TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

March 15, 1977

Prefatory Note

This transcript has been produced from the original raw transcript in the FOMC Secretariat's files. The Secretariat has lightly edited the original to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcript was not fully edited for accuracy at the time it was produced because it was intended only as an aid to the Secretariat in preparing the record of the Committee's policy actions. The edited transcript has not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Staff Statements Appended to the Transcript

Mr. Sternlight, Deputy Manager for Domestic Operations

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Meeting of Federal Open Market Committee

March 15, 1977

A meeting of the Federal Open Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, March 15, 1977, beginning at 9:30 a.m.

PRESENT:
Mr. Burns, Chairman
Mr. Volcker, Vice Chairman
Mr. Coldwell
Mr. Gardner
Mr. Guffey
Mr. Jackson
Mr. Lilly
Mr. Mayo
Mr. Morris
Mr. Partee
Mr. Roos
Mr. Wallich

Messrs. Balles, Baughman, Eastburn, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. Black and Kimbrel, Presidents of the Federal Reserve Banks of Richmond and Altanta, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Axilrod, Economist
Messrs. Balbach, T. Davis, Ettin, Kichline, Reynolds, Scheld, Truman, and Zeisel, Associate Economists

Mr. Holmes, Manager System Open Market Account
Mr. Pardee, Deputy Manager for Foreign Operations
Mr. Sternlight, Deputy Manager for Domestic Operations

Mr. Hudson, Assistant to the Chairman, Board of Governors
Messrs. Coyne and Keir, Assistants to the Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Mr. Van Nice, First Vice President, Federal Reserve Bank of Minneapolis
Messrs. Boehne, Davis, and Parthemos, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, and Richmond, respectively
Messrs. Brandt, Burns, Fieleke, Fousek, and Keran, Vice Presidents, Federal Reserve Banks of Atlanta, Dallas, Boston, New York, and San Francisco respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
March 15, 1977

CHAIRMAN BURNS. Gentlemen, we are ready to start our meeting. As you probably recall, we hold an organization meeting in March of every year, and there is a slate of officers which somehow has emerged, and I'll ask Mr. Broida to read the names of individuals on that slate. And after the names have been read, we will be ready for a revolution if one member of this Committee is in the mood to start it. Mr. Broida.

MR. BROIDA. Chairman, Arthur F. Burns; Vice Chairman, Paul A. Volcker; Secretary, Arthur Broida; Deputy Secretary, Murray Altmann; Assistant Secretary, Normand R.V. Bernard; General Counsel, Thomas J. O'Connell; Deputy General Counsel, Edward G. Guy; Assistant General Counsel, Baldwin B. Tuttle; Economist, Steven H. Axilrod; Associate Economists from the Board Staff: John E. Reynolds, Joseph S. Zeisel, James L. Kichline, Edwin M. Truman, Edward C. Ettin; Associate Economists from the Reserve Banks: Robert Eisenmenger (suggested by Mr. Morris), Richard G. Davis (suggested by Mr. Volcker), Carl Scheld (suggested by Mr. Mayo), Anatol Balbach (suggested by Mr. Roos), and Thomas Davis (suggested by Mr. Guffey).

CHAIRMAN BURNS. Now you have heard the names of the officers as read by Mr. Broida. These are suggestions for the Committee, and any other suggestions or set of suggestions will be entertained by the Chair at this moment. And Mr. Lilly is going to start the revolution.

MR. LILLY. I would move that the nominations be closed and that the Secretary be instructed to cast a unanimous ballot for the nominees contained on the slate.

SPEAKER(?). Second the motion.

CHAIRMAN BURNS. The motion has been made and it has been seconded. And now ready for discussion. Any other nominations, any dissents? All in favor will kindly say aye.

ALL. Aye.

CHAIRMAN BURNS. Any opposed? Next, we need to designate one of our Federal Reserve Banks to handle the System Open Market Account. And there is another opportunity to start a revolution. Now, the suggestion has been that the New York Bank might continue to perform this function. Is there a motion to that effect?

SPEAKER(?). So moved.

CHAIRMAN BURNS. Motion has been made and inaudibly seconded. Any dissent?

Very well, now that we know who will handle the System Open Market Account, or which [Reserve] Bank will handle it, we have to decide on the individuals who will perform the necessary functions. And we need to select a Manager of the System Open Market Account, a function presently performed by Mr. Holmes. We need to select a Deputy Manager for

Domestic Operations, and the present incumbent is Mr. Sternlight. And we finally need to appoint a Deputy Manager for Foreign Operations, and this function is handled by Mr. Pardee. And revolution so far has not taken place; here is your final opportunity to start a revolution. Any suggestion for a change in the officialdom?

SPEAKER(?). [Unintelligible].

SPEAKER(?). Seconded.

CHAIRMAN BURNS. Motion has been made very audibly that Messrs. Holmes, Sternlight, and Pardee be reappointed.

MR. JACKSON. Do we have an indication that they would accept the appointment?

CHAIRMAN BURNS. We have no such indication known, but we can proceed and make our decision, and then the individuals involved can make theirs. And if there is any dissent? I hear none.

And now we need to act on the minutes on the February meeting. Is there a motion to approve?

SPEAKER(?). So moved.

CHAIRMAN BURNS. Motion has been made and probably seconded. And not hearing any objections, we will turn to Mr. Holmes's report on the foreign currency outlook.

MR. HOLMES. [Secretary's note: This statement was not found in Committee records.]

CHAIRMAN BURNS. Thank you. I am a little puzzled by the attitude of the Swiss National Bank. Why did they intervene? Why didn't they let the Swiss franc decline? They have been worried for some time.

MR. HOLMES. I think it was the extent that it was declining on that particular day, Mr. Chairman. It moved by about 3/4 percent, as I recall.

CHAIRMAN BURNS. What's wrong with that?

MR. HOLMES. Basically, I think the Swiss are completely happy to see the Swiss franc depreciate. But they do believe in orderly markets and wanted their presence felt.

CHAIRMAN BURNS. I'm still puzzled.

VICE CHAIRMAN VOLCKER. There's a bigger drop of the Swiss franc relative to the mark. Considerably bigger than relative to the dollar. And it's their biggest trading partner. And I think they're a bit ambivalent. They worry a bit about inflation. I don't think they--I don't get the impression they're terribly unhappy, but they are not entirely happy, either, with it declining too far relative to the mark.

CHAIRMAN BURNS. Well, I have been wondering about that.

MR. PARDEE. There is an ambivalence there.

MR. WALLICH. Alan, you interpret the Swiss franc decline as a relaxation of tensions, which seems plausible. At the same time, we've got the rising gold price, usually stated to mean the opposite--do you see some way of reconciling this?

MR. HOLMES. Yes, I would think the rising gold price can be explained by two causes. One, the continued demand from the Mideast and the Far East, which is not really affecting any concern about European currencies. And second, with a rise in industrial production around the world, I think industrial demand for gold has picked up rather substantially. So the market has been able to handle substantial supplies from both Russia and South Africa, and sales by other countries, without problems.

MR. WALLICH. It looks as though there were a solid, nonspeculative [demand] under that price.

MR. HOLMES. I think it's partly that, yes.

MR. MAYO. Is there any concern, Alan, about the viability of South Africa as a gold producer because of their racial problems?

MR. HOLMES. Well, from time to time that comes up. But I don't think that has really been a factor in gold prices.

MR. PARDEE. It was reported in the last Basle meeting, though, that there has been more investment interest from the United States to be seen in the European gold market--investor interest, whatever that means. But both from the spot and the futures market.

MR. COLDWELL. Does it reflect also a concern over the cost of production of gold?

MR. HOLMES. Not that I know of.

MR. COLDWELL. I have heard this--that there is a possibility a few of the mines are running into problems, thinner veins, and so forth.

MR. HOLMES. But the market really has handled the IMF sales--which they were very frightened about when the IMF started--remarkably well. In fact, the price seems to go up just before each auction.

CHAIRMAN BURNS. Any other questions about Mr. Holmes's report? If not, is there a motion to approve transactions of the Desk?

MR. COLDWELL. So moved.

MR. MAYO. Seconded.

CHAIRMAN BURNS. I take it the motion has been made, seconded; I hear no dissent. Do you have any recommendations, Mr. Holmes?

MR. HOLMES. Mr. Chairman, as I said, it has been a very dull period, and I have no recommendations at this time. We do have the Swiss franc swap maturing on April 29, but we will pay it off before we get there.

CHAIRMAN BURNS. All right, we'll turn now to the domestic economy. Mr. Zeisel.

MR. ZEISEL. [Secretary's note: This statement was not found in Committee records.]

CHAIRMAN BURNS. Thank you very much, Mr. Zeisel. We will hear now from members of the Committee. Mr. Black, please.

MR. BLACK. Jerry, I found rather interesting your comments on the outlook for federal expenditures, particularly so far as regards the shortfalls we've had, and was interested to know that you expect this to continue. Could you elaborate a little, to the extent that you know, why this has taken place? I have read everything I can find on it, but I don't feel like I have a very good handle.

MR. ZEISEL. Well, nobody really does. The amount of the shortfall at this point seems to be, including a rough estimate for February, in the $9 [billion] to $10 billion range. It seems to be distributed fairly widely among expenditures categories, including unemployment insurance, Veterans Administration payments, defense, and several other categories.

[As to] the "why," well, there are just conjectures. It was felt last year that it was sort of a characteristic pattern of government agencies anticipating, or putting in, a budget item which would fully cover what they anticipate their spending to be and then coming in somewhat lower--because it looks better to come in somewhat lower, in effect. I might say that the pattern of anticipating higher spending than actually occurs has been characteristic of, oh, possibly the last two decades, and over the last--

CHAIRMAN BURNS. Are you sure of that?

MR. ZEISEL. Yes, our people tell us that the average spending has gone below the anticipation, as of October in this case, by about 1 percent on average for about two decades and about 2 percent for the last half-dozen years.

CHAIRMAN BURNS. I'd like to see the full evidence.

MR. PARTEE. Probably ranges widely, some years below and some years above. Because I can certainly remember a period in the middle '60s--they ran consistently above estimates.

MR. ZEISEL. Yes, there were times when it ran above. But as I recall the figures, there were years and years, many more years, in which spending ran below, than above--over the last decade, roughly.

I might make an additional comment. A number of these items are not likely to affect activity. They are financial in nature--at least they're not likely to have an immediate effect on activity, such as payments to the Defense Department by foreign recipients of military hardware, which is an offset to spending, and there are other such offsets to spending that don’t really have a significant current effect. The [overestimate] of unemployment compensation payments, for example, would not be a negative factor in any sense, because that means that they have estimated that unemployment would be higher than it really turned out to be, and if unemployment is lower, presumably people are working, which is a good thing. The “why,” though, remains still obscure in terms of the volume of the shortfall at this point. We expect much of it to be made up in the second quarter. But not all.

MR. PARTEE. Did you say it was $9 [billion] to $10 billion? Was that for January and February?

MR. ZEISEL. That was for February.

CHAIRMAN BURNS. I thought it was running around 7.

MR. ZEISEL. I may be wrong, I think the figure was 7 in January and an estimate of 9 in February. But that’s roughly--

MR. MAYO. This is cumulative for the year?

MR. ZEISEL. That’s a cumulative figure.

MR. MORRIS. Mr. Chairman, I heard a theory yesterday that the new budget procedure may have something to do with this. That under the present system it is more difficult to get supplementary budgets through the Congress. And therefore the agency heads tend to put a little more into the budget than they might otherwise have done. Whether there’s any validity to that, I don’t know.

MR. MAYO. Well, there’s also been the theory, Mr. Chairman, as you know, that with the advent of greater inflation in the last few years, agencies have padded their estimates more, just as a protective device. And that all of this hasn’t been wrung out by the executive budget process.

