TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

September 20, 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

9/20/77

Meeting of Federal Open Market Committee

September 20, 1977

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, September 20, 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, Kimbrel, and Willes, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and Minneapolis, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Axilrod, Economist
Messrs. Balbach, T. Davis, Eisenmenger, Ettin, Kichline, Reynolds, Scheld, and Truman, 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
Miss Klaput, Open Market Secretariat, Board of Governors

Messrs. J. Davis and Parthemos, Senior Vice Presidents, Federal Reserve Banks of Cleveland and Richmond, respectively
Messrs. Brandt, Burns, Fousek, Kaminow, and Keran, Vice Presidents, Federal Reserve Banks of Atlanta, Dallas, New York, Philadelphia, and San Francisco, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Ms. Clarkin, Securities Trading Officer, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
September 20, 1977

CHAIRMAN BURNS. Well, the first item on the agenda is perennial--the minutes of the last meeting. Any motion to approve?

SPEAKER(?). So move.

SPEAKER(?). Seconded.

CHAIRMAN BURNS. All right, we've had a motion to approve the minutes; no objection has been registered. We will proceed with the foreign currency operations. Yes, Alan, please proceed.

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

CHAIRMAN BURNS. What is the total now, Alan?

MR. HOLMES. It's something on the order of $670 million.

CHAIRMAN BURNS. All right, thank you. Any questions? Yes, Mr. Wallich.

MR. WALLICH. Didn't the Bank of England operate through its own channels in the New York market when it was doing this heavy buying?

MR. HOLMES. Yes, quite heavily. They bought a large amount of coupon issues, and they did that through the market using a number of dealers and banks in New York.

MR. PARDEE. Are you talking about foreign exchange?

MR. WALLICH. I meant foreign exchange--and whatever they put it into.

MR. PARDEE. Yes, they do operate in the New York market.

MR. WALLICH. Does the Desk know what they do?

MR. PARDEE. Yes, we call them, and they inform us if there is any extra on the next day.

MR. WALLICH. Thank you.

CHAIRMAN BURNS. Any other question at this time? Very well, a motion to approve the transactions of the foreign Desk is now in order.

SPEAKER(?). So moved.

CHAIRMAN BURNS. A motion has been made.

MR. PARTEE. Seconded.

CHAIRMAN BURNS. And seconded [unintelligible] approved. Do you have any recommendations, Mr. Holmes?

MR. HOLMES. No, Mr. Chairman, with our regular agreement with the Swiss, we will have some Swiss franc debt coming due, but that's automatic--no recommendation is needed.

CHAIRMAN BURNS. Very well. Mr. Kichline, please, we are ready for your report on the economy.

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

CHAIRMAN BURNS. Thank you, Mr. Kichline. Well, we're ready for the dialogue on the state of the economy. Who would like to speak first? Good, Mr. Baughman, please.

MR. BAUGHMAN. Mr. Chairman, as to the characterization of the economy, I don't have any basis for differing with what's been said. I thought I might just add a comment with respect to oil and gas activities, however. [They] continue to pick up and seem to be at about a practical capacity rate. Shortages of work crews in some areas and shortages of equipment [are] both putting upward price and cost pressures on those aspects of the picture.

CHAIRMAN BURNS. Are you speaking of exploratory activity or production?

MR. BAUGHMAN. Essentially, development of known deposits. And this is mostly low-grade stuff, in the sense that it's areas which [have] been tapped previously but [were] not economic to develop or exploit at the preexisting prices. And now they're going through the drilling wherever they have a reason to believe that, with the higher prices, they can more than cover their cost. And this is undoubtedly an important reason why, with the high level of drilling activity, we still see the figures on production and approved reserves drifting downward.

It's interesting that not only are the land-drilling rigs fully utilized, but there's been a sharp pickup in the use of rigs for off-shore exploration, even including those designed for deepwater drilling. There has been an increase in the total number of these available as a result of previously placed orders, [but] still, the number of idle rigs has dropped to a fairly small level at the present time. There is an experiment going on off the coast of Texas to adapt one of the deepwater rigs to use in shallow water, and it appears that that's going to work out successfully. And there is a report from firms in the District that manufacture drilling rigs that they are getting an increase in inflow of new orders, and they expect that activity to rise.

During the past week, I have come across--true, a fairly limited number, but still--several specific examples of individuals speculating in new houses. They acquire title to anywhere from three to six new houses, with the prospect of occupying only one or two themselves and the others being held for resale.

A matter of maybe not direct relevance to our consideration here, but it seems to be rather interesting--in a visit to a southwest Texas ranch area in recent days, I discovered for the first time the intensity of the feeling on the part of ranchers as to the activities of people to protect wildlife. This has resulted in such a buildup in the coyote and eagle population that it has gotten to a point where it determines whether they can afford to use cattle or sheep to harvest grass. I'm advised that, at the present price relationships, they could realize more in many areas [by] using sheep to harvest the sparse growth of grass, but because of the greater exposure to the predators, they have to go with the secondary use, namely cattle.

