 5-3/4 per cent path in the fall.

We believe that such a policy would be associated with appreciably higher interest rates than anticipated earlier. Given the stronger expansion in nominal GNP now projected, the income velocity of money would rise even further above its trend rate of growth. This will put upward pressure on interest rates, judging from past relationships, and we believe that the Treasury bill rate is likely to approach 10 per cent by early 1975. Long-term rates seem likely to rise in similar fashion, given projected strong financing demands, particularly by corporate business, and somewhat limited credit supplies. These high market rates will divert large amounts of savings from financial intermediaries; acquisitions of securities by households are estimated to rise from a very modest pace over the winter to an annual rate averaging well over \$30 billion in the quarters to come.

One final assumption should be noted. More careful review of the domestic oil situation suggests that oil imports are likely to rise more on the order of 1 million barrels per day, rather than the 2 million incorporated

in our incremental projection at the last meeting. This would hold imports below the trend rate of growth; the difference is expected to be made up by voluntary conservation--partly reflecting the effects of the substantially increased level of prices--and by increased domestic energy production. Nevertheless, we have assumed that present international oil prices will be maintained at current levels, largely because we are totally without guideposts as to when and by how much prices would likely be cut.

Even with the reduced estimate of the expansion in oil imports, the impact on our foreign trade balance will be very large. Indeed, the expected deterioration in net exports of goods and services contributes in a major way to our projection of a sluggish over-all economic recovery. Mr. Reynolds will briefly review the current account outlook as we see it at this time.

Mr. Reynolds made the following statement:

Our projection for the balance on goods and services is startling at first sight. That balance was in record surplus in the final quarter of 1973, but it is projected to worsen sharply and fairly steadily to a deficit rate of around \$6 billion by the second quarter of 1975. At that time the deficit on all current transactions, including transfer payments, would be about \$10 billion at an annual rate.

Given the sharp rise in petroleum prices, this dramatic change should not, I think, be regarded as an extreme projection. The oil price rise will be having similar adverse effects on the current payments positions of other industrial countries. A current account deficit of around \$10 billion for this country may not be too large in a world where all OECD countries combined are expected to be running current deficits totaling some \$40 billion. Beyond the projection period, we would not expect the deterioration to continue.

Virtually all of the projected \$22 billion deterioration in the balance on goods and services over the projection period is expected to occur in the trade account. Petroleum imports, assuming maintenance of present prices, are expected to increase by about

\$17 billion at an annual rate, with most of that rise occurring early this year. Agricultural exports are projected to decline by about \$6 billion; the pattern contemplates some further rise to a record level early in 1974, but then a drop of one-third as prices are assumed to decline with greater availability of supplies here and abroad. On all other trade, we expect some further net improvement early this year, followed by little further net change. We have assumed that the change in foreign industrial economies will be rather similar to that of the U.S. economy, with only slow growth on average, some increase in available industrial capacity, and a marked slowing in the advance of industrial commodity prices.

Two large uncertainties in our current account projections may have led us to overstate the worsening in the U.S. position. First, international oil prices may at some point fall back, rather than be maintained as we have assumed. If there were to be a decline of 10 per cent, for example, our oil import bill would be reduced by nearly \$3 billion at an annual rate. Second, we have assumed that the foreign earnings of U.S. oil companies will not be allowed to rise much above their late-1973 level, but they could well rise further.

The effective exchange rate has fluctuated very widely over the past 15 months. Our projection assumes that the international value of the dollar would recover somewhat and fluctuate near its February 1974 level, as large net inflows of capital--not projected in detail--would tend to outweigh the developing current account deficit. If, instead, the value of the dollar were to fluctuate near its more recent rate--that is, around 5 per cent below the February rate--the effect upon the projected goods and services balance early in 1975 would probably be small. On the one hand, import prices would be a little higher. But on the other hand, U.S. goods would be more competitive internationally--a factor inhibiting the quantity of imports and encouraging exports. This would tend to strengthen the current account beyond the projection period.

The marked deterioration in the balance on goods and services over the next 15 months will represent a

drag on the domestic economy, but a drag of a rather special kind. The relief from excess demand pressures for agricultural products will not be unwelcome from a domestic point of view. While the sharp rise in payments for petroleum will create structural reallocation problems of various kinds, we are not projecting much change in net real foreign demand for other U.S. goods and services.

Mr. Gramley made the following statement on the domestic aspects of the staff projection:

The staff expects real GNP growth to remain at a modest rate throughout the year ending in mid-1975. After a rebound in the third quarter of 1974, associated with a pickup in consumer spending and in residential construction, the rate of real expansion is expected to fall back to around 2 per cent in the first half of 1975. With real growth remaining below our long-term potential, the unemployment rate would move steadily upward--to around 6-1/4 per cent. We do expect substantial improvement in price performance, but--as I will indicate later--this reflects largely a slower rate of increase in the prices of food and fuel.

The sluggishness of the projected recovery stems partly from the effects of rising oil imports on consumer purchasing power. Our fuel import bill is expected to balloon to an annual rate of just under \$30 billion by early next year. Consumer purchases of gasoline and oil, in current dollars, will also rise sharply, because additional imports of oil will largely go into increased use of gasoline in passenger cars. The end of the embargo is thus a mixed blessing. Car sales will be stimulated, as will other travel-related expenditures. There will be some adverse effects in other consumer markets; however, we still think that the effect of rising expenditures on gasoline and oil will be partly at the expense of saving as well as of consumption of other goods and services.

The pessimism expressed by consumers in recent attitudinal surveys also argues against a boom in consumer markets. We have assumed, however, that consumer

sentiment will improve with the upturn in the economy, and that consumers will show a willingness to add to their instalment debts and to acquire durable goods. Actually, all major categories of consumer spending are projected to rise a little faster than disposable income, and the projected saving rate falls to a little below 6 per cent by early 1975. But while growth in real consumption expenditures exceeds the growth of real disposable income over the projection period, the projected rates of growth in real consumption are relatively modest.

Prospective weakness in housing is another factor that holds down the projected rate of expansion. Data to be released later today will show housing starts in March down by about one-fifth--back to the January level. Permits rose somewhat, and we believe some increase in starts will occur in the months ahead. But since the last Committee meeting, interest rates have risen sharply further, and signs of impending disintermediation have become quite evident. With Treasury bill rates projected to rise substantially further, savings flows to thrift institutions could drop appreciably. Even with large amounts of Federal financing assistance, mortgage credit would likely be in short supply. We believe, therefore, that housing starts would stage only a brief and abortive recovery and would be on the downswing again by early 1975.

Unfavorable financial factors dominate the housing outlook at the present time, but nonfinancial factors are also adverse. Prices of houses have risen sharply and are still going up, and there is a substantial number of unsold single-family houses overhanging the market.

Inventory investment is projected to be a relatively neutral factor over the next year or so, as it was in the early part of the recovery from the 1969-70 recession. The projected pace of inventory investment would imply a small rise in the aggregate inventory-sales ratio this quarter, and an unchanged ratio thereafter.

As you know, the rate of inventory investment is difficult to predict with any confidence. We seem to have gotten through the winter sales slump without

developing an overhang of unwanted inventories, and so we are reasonably confident that this sector of demand will not be a drag on the rate of expansion. There is some possibility that we may have underestimated the strength of inventory demands in the near term, given price expectations and the shortages that have plagued businesses over the past year or so. But recent data on inventories and new orders do not suggest that an explosive thrust of inventory building is in the offing.

For business fixed investment, on the other hand, both survey data and new and unfilled order figures suggest continued strength as far into the future as we can see. Of course, a substantial part of the projected rise in current dollar outlays for fixed capital reflects rising prices. In real terms, however, the projected increase is over 4 per cent for the year ending in mid-1975--a rather considerable advance in view of the high level of investment sustained over the past two and a half years and the limited capacity for increasing output in the business equipment industry.

Finally, let me comment briefly on the wage-price implications of the projection. We continue to expect increases in compensation per manhour at around an 8 per cent annual rate for the private nonfarm economy. This may seem rather optimistic, even for a period of rising unemployment, given the desires of workers to make up for losses of real income over the past year and the effects of the increase in the minimum wage next month and again next January. However, the incoming statistics continue to point to moderation in wages, and trade union demands are focused heavily on obtaining fuller protection against future increases in the cost of living. If the rise in consumer prices moderates, as we think it will, a wage explosion may be avoided.

We should be getting better gains in productivity as economic growth resumes, and therefore some reduction in the rate of increase in unit costs of production. But the best we can hope for, we think, is a rise in unit labor costs at an annual rate of about 6 per cent.

There is, therefore, little reason to expect substantial moderation between now and mid-1975 in the underlying rate of inflation--that is, the rate of price increase after allowance for special factors. Over the past year or so, however, average price increases have reflected heavily the impact of rising costs of food and fuels. However, those effects should be wearing off over the year to come, barring supply developments in agriculture or in the oil industry that we cannot foresee, and this should mean a material slowing in the rise of over-all price measures. An unwinding of the underlying inflationary process will take much longer than a year; but some progress on this front may be made between now and mid-1975, if economic conditions develop along the lines we have projected.

Mr. Partee will conclude the presentation with a discussion of the implications of alternative courses of policy action for economic activity and prices.

Mr. Partee made the following concluding comments:

Our projection of the economy produces what seems to me clearly to be an undesirable outcome. The economic recovery is too sluggish, and it begins to tail off again early next year. The unemployment rate rises too much; and yet the rate of price increase remains high, despite growing slack in labor and product markets.

Unfortunately, there is little prospect that any alternative course of monetary policy would bring a substantially improved outcome. A markedly more expansive policy would encourage greater real output and lower unemployment, at least for a time, but the result would be a worsening in inflationary pressures and expectations. Conversely, a substantially more restrictive policy might curb inflationary expectations, with desirable longer-run moderation in the actual rate of price increase, but the cost almost certainly would be much reduced real output, lower profits, serious financial strains, and markedly higher unemployment.

The options available to the Committee, therefore, appear quite limited. But some marginal improvement in economic performance does seem possible. Since one of the major difficulties is likely to be the housing sector, moreover, it would seem appropriate to provide somewhat more support to residential construction as a means of improving the over-all pace of economic expansion. The basic problem is that the continued sharp rise in interest rates would curb the growth in savings flows to the nonbank thrift institutions and bring about a constriction in mortgage funds that would abort the recovery in housing starts.

Some improvement in the performance of the intermediaries, and hence in the mortgage market, can be obtained by a further increase in permissible interest rates under Regulation Q. The ability of the thrift institutions to finance a further rise in rates paid is limited, but we believe that there is some room for maneuver. Therefore, we have assumed a 1/2 point increase in Regulation Q ceilings on certificate accounts at all institutions, effective in the third quarter. Given an unchanged rate of growth in  $M_1$ , we estimate that this would improve the rate of savings inflow to both banks and nonbanks after mid-year by about 2 percentage points.

We have also considered the effects of some alternative monetary policies, assuming in each case an increase of this dimension in Regulation Q ceilings, the effect of which is to hold down on interest rates somewhat and improve housing starts moderately as compared with our green book projection. Apart from the Q ceiling change, the alternative policies assumed are an extension of those presented in the blue book.<sup>1/</sup> Alternative A projects the continuation of a 6-3/4 per cent growth path in the narrow money supply, beginning in the second quarter; alternative B projects a 6 per cent  $M_1$  growth path; and alternative C projects a 5-3/4 per cent growth path beginning in the fourth quarter, following two quarters of reduced growth to offset the overshoot from that path experienced in the first few months of this year.