CHAIRMAN BURNS. Well, you know, none of this as far as I know has been planned even remotely, but it does put the Administration in an ideal political position. As far as the expansionists are concerned, the Administration could point to its fiscal package, and here is a policy for stimulating our economy by manipulating the budget. As far as the conservatives are concerned, who believe that the spending is much too high and the budget deficit is much too large--then one could point to the shortfall. Here the planned expenditure is not being realized, and all kinds of economies one way or another are accumulating. I’d hate to argue the Administration’s position in the Congress, in view of the shortfall at the present time, but people I’ve talked to just don’t know why [it’s] happening.

Now last year, Mr. Ford was blamed on the ground that he was seeking to curb expenditures. Well, Mr. Ford isn’t around to be blamed any longer. And now the finger of blame is pointing to a multiplicity of agencies, which one way or another are not doing their job--their job being to spend and keep on spending.

MR. PARTEE. Well, they are paying attention to it, though, Mr. Chairman; there is an effort being made to find out why the shortfall. And I certainly get the impression there's every intention to try to remedy the situation. So I think the thrust of what Jerry said--that some of the shortfall may well be made up in the months to come, and we may well get more strength in government spending--is [on] a reasonable basis.

CHAIRMAN BURNS. I think it is.

MR. ZEISEL. Some of the shortfall would be made up by legislative increase in the expenditures for the second quarter, which in a sense are already built-in by $3 [billion] or $3-1/2 billion.

CHAIRMAN BURNS. Yes, Mr. Balles, please.

MR. BALLES. I'd like to come back to Jerry's remarks on productivity and unit labor costs and ask him a question. As I look at the pattern for last year, it's somewhat disturbing if it were to be continued into this year, in the sense that, quarter-by-quarter last year, the rate of increase of real final sales changed pace as the year went along. Compensation per man-hour didn't really accelerate; it was growing at a lower rate during the last three quarters than the first quarter. The quarter-by-quarter rate of gain of output per man-hour went downhill; in fact, in the final quarter it actually was negative. And the net of that was that unit labor cost kept gaining in terms of rate of increase, quarter-by-quarter; in the fourth quarter, it took quite a sharp jump. If that were to continue, it'd have pretty adverse implications for 1977. I was wondering, taking this mix of things--[output] per man-hour, compensation against unit labor cost--what you see in the tea leaves for 1977.

MR. ZEISEL. Well, the productivity performance, if I may focus on that immediately, is very directly related to the weakness in real activity through much of the year. And typically, except in certain cyclical situations, one doesn't get good gains in productivity associated with sluggish gains in real output. And we're anticipating for 1977 a faster rate of growth in real GNP, in the 6 percent range, and for private output it's about 6-1/2 percent. And we feel that this is consistent with a faster rate of productivity gain in 1977 than 1976, by about 1/2 percentage point. The productivity average for 1976 was 2.8 for the four quarters, and we are projecting about 3-1/3.

In terms of the wage side I've expressed myself on this earlier. It's being optimistic, but it seems that there's really no strong basis for assuming a rapid acceleration in wage increases this year. I think that there will be some increase over the rate of gain that we had last year. But in general it seems to us that you're not going to get the kinds of big catch-ups that occurred over the last two years, since a much larger proportion of the labor force is protected by the cost-of-living clauses--have their wages protected thereby--and you're not going to get big, first-year increases. And we see compensation per hour rising on average a little above 8 percent, as opposed to about 7-3/4 percent.

And so this is a standoff, in a sense. We have the compensation rising slightly faster, the productivity rising slightly faster, and our unit labor cost outlook, therefore, is about the same as last year. Which is about a 4-3/4 percent rate of increase.

MR. BALLES. That's for the year as a whole.

MR. ZEISEL. That's for four quarters versus four quarters in 1972.

MR. BALLES. Oh, I see.

CHAIRMAN BURNS. Yes, Mr. Roos.

MR. ROOS. May I borrow Mr. Zeisel? Do you feel comfortable you've projected a growth through the four quarters for this year in GNP of about 6-1/4 percent? And I assume that's predicated on M1 and M2 growth roughly in the middle of the ranges that are presently set. Our evidence indicates that it would be difficult to reach that goal. We show projections of maybe 4-1/2 percent GNP growth using our present midranges, or conversely, having to maybe increase growth in M1 and M2 to maybe 7 and 11-1/2 percent to achieve that target--which is, of course, the stated target of the Administration--unless there is exceptionally high growth in velocity. Do you feel comfortable with that 6-1/4 percent projection?

MR. ZEISEL. Well, I will comment briefly and then turn the floor over to Mr. Axilrod for his reactions to that. As you know, our projections are basically judgmental in nature, and the translation, therefore, is not a rigorous mathematical translation. However, we do have an econometric model we use for simulations for this purpose, and there does not seem to be anything in the econometric forecast which would be significantly out of line with the projections that we have prepared judgmentally, that we feel are consistent with the M1 growth. The--

MR. ROOS. It assumes the rate of growth in velocity, which is sort of historically high, isn't it?

MR. ZEISEL. Well, Mr. Axilrod, I think--

MR. AXILROD. Yes, we would have to have a rather substantial growth in velocity over the next year. As you know, in this recovery, we have had periods of very substantial rates of growth of velocity of M1, particularly because of the change in financial technology. We expect some of these changes in financial technology to be continuing, but also in addition, as in the Bluebook, we do expect interest rates to rise. In the past we've had these increases in velocity in this recovery without rises in interest rates. Now this time we believe that there will be actually some rise in interest rates accompanying a rise in velocity.

We've checked it out against econometric models we have at hand. And our interest rate forecast and our velocity forecast are consistent with the models, after you allow for the mis-estimates that the models have been consistently making for the past two years. And allowing for those mis-estimates--that is, correcting the model by hand for the same mistake it made last year--you would end up roughly with the velocity and interest rate forecasts that are implicit in our projections. Now that may be cold comfort, as I have as little faith in the pure accuracy of models as maybe you do, but at least it double checks it.

CHAIRMAN BURNS. All right. Mr. Baughman, may we hear from you now.

MR. BAUGHMAN. Mr. Chairman, I have heard some rumblings in recent weeks as people apparently are beginning to discover that, with the change in tax laws, they cannot use certain benefits under drilling and exploratory work as offsets against other income to the extent that they could previously. This is generally described as, in effect, a 15 percent increase in income tax. The data on drilling activities, however, indicate a continued and rising level of activity. Unfortunately the production figures don't indicate the turnaround in the trend there, however.

One other thing that's been reported recently is a McGraw-Hill report on plans for investment in new manufacturing capacity extending over the next three years, and those figures show a rather spectacular prospect for Texas, with a total which exceeds the sum of the next five states in line--that is, with Texas having the largest amount and exceeding the sum of the next five.

MR. PARTEE. In total manufacturing.

MR. BAUGHMAN. For new manufacturing capacity. I would assume there is no reason for expecting those to be realized, but they do indicate what present thinking and intentions are.

And then it occurred to me that, just to avoid the impression that Texas is a one-industry or one activity-center state, I possibly should report that their 18th annual rattlesnake hunt was carried off successfully last weekend in the Sweetwater area, and this weekend in a community called Luckenbach, with a population of three, that they will celebrate the annual return of the mud daubers. You ask, Mr. Chairman, "What's a mud dauber?" A mud dauber is described as a Texas-size, wasp-like insect that makes it's nest out of mud and does an awful lot of buzzing. But you don't have those in New England.

CHAIRMAN BURNS. Well, it's clear that Texas is doing well. [Does] any member of our group differ at all basically from Mr. Zeisel's exposition?

MR. BALLES. I guess we do in San Francisco, Mr. Chairman. In tracking down the somewhat less optimistic forecast that we have on real GNP--for example, the Board staff has 5 percent year-over-year, we have 4.3; Board staff has 6.2 percent gain fourth quarter-over-fourth quarter and we have only 5.5--it appears that our staff is apparently assuming less stimulus from the Carter fiscal package then you are here, Jerry. If I remember the numbers right, and I hope that I do, my staff is guessing that only about 1/3 of the $50 rebate would flow immediately through to consumer spending, and I gather that your estimates are somewhat higher than that. Is that correct?

MR. ZEISEL. No, they're not [higher]. Our estimates are actually a bit lower. The immediate spending of the rebates--we estimate that it's about 20 to 25 percent, cumulating to a total of only about 1/3 by the end of the year.

CHAIRMAN BURNS. Well, currently the two staffs diverge, and my own thinking is very close to the thinking of our staff, but as far as the fiscal package is concerned, I don't think it is going to make any difference one way or another as far as the real economy goes. But whatever positive influence comes from a little larger spending will be offset by higher interest rates and inflation fears. So there are differences between our staffs, and I am not sure to what degree they are attributable to differences in estimates of what the fiscal package is going to do. And my reason for making this statement is that I think it's a little dangerous to assume that the fiscal package will necessarily prove beneficial to any degree. In any case, there is a contrary view, and I have just voiced it. Any other opinions? Yes, Mr. Volcker.

VICE CHAIRMAN VOLCKER. I might just note, Mr. Chairman, that our projections, prepared at the New York Bank, track the Board's projections so closely that I suspect collusion. Except, fortunately, the pattern changes a bit through the year as whole. They come up to the same tenth of a point on both the real growth and the prices, and there's something the matter there, there must be something--

MR. ZEISEL. Cut the telephone lines between them.

VICE CHAIRMAN VOLCKER. The pattern is somewhat different in that we show a slightly more rapid growth in the second quarter and the third quarter, and then it tapers off in late '77 into '78.

The point I want to make is that the analysis suggests somewhat more pressure on interest rates, I think, than is suggested by the remarks that were just made and the discussion in the Greenbook. Now these [projections] have been notoriously bad in the past year, and I am very conscious of that, but I do think this is the problem we may be facing during the year with more-optimistic economic projections. And my sense of it is that the Board staff's analysis leans on the side of moderation here. It may underestimate the kind of dilemma we have between holding our aggregate figures and interest rates as the year unfolds. I hope that's not the case, but I have a little feeling that we do face that risk in perhaps more pointed fashion than our analysis suggests.

CHAIRMAN BURNS. Thank you, Mr. Volcker. Mr. Lilly now, please.

MR. LILLY. Well, I have a little concern, Jerry, with your projection regarding chemicals and the primary metals and other industrial materials. I think the last couple of weeks there has been a substantial pushing up of prices in this area, and I am wondering if we are giving sufficient attention to it, because this could be the precursor of rather substantial increases in prices all the way through the manufacturing sector.

MR. ZEISEL. We have been very concerned with the increase in commodities prices, Governor Lilly. There has been a range of increases among nonferrous metals; lumber, which has edged off a bit. A number of food and related items--all rather special situations, such as the coffee price run-up. But as far as the metals [are concerned], for example, we've been concerned. It seems to have been an unreasonable sort of increase, except to the extent that the prices on a number of these commodities had dropped rather sharply earlier, and this would appear to be an attempt on the part of these manufacturers to recover profit margins. If that's the case, and we feel that it probably is, it may not be a harbinger of continued increases, particularly since demands are really not that intense worldwide.

MR. LILLY. Well, I am concerned that it may be the beginning of a trend rather than an episode of it.

MR. ZEISEL. It certainly has bad psychological implications, and we will be monitoring this very carefully.

CHAIRMAN BURNS. Well, next. Mr. Eastburn, please.

MR. EASTBURN. I want to give some support to Governor Lilly's comment on chemicals. One of our directors is in the chemical business, and he was extremely bullish the last time we had a go-around in our--

CHAIRMAN BURNS. Because prices would be rising?

MR. EASTBURN. Well, the volume of business he said was very strong, and then he expressed some concern about the price situation.