On the inflow of Mexicans, it's reported, as it has been elsewhere, that there has been a substantial pickup following the President's announced program. And I don't pick up any indication of any consensus of view as to what a workable solution to that problem might be--a great variety of views.

CHAIRMAN BURNS. Thank you, Mr. Baughman. Mr. Black, may we hear from you?

MR. BLACK. I continue to be concerned about this weakness in net exports that we're projecting, and I wonder if I might ask Mr. Kichline if we are wrong in our estimates of the growth that we expect to have in Europe and Japan. Say we've underestimated it by maybe 1 percent or so--would that be enough to have any appreciable effect on that sector and GNP?

MR. KICHLINE. I would prefer it if we could hear from Mr. Truman, who is much more familiar with the net exports. I think that is an important influence, but perhaps he has a comment.

MR. TRUMAN. In answer to your specific question, our investigation of historical relationships would suggest that a 1 percent increase in the growth of our major industrial countries--not just western Europe and Canada [but] Japan as well--would add about $3 billion to $4 billion to our trade position.

CHAIRMAN BURNS. Any other comments, Mr. Black?

MR. BLACK. That's all I have.

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

MR. COLDWELL. Jim, let me ask three or four questions here, and comment, if you wouldn't mind. Your briefing indicated that you believe consumers still have capacity to materially add to debt. I would like to hear your rationale on that.

MR. KICHLINE. Debt burdens as measured in a variety of ways relative to disposable personal income have gone up a good deal. And they're at reasonably high levels, cyclically. However, much of this has been attributable to mortgage debt, which is of a long-term character, and I think when we've looked at the various relationships, we've been reasonably convinced that--assuming real growth in the economy of something like 4 to 5 percent over the next year, year and a half--sufficient disposable income would be generated so that the increase in debt burdens on current levels would be only marginal.

In the consumer installment area, there too, there's been some lengthening of debt burdens, particularly because of the longer contracts for autos. But since March, we've had increases in consumer installment debt that have fallen short of what was a very high March level-- down in

April, down in May, down in June--and July was about the same as in June. So that, in the context of our projection, once again, we think that consumers will be less aggressive to some extent in acquiring durable goods, [and] given good growth in disposable incomes, we don't think there'd be much of an increase in the debt burden relationship on current levels. But I think an important point to stress is that those debt burden levels could deteriorate quite rapidly if income grew very slowly for any extended period of time.

MR. COLDWELL. That's not your expectation?

MR. KICHLINE. That's not our expectation.

MR. COLDWELL. Second question is [regarding] your expectation on federal government expenditures. If I heard you correctly, you indicated some pickup in such expenditures and that the full-employment deficit would narrow significantly. Is that what you said?

MR. KICHLINE. That's correct. In the third and fourth quarter of this year, we have a pickup in the rate of spending, and the deficit this quarter was estimated at $12 billion on a full-employment basis; [the deficit] rises to $16 billion in the fourth quarter, then declines in each quarter of 1978, [and] reaches $2 billion in the final quarter of 1978. The most recent experience is that the shortfall, depending on how one measures that, is [now] deepening. In August, federal expenditures picked up a bit--part of this relates to the CCC [Commodity Credit Corporation] purchases. But throughout the account structure, [there] appears to be some pickup in the pace of spending, and we anticipate that will carry through into the fourth quarter.

MR. COLDWELL. Presuming that there will be no new major thrust of federal expenditures flowing into 1978.

MR. KICHLINE. That's right. Now, on an NIA [national income accounts] basis, we still have some grants to state and local governments that will be fed out. I might note that the Carter Administration budget outlays for fiscal 1978 were $463 billion; the concurrent resolution that was approved is, I think, at 459. And our outlays are about 456. So we assume some continuing shortfall in 1978, which perhaps may not materialize. But that's built into our forecasts and into the full-employment deficit numbers.

MR. MAYO. Full employment is still defined as around 4-1/2 percent?

MR. KICHLINE. Just checked; it's 4.86.

MR. MAYO. Oh, gee.

CHAIRMAN BURNS. Have you read Herbert Stein's recent article in the *Wall Street Journal*?

MR. KICHLINE. I'm familiar with it. The argument, I guess, is that full employment is something around 6-1/2, 7 percent.

CHAIRMAN BURNS. He argues we're in full employment now. What's wrong with that argument, if anything?

MR. KICHLINE. Well, I would rather turn it around and hear very clearly what the arguments are for supporting such a notion. I think that's extreme. Absolutely extreme.

CHAIRMAN BURNS. Well, you don't have to hear it; read that article.