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

The differential economic results produced by these alternative policies are as follows: real GNP growth would be expected to rise somewhat above its long-run potential under alternative A, would be at about the long-run growth rate under B, and would remain somewhat below it under C. The unemployment rate behaves accordingly, dropping slightly under A, levelling off at about 5-3/4 per cent under B, and continuing to edge up under C. The increase in prices moderates by about the same amount in all cases, reflecting the projected slowing in the rise of food prices and in oil and other industrial materials. But our expectations would be that, beyond the projection period, the pace of inflation would moderate somewhat more under C than A, provided that a posture of monetary restraint could be maintained in the face of a sluggish economy and rising unemployment.

The Chairman, noting that economic forecasting was particularly difficult and uncertain at this time, invited the Committee members to raise any questions they had with the staff and to present their own views on the economic outlook.

Mr. Coldwell asked about the basis for the staff's expectation of a sharp decline in agricultural exports.

Mr. Reynolds replied that, although there might be a slight fall off in the physical volume of exports, the staff projection primarily reflected a decline in export unit values after mid-1974 because of expected declines in agricultural prices. Of course, the extent of any such decline was uncertain; he understood that economists at the Department of Agriculture expected a smaller drop than that implied in the Board staff's projection. The present

dollar volume of agricultural exports--\$23 billion at an annual rate--was extraordinarily high; only 2 years ago a \$9 billion rate of agricultural exports had been considered good. The recent price increases that had resulted in swollen values of exports did not seem sustainable, especially since prices had already begun to decline in spot markets.

Mr. Mayo complimented the staff on its excellent presentation and added that the staff at the Chicago Bank had come up with basically the same pessimistic conclusions about the economic outlook. He wondered, however, whether the Board staff was not too optimistic in its assumption that the annual rate of increase in compensation per manhour could be held down to 8 per cent--a rate not much higher than that prevailing in the last half of 1973--in view of the probable size of labor settlements in 1974.

Mr. Gramley agreed that if the advance in compensation did prove to be different from the staff projection it was more likely to be higher than 8 per cent than lower. There did not seem to be any good explanation for the unusually small rate of wage increases in the first quarter of 1974, when average hourly earnings of production workers on nonfarm payrolls apparently rose at an annual rate between 5 and 6 per cent. The staff had assumed an acceleration in the rate of advance of the

index, to a range of 7-1/2 to 8 per cent. He might note that labor contract demands thus far had focused primarily on negotiation of cost-of-living adjustments rather than on large wage boosts in the first contract year. Therefore, if the rate of increase in food and fuel prices were to moderate over the next year, it was quite possible that the rate of increase in compensation per manhour would not be larger than 8 per cent.

Mr. Holland asked whether the staff would speculate on the implications of the current sharp expansion in the money stock and in business loans. If the surge in business borrowing at banks actually did represent financing of an inventory bulge, it was possible that inventory accumulation in the second quarter of 1974 might match the \$18 billion rate of the fourth quarter of 1973. If that occurred in combination with a rise in long-term interest rates, the termination of controls, and expectations of price rises and shortages, what would the implications be for the course of economic developments and for the appropriate posture of monetary policy?

Mr. Gramley responded that the likelihood of a sharp increase in inventory investment in the second quarter seemed relatively small; available non-financial indicators of economic activity gave no evidence of such a development. If an inventory bulge did occur, the odds were that it would have a depressing

effect on economic activity from the third quarter on--that the economy would be weaker than now anticipated in late 1974 and early 1975. It seemed unlikely, however, that an inventory bulge would result in a significant general weakening in the expectations of businessmen or consumers, and there was at least some chance that it would produce business expectations of a more ebullient economy.

Mr. Kimbrel asked for elaboration of the staff assumptions about the impact of the minimum wage increase on employment and prices.

Mr. Gramley said the staff had examined carefully the past patterns of wage rate and employment changes in order to evaluate the impact of an increase in the minimum wage on employment and to assess the extent to which the rise might filter up through the wage structure. The analysis suggested that such effects would be minimal and that the main result would be the direct impact on compensation of low-paid workers. It was assumed in the projection of consumption expenditures that most of the addition to wages would be spent. The increase in the index of compensation per manhour attributable to the minimum wage increase was estimated at six-tenths of one percentage point in the second quarter of 1974, three-tenths in the third quarter, and another three-tenths in the first quarter of 1975.

Mr. Eastburn remarked that he assumed that the recent expansion in business loans at banks was related to inventory accumulation, associated perhaps with price speculation. As the economy strengthened later in the year, however, the demand for business loans was likely to be strong and rising, and the tendency for the prime rate to lag the commercial paper rate would increase demands for funds at banks. He asked whether the staff would agree with that assessment.

Mr. Partee replied that the staff's flow-of-funds projection suggested that, while the rate of increase in bank loans would not be quite so high as in the first quarter of the year, it would continue at a very high rate throughout the period of the projection. The staff had projected a high level of plant and equipment expenditures, as well as a positive rate of inventory accumulation, throughout the projection period. Given the expected levelling off or decline in profits, except in the oil industry, business financing demands would be very substantial. Much of that demand for funds would be met by long-term debt offerings; because the stock market situation was unfavorable to new issues, it was unlikely that much of the needed financing would be done through equity offerings. Even with the fairly heavy capital market financing projected, there would be a substantial residual

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need for funds because of price increases for capital goods and the large differential between internal funds generation and the volume of capital investment. He agreed that business demands at banks would be augmented by the tendency of the prime rate to lag increases in other rates. The projection allowed for a small net increase in commercial paper outstandings, but business loans at banks were expected to rise at an annual rate of about \$30 billion, as compared with an estimated rate of over \$36 billion in the first quarter.

Mr. Brimmer remarked that the flow of funds projections presented to the Committee this morning indicated a decline in the share of funds supplied by commercial banks in the first half of 1975 as compared to the first half of 1974. At the same time, there was a sizable increase in the growth of total funds supplied to the credit markets. It appeared that the share of funds raised by the Federal Government accounted for much of that increase and that the funds were then rechanneled to the private sector through Government credit agencies. Historically, a decline in the share of funds supplied by banks and a sharp increase in the share provided by the household sector was associated with a substantial rise in the level of interest rates.

Mr. Partee agreed and noted that one of the reasons the staff expected a rise in interest rates was the necessity for the household sector to absorb a large volume of securities. The projection called for a rise in purchases of securities by households from almost zero in the winter to an annual rate of over \$35 billion in the second half of 1974. As a result, time deposit growth at banks would be lower and the banks' share of lending would decline.

The Government-sponsored agencies, Mr. Partee continued, would be a significantly more important factor in fund flows--as Mr. Brimmer had observed--and those agencies would, of course, finance themselves in the credit markets. The projection for the second half of 1974 included an increase in Federal Home Loan Bank advances to savings and loan associations of about \$9 billion at an annual rate and an increase of over \$12 billion in funds provided by other credit agencies to the mortgage market. Therefore, the total flow of funds from the Government sector to the mortgage market would be at a rate slightly over \$20 billion, beginning with the second half of the year. That volume of aid was necessary to provide sufficient mortgage financing to support housing starts at the rate the staff projected. Such financing, would, of course, exert upward pressure on market interest rates; in the judgment of the staff, both short-term and long-term rates would be around 10 per cent, an

historically high level. It was possible that rates would go even higher; the Board's econometric model, left unconstrained, would produce an even larger increase in rates.

Mr. Hayes noted that the projections made by the staff of the Federal Reserve Bank of New York did not extend into 1975; but, through 1974 at least, they were quite similar to those made at the Board. Like Mr. Mayo, however, he wondered whether the Board's projections of labor compensation were not too optimistic. He asked in that connection how much steel wages were likely to go up over the next few years as a result of the steel contract settlement.

Mr. Gramley responded that it was not possible to draw any firm conclusions yet because of the lack of information. It was clear, however, that the steel wage agreement was basically similar to the settlements made in the can and aluminum industries; that is, it involved a 3 per cent rise in wages plus a cost-of-living adjustment clause. The ultimate effect of the settlement on future wages would, therefore, depend on the rate of increase of the consumer price index.

Mr. Hayes then asked if there were any indication yet of how much steel prices would be raised.

Mr. Partee replied that he felt that the increase in steel prices would be very large and that it would probably occur at the

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end of April when the controls program was terminated, because much of the rise in steel industry costs would take effect immediately.

With respect to the wage structure in general, Mr. Partee continued, the advance in compensation per manhour projected by the staff would accommodate increases for union workers well above the estimated 8 per cent average; the projection allowed for increases of 10 or 11 per cent for the major union collective bargaining agreements. However, because it was anticipated that unemployment would rise to a rate of about 6 per cent, the staff expected increases for nonunion workers to be smaller. Accordingly, the average annual rate of increase in compensation per manhour could be as low as 8 per cent in spite of a number of settlements at much higher rates.

Mr. Leonard asked for clarification of the projected drop in capacity utilization in 1974. He was particularly curious about the expected decline in the index of capacity utilization in the major materials industries. According to the green book, that index was expected to dip from about 95 per cent in the fourth quarter of 1973 to 91.5 per cent in the first quarter of 1974 and then to 90.5 per cent.

Mr. Partee replied that the capacity utilization projections were consistent with the staff's industrial production

estimates. Part of the drop in the first quarter was attributable to the substantial decline in petroleum refining, as a consequence of reduced supplies of crude oil. It was expected that output of refined petroleum products would rise as the year went on, but that the gain would be offset by a downward drift in production of other basic materials as a result of the projected weakness in demand for such products.

Mr. Gramley added that the decline in the capacity utilization index was expected to end by the second quarter of 1974; the greater part of the fall was a consequence of the decline in economic activity during the winter. According to the staff projection, industrial production would increase over the rest of the projection period at a rate consistent with relative stability in the capacity utilization index.

Mr. Morris remarked that he was troubled by the Board staff's projections for 1974 and by those made at the Federal Reserve Bank of Boston, which were almost identical. The latest projections differed very little from those made 2 months earlier, even though the current indicators becoming available during that period suggested greater-than-anticipated strength and resilience in the economy. That discrepancy apparently was attributable to the assumption about inventories--that is, to the assumption that

the buildup in inventories had been confined largely to the automobile industry and was now over. He would like to have the staff elaborate on their belief that the real indicators did not support the inference one might draw from recent business loan data that a strong inventory accumulation was in process.

Mr. Gramley commented that one's conclusions about the need to revise any projections would depend on the degree of agreement between the original assumptions and actual developments. The Board staff had initially assumed that the decline in activity would be short-lived and would not cumulate into a typical cyclical downswing. The nonfinancial indicators that had become available over the past 2 months supported the thesis that the decline was bottoming out and that the economy was ready to move into an expansionary period again. Thus, the recent data had not held any major surprises on that score.