CHAIRMAN BURNS. I have a note before me from a member of our staff which reads "many chemical prices are scheduled to be raised in the second quarter." What the basis for that report is, I don't know.

MR. LILLY. I think increase in demand.

MR. PARTEE. They've had annual increases.

MR. JACKSON. They've had a good bit of cost pressure and relatively little price relief from it.

MR. EASTBURN. One difference between our projections and the Board's, particularly with respect to the unemployment rates--the Greenbook has this about a half percentage point lower than ours by the end of the year. Now this is partly because you have greater strength in the economy than we do, which is attributable largely to the capital goods sector. And also this is my question having to do with the anticipated growth in the labor force, which is slower in your case than it is in ours. It has been very strong, of course, and I just wondered if you have some basis for slowing down the labor force growth.

MR. ZEISEL. The labor force growth that we have projected is still fairly substantial. It's 2 million, roughly, and involves a steady increase in the participation rate. It is not as rapid as the increase that we had in 1976, and we feel the major factor there is that the pressures from price increases and declines in real family income are not as intense as they were. They had pushed a lot of women, a lot of secondary workers, into the labor market at that point. As so we feel that [given] an easing of this particular pressure [because of] rising real incomes, we will move back toward a more reasonable rate of growth in the labor force.

MR. EASTBURN. And what follows, I suppose, is that, if you are underestimating price increases, this could have an upsetting effect on your labor force projections.

MR. ZEISEL. It could, yes.

CHAIRMAN BURNS. Well, I thank you, Mr. Eastburn. Mr. Partee, please.

MR. PARTEE. Well I, of course, don't have a projection of the economy, Mr. Chairman.

CHAIRMAN BURNS. You say you do not?

MR. PARTEE. Oh no, just hunches, and I want to share both Governor Lilly's and President Volcker's concerns. As far as the physical side is concerned, it seems to me the outlook is very good. In fact, I could make a case that it could be stronger than the staff projection in the immediate quarters ahead. Not in the second [quarter] so much--you've had 8 percent already there, but in the third and perhaps the fourth, based on a real recovery in investment expenditures, which I think is probably in process now, and also a larger amount of inventory accumulation, than you have in the projection. So I think the real activity outlook is quite strong.

But as to prices, I must say that I find myself doubtful that the rate of inflation is going to subside, as in the projection, to 5-1/4 percent, partly because I think food prices may go up more rapidly than you are still allowing. And also partly because of Governor Lilly's concern about industrial materials and the kinds of tensions that may occur there. You have already, in the last four weeks, raised the nominal GNP projection by 1/2 point--a quarter percent real and a quarter percent price. You've got 8--even a little more real than that--and if you have more price than that, it really begins to put pressure on the financial system. And I think interest rates could rise significantly more than is now being projected, and that, of course, will have its GNP impact not so much this year but in 1978, which I think does make a case for a different profile.

Looking out further ahead than you have, Jerry, in your comments, along the lines that President Volcker was mentioning, I don't really know what we can do about this, because the interest rate effect will come if, in fact, we have this kind of inflationary development and inflationary expectation. And I suppose in the short run almost everybody would be happy to see stronger real growth in the economy. But I, like President Volcker, see some difficulty in financial markets as we get to the end of the year, and difficulty in markets which are greatly affected by credit costs as we go into 1978--such as housing.

CHAIRMAN BURNS. I would like to amplify Governor Partee's comments on prices. In the past four months, the price of cocoa has risen 40 percent, the price of coffee 82 percent, the price of orange juice 66 percent, soybeans 27 percent. An average for metals prices is up 17 percent, hides and rubber prices average up 17-1/2 percent, lumber and plywood prices up 11 to 12 percent, fuel oil and gasoline up 8-1/2 percent. The increases have been rather large and spreading.

MR. KIMBREL. Mr. Chairman in those lumber figures, I think maybe even that's conservative according to some of the builders, because they are almost quoting a $1,000 addition to the price of lumber in the average home in our area at the moment. So just the lumber alone is becoming a substantial deterrent in cost--particularly in houses.

VICE CHAIRMAN VOLCKER. Mr. Chairman, if I may just chime in on this again, briefly. I reported that our price projections were the same as the Board's, but I also want to report on qualitative evidence. The kind of noise we are getting from the business community--certainly somewhat to my surprise, I guess, and maybe it shouldn't have been--is louder and shriller about price increases than I can recall at any time during this expansion. It's partly reflecting this commodity business, but not just that. [There is a] kind of a feeling [that] the better market is coming and the opportunity [is coming] to raise profit margins once again. Now they have been talking about this, of course, before, but I am somewhat taken aback with the strength with which I have heard these sounds in the past month or 45 days.

CHAIRMAN BURNS. To what degree are businessmen concerned or somewhat nervous about the prospect of governmental controls over prices? Do you hear much about that?

VICE CHAIRMAN VOLCKER. I've heard less of that just recently.

MR. MAYO. I think it's faded, Mr. Chairman.

MR. KIMBREL. I'm not sure we can say that, Mr. Chairman, because every time the Administration says that [they] are not interested, it surfaces again. So if they'd just quit saying "we are concerned," I think it will settle back down. But "the louder thou persisteth"--it seems to be coming through to the businessmen.

CHAIRMAN BURNS. Mr. Winn, we are ready to hear from you now, please.

MR. WINN. Two or three points, Mr. Chairman. First, in terms of prices, particularly in the building materials area, I just call your attention [to the fact] that home modernization repairs are estimated to exceed new building costs this year.

CHAIRMAN BURNS. You mean total outlay on buildings?

MR. WINN. That absorbs building materials and workers. That's really getting to be a very sensational--

CHAIRMAN BURNS. Are you talking about the residential?

MR. WINN. Yes. The second point I'd make is that the psychological impact of the second quarter sales are likely to be quite bullish in view of last year's second quarter sales. But people don't always recognize that the downturn occurred in the second quarter last year, and then they get these sensational figures this year to get a real buildup.

MR. PARTEE. Year-over-year?

MR. WINN. That's correct. Now, [number] three--the interesting price phenomenon has been the oil-based chemicals, [which] have been weak in price, and this has been a puzzle and may come back quite strong in view of oil costs, for basic stock.

In a quite a different vein, Mr. Chairman, I have been spending some time talking to low-income people, and the underlying rage in that area is troublesome. I don't think it's purely the outbreak both here in Washington and in Cleveland recently, but these people are faced with, oh, a 40 percent increase in their rent, and their energy cost now exceeds their rental cost. Now, food costs are really [taking a toll], in terms of this group. In addition to that, we have a phenomenon of a cutback in governmental services to these people as a result of budget restraint.

[There is] a great deal of underlying unrest in terms of desegregation school efforts in a whole host of communities. And I don't know whether we're going to have to go to energy stamps or some effort of this kind, but I am recognizing in history that revolutions occur only when conditions are improving. The feeling of being left out is stronger than I have seen in a long period of time. This troubles me. It in no way depreciates the idea of the strength of the economy, but there is a group being left out, and they are bitter, and this worries me.

CHAIRMAN BURNS. Well, I have been getting a good deal of mail from apparently lower-income people who are only semiliterate but who know that the substantial increase in congressional salaries has recently occurred, and they are quite bitter about that. More bitter mail like that than I have seen in quite a long time.

MR. BLACK. Are any of these letters commending us for our actions, Mr. Chairman?

CHAIRMAN BURNS. Oh, there have been many, oh yes, though some blame the Federal Reserve Board for not stopping the increase in congressional salaries. Governor Wallich, please.

MR. WALLICH. I wonder whether we'd be helped in looking at the price situation by distinguishing between the macro and micro elements. I think our discussion has been in good part on micro aspects--particular prices, particular sectors. And while, in the past, I have always heard industry people predominately talk about the absence of [macro-type] pressures, the conversation here has been predominately focusing on where there are pressures. I find myself somewhat confused.

What I am going to ask you is, [what weight do these] two elements carry in your forecast? We have capacity, which I think is less large than most people think at the present time, [but] nevertheless, it is substantial. There are wage increases, and they do not seem to be accelerating significantly. There is monetary and fiscal policy. Monetary policy, I think, one can hardly say is excessively stimulatory. Fiscal policy has a question mark. On the whole, I would look at the macro variables as being more nearly on the side of a slow rate of increase in prices. The micro I have a difficulty in telling. What is the weight that you would attach to these things, Jerry?

MR. ZEISEL. Well, like you, my contact with businessmen has not suggested any great concern during 1977, at least. The possibility of impinging upon capacity--[there has been] some talk that that may occur in 1978, if things continue at a vigorous pace in selected industries. So that has not been a major concern here.

In terms of macro policy--I assume fiscal policy--I assume you mean those components of policy that are generating or helping to generate a given rate of growth from the economy--is that the point you have in mind, Governor? With the first point, the rate of increase in real GNP growth that we have projected is somewhat greater than the increase in capacity that appears to be on stream, which is somewhere between 4 and 5 percent. So we will be moving back toward the capacity line, but we would be moving at a rather moderate pace. In our projections, it isn't until mid-'78 that we begin to get to a point with capacity utilization for either materials or manufacturing that we may begin to see any significant bottlenecks, even in selected areas. And in macro terms we would still be well below the potential rate of growth. That's not a substantial factor.

I think the concerns that we have relate to the shorter run, that is, in ’77--a worry about inflation and its psychological impact and an aggravation of inflationary anticipation. There are implications both for inflation itself and for attitudes of business and consumers. For ’78, we see these situations beginning to possibly concern specific areas.

MR. PARTEE. Are there a lot of wage contracts in ’78?

MR. ZEISEL. This is a big year, so ’78 should be a small year. This year is bigger than last year. It’s about 4-3/4 million, and last year it was a little over 4, and then it’s a three-year cycle--pretty much standard.

CHAIRMAN BURNS. Well, I do want to say a word about the macro side. For the past twelve months, M2 has risen by 10-1/2 percent and M3 by 12-1/2 percent. These figures hardly suggest a policy of strong monetary restraint. On the fiscal side, we are continuing to run large deficits, and the prospect is that these deficits will increase. And that undoubtedly is not only [a] situation [of] so much more money being put into the pockets of people than is being withdrawn from the pockets of people, but [it] is having [a] large psychological effect on our people across the land. Yes, Mr. Partee.

MR. PARTEE. Could I just say to Governor Wallich, it is a question of confidence in the economy aside from governmental policy. And I do feel that one thing that hasn’t been mentioned that ought to be mentioned is that I think the confidence in the economy is increasing rather rapidly, and in particular, confidence in the new Administration is at this point quite high. The surveys show it--a very high proportion of the public approves of the way the President is doing his job at this point. And I really do think that’s a new factor that needs to be mentioned, and that in itself could lead to a stronger business rise if it’s not upset. And in coming months, then one would just argue on the basis of past relationships in macro/micro stimulation.

CHAIRMAN BURNS. Mr. Morris, please.

MR. MORRIS. Mr. Chairman, I would like to follow up on Governor Partee’s question and ask, in terms of your flow of funds work, what is the implication of this projection for the flow of funds, particularly the external corporate demand for monies? What does that tell us about the likely behavior of interest rates?

MR. AXILROD. President Morris we continue to have no greater external demand for funds by corporations projected for 1977 than we have for 1976. In 1976, corporations were net borrowers, that is, in net assets less liabilities, they were net borrowers of around $25 billion in financial markets. This compared, say, with $70 billion in ’74, and we were projecting for ’77 a very similar number--in fact, almost exactly the same--and with very little uptrend in the course of the year. And, of course, we have large profit flow and an increase in plant and equipment spending, but not of boom proportions.

So from that point of view, you don’t have a factor which is adding to credit market pressures as compared with the previous year. That has been one of the factors that has kept--me, at least--thinking that interest rate pressures, viewed from credit demand and supplies--not just from velocity but from the markets themselves--are not extremely intense.

Now, we have projected a rather substantial rise in interest rates, I might add, a bill rate going around 4-1/2 to 7 by early ’78--in a period when price pressures aren’t intensifying. That’s a rather substantial rise in interest rates for such a period.

CHAIRMAN BURNS. Steve, to what extent are your flow of funds projections integrated with your overall economic projections?

MR. AXILROD. Well, we hope they’re fully integrated--they’re integrated with the Bluebook, and they’re integrated with the housing starts and plant and equipment numbers that come from the economic projection.

CHAIRMAN BURNS. Well, does that mean that your flow of funds projections are revised every month?

MR. AXILROD. Yes, they are.

CHAIRMAN BURNS. I don’t see them.

MR. AXILROD. No, you don’t, but I’d be glad to have them forwarded to you.

CHAIRMAN BURNS. Well, yes, I certainly want to see them. I was under the impression that you do that once a year and then you stop.

MR. AXILROD. No, we get a printout monthly.

MR. PARTEE. Well, I think we ought to have a summary table in the Greenbook now that we’re doing them monthly. I think that’s a fairly recent development.

MR. AXILROD. Well, we could--I think a summary table.

CHAIRMAN BURNS. Let me start with them.

MR. AXILROD. I’ve been getting them monthly for some time. You know the exact--

MR. PARTEE. ’75.

MR. AXILROD. The manufacture of them--

CHAIRMAN BURNS. [Unintelligible] our excellent staff has a way of hoarding treasures.

MR. PARTEE. If I may, Mr. Chairman, that very point bears on President Morris’s question, because my thought was that there could be more inventory accumulation than is in the projection. There could be more plant and equipment, and there could be more inflation. All that would add to the nominal GNP, and it would also add to the corporate, business financing need of the year as it went on, so that the consistency of the flow of funds with the current GNP projection has to be looked at both ways. But also can be stronger.

MR. AXILROD. An evaluation of the flow of funds doesn't find the normal kind of pressure points in credit markets that you often associate with it. That's one of the problems.

CHAIRMAN BURNS. And these flow of funds projections have been revised, but about the same time when the GNP, etcetera, projections were revised?

MR. AXILROD. Yes. I might add that we will be glad to work on a summary table and use them. I'm not sure--we won't have it in time for the Greenbook because of our schedule; we will either have to have it appended to the Bluebook or [provide] it separately on Monday, but we can forward it.

MR. MORRIS. Mr. Chairman, it seems to me that the analysis of velocity numbers for the third year of expansion would suggest extremely heavy pressures in the credit markets. Because the flow of funds numbers are giving us a contrary indication, it would be quite unique to have a third-year expansion with very little change in corporate demand and the big jump in velocity coming together.

CHAIRMAN BURNS. You can say, using National Bureau [of Economic Research] chronology, that we will soon be entering the third year of a business cycle expansion. But you can also say that a new expansion started in the month of October. Now, I think business cycle analysis has to be flexible, and while the National Bureau scheme has great virtue--I couldn't say anything else--in our own thinking about developments in the economy, we have to use that along with other judgments or other ways of looking at the economy.

MR. MORRIS. I think also the fact that the recession was much more severe than most in the past is another dimension.

MR. AXILROD. I would add, Mr. Chairman, that we do have an indicator in the second half of 1977 that is often associated with credit market pressures, and by that time we do expect the banking system to be financing more of business than it did last year. That is, the trend, the last two months of '76 and early '77 of increased business loan demand, we expect [it] to remain fairly substantial throughout the year, with mortgage needs, consumer needs.

We would expect the banking system would not be as substantial a financer of the government--as we get into the latter part of this year--as it had been, and we would project that the household sector would have to buy a very substantial amount of government securities by the second half of this year. And more, for example, than they were buying on average in '74; considerably more than in '75 and '76.

So from that aspect, in the last half of this coming year, we do get a traditional source of upward rate pressures, that is, the necessity to price Treasuries so you could sell them to the household [sector] favorably priced relative to [Regulation] Q ceilings, things like that.

MR. WALLICH. If I may follow up on Frank Morris's point, I think these two things--the projected rise in velocity, which is really remarkable, and the contrary indication of business plant financing needs--do belong together. But maybe they belong together in a different way. Namely, that at a time when there is no great pressure for business financing, there is then the possibility of getting much more work and turnover out of the given money supply because the money supply isn't being increased by business financing. So that we might get high rates of increase of velocity without the kind of interest rate pressure that's--

MR. MORRIS. Offsetting balances?

MR. WALLICH. At least this is a hypothesis. I am troubled and puzzled by this very high increase in velocity, including a high increase in V2, which supposedly does not move around that much.

MR. AXILROD. I think, Governor Wallich, [what] is being left out is that we are--we may be wrong, we have been wrong for two straight years--but we are projecting a rather substantial rise in interest rates. Now, it may turn out to be higher, but we are projecting a rise from about 4-1/2 percent for the bill rate to 7 percent. That gets you up into the area of disintermediation, and that disintermediation is what causes the income velocity of M2 to rise. So in some sense we have a rather consistent set of projections, not inconsistent with past historical experience, once you feed-in the rise in interest rates and make allowance for some continuing shifts in financial technology. It may be more intense, or it may be that we are wrong again and it will be less intense; we really don't know. But I think this is a fairly good sort of mean projection of the future.

CHAIRMAN BURNS. All right. Mr. Guffey, please.

MR. GUFFEY. Yes, question, Mr. Chairman, to Jerry. As to the assumptions that the staff is building into your projections both on price and GNP with respect to the drought in the western part of the United States, and if that moderates for the better or gets substantially worse, will it make a substantial difference in your projections?

MR. ZEISEL. Yes, we have built in an increase in the second half of '77 and early '78, which reflects the news that's come in--unfortunate nature of the weather in the West and Midwest. I think we are still on the relatively optimistic side of the range of forecasts. It's conceivable that if the news continues bad, if the weather really is as bad as it appears to be at this point, and that continues to be the case, we could easily get another 1 to 1-1/2 percentage point rise in food prices in late '77 and early '78.

MR. GUFFEY. Would it materially affect your GNP forecast? Is food that big of a component?

MR. ZEISEL. Well, it certainly will affect the GNP forecast in the sense that this will be a tax on consumers for higher prices for food, and this has a negative effect in general--aside from the distinct possibility that it may erode consumer attitudes about the outlook for the economy and may be evident in a much more significant way in purchases of other things.

MR. GUFFEY. With respect to your latter point, I think that is a very real consideration in our part of the world, in the sense that there is real pessimism yet with respect to the economy in the western--Tenth District, at least.

MR. PARTEE. Mr. Chairman, is that [pessimism] there because of low farm prices? Or high farm prices?

MR. GUFFEY. It's a combination of high farm cost and low prices for the product. Coupled with the fact that they have been through a very difficult winter, and the outlook isn't very bright even yet. I should quickly add that a good rain or two would change that very quickly, and particularly when the sap begins to rise in the spring, those attitudes can change.

VICE CHAIRMAN VOLCKER. Did you get a rainstorm the other day?

CHAIRMAN BURNS. Mr. Roos.

MR. ROOS. In connection with this, just last week the head of one of our very large industries with significant activity in the western part of the nation said that, as important as the continued drought in that part of the country might be as an effect on food prices, they feel that there's a terribly serious possibility of a drought affecting the generation of electrical energy, with the very real possibility of plants having to actually curtail operations due to an inadequate supply of energy as a result of the low water in the dams. Now this is just an aside, but he was very strong in this.

CHAIRMAN BURNS. Thank you, Mr. Roos. Mr. Mayo, please.

MR. MAYO. Mr. Chairman, I have never felt any confidence in the velocity projections. I asked my staff, though, to go back and chart the actuals of annual rates of change from one quarter to the same quarter a year later to see what it looked like, and I find the projections a little more comfortable with that background in mind. Not only have there been, oh, I think it comes to about 26 quarters out of the last 30 years that we have had more than a 5 percent velocity change; but more important than that, I note in charting this that there is definitely a primary and secondary peak in every business cycle all the way along the line, with the possible exception of '70-'73, where it isn't as apparent. The secondary peak typically is not quite as high as the primary peak, but there is a definite recurrence of an expansion in velocity later in the cycle.

MR. PARTEE. As interest rates go up.

MR. MAYO. Yes. This is M1, though.

CHAIRMAN BURNS. Well, I haven't said a word about velocity. But I believe members of the Committee know my basic thinking. Interest rates play a role. But the predominant factor in changes in velocity is not the rate of interest but the state of confidence. And if those of us who believe that confidence is improving turn out to be right, it's a pretty good prospect that velocity will rise, will be at a quite high level. Mr. Partee.

MR. PARTEE. Well, I also have a comment about velocity. I'm glad that Bob came back to it, because it doesn't seem so far out of line--I think a lot of comments about velocity that I am hearing relate to M1 velocity, and they don't take into account what we believe to be the substitution process. That has been accelerating and may be reaching a level of a stampede. And so I think that we are in some danger here of reasoning on the basis of past relationships, even making some allowance for them, that still don't hold. It's still not relevant because of the rapid change in the meaning of narrow money supply to GNP.

Now I have to admit that I can't remember much about M2 velocity; perhaps we ought to have more historical information on that, but I just can't keep it in mind. But I do think that I recall the times when M2 and M3 ran up less rapidly because of what Steve said of disintermediation--rising market interest rates relative to institutional rates--and in which there must have been increases in M2 and M3 velocity. Paul has got the charts; [do they] show it?

MR. AXILROD. Governor Partee, the increase in velocity that we have is high relative to past experience. In the third year of the 1970 expansion, M2 velocity rose at about a 2 percent annual rate, and in the third year of the '54 expansion at about a 3 percent annual rate, and what we have is about a 3 percent annual rate of rise.

MR. PARTEE. The M2 on President Volcker's chart projection looks a little stronger on the rise in velocity, and M3 doesn't look out of line.

VICE CHAIRMAN VOLCKER. Velocity of M3--velocity is declining.

MR. PARTEE. Yes, and it seems to me quite possible. I might also say that I also have a great difficulty with M2 velocity when you remember what's in M2, that is, when you remember what commercial bank time deposits have been added in order to make M2. It includes state and local government deposits, it includes large CDs and nonnegotiable large CDs everywhere; it includes negotiable CDs in the nonweekly reporting banks; and now it includes consumer certificates having maturities of four to six years, [which] don't seem to me to have an awful lot of moneyness about them. So I am always nervous about this more than M2 velocity, and also because of those definitional problems.

CHAIRMAN BURNS. Any other comment on the overall economic situation and prospects? I think it would be helpful to have a show of hands on the part of members of the Committee on your judgments about the economic prospect. If you feel that our staff projection is more or less in the ballpark, as far as the real economy is concerned, will the members of the Committee be good enough to raise their hands?

MR. BROIDA. Eleven.

CHAIRMAN BURNS. Thank you very much. I asked for that show of hands for a very definite reason. We now have a monthly detailed report of Committee deliberations, which is made public. And our staff has to [write it] on the basis of what is said at this table, and not enough has been said about the general economic outlook. And to aid our staff on that very critical point, I asked for a show of hands.

MR. COLDWELL. Mr. Chairman, I did not raise my hand on that because I think the pattern is going to be different.

CHAIRMAN BURNS. Well, you've made that comment before, and I supported you, but I was thinking really of the--

MR. COLDWELL. Thinking of the--

CHAIRMAN BURNS. --pattern, not the average for the year rather than the pattern. All right now, would anyone else like to speak? If not, this is as good a time as any to break for coffee.

[Coffee break]

MR. STERNLIGHT. [Statement--see Appendix].