What was surprising, Mr. Gramley continued, was that the data on book value of inventories for January and February did not support the staff's projection of a \$10 billion increase in business inventories in the first quarter; it seemed likely that the inventory rise shown in the preliminary Commerce Department figures for the first quarter would be lower than \$10 billion. For the period ahead, the staff might well have underestimated the strength of businessmen's

desire to build inventories in anticipation of price increases or because of persisting shortages. However, since the nonfinancial indicators, such as new orders, did not suggest a sharp inventory buildup, he thought the odds that the inventory change would significantly exceed the staff projections were not very high.

Mr. Partee remarked that, in view of the widespread, long-continuing reports of shortages, it seemed quite reasonable to expect a bulge in inventory accumulation of the kind Mr. Morris had suggested, which might be followed by a period of low inventory accumulation and a true recession in 1975. The staff had not incorporated an inventory cycle in the projection, however, because of the lack of concrete evidence to date of a big buildup. Furthermore, if there were a high rate of inventory buildup at this point, it could well be a transitory development related to the imminent ending of the controls program.

In response to a question about possible data problems, Mr. Gramley remarked that there always were problems with inventory data and such problems were accentuated in a period of rapid inflation.

The Chairman observed that the inventory data were a statistical morass. For one thing, information on the methods used by business firms to value inventories was inadequate. There were indications of a shift from use of the LIFO inventory valuation method to the FIFO

method, but there were no reliable data. For another thing, inventory figures were reported in dollar terms, and the methods used to adjust them for price changes were highly uncertain. He agreed that one would expect inventory investment to rise in a period of economic recovery, but it was difficult to determine what was actually happening.

Mr. Bucher commented that in recent conversations with retailers he had detected a mood of concern which did not seem to be based on their current sales volume. With respect to Mr. Gramley's comment that consumers had expressed pessimism in recent attitudinal surveys, he asked how current those survey data were.

Mr. Gramley replied that no information on consumer attitudes had become available since the results of the latest University of Michigan survey had been released several weeks ago. That survey had suggested a significant decline in consumer confidence. If the Michigan findings had been given full credence in the Board staff forecasts, the projections for consumer spending would have been much lower. It was assumed, however, that the arrival of spring weather and the expected upturn in economic activity would encourage consumers to step up their spending.

Mr. Partee observed that, in addition to the anticipated improvement in consumer attitudes, the projection incorporated a

considerable rise in consumer income in the third quarter of 1974. First, the expected change in withholding schedules represented an increase of \$8 billion, at an annual rate, in disposable income. As in the case of tax refunds, the staff had allocated half of the increase to consumption and half to savings. Secondly, there would be a windfall gain in income of \$2 billion, at an annual rate, as a result of the retroactive Federal pay increase. Third, the rise in the minimum wage rate would take effect fully in the third quarter. And, finally, an expanded public employment program was expected to begin in the third quarter. Taken together, expectations of those additions to disposable income and of some decline in consumer bearishness resulted in a fairly optimistic view of personal consumption expenditures.

In reply to a further question by Mr. Bucher, Mr. Partee noted that a half-point increase in Regulation Q ceilings on certificates had been assumed in all three of the alternative monetary policies he had mentioned in his earlier statement. Of those three alternatives, A and B differed from the projections shown in the green book--and discussed by Mr. Gramley today--also with respect to the assumed rate of growth in the money supply. Alternative C, however, incorporated the same monetary assumption as the green book projections: a long-run growth path of 5-3/4 per cent for  $M_1$ . In order to isolate the expected effects of the change in Regulation Q ceilings, therefore, one should compare the alternative C projections with those in the green book.

Mr. Bucher noted that such a comparison suggested that the change in Regulation Q ceilings would have significant effects in the first half of 1975 on housing starts, the rate of growth in real GNP, and the unemployment rate.

Mr. Mitchell asked about the extent to which the projected deceleration in the fixed-weight price index represented a staff judgment rather than a direct outcome of the price equations in the Board's econometric model.

Mr. Gramley replied that price projections incorporated explicit staff assumptions that the rise in prices of fuel and foods would decelerate sharply as the year went on.

Mr. Mitchell commented that the projected decline from "two-digit" inflation to a rate of 5 or 6 per cent would then appear to be related to improvement of supply conditions.

Mr. Gramley agreed. He noted that an index excluding food and fuel prices might be taken as a measure of the underlying rate of inflation. That measure had not increased as sharply as the total index, nor was it expected to decline as much.

Mr. Mitchell observed that, from the point of view of monetary policy, it was the underlying 5 to 6 per cent rate of

inflation that was of concern. However, the rates of price advance projected under the three alternative policy courses outlined today did not differ much from one another over the projection period. The staff evidently had made an implicit judgment that a policy course which would affect prices significantly in that period would be too austere in terms of its impact on real GNP and unemployment, and that the most that could be hoped for with respect to prices was some improvement after mid-1975.

In response, Mr. Partee said the staff had not presented a policy alternative sufficiently restrictive to have a significant effect on prices within the projection period because, as Mr. Mitchell had suggested, it thought such a course would be considered too restrictive--particularly since the unemployment rate would be expected to rise above 6 per cent in the first half of 1975 under the more restrictive of the alternatives presented. It should be noted, however, that monetary policy actions affected prices with a longer lag than they affected real output. Simulations made with the aid of the Board's econometric model suggested that under alternative A the rate of price increase would remain as high in the last two quarters of 1975 as in the second quarter,

and it might even drift up a bit. Under the restrictive alternative C, the rate of inflation would continue to decline; it would be down to 4-1/2 per cent by the fourth quarter, and dropping rather rapidly. That was because an unemployment rate over 6 per cent would, in time, slow the rise in wage rates. Maintenance of the alternative C course would produce very sluggish growth in the economy and an unemployment level of about 6-1/2 per cent by the end of 1975. If the projections were carried through 1976, the spread between the rates of price advance under alternatives A and C would widen further.

Mr. Mitchell then asked if savings and loan associations could comfortably absorb a half-point increase in the rates they paid.

Mr. Partee replied that in his opinion the industry as a whole could accommodate an increase of that magnitude.

Mr. Wallich said he found it curious that excess capacity in the major materials industries was not expected to rise in spite of the slowness of the projected recovery. Stability in the capacity utilization index while GNP growth remained below its potential implied a low rate of investment, and that did not seem realistic.

Mr. Partee replied that the relative stability of the capacity utilization index between the second quarters of 1974 and 1975 was based on an expected rise of about 4 per cent in real GNP, a somewhat larger rise in industrial production, and a 5 per cent rate of growth in industrial capacity. The estimate of the growth rate in

capacity was particularly uncertain, since it depended on the dates at which production began at plants now under construction, the amount of current investment that was devoted to pollution control rather than to additional capacity, and so forth. While the projected rate of capacity growth was probably of the right order of magnitude, such a rate might well prove to be inadequate.

Mr. Wallich then asked the staff's opinion about the probabilities that the projection of real GNP would err on the upside or the downside. It seemed to him that there was a larger chance of underestimating the growth of economic activity. For one thing, there was the potential for greater inventory expansion than allowed for. For another, there seemed to be considerable pressure for additional plant and equipment spending. Also, if conditions with respect to the rate of price advance did not worsen, it was quite possible that consumers would react as if they had improved. Housing appeared to be the main area of potential weakness, and he felt there was some chance that activity would strengthen even in that area.

In reply, Mr. Partee expressed the view that, in terms of the internal relationships of the model, the staff projection was highly optimistic. For example, consumption expenditures were as large relative to disposable income as could conceivably be justified. However, there were uncertainties with regard to a

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number of external factors, especially inventories. He doubted that the rate of increase in plant and equipment expenditures in real terms over the next six quarters would be much higher than the projected 4 per cent, because that rate was consistent with the capacity of the capital-supplying industries. But the inventory investment projection could be low by several billion dollars. It was also possible that the housing estimates might be a little low, particularly around mid-1975. The outlook for housing depended on a number of factors: the amount of governmental assistance that would be forthcoming; the ability of FHA field offices to process applications and make loans--that ability was not so great as it had been several years ago; and the capacity of the market to adjust--that is, whether the rates paid on savings deposits would rise enough to maintain funds flows into the mortgage market and whether consumers would be willing to pay 10 per cent mortgage rates.

Mr. Mayo observed that, in order to get an appreciable increase in housing starts above the present level, according to the staff's analysis, it was necessary to assume not only a half-point increase in Regulation Q ceilings but also the fastest rate of growth in  $M_1$  of those considered--the 6-3/4 per cent rate of

alternative A. He also found it significant that under alternative A the annual rate of housing starts would be only 320,000 units higher in the second quarter of 1975 than the green book estimate, but the rate of growth in real GNP would be double that projected in the green book--4.8 as compared to 2.3 per cent. Even allowing for the faster rate of monetary growth assumed under alternative A, that seemed to represent an unusually strong multiplier effect.

Mr. Gramley remarked that the econometric model suggested that the Regulation Q change would have an even larger impact on housing and on activity in general. The staff had been dubious about that result and had modified it judgmentally.

Mr. Partee noted, in addition, that the increment to the rate of growth in the money supply under alternative A was close to 1-1/2 percentage points over the entire projection period. Past experience with the model indicated that a change of that magnitude in the growth rate of money had a significant impact on the economy after a sufficient amount of time elapsed. The increased money supply stimulated not only housing but also State and local construction, business fixed investment, and personal consumption--the latter through the impact on stock market prices.

Mr. Morris observed that over the past 2 months there had been a very sharp rise in interest rates and indications of the beginning of disintermediation. In the past such events had precipitated strong protests about restrictive monetary policy in the Congress, but he had seen no evidence of such a reaction as yet. He wondered if the Chairman expected that situation to persist.

The Chairman observed that he would not be willing to predict that the absence of protests would continue indefinitely. However, he might note that, although he regularly received a great deal of protest mail from the public, he had not as yet received any communications from Congressmen critical of the recent increase in interest rates. He suspected that Congressmen, as well as others, were not surprised by rising interest rates at a time when prices of goods and services were surging and when there were expectations of substantial rises in wage rates. They also might be aware that interest rates were higher in foreign countries--for example, that mortgage rates in Canada and Great Britain were well above those in the United States. The criticisms of interest rate trends that he had been receiving recently were mainly from the stock exchange community and occasionally from owners of small businesses.

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Mr. Eastburn asked whether a half-point increase in Regulation Q ceilings would be likely to stir criticism.

The Chairman said he was skeptical about the staff's assumption of such an increase in developing its policy alternatives. While he had not discussed the matter with representatives of the other regulatory agencies, he would expect the Federal Home Loan Bank Board to oppose any ceiling increase at present, even though it might accept an increase 2 or 3 months from now. He might note that officials of some savings and loan associations had complained to him that current rate ceilings were too high.

In response to a question from the Chairman, Mr. Mitchell said the Inter-agency Coordinating Committee had not had recent discussions of the possibility of increases in ceiling rates. He agreed with Mr. Partee's earlier statement that the savings and loan industry as a whole could accommodate an increase in the rates it paid, but whether the regulatory agencies would agree to an increase in the ceiling rates was another question.

The Chairman expressed the opinion that a rather high percentage--perhaps as much as 25 per cent--of the savings and loan institutions would find themselves in some difficulty if interest rate ceilings were raised.