CHAIRMAN BURNS. Mr. Black? Please.

MR. BLACK. Peter, has market sophistication reached the point--now that they [have] deemphasized the recent figures on money supply and [have] moved on to monthly figures--that they also, similarly, [have] deemphasized any bulge in the April money supply, remembering that this happened last April and was then reversed the next couple of months? Will they take this in stride, or are they going to be terribly surprised?

MR. STERNLIGHT. I don't know that they really have. Some of the recent week-to-week reactions have been a little milder, but there is still a good deal of sensitivity to the weekly numbers and interest in seeing how the Desk might respond. There is, of course, a consciousness that the growth was slower in February, so that if there were to be a pickup [in growth rates] in March and April, the market would perhaps not jump to a conclusion. Unless they got some sign from the Fed, they would not come to a conclusion that this was going to be followed by some stiffer posture at the Desk.

VICE CHAIRMAN VOLCKER. On that point, Mr. Chairman--I was going to mention this later--but I report the impression of my staff, rather than an impression I get directly, that the market has looked into this bulge problem, [and] their estimates of the bulge from the rebates is substantially larger than our own, meaning the New York Bank's. I suspect also the Board's. If that is true, perhaps it raises some interesting psychological problems of that time--if they think our estimate of the bulge is the same as their estimates of the bulge [but] their estimate is substantially larger.

MR. BLACK. Paul, to compound the confusion, our estimate is larger than yours, too.

VICE CHAIRMAN VOLCKER. Well, I mean much larger.

CHAIRMAN BURNS. Well, I think our staff estimate will satisfy everyone because it will not present a single point estimate, it will present several estimates. I was just talking to Mr. Axilrod, and I think he had in mind presenting three sets of estimates; each set of estimates will cover several months, and I suggested that he might not stop at three [but] go beyond that. So that the range of uncertainty will be fully reflected and all that will be before the Board in due course.

MR. COLDWELL. Mr. Chairman, may I ask a question? Peter, has there been any reaction in the market to the change in our policy on purchases of agencies?

MR. STERNLIGHT. Very little, as I commented. Very few people in the market raised the question about it, and it was done in rather a low-key way, and we've been unable to detect any change in the quotations for the eligible versus ineligible issues, either as to the level of prices and yields or the spreads on those quotations.

CHAIRMAN BURNS. Now, that is very good, as I understand. It really means that we've been so wise in not becoming the dominant factor of market increase. If we had been, you'd see some market reaction.

MR. STERNLIGHT. Well, I think activity had been pretty light in those issues.

MR. COLDWELL. Are the dealers showing you any agency issues for purchase?

MR. STERNLIGHT. We haven't had occasion in the last few months to go in and buy agency issues when we do get quite a sizable range of offerings.

MR. COLDWELL. What you're saying, then, is that only when you go out and ask for the agency offerings do you get some offerings.

MR. STERNLIGHT. Right. There've been too few occasions when we have anything to do, away from our go-rounds. Those with Treasury coupon issues will occasionally have some foreign-customer orders, so that it's worth the dealer's while to show us occasional Treasury coupon offers, but it would be rare with an agency.

CHAIRMAN BURNS. I hear no other question or comment. Now the time has come for a motion to confirm transactions of the Desk. Is there such a motion?

SPEAKER(?). So moved.

CHAIRMAN BURNS. Motion has been made and seconded. I hear no dissent.

MR. AXILROD. [Secretary's note: This statement was not found in Committee records.]

MR. LILLY. May I ask a technical question? Wouldn't that show up if this was being financed in the funds market? Wouldn't that show up in other liabilities?

MR. AXILROD. Yes.

MR. LILLY. Well, then, have you had a verification of it?

MR. AXILROD. Well, we get reports on, the daily report of deposits of federal funds and other borrowings. RPs--there are varying definitions, District by District, so it's not exactly comparable. And what I was reporting on--our aggregation of that for all member banks, with some added allowance for the nonmember banks--and this figure, for example, such borrowing net of lending [unintelligible] showed an increase, on this fragmentary basis, of $3.6 billion in February, whereas in February of the three previous years, it had declined, on average, $400 million. So that's the factual basis for it, but, I would hasten to add, it is fragmentary, and I was offering an explanation which should be taken in the nature of a hypothesis.

MR. PARTEE. We can't distinguish between the federal funds and RPs.

MR. AXILROD. No, we don't, but I don't think that Governor Partee--

MR. PARTEE. Federal funds in concept would be borrowed from another bank and thus would not change total bank credit.

MR. AXILROD. No, no. I was giving you net. I was netting out, and this would be the loans to the nonbanks. This would be from all nonbanks. An S&L, for example would be a lender here. A corporation would be a lender under an RP. An S&L could be under federal funds.

CHAIRMAN BURNS. All right, any other questions? Mr. Wallich, please.

MR. WALLICH. Can one try to anticipate the behavior of businesses as they look toward the rebates and the bulge? Is it reasonable to think that it will be different from the behavior of banks, in that the businesses must anticipate a spurt in sales, therefore an increase in liquidity? This ought to cause them to be less liquid in advance, knowing that these funds are likely to come to them.

MR. AXILROD. Well, if they were going to do anything in anticipation of sales, I would assume they would build up inventory somewhat and possibly borrow from banks in order to do so, which would be, in a sense, reducing their liquidity somewhat. I have no evidence of an unusually substantial inventory buildup in anticipation of such sales. But maybe Mr. Zeisel--

MR. ZEISEL. There was, as I mentioned earlier, actually a rundown of inventories late in the year. The only thing we have for January to date is manufacturing and wholesale trade inventories. There was some rise in materials, particularly, and raw materials, and goods in process. It's felt that a significant amount of that was a backup because of the inability fully to ship during the cold weather. So we don't really see any intended buildup in inventories very clearly as yet.

MR. WALLICH. I wouldn't disagree with your analysis that it might call for an increase in inventory. But the more immediate look ahead suggests simply that more cash is going to come in, and they may meet that from existing inventory as well as from a previous buildup. So that the main impact of looking ahead to the bulge would seem to me would be in the demand for M1 and other liquid assets.

MR. PARTEE. --would fall just prior to the refund. I don't think we saw anything like that in 1975.

MR. COLDWELL. You may have said this, but it didn't sink in. You said the second quarter does not contemplate the effect of the rebate. Is that correct?

MR. AXILROD. No, what I said was that we expect a substantial effect in the second quarter but that the March-April figures currently before the Committee do not include any effect of the rebates directly because we don't expect the payments to begin until May.

MR. COLDWELL. And yet, you do expect a significant effect in the full second quarter?

MR. AXILROD. Yes, at the moment, on the order of 2 percentage points on average, but that's quarter-over-quarter, roughly. I would expect substantial effects in May and June--very large, in fact.

MR. COLDWELL. I guess my timing is a little bit different. I thought you might get those mailed out in late May, and you might start getting an impact in mid-June, which would mean that your deferred impact would be into the third quarter.

MR. AXILROD. On that mailing period you would get less effect in the second quarter, assuming our rough assumption at the moment, [which] is that the first mailing will be around the end of the first week in May. Now, again, that will depend on when the legislation is passed, whether the Treasury can gear up to mailing out the checks, which we will know more definitely, of course, in the next four weeks.

MR. COLDWELL. I'm looking at your pattern here, on whatever table this is on p. 5 of the Bluebook, showing the M1 pattern for the alternative B. In effect, you've got stability for three quarters and a 3-1/2 percent jump in one quarter.

MR. AXILROD. Yes, that quarter, the second quarter, does include about roughly plus 2 for the rebates, and the third quarter roughly a minus 2.

MR. COLDWELL. Coming back to the discussion concerning inventory, I thought we had a prospect of relatively slow inventory growth in the first and second quarters, which does not seem to me to imply major expansion for inventory purposes in bank credit.

CHAIRMAN BURNS. Slow growth in inventories in the second quarter?

MR. COLDWELL. First, and second.

CHAIRMAN BURNS. Yes, I understand the first, not the second.

MR. COLDWELL. Well, at least in the early part of the second. Maybe that's my problem. I'm looking really through mid-May.

MR. ZEISEL. Our assumption has been that there would be a moderate rate of growth in inventory investment--actually, a rate of inventory investment that's quite modest during this period. If I may refer to the discussions I've had with business people, particularly at the retail trade level, I have asked them about their anticipations in regard to the impact of the rebates. And they tend to be rather cautious. One of them said, for example, that he was afraid that the individual stores will start over-responding.

CHAIRMAN BURNS. You're reporting the thinking of an economist.

MR. ZEISEL. I am reporting the thinking of an economist at one of the chains. I suppose I should distinguish between businessmen and economists--you're right, Mr. Chairman. But the company policy in this particular chain and in the case of several others was to be rather conservative in building inventories during this period.

MR. PARTEE. Of course, you could have offsets, too. That is, the retailers could build it up, and it could come out of the manufacturers in the first instance.

MR. COLDWELL. Yes. A different stage of inventory operations here, but who's doing the financing through bank credit, I guess is the question. If you're building your M1 growth exclusively on the rebate, that would be one thing, but I gather you are not.

MR. AXILROD. Lord no.

MR. COLDWELL. On the strength of the economy, bank credit demands, and so forth; partly on the inventory expansion.

MR. AXILROD. Right, right. Now, we would expect a rather substantial second quarter based on the strength of the economy, which, of course, in itself also reflects partly the rebates. But, in addition, it's the particular effect on the rebates and people just holding cash for, on average, a little bit longer than they normally hold it.

CHAIRMAN BURNS. Any other questions or comments? If not, we are ready for the discussion on monetary policy. Gentlemen, I am inclined to think that we don't have a very difficult job today. Having said that, I will say no more, for a while anyway. Who would like to speak first, at somewhat greater length but not excessively?

VICE CHAIRMAN VOLCKER. I don't know whether it's difficult or not, but I want to be radical and suggest that we be particularly sensitive to our long-range intentions on the aggregates today, and that should make it easy. I say that against the feeling that the business outlook is quite satisfactory, but the risks may be greater of maybe getting a little too much too soon and aggravating this price and interest rate sensitivity. I continue to feel, or hope, anyway, that the kind of macroanalysis on prices that the economists have presented is valid, but there are a whole lot of psychological and confidence problems at work here, and they are important, and they are important in the financial markets, too. [Those problems include] the fear of deficits and, I think, some underlying concern that maybe the Federal Reserve may turn out to be too easy in the end, when the crunch comes, in terms of a different trend in interest rates.

Maybe in some of this thinking of uncertainty about the price situation and about the interest rate situation, a feeling that between the deficits and maybe some pressure toward too expansionary a monetary policy, [it] would be counterproductive in terms of interest rates [ending] up higher rather than lower if we don't handle it right. And this rebate problem is going to confuse things in the spring and may make it difficult during that period to repair any move that we make now or [any] failure to make a move now.

Having said all that, I don't see any case for making any aggressive move at all in the money market indicators right at the moment. But what I'd like to see is a situation set up so that if the aggregates do begin moving on the high side--and, indeed, I'd accept the symmetrical side of that, if they continue low--we be prepared to move reasonably quickly in a modest way. And I guess I don't like the matrix that's set up for us, which depends very much on a specific projection of the money aggregates for the two-month period. And a typical way of doing this--it puts a lot of weight on whether there is a deviation from the current projection--the short-term projection--rather than how we are doing in terms of the longer-run projections.

If I look at it in terms of the longer- run projections, you come out more like the C alternative in the Bluebook. Even there, M1 is too high. It doesn't straddle, symmetrically anyway, the longer-term target, and I would like to see it straddle that target a little more. The M2 projection does straddle it very symmetrically--a half a point on either side--and I'm sure it would make me happier if the M1 short-term range was reduced to something like 4 to 8 percent, maybe even 3-1/2 to 7-1/2 percent, which would be symmetrical around the longer-term range. I would do that without contemplating any particular change in the federal funds rate at this point.

But then, if we began moving in the upper part of those ranges, we would begin moving the federal funds rate a bit. Just where I'd put the limits on the federal funds rate--I don't feel strongly about the particular numbers. I might be inclined to a 4-1/4 percent to 5-1/4 percent range [with] 4-3/4 as a midpoint or 4-5/8 to 4-3/4, a slightly asymmetrical midpoint. I would be equally happy--maybe slightly happier--with a 4-1/2 to 5-1/4 percent range but leave the midpoint, in effect, asymmetrical--leave it where it is, or maybe 4-3/4 percent.

But what I am looking for here is not a move at the moment in terms of the money market but a readiness to move quite gently if the aggregates began coming in toward the upper end or beyond the upper end of our longer-term ranges. Because if we didn't make that move if that happened, we might be piling up a little difficulty in the future, when we certainly expect the aggregates to be rising more rapidly for some months thereafter, during a period when obviously we'll make our own estimates of what the rebate influence was. But it might be difficult to act very much even if it exceeded our estimate of what the rebate affect was, as current estimates do assume.

So basically I would specifically substitute for that M1 range under C something more like the long-term range. I'd be satisfied with a fed funds range more like what we have, or just slightly tipped up on the upper side without any change in the actual rate, at the moment, until we saw the evidence in the aggregates.

CHAIRMAN BURNS. Thank you, Mr. Volcker. I would pretty much endorse what Mr. Volcker has stated. And it might possibly focus our discussion a little better if I suggested some numerical specifications for the Committee to shoot at one way or another.

I would suggest that we adopt a range of 4-1/2 to 8-1/2 for M1, 7 to 11 for M2, and stay where we are for the federal funds rate range and also [for] the slightly fuzzy midpoint between 4-5/8 and 4-3/4. Mr. Coldwell, may we hear from you next.

MR. COLDWELL. Mr. Chairman, I am going to have to start talking before Mr. Volcker. He stole what I wanted to say. I had a slightly different perspective, but it tracks what he had in mind. I really had in mind bringing that M1 down to the 4 range and lifting the top of the M1 to 9, but giving some movement in there, as Mr. Volcker has indicated, as we approach either the top or the bottom--and I assume it's going to be the top--that we start moving slightly.

On the federal funds range, I had planned to suggest to the Committee a 4-1/2 to 5-1/4, with the same fuzzy 4-5/8 to 4-3/4 percent center point until we see some movement. I am bothered also, as he indicated, about this basing it on a projection. I have a nagging suspicion that these things are not going to work out with all of this beautiful symmetry that the staff has worked out for us, and I suspect we might be surprised on either too high or too low a level. And consequently I would hope that we would have a little more upward side to this, but, in effect, validate these projections before we make a move.

CHAIRMAN BURNS. Thank you, Mr. Coldwell. Mr. Black, please.

MR. BLACK. Mr. Chairman, I have a feeling that in the second quarter we are going to see a pretty substantial bulge in the aggregates. We've touched on many of these points, and our own work suggests we'll have even a greater rise in April associated with the buildup in balances by individuals around the April tax dates. Then, with the rebates and, later on, special Social Security payments, we think it's going to be a pretty good bulge throughout all of the second quarter.

Now I think we have to be rather cautious in reacting to such tax-related bulges in aggregates, since as the staff points out these are likely to be reversed later on. The problem here, to me, is to distinguish between the part that results from these special factors and the part stemming from an underlying increase in demand for money. I don't know any way to do this, so I think we ought to remain particularly alert to increases in the volume of commercial paper and business loans at banks. My own feeling is that we are going to get a larger demand on the part of the public for money than was true in 1975 and 1976, when we had similar bulges. But of course you can't tell at this point. Overall, I think the aggregates are behaving better now than I can remember their behaving at any time since I have been sitting around the table.

Since these are uncertainties for the present, I'd be inclined to hold pretty much to our current stance. So, along with alternative B as a general prescription for the March-April period--but since I think, for tax-related reasons, M1 growth in April could be much stronger than the Bluebook suggests--I would be inclined to raise that M1 range to 6 to 10 percent and leave the M2 at 7 to 11. And I agree with the assessment of all of you that we ought to have this fuzzy midpoint of the range, 4-5/8 to 4-3/4.

At this stage, since I think what strength we see in the aggregates may be largely a tax-related phenomenon, I would be reluctant to see the funds rate moving more than 5 to 10 basis points above that 4-3/4 in any week, even if the aggregates are coming in a little bit above these limits that we've set. But I agree with Paul's long-run assessment of the problem. It's just that I think you are going to have some rather misleading signals in this period. We've been fooled a couple of times in recent years and it could happen again.

MR. PARTEE. That was 6 to 10 for March and April--those two months. You want a 6 to 10 range for March-April--before the refund is paid out?

CHAIRMAN BURNS. All right, thank you, Mr. Black. Mr. Eastburn, please.

MR. EASTBURN. Thank you, Mr. Chairman. I've been impressed with the earlier discussion of the degree of uncertainty that I think exists for the next few months. I think if we had perfect knowledge, we'd try to anticipate some things--we'd try to anticipate the price increases which a number of us feel are likely but we're not sure about, and we'd do some anticipation of the rebate and its effect. Probably do some anticipation of the interest rate increase, so that it doesn't come too sharply.

But in view of the uncertainty about all three of these, I think it is the best thing to do to stay approximately where we are. I don't think we should be permitting interest rates to go up substantially until the money supply seems to be behaving quite differently than it is. So I generally like very much, Mr. Chairman, your specifications for the aggregates. And I also would hold to the specification for the funds rate.

I would like to suggest, however, one possible modification on the funds rate. I think we have the makings, [in] this fuzzy range of 4-5/8 to 4-7/8, of the possibility of getting more movement in the funds rate from week to week than we have been getting. And one possible way to do this is to widen that inside spread very slightly and make that something like 4-5/8 to 4-3/4. With Paul, I think I agree that this already happened.

CHAIRMAN BURNS. Your first number you meant 4-5/8 to 4-3/4, and the second you meant 4-5/8 to 4-7/8?

MR. EASTBURN. I think one thing this might do, with Paul's suggestion, would be to put us in a position of being prepared to introduce greater flexibility on the upside if that appears necessary.

CHAIRMAN BURNS. Thank you, Mr. Eastburn. Mr. Kimbrel now, please.

MR. KIMBREL. Mr. Chairman, I thought I'd acknowledge the [unintelligible] weather conditions induced and the uncertainties, but I guess I am quickly moved to the feeling that Governor Partee discussed somewhat earlier. I think the economy actually is going to be much stronger in the third and fourth quarters than we have [assumed]. Inventory-induced stronger real growth [and] capital investments--I think that's going to react in prices, create difficulties in financial markets, relate to interest rates. And I'd hope that maybe even now we'd begin to not offset or necessarily anticipate but to be aware of and guard against some of that and against excessive growth in the aggregates.

With that I would be quite happy with the numbers you have assigned to the aggregates. In the federal funds area, I'm perfectly agreeable still with the 4-1/2 to 5-1/4 numbers. But more than I've heard expressed otherwise, I'd want to lean a little bit more in the area of 4-3/4 to 4-7/8. And if we are indeed going to be moving in the area of 7 percent by the end of the year or early next year, I think that we might as well begin to gradually do that without a precipitous move.

CHAIRMAN BURNS. Thank you, Mr. Kimbrel. Mr. Mayo, we will hear from you.

MR. MAYO. Well, again, my remarks were made by Paul Volcker, to whom I give my thanks. I have the same reasoning that he has, apparently. Maybe it's because I'm holding in my hand the Federal Reserve Bank of New York pencil, which I apparently stole when I was there two weeks ago, and it must have some effect.

But, anyway, in the precision, I'm slightly different, I guess. I wouldn't care to move below 4 to 8 for M1. I think I would want to move down from the 5 to 9 because I'm also concerned about getting closer, not precisely, but getting closer to a bracketing of our long-term range. Particularly since the last two meetings, we've skidded along fairly close to the very low end of that range. And I don't want to give the appearance here of as significant a change in our short-term target as going 3 to 7, 5 to 9 would indicate.

This may be imagery, but I think it is still of some significance. I would prefer a 4-1/4 to 5-1/4, Mr. Chairman, for the range, just raising the upper end of the fed funds range a little. But I don't think I would tamper with the 4-5/8 to 4-3/4 as the inner range at this point. That is all.

CHAIRMAN BURNS. Thank you, Mr. Mayo. Mr. Guffey.

MR. GUFFEY. Mr. Mayo has said what I would like to say, in the sense that the range that has been stated [for M1], 4-1/2 to 8-1/2, is satisfactory and probably more consistent with our staff projections of what may happen in the remainder of March on into April. But more importantly, with respect to the federal funds rate, we would opt for 4-1/4 to 5-1/4, increasing the upper side of that [a] quarter, making the midpoint 4-3/4, with the hope that we would stay in the fuzzy range through most of the period and, again at this time next month, that we would end up at 4-3/4. And essentially taking a very little bite [out] of what perhaps we may have to do in the May and June area, perhaps into July and the period ahead.

CHAIRMAN BURNS. Thank you, Mr. Guffey. Mr. Baughman now, please.

MR. BAUGHMAN. Mr. Chairman, I am in agreement with what you have suggested. I have to admit I had jotted down 4 to 8 for a range on M1, as compared to 4-1/2 to 8-1/2, but obviously that's a very small difference. I see no need to change the range on the federal funds at this time. I am sympathetic, however, to Mr. Eastburn's suggestion that it might be appropriate to widen the inside of the range somewhat. Generally speaking, it seems to me it's a period for standing pat. With respect to the form of the directive, I'd be inclined to favor the aggregates directive rather than money market conditions.

CHAIRMAN BURNS. Thank you, Mr. Baughman. Mr. Partee next, please.

MR. PARTEE. Well, Mr. Chairman, I'm in a quandary, really, which I guess results in my being agreeable to your suggestion. I do think strongly that our problem in the months to come is going to be overly large monetary aggregates growth and that we're going to have deal increasingly with rising interest rates as a prevalent thing to cope with.

But on the other hand, up to now, we would have to say the aggregates have fallen short, or at least that they've been on the low side. In particular, in January and February, for example, M1 was 3.1 percent, Paul ,well below the lower end of the long-run range. And on M2, although I never thought that we were going to any place close to the bottom, it's only 7.9 for the two months, which is getting down in the lower half of the range. And, of course, February was more pronounced in both of those, in terms of a shortfall, than the January-February average. And so it just seems to me we don't have the financial indicators that would permit us in good conscience to take a step toward somewhat tighter conditions at this moment.

Likewise, I'm nervous about M1. Not understanding why February was so low, but just being given an explanation by Steve Axilrod, it occurs to me that there may have been some kind of a temporary inducement to go into RPs or federal funds, in lieu of cash balances, that might be reversed in this period immediately to come. So that, as [has] happened to us so often, a low month could be followed by a high month. There's a considerably erratic growth record in M1, and I think we may stand a risk of getting a rather high growth rate. I don't think I could accept going as high as Bob Black suggests for these two months--6 to 10 on M1--but I could accept either 5 to 9, which is the alternative B specification, or 4-1/2 to 8-1/2.

I think the most important point is that we should not go above the 5 percent funds rate without having a conscious redetermination that that's what we want to do. But I think the most important thing is to leave that funds rate range at 4-1/4 to 5, with the same fuzzy midpoint that we've had before. So I could accept either 5 to 9 or 4-1/2 to 8-1/2 for M1; M2 looks okay. But the most important thing is to leave the funds rate in that range until we have a solid demonstration that we ought to go above.