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Mr. Partee noted that the most recent disaggregated income data for savings and loan institutions was for the year 1971 and, therefore, was not very useful for analyzing the problem. However, the Federal Home Loan Bank Board had access to more recent information on problems of individual institutions, and they would probably estimate that a substantial minority of savings and loan institutions, perhaps 1,000 to 1,500, would suffer losses. It was not a question of those institutions going bankrupt, but rather of having to reduce their surplus for a time. The industry as a whole had achieved a good increase in return on assets over the past year or 18 months, and the future profit situation was likely to be adequate since the projected high mortgage interest rates over the next year would mean sizable incremental additions to portfolio income.

Mr. Partee said it might be worth emphasizing that the increase in interest rate ceilings assumed by the staff in preparing the alternative projections related to certificate rates, and did not extend to rates on passbook accounts. The resulting cost increase to the thrift institutions would, of course, be considerably less than under a more general increase in ceiling rates.

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Mr. Brimmer observed that the savings and loan associations would also benefit from not having to pay the new higher levels of interest on the outstanding four-year certificates sold since last summer.

Mr. Black said he regarded the uncertainty about the duration of the recent business loan expansion as a key question. The projected slowing in the growth rate of the monetary aggregates might imply that the staff expected the business loan bulge to be temporary. Indeed, there were several factors which suggested that the rapid increase in loans would not continue. Rising bank lending rates would encourage some borrowers to shift to the commercial paper market. Auto dealer demands for financing floor stocks would be declining, and demands of businesses generally for financing precautionary inventories of goods in short supply would probably abate when shortages were relieved by the removal of price controls. Some business borrowing had been associated with the sharp increase in oil payments, which was unlikely to continue at the recent rate. Finally, some bankers reported that there had been a substantial switch, particularly by agricultural producers, from trade credit to bank credit, and that process had about run its course. Taking all those factors into account, it was his feeling that growth in business loans would probably not remain rapid. He wondered,

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therefore, if it would not be reasonable to expect a slower rate of growth in the monetary aggregates for any given level of interest rates than had been the case in recent months.

Mr. Partee said he agreed with some of Mr. Black's points. He might note, however, that the staff was projecting that a continuing, substantial increase in bank loans to business would result from the wide spread between plant and equipment expenditures by corporations and their internal generation of funds for investment purposes. Except for the oil industry, corporate profits were expected to decline over the projection period.

The Chairman suggested that, in addition to addressing questions to the staff, the members express their own opinions regarding the economic situation. The Committee's major task was to deliberate on monetary policy, and that could be done most effectively if the members shared their individual views on the economic outlook. The projections presented by the staff were by their nature rather conjectural, and his own forecast--were he to present one--would be stated in rather different terms. He would have made other policy assumptions, and his conclusions would have differed from the staff's in some respects.

Mr. Coldwell noted that the staff had projected an increase of roughly one percentage point in the unemployment rate by mid-1975

under alternative C. He asked whether that was a result of an expectation of faster growth in the labor force than in jobs, or whether it reflected an anticipated decline in jobs because of higher labor costs, slackening demand, or problems in specific industries.

Mr. Partee replied that the primary reason for the estimate of higher unemployment was that the staff expected the labor force to increase faster than employment. No massive layoffs in depressed industries, such as might occur in a typical severe business cycle, were anticipated. The staff had forecast some slowing in labor force growth--estimating an increase of 1.3 million persons at an annual rate as compared with the 1.6 million that might be expected on a trend basis--but it believed that the economy would not be strong enough to absorb the natural additions to the labor force.

Mr. Coldwell asked whether growth in the labor force might not be less than 1.3 million, in view of the exceptionally large growth over the past few years.

Mr. Partee responded that a more marked slowing than projected was possible; indeed, labor force growth in the past few months had been below the projected rate. In his opinion, however, growth at about a 1.3 million rate was more likely.

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Mr. Coldwell then said he found it difficult to believe that there would be a difference of only two-tenths of a percentage point in the rate of increase of the fixed-weight price index by mid-1975 as a result of the different monetary growth rates associated with alternatives A and C. There would be serious problems in formulating monetary policy at this meeting if it were true that the Committee's actions would have so little impact on the rate of inflation.

Mr. Partee responded that, as he had noted earlier, the differential impact of the alternative policies on the rate of inflation would be greater in the later part of 1975, at least if one could accept the results yielded by the Board's econometric model. The Committee could, of course, also slow the rate of price increase more within the projection period by pursuing a monetary policy considerably more restrictive than that assumed under alternative C.

Mr. Coldwell observed that the effect of the alternative C policy on the rate of inflation within the next year might be greater than the staff suggested as a result of the changes in expectations that might be generated by continued stringency in monetary policy.

Mr. Partee agreed that that was a possibility.

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Mr. Clay commented that recent developments in farm prices offered some promise that retail food prices would stabilize during the last half of 1974. Since reaching a near peak in mid-February, farm prices had slipped substantially, led by declines of about one-third, or \$2 a bushel, for wheat; one-fifth, or \$0.60 a bushel, for corn; and 10 to 20 per cent, or \$2 to \$4 a hundredweight, for cattle and hogs. Although it was likely that meat animal prices would rise seasonally in the summer, grain prices were expected to trend lower as the new crops were harvested.

It was not clear, Mr. Clay continued, how food merchants would respond to those developments, but recent information indicated that the spreads between farm and retail prices had widened to near-record levels, especially for red meats. If retailers showed a willingness to let those price spreads narrow in the months ahead, the upward pressures on food prices should ease considerably, as the Board staff had predicted.

Mr. Clay then said he found the projections associated with the alternative policy courses intriguing. As he understood it, the effects of policy actions taken now--in the second quarter--would reach significant proportions in the fourth quarter for such variables as the unemployment rate, but there would be practically no differential impact on prices through the second quarter of

1975. Like Mr. Coldwell, he believed that monetary policy could affect the rate of inflation more quickly, by altering the expectations of those who now thought inflation would continue at its present pace.

Mr. Gramley said he wanted to emphasize that past experience supported the conclusion that changes in monetary policy affected prices with a much longer lag than they did real economic activity. It was possible that a shift to a highly restrictive monetary policy might generate a sharp change in expectations. However, inflation was essentially a long-run problem, and in his view it would be unduly optimistic to expect substantial progress on the price front within the next year or 18 months as a result of any feasible monetary policy.

Chairman Burns observed that the current inflation differed in one important respect from most previous periods of rapid price increases: there had been an explosive rise in prices of foods and raw materials. The markets for those goods were still highly competitive, by and large, and if monetary policy were to remain moderately restrictive, it was possible that such prices would break sharply, resulting in an effect on the general price level much larger than past experience might suggest. The relevant comparisons were with the commodity inflations of 1920 and, to a lesser extent, the Korean War period.

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In evaluating any projection, the Chairman continued, it was necessary to remember that other projections had often proved to be far off the mark, even when made by highly qualified analysts. While the staff's projections were useful, they should not be taken literally.

Mr. Kimbrel asked whether the Chairman considered it likely that the Congress would restructure the tax laws so as to affect Federal revenues during the projection period.

The Chairman said he did not expect any significant change in the tax structure in the near future.

Mr. Kimbrel then remarked that Sixth District businessmen had indicated in recent conversations that the economy was showing much more strength than they had expected. Bankers had been completely unprepared for the recent sharp expansion in business loans. Businessmen were anxious about inflation and were girding themselves for the price increases that might follow the lifting of the controls program at the end of April. Contractors reported that costs were rising so sharply and delivery schedules were slowing so much that they were reluctant to make firm bids on new contracts. In general, financing problems and high interest rates were of much less concern to the Sixth District contractors than were problems associated with availability of materials, delivery schedules, and costs.

Both banks and insurance companies, Mr. Kimbrel continued, were becoming somewhat concerned about the quality of credit because of the increasing frequency of delinquencies. In general, though, businessmen in the Sixth District felt that the worst part of the economic slowdown was now in the past, and that the most important current problem was inflation.

Mr. Brimmer said he found the staff's projections and analysis useful as background material for thinking about monetary policy. He accepted the staff's view that the effects of monetary policy actions should be expected to be evident first in interest rates and financial variables and then, in sequence, in output, employment, and prices, with lags of varying length. Because he was particularly concerned about the long-run inflationary situation, he felt that the Committee's deliberations should focus on how monetary policy could reinforce the efforts already under way to restrain inflation. The objective of monetary policy should not be to revive housing or to assure any particular short-run behavior of the unemployment rate. There were specialized instruments to provide aid to housing, and public employment programs and unemployment compensation could help deal with the very real problem of unemployment. That was the general direction of his thinking; he would offer more detailed views on policy when the Committee turned to that subject.

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

I would like to offer only two additional comments to the Committee with regard to the blue book alternatives.<sup>1/</sup>

First, the Committee may, as a policy matter, again wish to consider lowering the bottom of the ranges for the aggregates. With the aggregates running strong relative to long-run desires, this would permit a more rapid move back to path, at current interest rates, should the incoming data weaken.

Second, the even keel constraint before the Committee over the forthcoming weeks suggests that any tightening of the money market--should it prove necessary--would be better accomplished over the next several days. The Treasury refunding is fairly large, and late April through the first week or two of May will be a critical period in determining market attitudes toward the new issues and in distributing them. Thus, it may be desirable to keep money market conditions generally stable during that particular period. However, if on top of recent overshoots, the aggregates are growing considerably more rapidly than desired, it seems to me that 3 weeks is an excessively long period for an absolute even keel constraint. It may--under such circumstances--prove desirable to permit some money market tightening in the weeks of the financing, particularly if market attitudes have been prepared by some tightening prior to the financing.

Chairman Burns observed that the Committee was ready for its deliberations concerning monetary policy.

Mr. Bucher remarked that in his view the System had pursued a policy of restraint too far too quickly; he was uncomfortable

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

with the Committee's general posture and with the level to which money market rates had risen. Nevertheless, he would not propose that the Committee reverse policy precipitously.

Continuing, Mr. Bucher commented that the risks involved in forecasting became greater as the forecasts extended further into the future. Moreover, he thought that it was important to emphasize staff comments to the effect that the latest GNP forecasts might be on the optimistic side. It was important to emphasize also that at present there was little basis for assuming that Government programs would be implemented to help in dealing with the employment and housing problems, particularly in the current political environment. The Committee had to act and to bear the responsibility for its actions without relying on the assumption that some other part of Government would take appropriate actions.

In that light, Mr. Bucher said, it was important to consider the trade-offs involved in pursuit of a still more restrictive monetary policy. Staff projections suggested that in the second quarter of 1975 housing starts would be about 200,000 lower under alternative C than under alternative A, and they also suggested fairly major differences between the two alternatives in rates of growth in real GNP and in the unemployment rate. Therefore,

he was concerned about the possibility of the Committee over-reacting. In his view, a great deal of monetary restraint had already been put in place, and he would wait a month to observe its effects before considering any further tightening. He could accept alternative B--which represented a continuation of prevailing money market conditions--although he preferred specifications somewhere between those of alternatives A and B.

Chairman Burns remarked, with respect to the current political environment, that the Administration's position at the beginning of the year was that a recession must be prevented and that whatever needed to be done would be done. Members of the Administration--including the President--had been weighing the economic situation, and in view of signs of improvement in economic activity and of intensification of the inflation, the present position was that a tax cut--such as had been proposed by some members of the Congress--must be opposed. That was a clear and deliberate decision reached by the Administration. Of course, some confusion and uncertainty about Administration policy might develop as a result of the departure of George Shultz as Secretary of the Treasury.

In response to a question by Mr. Black, the Chairman added that the Administration, a little reluctantly, had gone

along with a recommendation that income tax withholding rates be reduced. While such a reduction would alter the distribution of tax receipts during the fiscal year, it would not change the total for the year.

Mr. Brimmer commented that he favored alternative C; in pursuit of a policy of restraint, he did not wish to go beyond alternative C, but neither did he wish to stop short of it. He wanted the Committee to take responsibility for its part of the job, and he would encourage other agencies of the Government to take responsibility for their parts. As he had said earlier, there were specialized means for dealing with excessive unemployment and for aiding housing. He would not wish to see the Committee assume responsibilities that belonged to others.

Continuing, Mr. Brimmer said he foresaw more pressure on interest rates in the period ahead, and he believed that a higher Federal funds rate was necessary. He would be inclined to raise the funds rate ceiling under alternative C to at least 11-1/2 per cent, and he would instruct the Manager to move the rate toward that level. He recognized that such a policy would result in a slower rate of recovery in economic activity over the next 9 to 12 months than would alternative A, but the cost had to be paid.

Mr. Bucher commented, in clarification of an earlier statement, that there was some uncertainty as to whether other Government agencies having responsibilities for programs affecting housing and employment would in fact be able to act. Specifically, it was a serious question whether FHA would be able to perform its role with respect to the "tandem programs."

In response to a question by Chairman Burns, Mr. Partee observed that--while administered by GNMA--the tandem plan involved only new FHA and VA mortgages, not conventional mortgages.

Mr. Kimbrel said he held the same policy views that Mr. Brimmer had expressed. While the staff's projections might be viewed as being on the optimistic side, the System's performance in achieving its objectives was something less than excellent. He favored alternative C and, like Mr. Brimmer, would set the upper end of the range for the funds rate at 11-1/2 per cent.

Mr. Hayes observed that, in his view, persistent and virulent inflation was the overriding problem, both domestically and internationally. Over the past year, growth in all of the aggregates had been somewhat excessive for a period of rampant inflation. In formulating policy for the next month, consequently, he would place the emphasis on maintaining firm money market conditions or achieving slightly firmer conditions. A firm monetary

policy, moreover, would strengthen the exchange rate for the dollar against other major currencies. He had been glad to see the funds rate edge up to 10-1/4 per cent, and he favored specification of a symmetrical range around that level--a range of 9-3/4 to 10-3/4 per cent, which was between alternatives B and C. For the longer-run  $M_1$  target and for the other aggregates, he favored the specifications of alternative C.

Mr. Hayes commented that the time was getting very close when an increase of one-half of one per cent in the discount rate would be desirable; recently some directors of the New York Bank had expressed impatience with respect to an increase in the rate. He thought that the increase perhaps ought to be effected as early as the current week, provided the timing was acceptable from the point of view of the Treasury financing. With respect to reserve requirements, an increase in the marginal rate on CD's in addition to action on the discount rate would be excessive tightening. A reduction in the requirement under Regulation M, to 5 per cent, along with an increase in the discount rate, would have a favorable effect on the dollar's international position.

Mr. Mitchell said he favored alternative B. In his view, the market had become aware of the System's policy course, and less sophisticated people were going to become apprehensive

when they saw the pattern of interest rates that would flow from the actions that had already been taken. The System had now demonstrated by the recent changes in monetary policy that it was on the side of the angels, but it could overdo it. Additional tightening--on top of the actions of the past few weeks--would be excessive. Moreover, it might make the Treasury's refunding problem more onerous than would be desirable from the standpoint of the public as well as the Treasury. He would prefer to retain about the present policy posture.

Mr. Mitchell added that if some further action were deemed to be necessary, he would prefer to raise the marginal reserve requirement on CD's, with the expectation of achieving a better and more localized effect on bank lending policies than could be obtained through open market operations. It might also be desirable to do something with respect to Euro-dollar borrowings of U.S. banks; that was a question that ought to be studied in the context of the interest rate differentials between the U.S. market and the Euro-dollar market that might develop as funds flowed into the latter market.

Mr. Holland commented that a policy of reasonable restraint was appropriate at the present time. The Committee had leaned in that direction at the last meeting by toughening

its reserve provision policy, and that had turned out well. Interest rates had moved up to levels that were starting to slow inflows to the thrift institutions, a development that might be characterized as mini-disintermediation. The interest rate increases since the last meeting had cut perhaps 2 percentage points from the prospective rates of growth in  $M_2$  and  $M_3$  later in the year. In his view, those two aggregates--as compared with  $M_1$ --were even more important this year than last in analyzing the effects of policy. The recent actions had been in just about the right degree to dampen the recovery in housing activity and to produce a significant anti-inflationary effect. Before tightening further, however, the Committee should pause for a while, because the next significant round of tightening in reserve supply and of increases in interest rates would produce full-scale disintermediation, which would precipitate a number of other developments. In effect, it would be a threshold decision, having important consequences for financial institutions, housing activity, the distribution of resources, and attitudes generally.

Continuing, Mr. Holland observed that more evidence was required to determine whether the current expansion was cyclical in character, with a renewed generation of inflationary pressures, or whether it was influenced by temporary factors, such as a

short-run buildup of inventories in advance of the April 30 termination of the price control program. Although such inventory investment was not evident in the available statistics--which were not as up to date as other statistics--it might appear when later data became available. If that proved to be the case, the degree of tightening in money and credit availability that had already been accomplished would prove to be about right; a further tightening would be unnecessary. Indeed, as Mr. Gramley had suggested earlier in response to a question, a second-quarter bulge in inventory investment would most likely lead to some softening in economic activity in subsequent quarters. On the other hand, if the evidence indicated that a cyclical upsurge in economic activity and in inflationary pressures was developing, he would be prepared to accept a more restrictive policy.

In conclusion, Mr. Holland said he would like to continue the present posture of policy until the next meeting of the Committee, when additional evidence on the nature of the situation would be available. Alternative B would accomplish that. If the Committee favored the B language for the operational paragraph of the directive, he would delete "somewhat" from the statement that the Committee sought to "moderate somewhat growth in monetary aggregates." However, he would prefer

to couch the directive in terms of money market conditions, using the variant for B shown in the blue book--namely, ". . .the Committee seeks to maintain about the prevailing money market conditions, provided that the monetary aggregates appear to be growing at rates within the specified ranges of tolerance." That language more precisely described what he had in mind, and this was a time to be particularly precise in describing what the Committee was trying to achieve. He favored the aggregates of alternative B, although he would reduce the lower end of the 2-month ranges for the reasons given by Mr. Axilrod. And with a view to publication of the specifications in 90 days, he would round the limits to the nearest full percentage point in order to avoid a suggestion of great precision. He would try to hold the funds rate within a range of 9-1/2 to 10-1/2 per cent.

Mr. Hayes remarked that, while he had indicated a preference for the aggregates specified under alternative C, he would both broaden and lower the short-run ranges of tolerance; it would be acceptable if the aggregates fell short of the alternative C ranges for a brief period. Thus, he would suggest a range like 1 to 7 or 2 to 7 per cent for  $M_1$ . And, like Mr. Holland, he would prefer to couch the directive in terms of money market conditions. However, he would prefer to say ". . .the Committee seeks to maintain firm money market conditions and to seek

additional firming if the monetary aggregates appear to be growing unduly rapidly." That language indicated a little more specifically that the Committee was prepared to tighten money market conditions in the event of too rapid growth in the aggregates. Finally, with reference to Mr. Holland's remarks, he noted that the longer-run target specified under alternative B was 6 per cent, compared with the 5-1/4 per cent target that the Committee had adopted at the March meeting; in terms of the  $M_1$  target, therefore, alternative B did not represent a continuation of the Committee's present posture.

In response, Mr. Holland commented that at the March meeting the Committee had established a longer-run  $M_1$  target that, in his view, was too low; the 6 per cent target was more reasonable. By advocating continuation of the present policy posture, he meant only that prevailing money market conditions should be maintained.

Mr. Morris observed that a few months ago he had felt a need to give a lot of weight to the possibility--which he had viewed as serious--of a cumulative decline in economic activity. Now, on the basis of the evidence of the past 8 weeks, he felt that such a risk had been largely eliminated. As a result, there now was a lower potential social cost in giving a higher

priority to controlling the rate of growth in the money stock in order to slow the longer-run rate of inflation. Accordingly, he would accept the specifications of alternative B, except for the funds rate range. To provide the Manager with sufficient flexibility to assure that growth rates of the aggregates would not exceed the upper limits of their short-run ranges, he would raise the upper limit of the funds rate range to  $11\frac{1}{4}$  per cent, thus specifying a range of  $9\frac{1}{4}$  to  $11\frac{1}{4}$  per cent.

Mr. MacLaury remarked that he felt more than the ordinary uncertainty about the GNP projections at this time. While he thought that a cumulative downturn now was less likely--if not much less likely--he still was uncertain about the probable course of economic activity in the second half of the year. Therefore, he would emphasize the various measures of the money stock, in contrast with some speakers who had defined the degree of ease or restraint in terms of money market conditions.

Continuing, Mr. MacLaury said growth in the monetary aggregates--both in the recent past and projected for the short run--was excessively rapid. Consequently, he saw no reason to depart from the longer-term objectives set at the March meeting, involving a 6-month target of a  $5\frac{1}{4}$  per cent rate of growth in  $M_1$  to return it to the longer-term path of  $5\frac{3}{4}$  per cent. In that

light, he favored specifications falling between alternatives B and C. However, he could accept the specifications of alternative B if the lower limit for the  $M_1$  short-run range of tolerance were reduced to 5 per cent; the mid-point of the range then would be the same as the 6-1/2 per cent mid-point under alternative C.

Mr. MacLaury added that he wished to compliment the staff for providing in the blue book the projected rates of growth for the three measures of the money stock on the quarterly average basis. It was also helpful to have the reference, in connection with one of the alternatives, to the length of time that it would take to return growth in  $M_1$  to the long-run path of 5-3/4 per cent.

Mr. Leonard observed that he had confidence that the techniques of formulating monetary policy and of controlling money would improve substantially in the future--perhaps even in the near future--even though the precise role of money in influencing the course of economic activity was, and for some time probably would continue to be, a subject for debate. Once such improvement had occurred, the Committee would find 3 months after a meeting that monetary growth was on target, and consequently, there would be less concern about the effects of publishing the longer-run targets.

Continuing, Mr. Leonard remarked that it was the Committee's practice at its meetings to examine three alternative policy courses--A, B, and C--and it seemed to him at times that one could determine in advance that the Committee would adopt a course close to that of alternative B. At the last three meetings, for example, the Committee had rejected the A alternative because the specified rates of growth of money were deemed to be too large and the implied consequences for the future were not desirable. In like manner, the Committee had rejected alternative C because the interest rates projected for the short term were deemed to be too high. So in the last 3 months the Committee had voted something close to the B alternative, with perhaps some minor changes in specifications. However, the growth of money observed so far this year was faster than that specified under the B alternatives; it was even faster than growth under the A alternatives, which had been rejected as being too fast. At the same time, during most of the first 3-1/2 months of 1974, short-term interest rates were higher than had been deemed necessary or desirable in order to achieve the desired rate of monetary growth. Consequently, he believed, this would be an excellent time to break away from the B alternative and to get hawkish on inflation.