CHAIRMAN BURNS. Thank you, Mr. Partee. Mr. Wallich now, please.

MR. WALLICH. Well, it seems to me that we have a decision more of strategy than of economics here. The economics of the situation, for what my view on it is worth--we have shocks ahead. They come mostly from the monetary side, but to some extent inventory accumulation also from the real side. That counsels, broadly speaking, sticking with interest rates and letting the aggregates run.

But that argument, it seems to me, is dominated by broader considerations. In the medium run, we're going to have the prospect of rising interest rates. The earlier we face up to that, I think, the less that increase will have to be and the better off we are. We're quite well positioned to meet this. The aggregates have been slow, and we've accumulated some reserves, as it were, there. I think we ought to go on accumulating as long as we can until the bulge hits us.

And that leads me to suggest, first, pulling down the aggregates a little from alternative B, as you proposed, Mr. Chairman--4-1/2 to 8-1/2 for M1; 7 to 11 looks all right for M2; funds rate, I would widen a little on the up side, 4-1/4 to 5-1/4, and I would, over the period, suggest drifting up to 4-3/4 if nothing unexpected happens. And despite all this emphasis on the funds rate, I would stick with an aggregates directive, because in the days ahead I think it would be important to draw public attention, even with a lag, to the aggregates rather than to interest rates.

CHAIRMAN BURNS. Thank you, Mr. Wallich. Mr. Jackson now, please.

MR. JACKSON. Mr. Chairman, I just think that the underlying economic situation is stronger than the staff expects, and that the prospects for continued expansion are probably better than they estimate, although how materially is hard to anticipate, as much as it's hard to anticipate anything. It's my guess that we will see some increases in the public's demands despite our generally liquid position. For that reason, I'm inclined for strategy reasons to go ahead and remind the country that the central bank will be responsive to that need.

And while we have remained relatively static, almost mechanical, for the last couple of months, I think we ought to not lure the market or the country into thinking that we would continue to do so. And therefore, for strategy reasons as much as any other, I would be prepared to use a 4 to 8 [for M1] and a 6 to 10 [for M2], and a federal funds rate of 4-1/2 to 5-1/4, moving to the midpoint with deliberate speed even now, anticipating that it would have a generally salutary effect, even though it might be very small.

Unfortunately, I think the problem of our meeting today is that we're arguing over millimeters out of our universe, and it's somewhat foolish on our part, but at the same time, the market has gotten so sensitive to millimeters, I guess even those little tiny steps do have some psychological impact, and I think it's worth taking them.

CHAIRMAN BURNS. Thank you, Mr. Jackson. Mr. Winn is after you.

MR. WINN. Mr. Chairman, have we got too short of a horizon in our view today? How do we face the blip in terms of the tax [rebate] on M1? And coinciding with an underlying thrust, we may not get the decline after we get the blip because the economic situation may counter the normal sort of a decline in M1 that we're thinking about? On the other hand, to just be ignoring the blip--if it goes up, we lose the rate, and we have to lower them, and it's a bad signal. And so what I'm concerned about is [whether] we're not shutting ourselves off in our thinking in terms of just the April deadline here, in terms of our forecast.

On the other hand, raising the question, I don't have a very good answer as to what we ought to do on the longer horizon. But I'm just thinking in terms of the strategic sort of a move as to where you go on this sort of a thing. It seems to me we've got an awful short horizon here in terms of policy.

Now, do we ignore the blip, and then we make the adjustment? And if you do that, and you take the rate spread we've got, in the last half of the year, an awful big rate rise to accomplish in a very short period of time.

CHAIRMAN BURNS. Well, as far as the bump in the money supply is concerned, I think we will have to make our estimates. They could be wrong, and we should accommodate the bump that we estimate. Then if it turns out that the rate of growth greatly exceeds our estimate, we will have to recognize that and counter it, but if it's within the range of our estimate, we ought to leave it alone. And we can always make mistakes. Now take our figure for M1 for the month of February, we started out with an estimate of--how much, Steve?

MR. AXILROD. 6-1/2.

CHAIRMAN BURNS. All right, 6-1/2--we're down to 8/10 of 1 percent. Well, we made a mistake in 1975. I think we should be a little more careful this time than we were in 1975 and not take our staff projections quite as literally as we tended to at that time. But apart from that, if the figures come in very much above our estimate, we'll have to deal with it and recognize it. I don't see what else we can do.

I do think that, in view of the uncertainties--and I think Mr. Eastburn expressed that very well--we ought to be very cautious about any anticipatory movement that we make. And we're capable of responding--and responding quite promptly--without anticipating these very short-run adjustments.

Well, there's one other point that I have not mentioned before, but I think it's something on the side of strategy that is of importance to my mind. We've had a period of virtual stability in the federal funds rate for some three months. We didn't plan it that way. And we were ready to move one way or another depending on how the aggregates came in. But in view of the behavior of the aggregates, the Desk did not move at all appreciably. Now I think this three-month experience has proved most instructive, and it has helped me enormously in dealing with members of the Congress and others. Now there's only one interest rate over which we have a high degree of influence, and that is the federal funds rate. That rate for some three months has been virtually constant. In the meantime, our other interest rates, short-term rates, market rates, and, more particularly, longer-term interest rates, have moved up, and moved up very appreciably. Well, now, the Federal Reserve has not played any role, except in so far as the market may have expected us to continue moving down, as we were for a time, and we stopped doing so. And the response of market rates has been greatest in the particular maturities where the Treasury has concentrated its borrowing, and that has spread out over the medium-term and long-term market.

And the very fact that the one interest rate that we virtually control has stood still for three months, while other market interest rates have shown very considerable movement, has served a very important educational purpose in my dealing with members of Congress who think that we control interest rates. The *New York Times* thinks that; many people think that; but we don't.

So this is a consideration in my own mind--there ought to be a clear reason for moving, and if there isn't, since what we're talking about are minute changes, really, I'd be inclined to stay with pretty much where we are on the federal funds rate. And we still have a range to move down or move up [in], depending on the behavior of the aggregates. We'll, I've talked too long. Mr. Balles, please.

MR. BALLES. Mr. Chairman, I think a good deal of public reaction and psychology in the market place will probably depend on your follow-on remarks and how we will handle this bulge in the Ms because of the rebates. You had some very interesting things to say about that in recent testimony, about how we had learned some lessons and probably could improve on our performance. And I think a great deal of reaction in markets will depend, perhaps, on how you are going to testify on this the next time around, whether this will be May and--

CHAIRMAN BURNS. The next time around will be next week. And the Senate Budget Committee wants to go into these very questions, very closely. And the testimony I think will deal with that--that is, the prepared statement, quite apart from the oral questioning, which is going to be intensive in this area. And it may be a good thing.

MR. BALLES. I think that would clear the air quite a bit, and particularly if it came through that, for the year as a whole, unless we see some significantly different change in the business outlook than we do now, we would probably end up within the ranges that we heretofore specified, the 12-month ranges.

If that point got across loud and clear; and if the country pretty well understood that this bulge--if it occurs, say, in the magnitude that Steve's talked about in the second quarter--would be offset in the third quarter, and [if it was understood that] for the year as a whole we didn't expect to accelerate the rate of monetary growth, I think that would be a healthy dampening influence on inflationary expectations. That, in my mind, is the key to how the market's going to react to our moves.

In getting down to the immediate situation, I would be prepared to accept your specifications, with the further proviso that we might--if the acceleration begins in the Ms during the March-April period, as Steve thinks it will--begin to lean against it a little bit by moving up fairly quickly to that 4-3/4 upper end of this fuzzy midpoint range. If we don't move a little bit now, we'll have to move much faster later on in a rather precipitous upward movement, and that has bothered a number of people around the table, and it would bother me, too.

CHAIRMAN BURNS. Thank you, Mr. Balles. As far as public psychology is concerned, I just want to add one more observation. There was a feeling, rather widespread within the Congress, at least, that we deliberately set out to frustrate the will of the Congress in connection with the tax rebates in 1975. And I think that this is a question that I will have to address very specifically before that committee. Mr. Morris now, please.

MR. MORRIS. Well, Mr. Chairman, I would accept your specifications, and I also agree with you that our actions in the coming months ought to be in response to the facts as they come in and not in anticipation that the projections will be realized. I think, in general, this Committee has functioned better when it moved on the basis of the facts coming in than when it moved on the basis of projections. I think of 1968 and 1972, two years where we got in trouble because we acted not on the basis of facts coming in but on the basis of projections which proved to be incorrect. So I think as a general strategy matter, the course you recommended is one that I would accept.

CHAIRMAN BURNS. Thank you, Mr. Morris. Mr. Lilly now, please.

MR. LILLY. Well, I'm somewhat more bullish than the staff. However, I agree with your ranges for M1 and M2. I would like to repeat what I said last month; if I can see the outer limits [for the federal funds rate] from 4-1/4 to 5-1/4, it's just that it is easier to get that 5-1/4 in there now than it will be a month from now. I like the 4-5/8 to 4-3/4 midpoint.

CHAIRMAN BURNS. Thank you, Mr. Lilly. And we haven't heard from several members of our family. Who would like to speak next? Yes, Mr. Van Nice, please.

MR. VAN NICE. I think I share Mr. Balles' concern as to what our long-range targets are going to be. I could comment more wisely on our short-range targets if I knew what's going to happen perhaps next month, when you review the long-range target. We had a shortfall in the aggregates in the first quarter of the year, particularly in M1, and if we're going to make up that shortfall, perhaps the second quarter is the best time to do it. We might be in a better position to make it up this time than later on in the year.

And that would seem to argue, really, for alternative A. Instead of worrying about the shortfall in the first quarter of the year--I don't happen to be worried about that, and I think the Committee in its wisdom possibly may even lower the long-range targets next month, when I probably won't be here. And so I guess I would go along with either alternative B or alternative C.

CHAIRMAN BURNS. Thank you, Mr. Van Nice. And we'll hear from Mr. Gardner next.

MR. GARDNER. Well, gentlemen, I'm pleased with many of the perceptions that have been expressed, and I particularly want to identify with Mr. Morris's view that we do better when we don't deal with our expectations but we deal with what our current knowledge is. And I have nothing, really, to add to the discussion, because I synthesize it into some accord on the 4-1/2 to 8-1/2 range for M1, and 7 to 11 on M2.

I want to point out that M2 has been living a reasonably happy life for many months. M2 has grown consistently, I think, based on a pattern of rates and structure that will begin to change. We've seen some falloff now in the competitive nature of savings, and I expect to see more of it. While I've never understood M1, I think if we can exclude M1 from M2, I think I can understand the residue called M2. We're going to have probably some slower growth in M2 for a variety of reasons in the competitive world.

On the other hand--well not on the other hand, but as we get down to a federal funds range, I'm perfectly happy with the inner range. I think it's desirable and wise. And I see no harm in adding 1/4 to the upper limit of that range, because, I don't know, Frank, whether it's my expectations or absolute assurance that there is going to be a rise in the federal funds rate sometime this year. And I see no harm in expanding that a little bit for the comfort that we may gain philosophically from, in a sense, believing we are preparing modestly for the future, and that preparation would probably be inadequate. So I wouldn't find anything wrong with keeping the inner range and adding 1/4, and many people have spoken to that possibility about our outer limits of the federal funds rate.

CHAIRMAN BURNS. Thank you, Mr. Gardner. Mr. Roos, would you like to speak now?

MR. ROOS. Well, I have nothing of value to add other than to say that I'm fully agreeable with 4-1/2 to 8-1/2 for M1; 7 to 11 on M2; and perhaps the upper limit of the fed funds rate placed at 5-1/4.