The real question, Mr. Leonard said, was whether the economy was or was not stronger than indicated by the staff projections. If it was stronger, adoption of either the A or B alternative might lead to great difficulty next summer. At that time both rates of interest and rates of money growth might again be higher than desired, and the Committee might have to dig in during a period of heavy Treasury borrowing. With that prospect, alternative C clearly would be the better choice today. On the other hand, the staff projections might be right, and the economy might not be as strong as he believed it to be. Nevertheless, he would not favor re-acceleration in monetary growth because of the possible difficulties he foresaw. Alternative C was intended to return  $M_1$  growth to a 5-3/4 per cent growth path by September, which compared with a 5.5 per cent growth rate during the first quarter, on the quarterly average basis, and a 4.8 per cent rate in the second half of 1973. If it became apparent later in the year that real economic growth was weaker than he now expected, a more expansive policy at that time would fit in well with the heavy Treasury financing. It also would cushion the decline in the rate of growth in real output that the staff foresaw for the first half of 1975.

Mr. Mayo observed that he advocated alternative B because he believed it would steer a constructive path--in contrast with alternative C, which would invite serious disintermediation and run the risk of forcing an easy money policy next autumn. Alternative B represented a mildly and appropriately restrictive policy; under it, the annual rate of growth in  $M_1$ , after declining from 7.5 per cent in the fourth quarter of 1973 to 6.7 per cent in the first quarter of this year, was projected to decline further to 5.7 per cent by the third quarter. He favored the  $M_1$  target of 6 per cent for the second and third quarters combined and the indicated range for the funds rate. However, he believed that the short-run ranges of tolerance for the aggregates were too narrow; he would widen them to 5-1/2 to 8-1/2 per cent for  $M_1$  and 6-1/4 to 9-1/4 per cent for  $M_2$ . Like Mr. Holland, he preferred the variant alternative B language for the operational paragraph couched in terms of money market conditions, as shown in the blue book.

Noting that the Chicago Bank had been among those whose directors had recommended an increase in the discount rate last week, Mr. Mayo said such an increase was preferable to a further rise in the Federal funds rate as the next tightening step; it would confirm the tightening that had already occurred in the market and

would indicate clearly that the System meant to be restrictive, but it would not provoke further tightness. It would be appropriate to raise the discount rate before taking any action with respect to reserve requirements on CD's or Euro-dollars, or with respect to Regulation Q ceilings. Those instruments could be used later, with both announcement and substantive effects, and they were subject to better control than the open market operations involved in alternative C.

In the Chicago District, Mr. Mayo added, the recent rapid expansion in bank credit involved borrower use of existing lines of credit rather than aggressive efforts by the banks to expand their lending. In his view, that made a difference in the interpretation of the recent loan expansion.

Mr. Coldwell observed that, in contrast to Mr. Mayo, he would prefer not to act on the discount rate--or reserve requirements--at this time, because such action would raise interest rates further and generate expectations of additional increases. Like Mr. Mayo, he would widen the ranges for the short-run ranges of tolerance for the aggregates, but preferring alternative C, he would specify ranges of 4 to 7 per cent and 5 to 8 per cent for  $M_1$  and  $M_2$ , respectively. And he would specify a range of 9-3/4 to 11-1/2 per cent for the funds rate. He was

especially concerned about efforts directed toward fine tuning; he preferred that the Manager be given, and use, greater flexibility than in the past.

Mr. Coldwell added that he was opposed to operations by which the Desk injected reserves over the weekend--especially through repurchase agreements--just for the sake of "touching up the market." He doubted whether the market had needed much touching up in the period since the last meeting and hoped that the Desk would stay out of the market as long as developments were acceptable.

Chairman Burns remarked that it might be helpful if the Committee's senior economist gave his policy recommendations at this point.

Mr. Partee observed that he, like Mr. Bucher, believed that monetary policy had been tightened quite a lot in recent weeks, given the basic economic situation. If not for its potential effects on inflationary expectations, he would favor a return to a somewhat more liberal stance with respect to the aggregates, which might bring about some easing in money market conditions, along the lines of alternative A. However, he recognized that inflationary expectations were great, and that any move in the direction of a more expansive monetary policy might fan those expectations; it might tend to raise the increases

demanded in coming wage negotiations and to lessen business resistance to such demands. Accordingly, he would accept the specifications of alternative B, although he would do so reluctantly because they seemed likely to be associated with inadequate economic growth over the period ahead.

Continuing, Mr. Partee said he would be prepared to see a decline in the funds rate over the weeks ahead, should incoming data for the monetary aggregates indicate low rates of growth, because the Committee was tolerating high interest rates--and their consequences--as a means of achieving moderate monetary expansion. Signs that monetary expansion was moderating would permit the Committee to ease the pressure that high interest rates exerted on the economy. On the other hand, since market rates had already moved so high, he would be prepared to accept a significant further rise only if the incoming data indicated that monetary growth was running very much on the high side.

With respect to monetary growth, Mr. Partee observed that the numbers becoming available in recent weeks had rather consistently been above staff projections, but that did not mean that incoming data would continue to be on the high side. The past suggested that the periods when the numbers ran very high or very low relative to projections generally were brief. The chances were about even that a run in one direction would be followed by one in the other direction.

Mr. Brimmer remarked that recent developments, as described in the blue book, suggested to him that the chances were greater than even that expansion in the aggregates would remain on the high side, given prevailing money market conditions. In his view, maintenance of about the funds rate range adopted at the last meeting, in the face of strong demands for business loans, would encourage the banks to compete in making loans, and the System would supply the reserves. That had been happening since the middle of March, and he suggested that a repetition was likely.

In response, Mr. Partee commented that the developments that might permit an easing of money market conditions under alternative B probably would encourage some decline in interest rates in the commercial paper market. Because of the lag in the prime rate, some loan demands then would tend to shift back into the commercial paper market, and the pace of expansion in banks' business loans would moderate.

Chairman Burns observed that his own position, in general, had been well stated by Mr. Mitchell. A little more tightening in policy was indicated, but in view of the considerable tightening that had occurred, he would be inclined to pause for a while before making any major move. At present, the directive language

of alternative B couched in terms of money market conditions, as shown in the blue book, appeared appropriate. Concerning specifications, he would suggest that the Committee give consideration to a 6-month target for  $M_1$  of 5-3/4 per cent or, preferably, 5-1/2 per cent, rather than 6 per cent as indicated under alternative B; the longer-run targets for  $M_2$  and the credit proxy would be adjusted correspondingly. For the short-run ranges of tolerance, the lower limits ought to be below those specified under alternative B; he would suggest 3 to 7 or 3 to 8 per cent for  $M_1$ , with ranges for  $M_2$  and RPD's adjusted accordingly. The Federal funds rate range might be rather narrow at this time; he would suggest 9-3/4 to 10-3/4 per cent. Finally, in view of the sensitive state of market conditions, it might well be necessary for the Chairman to communicate with the Committee before the next scheduled meeting.

In response to a question by Mr. Winn, Chairman Burns remarked that if the specifications he had suggested proved not to be internally consistent, the Committee had a mechanism for dealing with the situation. In any case, the staff had indicated that they were consistent. He asked Mr. Axilrod to comment.

Mr. Axilrod said he believed the specifications suggested by the Chairman were internally consistent. They suggested that

the Committee would be willing to accept a slower rate of growth in demand deposits and currency, compared with that under alternative B, if in fact it developed with prevailing money market conditions.

Mr. Partee added that the funds rate was likely to move quickly to one limit or the other of the narrow range of tolerance. However, it was appropriate to specify a narrow range in association with a directive couched in terms of money market conditions.

Mr. Eastburn commented that he liked the direction in which the Chairman's suggestion went, but he questioned whether it went far enough. There had been a number of remarks at today's meeting about continuing the existing posture of policy. To accomplish that, it seemed to him, growth in  $M_1$  had to be returned to the growth path of 5-3/4 per cent. Alternative C-- which specified a 6-month target of 5-1/4 per cent--was a prescription for doing that by September. Also, he preferred the language of alternative C, because it placed the proper stress on returning to the growth path. If the Committee tolerated the deviation from path for too long a time, it might have to choose between, on the one hand, accepting higher aggregates than it really wanted and, on the other hand, accepting a substantial adjustment to return  $M_1$  to a reasonable path. The

issue arose whether the Committee was going to adhere to the 5-3/4 per cent path, or whether, in a series of small steps, it was going to abandon it. If the Committee was not going to pursue a return to that path, it ought to focus on the kind of growth path it did want.

Mr. Mitchell remarked that it could not yet be said that the Committee had abandoned the 5-3/4 per cent path, although subsequent events might indicate that it had. The Committee had made a change in policy recently, and the changed reserve and money market conditions had not yet had an opportunity to affect the aggregates.

Mr. Eastburn commented that it might take a long time to return to the 5-3/4 per cent path if  $M_1$  grew at a rate of 5-1/2 per cent over the next 6 months.

Mr. Hayes observed that he would be uneasy about raising the 6-month target for  $M_1$  to a rate of 5-1/2 or 5-3/4 per cent from the 5-1/4 per cent rate specified at the March meeting.

Mr. Holland said there was a very practical reason for adopting a 6-month target higher than 5-1/4 per cent. In the month since the March meeting, developments in the real economy, interacting with developments in the banking system, had produced larger increases in  $M_1$ , in  $M_2$ , and in business loans than

had been anticipated. Because of the upsurge in recent weeks, an effort to hold to an  $M_1$  growth rate of 5-1/4 per cent over the second and third quarters would require more severe restraint than was contemplated a month ago. In the circumstances, it would take more time to return to the 5-3/4 per cent path than had been expected at that time.

Chairman Burns remarked that he personally would prefer a 6-month target of 5-1/2 per cent to one of 5-3/4 per cent.

Mr. Mitchell commented that the 6-month targets really were not of great importance because of the uncertainty as to whether they could be achieved.

Mr. Brimmer observed that the formulation suggested by the Chairman--including a longer-run  $M_1$  target of 5-1/2 per cent--moved a little away from alternative B toward alternative C and was acceptable to him. For the next month, the crucial operational question was the range established for the funds rate. In his view, the proposed ceiling of 10-3/4 per cent--which was not much higher than the ceiling of 10-1/2 per cent adopted at the March meeting--was not high enough. An 11 per cent ceiling would be preferable.

Mr. Mitchell asked whether the proviso clause of the directive language proposed by the Chairman meant that the Committee would be consulted in the event that the aggregates appeared to be growing at rates outside the specified ranges.

Chairman Burns replied that under the Committee's procedures the Manager would promptly notify the Chairman if growth in the aggregates appeared to be outside the specified ranges of tolerance. If the departures from the ranges were significant, the Chairman would communicate with the Committee promptly.

Mr. Holmes asked whether the proposed language meant that the Federal funds rate should be held at its present level as long as growth in the aggregates appeared to be within the specified ranges, or whether some gradual tightening was to be undertaken in the event that growth in the aggregates appeared to be moving up toward the ceilings of the ranges.

Chairman Burns replied that the second interpretation was the correct one. The narrow range of 9-3/4 to 10-3/4 per cent that he had suggested for the funds rate represented prevailing money market conditions. He would not object to specifying a range of 9-3/4 to 11 per cent.

Mr. Clay observed that he found it difficult to contemplate an  $M_1$  growth rate above 5 per cent for the second

and third quarters. The economic slowdown had been mild, and prospects for a recovery in the second half of the year were stronger now than generally had been expected a short time ago. For the past 6 months, monetary growth had substantially overshoot the Committee's longer-run targets, accommodating excessive rates of inflation and thus contributing to the high level of interest rates. Under those circumstances, the Committee's primary job was to slow the rate of inflation. To achieve the objective of lowering interest rates, inflation had to be brought under control. Accordingly, he preferred both the language and the specifications of alternative C.

Mr. Sheehan remarked that he, like Mr. Morris, had shifted his position. Eight to 12 weeks ago, he had been worried about the possibility of a cumulative decline in economic activity and an unemployment rate possibly as high as 7 per cent by the end of 1974. Now, however, he was much more confident about the economic outlook. For example, an executive of a large company supplying abrasives--which are very widely used in manufacturing--had told him that the demand for abrasives had remained very strong despite the drop in production in the automobile industry. Similarly, demands remained strong in the steel industry. A large supplier of materials to the glass industry had indicated that he had to

allocate supplies. Businessmen were building up inventories of raw materials and other supplies in view of the current and prospective high rate of inflation. Consequently, he believed that any errors in formulating policy today should be on the side of tightness.

Mr. Sheehan said the differences in the specifications among alternatives A, B, and C were very narrow and hardly worth arguing about. He, like Mr. Brimmer, preferred to set the ceiling for the funds rate at 11 per cent; he could accept the other specifications suggested by the Chairman. He preferred the language of alternative C.

Chairman Burns then asked the members to express their preference between the language of alternative C and that of the variant of B couched in terms of money market conditions.

A majority of the members expressed a preference for the language of alternative C.

Thereupon the meeting recessed until 2:25 p.m. Committee attendance was the same as at the morning session. Staff attendance was the same as at the morning session except that Messrs. Bryant, Pierce, and Pizer were absent.

Mr. Black observed that he agreed with much of what Messrs. Hayes and Holland had said. And the specifications

suggested by the Chairman were almost precisely those he would establish, including 5-1/2 per cent for the longer-run  $M_1$  target. There were two basic reasons for the policy posture represented by those specifications. First, the worldwide inflation problem and the fragile state of the international payments mechanism in the context of a closely integrated international economy required the United States to pursue a policy that was neither too tight nor too loose in relation to the policies of other major countries. In his view, the policy course recommended by the Chairman would be compatible with policies abroad. Second, interest rates had been pushed up quite a bit in recent weeks. As a result, growth in the aggregates might now moderate.

Mr. Black said he agreed with the Board that this was not the time to raise the discount rate. If growth in the aggregates continued to spurt and the Federal funds rate remained above 10 per cent for some time, an increase in the discount rate would be appropriate. In his opinion, it would not have a great effect on the market, and it would facilitate administration of the discount window. He would not change marginal reserve requirements, except as a last resort. Viewing them as selective controls, he was philosophically opposed to their use.

Mr. Williams remarked that he would associate himself with the views expressed by Messrs. Brimmer and Clay. Concerning marginal reserve requirements, he would prefer that they not be used and, if they were, that nonmember banks not be asked to participate in the program.

Mr. Wallich commented that he welcomed the Chairman's suggestion for a 5-1/2 or 5-3/4 per cent longer-run rate of growth in  $M_1$ . He would be concerned about adoption of too restrictive a policy, because it was quite early in the business cycle upturn to lean toward a hard line--even though the severity of the inflation probably made both higher rates of unemployment and other remedial programs more acceptable politically and socially than at other times. Moreover, the very high levels of interest rates made him uneasy, despite the fact that real interest rates were much lower. The economy should be rising, but it should not rise too fast. If the risks on the down side were greater than he believed them to be, there probably would be time to take action later on.

Mr. Wallich remarked that--given the System's limited ability to achieve its targets for the aggregates--the 2-month ranges of tolerance shown under the three alternatives did not differ much from one another and all were well within acceptable limits.

He favored widening the short-run ranges for the aggregates. The Committee could be more specific with respect to the funds rate; he preferred a range of 9-3/4 to 10-3/4 per cent.

Mr. Winn observed that there were a number of circumstances that might have an important bearing on economic developments which had not been taken into account in today's discussion. He had in mind, in particular, the situation in the Middle East and the political environment at home.

Chairman Burns said he agreed. Developments in the areas Mr. Winn had mentioned might make a Committee consultation not only desirable but necessary during the period before the next scheduled meeting.

The Chairman then asked the members whether a longer-run target of 5-1/2 per cent for  $M_1$ , along with associated targets for  $M_2$  and the credit proxy, would be acceptable.

A majority of the members indicated that such targets would be acceptable.

The Chairman next asked the members to express their preference between a funds rate range of 9-3/4 to 10-3/4 per cent and a range of 9-3/4 to 11 per cent.

A majority of the members expressed a preference for the 9-3/4 to 10-3/4 per cent range.

Chairman Burns observed that in view of the recent overshoots in monetary growth, the lower limit of the 2-month ranges of tolerance should be relatively low. He suggested that the members indicate informally their preference between 3 and 4 per cent for the lower limit of the range for  $M_1$ .

A majority of the members indicated a preference for a lower limit of 3 per cent.

Mr. Mitchell commented that he could accept zero or even a negative number for the lower limit of the short-run range for  $M_1$ . He would be happy to see a very low rate or even a negative rate of monetary growth for a couple of months.

Mr. Partee remarked that the latest  $M_1$  data available were preliminary estimates for the second week of April. The rate of growth now estimated for the month of April was 8 per cent. Thus, a zero rate for the April-May period implied a -8 per cent rate for May.

Chairman Burns observed that if the rate of growth for April proved to be about 6 per cent, the 3 per cent lower limit for the 2-month range implied a zero rate of growth for May. He suggested that while accepting a lower limit of 3 per cent at this time, the Committee might wish to reconsider it in the light of subsequent developments.

The Chairman then suggested that the members indicate informally their preference between 7 and 8 per cent for the upper limit of the 2-month range of tolerance for  $M_1$ .

A majority of the members indicated a preference for an upper limit of 7 per cent.

Mr. Holmes asked what the mid-point of a range of 3 to 7 per cent might imply for operations.

Chairman Burns replied that ordinarily, the Committee viewed the mid-point of the 2-month range for  $M_1$  as consistent with the mid-point of the range for the Federal funds rate. If the Committee were to adopt an  $M_1$  range of 5 to 7 per cent, for example, incoming data that suggested a rate of growth approaching 5 per cent would require either that the funds rate be moved down toward its lower limit or that the Committee reconsider the instructions. In this case, however, the Committee was deliberately introducing an asymmetry into the  $M_1$  range. With the specification of a 3 to 7 per cent range, the mid-point of the range had no significance.

Mr. Axilrod observed that the numbers becoming available later this week might confirm staff projections of a 7 per cent rate of  $M_1$  growth in the April-May period. He asked what the implications for operations might be in the event that the data suggested a growth rate slightly above 7 per cent.

Chairman Burns said that if the data becoming available so soon after the meeting suggested a rate slightly over 7 per cent, the Committee would want to be patient and wait for another week's data.

Mr. Mitchell remarked that a short-run range for  $M_1$  with an upper limit of 7 per cent still seemed to him to be inconsistent with a funds rate range of 9-3/4 to 10-3/4 per cent. He wondered whether the specifications implied that the funds rate would be moved to 10-3/4 per cent and held there.

Mr. Holland said he agreed that the specifications were inconsistent. In view of current staff projections of monetary growth in the April-May period, the specifications represented an instruction to the Desk to tighten reserve and money market conditions if the projections for the aggregates remained exactly as they were.

Chairman Burns observed that on occasion the Committee had adopted specifications that it recognized might be internally inconsistent only to discover that they were consistent; at other times seemingly consistent specifications had proved not to be so. Considering that the Committee had a procedure for dealing with the problem, it did not need to be overly concerned about possible inconsistencies. The specifications being considered should be

interpreted in the light of the present market situation.

Although the Desk had been aiming for a funds rate in a range of 10 to 10-1/4 per cent, the market was tending toward a rate of 10-1/2 per cent. In the period ahead, the Desk should aim for a funds rate in a range of 10-1/4 to 10-1/2 per cent until additional data for the aggregates became available. He asked Mr. Holmes how he would interpret the specifications.

Mr. Holmes replied that his interpretation was in agreement with the Chairman's. Since the market had already carried the funds rate above 10-1/4 per cent, a range of 10-1/4 to 10-1/2 per cent might be considered appropriate at present. If the new projections available toward the end of the current week suggested that growth in  $M_1$  for the 2-month period was 7 per cent or above, he would assume that the Desk ought to aim immediately at a rate of 10-1/2 per cent and then await additional information. There was a danger of waiting too long and being limited by even keel considerations; in that event, the rate might have to be held at 10-1/2 per cent rather than moved all the way up to 10-3/4 per cent.

Mr. Winn asked what circumstances would cause the Desk to aim for a funds rate at the ceiling of 10-3/4 per cent in the short time available before even keel.

Chairman Burns replied that the Desk should aim for a funds rate in a range of 10-1/2 to 10-3/4 per cent if incoming data suggested that  $M_1$  would grow in the April-May period at a high rate, for example, 10 or 11 per cent.

Mr. Coldwell remarked that such an interpretation implied that the Committee would be willing to accept a 7 per cent rate of  $M_1$  growth in the 2-month period without seeking to change money market conditions.

Chairman said he agreed. In contemplating a move in the funds rate from 10-1/2 per cent up toward the ceiling of 10-3/4 per cent, both the amount by which growth in  $M_1$  exceeded the specified range and the duration of the excess should be taken into consideration. If any excess were small and were indicated on the basis of data for only one week, he would not be inclined to move the funds rate toward the upper limit.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs and alternative C of the operational paragraph on the understanding that it 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 5-1/2, 6-1/2, and 9-3/4 per cent for  $M_1$ ,

$M_2$ , and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the April-May period would be 6 to 11 per cent for RPD's, 3 to 7 per cent for  $M_1$ , and 5-1/2 to 8-1/2 per cent for  $M_2$ . The range for the weekly average Federal funds rate in the inter-meeting period would be 9-3/4 to 10-3/4 per cent.

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

The information reviewed at this meeting suggests that real output of goods and services declined appreciably in the first quarter and that price increases were exceptionally large. The decline in economic activity reflected mainly the impact of the oil shortage, which is being eased by the ending of the oil embargo. In March industrial production and manufacturing employment receded further, but retail sales strengthened. The unemployment rate changed little, remaining slightly above 5 per cent. Prices of farm and food products declined in March, but increases among industrial commodities were widespread and extraordinarily large. Advances in wage rates were moderate in the first quarter.

In March the dollar depreciated further against leading foreign currencies, and the balance of payments was in deficit on the official settlements basis. The U.S. trade surplus diminished again in February as the cost of imported oil rose sharply.