CHAIRMAN BURNS. Thank you, Mr. Roos. Well, then, I think that on the basis of the opinions that have been conveyed by members of the [Committee], I'm quite ready to make a recommendation to the Committee for a vote, which I think will express the consensus pretty closely. Such differences as exist among us are very minor. And very few members of the Committee have expressed a view on the language of the directive, but I would assume we are not going to depart at all appreciably from our decision last month that the monetary aggregates directive should be retained.

And therefore, I suggest that we vote on the following: monetary aggregates directive; an M1 rate of growth of 4-1/2 to 8-1/2; an M2 range of 7 to 11 percent; a federal funds range of 4-1/4 to 5-1/4 percent, but with a midpoint of 4-5/8 to 4-3/4, where we happen to be at the present time. Now if there is no dissent or no comment, and I hear none, I'll ask the Secretary to call the roll.

MR. BROIDA.

Chairman Burns	Yes
Vice Chairman Volcker	Yes
Governor Coldwell	Yes

Governor Gardner	Yes
President Guffey	Yes
Governor Jackson	Yes
Governor Lilly	Yes
President Mayo	Yes
President Morris	Yes
Governor Partee	Yes
President Roos	Yes
Governor Wallich	Yes

Unanimous.

CHAIRMAN BURNS. All right. Then we have a few matters of business that we need to take up, and let us turn to item 9 on the agenda, which deals with the authority of the Desk to lend securities from our account. Mr. Sternlight, would you good enough to comment on--

MR. STERNLIGHT. I'll comment very briefly as indicated in the March 4 memorandum, Mr. Chairman. The [System Open Market] Account Manager continues to find the lending program reasonably necessary to the effective functioning of the government securities market and, hence, to our open market operations. The dollar volume of lending was up in the past year but much less than in proportion to total trading activity in the market.

Without system lending in securities, we believe the fail situation could have been much worse in the past year, and the market would not have functioned as well. The System's charge for lending, which exceeds the charge set by other lenders, far more than covers our costs. For the [Federal Reserve Bank of] New York, earnings from lending securities last year were nearly $2 million. Our expenses attributable to lending are estimated at something less than 10 percent of that figure. That's all I have.

CHAIRMAN BURNS. Any comment? Any dissent from the recommendation?

MR. PARTEE. Is it true that you need to find this reasonably necessary to the functioning on the market account? Can you do that in good conscience with the volume of governments that are outstanding now?

MR. STERNLIGHT. Given that we have a charge that's double what other lenders are charging and that people are coming to us, we believe that the fail situation would be materially worse if our lending program was not there. So I think we can reach that conclusion.

CHAIRMAN BURNS. All right, any other comment? Any objection to permitting the Desk to function as it has been functioning in this area? I hear none.

Let's turn to item 11 on the agenda, the Authorization for [Domestic Open Market] Operations. No changes are being proposed by the staff. Do members of the Committee wish to propose any change? Apparently not.

Let us proceed then to item 12, and there we need to review, once again, certain authorizations. First, the Authorization for Foreign Currency Operations; next, the Foreign

Currency Directive; and next, the Procedural Instructions. And I hope that is clear. And finally, a special authorization which I hope is superlatively clear.

Now, the first question, do members of the Committee seek clarification of these categories to just what is involved? I hear no such requests. No changes proposed by the staff. Do members of the Committee wish to propose a change or raise any questions? The members of the Committee are singularly acquiescent on these matters, which must mean that we're doing things just right.

And we have finally an item that I was hoping we would never get to, but the hour permits it. But if we can't solve this problem in the next ten minutes, I suggest that we postpone further deliberations on it. And that's the report of the Subcommittee on Bankers' Acceptances. That report has been made available. And Governor Gardner is prepared to advise us.

MR. GARDNER. Mr. Chairman, the [sub]committee--a well-balanced group--met and discussed the issues which are fully set forth in the memorandum. I hope everyone has had a chance to read it. If you have, you know it's the [sub]committee's conclusion that the Desk continue to use repurchase agreements in bankers' acceptances, which is a useful and important tool.

Point number two, that the Desk will allow its direct holdings of acceptances--which are now at about $175 million and have been much reduced from the peak in the past, when we were up near 3/4 billion dollars--to run off and no longer engage in direct purchases of bankers' acceptances from the accepting bank. If someone wishes to discuss the issues, they're on pages 4 and 5, the arguments for and against.

I want to assure you there was a full and complete discussion [within] the [sub]committee. There remain--we can go back to that in a moment--but there remain two or three other items. If the Committee does approve the recommendation before it, there is a question about how we treat the present authorization to the Desk. The [sub]committee felt in the majority that they would leave the authorization in place for direct purchases up to $100 million--not practice or use that authority routinely, but have it available for exceptional developments. One member of the [sub]committee, President Eastburn, felt we should remove entirely that authorization and retain only the language that pertains to the repurchase process, which is contemplated by the [sub]committee's original recommendation.

The majority of the [sub]committee then is recommending that we continue to use repurchase agreements on bankers' acceptances; that we allow our outright portfolio to run off, which it is presently in the process of doing; that we leave the authorization in place for emergencies or exceptional developments; and finally, that there should be some form of public release, if the Desk is no longer the direct buyer of acceptances.

Lastly, there was some discussion about the quality of acceptances. The Desk has generally followed the practice of treating what the market considers prime to be prime and to deal only in prime acceptances. Of course, by the workings of our own intimate knowledge of the banking system, we may often have some different perceptions about what is a prime name, based on examinations and supervisory information. It was the general feeling of the

[sub]committee that we should follow in good conscience the normal workings of the prime mechanism in the market place, not deal in what the market classifies as nonprime, and very rarely, if ever, use our special knowledge of an individual bank's condition to question the use of its acceptance or the purchase or repurchase agreement for its acceptance.

And that's a general statement of the issues, Mr. Chairman, and the [sub]committee's recommendation to the FOMC.

CHAIRMAN BURNS. Well, thank you very much for your report and for the work that you've done in connection with it. Does the Committee want to discuss? There are several recommendations, Mr. Kimbrel you have a--

MR. KIMBREL. Just a question, Mr. Chairman. Timing really must have come into the discussion--with these exceptional cases or delicate banking structure--that you resolved to your own satisfaction.

MR. GARDNER. I think we did, Monroe, basically by the majority view that we no longer would purchase directly because, when we use the repurchase agreement, we have an additional point in strength. And therefore, the issue to which I think you're alluding would probably be of minimal importance.

CHAIRMAN BURNS. Mr. Mayo, please, and then Mr. Coldwell.

MR. MAYO. I note at the bottom of page 1 of the report of the subcommittee that one member of the subcommittee, namely Governor Gardner, favored continuation of outright System operations within recent limits and so forth. I find myself somewhat sympathetic to that point of view--although there are no reasons as such given in the footnote--for a reason that doesn't appear really in the memorandum anywhere. We have in Chicago a development, which is still in its infancy, to encourage the development of a bankers' acceptances market in Chicago which would be, in some phases at least, independent of the market in New York; maybe independent isn't the right word, but it would be able to stand on its own feet. Our banks feel that there are certain advantages in this in terms of physical transfer of bankers' acceptances, which, of course, are trade-related, and we have a great deal of international trade going out of Chicago, and it's growing.

The main reason that I can remember that we encouraged the continuation of the bankers' acceptances operation at the Fed earlier was to in effect nurture a market which hadn't developed as well as perhaps we thought it might develop. Maybe that is true in New York. It hasn't developed as well as I think it should in Chicago, and there may be other centers, such as, for instance, San Francisco, where this sort of development might be on the horizon.

Adoption of the subcommittee's report, I realize, does not close the door on the possibility that there might be some way in which the Federal Reserve Banks, in areas where a bankers' acceptances market is developing in the future, could participate in that. But I am inclined to think that it would be easier to do it under the adoption of Steve's favored plan here, rather than the plan as recommended by the full subcommittee.

MR. GARDNER. Well, I can only say, Bob, that the [sub]committee did not address the implications of an incipient growth of regional new markets of acceptances. Perhaps we were over-awed by the size of New York, and the fact is, we didn't think of your particular point as we deliberated.

CHAIRMAN BURNS. Mr. Coldwell, please.

MR. COLDWELL. Mr. Chairman, I found myself perfectly compatible with the majority's recommendations on this matter. I think it does leave--with the intention of the authority that's in the directive--the possibility of reopening. I would not be too sympathetic with the idea of using the Open Market Desk as a means of fostering regional markets. I think we could get into some problems there, but with that caveat, I'm perfectly happy with the results of the subcommittee.

CHAIRMAN BURNS. I have no difficulty with the report of the [sub]committee, but I do have a question on one point, and that is, let me read paragraph [unintelligible] on page 8 of the [sub]committee's report. "The FOMC also may want to consider the term prime as applied to acceptances described in the Authorization for Domestic Open Market Operations. In the view of the account management, with which we would concur, the Desk should be guided by prudent investment principles and credit standards." So far, so good; I have no question.

But then I do have a question about what follows: "but should not feel obliged to automatically refuse to execute a repurchase agreement against the bank's acceptance because it received some information which may raise a question about the financial stature of the accepting bank." And then it goes on, "the word prime should be used to describe acceptances of banks which are known to have confidence in the field of acceptance financing and acceptances which have established a reputation for freely trading in the market." I think that there's a touch of ambiguity here. I may be visualizing a difficulty that doesn't exist. I think the Desk ought to accept the judgment of the market.

MR. PARTEE. That's what this says.

CHAIRMAN BURNS. Well, it's not the way I interpreted Mr. Gardner's--Mr. Gardner left an opening for the Desk to use its judgment.

MR. GARDNER. Well, I'd hope not to give the implication that there isn't--the opening that I believe should exist, Mr. Chairman, is the fact that we were buying Franklin National's bankers' acceptances too close to the day that Franklin National became a problem. Now, I shouldn't be talking about what the Desk was doing at a period of time when I wasn't here.

Nevertheless, the purpose of the paragraph was to mean that we may classify in our own examination process some major banks who have perfect confidence in the acceptance market and general marketability--we may find some problems in those banks as we look over their day-to-day operations. The Desk should be guided, in our view, by the market's perception. Of course, there could be a case where a major bank or an accepting bank is beyond repair. And in such case, I think the Desk would have some difficulty. And that's the only opening I meant--

CHAIRMAN BURNS. But at that point the Desk--here is my warning--the Desk should not act on its authority.

MR. GARDNER. I agree.

CHAIRMAN BURNS. If there is a question that the Desk has about a particular bank, then before it takes any action which deviates from market judgment, it should consult promptly with the Committee. Unless that is done--unless there is such consultation, the possibility of real trouble--

MR. PARTEE. That's one of the major issues. You see, if you're buying outright and you have knowledge, why then you are in a conflict-of-interest sort of situation.

CHAIRMAN BURNS. I know. I think that's good.

MR. PARTEE. If you're dealing in RPs, it's a financing mechanism. It seems to me you can very readily just take the market's judgment for the collateral you accept for the RPs. That's one of the reasons I supported the majority view of the [sub]committee rather than Governor Gardner's view.

CHAIRMAN BURNS. Any other question or comment? Yes, Mr. Volcker.

VICE CHAIRMAN VOLCKER. Just very briefly, Mr. Chairman. I don't feel strongly about this issue. I get a little nostalgic about this long tradition of the acceptance market that the System explicitly nurtured, and it's in the law. On the other hand, there's an element of artificiality at this point when we operate the way we do, and here's this credit problem. But I do think it's wise to keep in the authorization and at least bow out in easy steps and continue to do the repurchase agreements thing.

CHAIRMAN BURNS. Well, I sense an attitude of acceptance of the subcommittee's report. Am I interpreting the Committee's thinking correctly? Well, we can take a formal vote. Any dissent? There is none. Then the Committee's unanimous. And we haven't done badly. It's only 5 minutes after one.

END OF MEETING