The narrowly defined money stock increased sharply again in March. Broader measures of the money stock rose more moderately, however, as net inflows of

consumer-type time deposits at banks slowed substantially. Business short-term credit demands remained strong, with demands at banks exceptionally large. To help finance loan growth, banks in late March and early April stepped up the issuance of large-denomination CD's and also increased borrowings from abroad. Both short- and long-term market interest rates have risen considerably further in recent weeks.

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

To implement this policy, while taking account of the forthcoming Treasury financing and of international and domestic 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.

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

It was agreed that the next meeting of the Committee would be held on May 21, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.

  
Secretary

ATTACHMENT A

Henry C. Wallich  
E. M. Truman  
April 15, 1974

Report to the FOMC on the C-20 Deputies' Meeting  
(March 27-29, 1974)

The Tenth Meeting of the Deputies of the Committee of Twenty established the basic agenda for the last meeting (May 7-9) of the Deputies and the final meeting of the Committee on June 12 and 13.

It was generally recognized that it was not possible or desirable at this time to try to reach agreement on the specific provisions for a comprehensive reform of the international monetary system. There was general endorsement of the U.S. position that international monetary reform should be an evolutionary process. But the French, with some support from the Italians, stated that the Committee should merely frankly acknowledge its lack of progress. And the representatives from the developing countries expressed considerable disappointment concerning the lack of agreement on the long-run reform and dismay about what was in the reform for them.

In terms of the long-run reform, therefore, a Revised Outline of Reform will be issued following the June meeting of the Committee. The content of this document will not differ greatly from the First Outline of Reform issued in Nairobi last September. But it is anticipated that the Revised Outline will be an agreed statement endorsed by the Committee itself, rather than just a report prepared by the Chairman and Vice-Chairmen of the Deputies. There will be, however, a separate document, or set of annexes, prepared by the Chairman and Vice-Chairmen

of the Deputies that will not necessarily reflect the views of the Deputies and the Committee. It will describe the extent of the remaining disagreement concerning the operational provisions for the reformed system and will, inter alia, outline some of the options examined by the four Technical Groups established in Nairobi (Adjustment, Global Liquidity and Consolidation, Intervention and Settlement, and Transfer of Real Resources).

To cover the so-called "interim period," there will be either a separate part of the agreed Revised Outline or a separate document containing provisions that will be implemented right away. These provisions will include: (a) the establishment of a high-level Council representative of the twenty constituencies in the IMF that will periodically review the operation and structure of the international monetary system; (b) the resolution of the issues surrounding the valuation of Special Drawing Rights; (c) the establishment of guidelines for intervention during the expected continuation of an exchange-rate regime of generalized floating; and (d) the basis for review of the adjustment process and international liquidity probably using experimentally a reserve indicator structure. The agreement covering the interim period may also cover (a) the possible treatment of gold, (b) new provisions governing the use of trade restrictions for balance-of-payments purposes, (c) special arrangements for the developing countries, and (d) possible procedures for dealing with oil-money flows.

It has not been decided whether or not the provisions in such an interim package should be embodied in a set of amendments to the IMF Articles of Agreement. The United States supported the amendment approach. France, consistent with its views on the failure of the C-20, rejected it. Most countries reserved their positions. Moreover, the developing countries stated that they would not support an interim package that excluded the establishment of a link between SDR allocation and development assistance; if they were to maintain this position, agreement on a set of amendments to the Articles would be very difficult.

Four aspects of the interim package received extensive discussion at this meeting of the Deputies: guidelines for floating, provisions concerning gold, the possible new provisions governing trade restrictions, and the terms of reference for the continuing work of the C-20 Technical Group on the Transfer of Real Resources.

On guidelines for floating, there was continued resistance by the French to the idea that any new provisions were needed. The rest of the participants did not seem to share this view. In particular, there was general support for a guideline calling for intervention for smoothing purposes to maintain orderly market conditions. There was extensive, but less than unanimous, support for a guideline permitting intervention to moderate trends in market rates. There was considerable resistance to a guideline that would call for the establishment of zones or ranges for effective exchange rates outside of which

countries could or should be more active in resisting exchange-rate movements. Canada, Japan, Germany, Italy, and the United States were among the skeptics; the United Kingdom, the Scandinavians, and the developing countries were among the more active supporters of such a guideline. The entire subject will be discussed by the Deputies in Paris in May and is also being considered by the Executive Board of the IMF.

The discussion on gold primarily involved a restatement of previously stated positions, although the representatives of several major countries (United States, Germany, France) did not speak at all. A major personal statement was made by Mr. Mitchell of the United Kingdom. He reaffirmed his support for the SDR, rejected an increase in the official price, rejected any procedure that would lead to official manipulation of the market price, but had no objection to voluntary transactions among monetary authorities at mutually agreed prices. The representatives of the developing countries expressed their dismay about any arrangement concerning gold that might be agreed outside of the IMF -- a position also taken by Japan -- and stated their concern about the distributional implications of any action on gold that would increase the effective reserves of a limited group of developed countries.

Mr. Jack Bennett of the United States introduced a proposal that, in light of present circumstances, countries should pledge not

to impose trade restrictions for balance-of-payments purposes and that, in support of this concept, there be an amendment to the IMF Articles requiring IMF approval of any such trade restrictions in the future. Most participants reserved their positions on this proposal. There were, however, doubts expressed concerning the implications of the proposal for the GATT and its procedures. The proposal will be discussed again by the Deputies in May.

Finally, it was agreed that the Technical Group on the Transfer of Real Resources should prepare, in cooperation with the relevant international institutions, a detailed framework for the study of the broad question of the transfer of real resources and make recommendations concerning the implementation of such a study. It is understood that this proposal might look toward the establishment of what has been called a "C-20 for Development."

If the final result of the C-20 exercise turns out the way the meeting here reported on suggests, there will be no real reason to call the effort a failure. To develop a new monetary system from scratch and in the abstract is an almost impossible task. Whether having on the shelf a plan that is agreed only in part will help at some future point is an open question. The history of the IMF suggests that agreements reached in the past can be helpful more than ten years later, even if not implemented fully in the meantime. On the other hand, the experience of floating is

likely to change the minds of policymakers in many ways and may cause them to make a fresh start at some future time.

The American plan, upon which the long-run reform is based, is highly innovative. It seeks to reconcile the demand of mainly the Europeans for dollar convertibility with the need of the United States not to let convertibility hamstring domestic monetary policy. In the course of a period of floating the Europeans may well come to take a different view of the need for dollar convertibility. Conceivably, also, the U.S. may come to take a different view of its own interests in international monetary relations. This consideration lends strength to the view that long-run reform should be an evolutionary process.

The group decision to focus immediate attention upon short-run matters seems to be a wise one. Worldwide inflation in combination with the great increase in oil prices will make the period ahead a very difficult one. This is reflected in the great difficulties that the C-20 group had in arriving at a consensus on guidelines for floating after both the Committee Bureau and the IMF had proposed rather detailed formulations for that purpose. The desire to restrain inflation makes countries want to keep the value of their currencies high. Difficulties in financing the oil deficit may force the weaker countries in the opposite direction. In the absence of more detailed guidelines for floating, continued international contact among policymakers, including on the delicate subject of exchange rates and interest rates, is urgently needed.

ATTACHMENT B

Henry C. Wallich  
April 15, 1974

BIS Meeting of April 8-9, 1974

The following principal points of interest emerged.

Inflation

There appears to be a growing resignation with respect to inflation and less of a sense of urgency and even of capability to do much about it. Among the reasons are the supply conditioned nature of the present inflation, which has its roots in good part in the food, oil, and other commodities situations; the weakness of the governments in some countries, e.g., the U.K. and Italy, and the lack of a government in others, e.g., Belgium and France; finally, the familiar evidence of massive wage increases and unwillingness to accept severe restraining measures. This state of mind seems to lead to a growing interest in means that would make it possible to live with inflation. An Italian plan reported by Carli for the issuance of government bonds, the interest rate of which would be tied to short-term market rates, possibly with some additional indexing features, aroused considerable interest. Zijlstra suggested that indexing should be discussed at some future meeting.

Lender of Last Resort

There was continued concern about the impact of Arab money on the liquidity of Eurocurrency banks. It seems to be taken for granted that there will be a considerable amount of medium-term

lending based on short-term deposits. Should a problem arise, it was indicated, the responsibility for helping the bank or banks in trouble could lie with the central banks of the country where the trouble occurred, or with the central banks of the head office of the branch if a branch were in trouble, or the central bank responsible for the currency in which the bank affected principally operated. Janson (Belgium) and Masera (Italy) indicated that their respective central banks could not be responsible for the foreign currency operations of banks located in their countries. I pointed out that a central bank could not be expected to act as lender of last resort with respect to problems that arose in its currency but affecting banks in third countries. If the problem affects a branch whose head office in turn might be affected, this would be a different matter. I believe that the lines of responsibilities in this regard will need to be clarified more effectively than they have been by the meeting on which I am reporting.

#### National Economic Conditions

No great concern was visible concerning the consequences of the oil situation. Only the Italians were quizzed intensively, especially with regard to their anti-inflation program. It involves both fiscal and monetary restraints, the latter both in the form of higher interest rates and credit ceilings. The recent support of the lira at a rate of about a billion dollars a month was questioned.

The Germans believe that they turned the corner in the first quarter and are on their way up, although housing, automobiles, and textiles remain weak.

The British are aiming at expansion, within the context of what was claimed to be a neutral budget. The Japanese economy, with inflation approaching 30 per cent per year, is slowing somewhat. A tight monetary policy nevertheless is intended to be maintained to curb inflation.

#### Money Supply

A review of the main national statistics conveys the impression that the over-all increase in national money supplies is slowing, a development which contrasts somewhat with the resigned attitude toward inflation.

ATTACHMENT C

April 15, 1974

Drafts of Domestic Policy Directive for Consideration by the  
Federal Open Market Committee at its Meeting on April 15-16, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services declined appreciably in the first quarter and that price increases were exceptionally large. The decline in economic activity reflected mainly the impact of the oil shortage, which is being eased by the ending of the oil embargo. In March industrial production and manufacturing employment receded further, but retail sales strengthened. The unemployment rate changed little, remaining slightly above 5 per cent. Prices of farm and food products declined in March, but increases among industrial commodities were widespread and extraordinarily large. Advances in wage rates were moderate in the first quarter.

In March the dollar depreciated further against leading foreign currencies, and the balance of payments was in deficit on the official settlements basis. The U.S. trade surplus diminished again in February as the cost of imported oil rose sharply.

The narrowly defined money stock increased sharply again in March. Broader measures of the money stock rose more moderately, however, as net inflows of consumer-type time deposits at banks slowed substantially. Business short-term credit demands remained strong, with demands at banks exceptionally large. To help finance loan growth, banks in late March and early April stepped up the issuance of large-denomination CD's and also increased borrowings from abroad. Both short- and long-term market interest rates have risen considerably further in recent weeks.

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

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of the forthcoming Treasury financing and of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with growth in monetary aggregates over the months ahead sufficient to accommodate moderate expansion in real GNP at the higher dollar values now prevailing.

Alternative B

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

Alternative C

To implement this policy, while taking account of the forthcoming Treasury financing and of international and domestic 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.