MR. KICHLINE. Well, I'm not convinced. The arguments in part relate to the demographic factors involved in the composition of the labor force, the change in welfare programs, food stamps, and other things, the upward bias associated with the numbers--a whole host of arguments. When we've looked at some of those in our own analysis, we would clearly conclude that the unemployment rate, full-employment unemployment rate, is higher today than it was several years ago. [But] in no way is it close to 7.

MR. MAYO. But my point is less extreme than Herb's. Isn't 5-1/2, say, just to pick a figure, a much more reasonable figure than 4.86?

MR. KICHLINE. That's true, and I don't think we have any difficulty with that at all.

MR. MAYO. And that puts quite a different complexion on the figures that you would be using. You would be far short of a full-employment surplus if you adopted that.

MR. KICHLINE. Well, I would use the full-employment concept cautiously. I think what's much more important than the absolute size of the surplus or deficit is the movement in the deficit over time. And if you adopt a higher unemployment rate on a full-employment basis, then you have lower receipts and hence a larger deficit. But over five quarters, you would not change the movement from quarter to quarter; rather, we'd be talking about perhaps $30 billion instead of 15--moving to a $15 billion deficit as opposed to [moving from] 15 down to 2.

MR. MAYO. In other words, you have done the figures on something like the 5.

MR. KICHLINE. Right.

MR. MAYO. That's reassuring.

MR. BALLES. Jim, have you assumed a shortfall in the expenditures as estimated by the Administration in the July review? If I've interpreted the Greenbook correctly, you have an estimate of a shortfall, and I think it's around $10 billion. Is that about right?

MR. KICHLINE. That's right--you're talking about for fiscal '78?

MR. BALLES. Right.

MR. KICHLINE. It's about $10 billion in expenditures, and then we have interest payments, which are about $2-1/2 billion or so higher than that of the Administration's. Net, we're about, I think, $7-1/2 billion off.

MR. BALLES. I would like to make a quick comment on this, Mr. Chairman. As my staff [members] looked into the causes and the nature of these so-called shortfalls, [they] found out something that kind of surprised me. There have seldom, if ever, been shortfalls in expenditures if you start with the--say, in this case, the July--*Mid-Session Review*. The well-advertised shortfalls have come about during the course of the fiscal year; the Administration continues to up its forecast of what it's going to spend. So for that reason, we have some doubts as to whether there ought to be an allowance for a shortfall based on the Administration's July *Mid-Session Review*. In other words, we would assume that, in our particular way of looking at things, government expenditures in fiscal '78 might be as much as $10 billion higher than you've allowed, although we haven't taken into account this interest payment phenomenon.

MR. KICHLINE. This is a difficult area [in which] to compare notes verbally, since there are many concepts of what number you take and when and what you include. We have a different impression. I only would like to note that, if we're wrong in $455 [billion], I would think that we're probably better assuming something like 459. Which was the House, Senate concurrent resolution number, which is $4 billion or so short of the Administration's proposal. And the only other catch, of course, is that there are other federal programs that may be coming along that we haven't allowed for, some of which may come along sooner than later, such as in the tax reform area; the energy program, which is uncertain; and many other things. So I'd really hesitate to argue at this juncture on that point because my suspicion is that we've made adequate allowance for a shortfall, but if we're wrong, the odds are that it will be higher rather than lower in terms of outlays for fiscal '78.

MR. COLDWELL. I'd like to finish up one other thing, Mr. Chairman. I noticed no comment, Jim, on the impact of expectations. Have you factored this into your forecast?

MR. KICHLINE. Well, we have, we think--importantly in the investment area, and that's where we're particularly concerned. If we look at the fundamentals in a variety of ways and dispense with expectations, we tend to [estimate] a more rapid rate of growth of business investment outlays than we have in our projections. But we think expectations there are somewhat adverse, and business confidence generally has not been reestablished sufficiently to give you an investment boom.

We [also] factored in expectations on the consumer side. But I must say we're getting a bit concerned with the performance of the stock market. In our own analysis [of consumer spending], we believe that wealth plays an important role, and stock prices are not performing well, and if [this] were to persist for some time, we think [it] would damp consumption spending prospects. So we have it in mind, and implicitly in some areas it's built in.

CHAIRMAN BURNS. Let me ask--if you pay attention to the wealth factor, do you include in wealth the value of dwellings?

MR. KICHLINE. Yes.

CHAIRMAN BURNS. And doesn't that more than offset what has been happening in the stock market?

MR. KICHLINE. That’s right. As you can well imagine, it’s difficult to have a great deal of faith in the numbers that one cranks in on real property values, although they’re large. But in any event, the stock market is highly visible, and real property is not generally thought of as very highly liquid. There is some notion, too, that liquidity matters in this concept.

CHAIRMAN BURNS. Well, I was really thinking of a formal point only. Namely your econometric model. You did include the value of dwellings.

MR. KICHLINE. Yes, we do.

CHAIRMAN BURNS. Do you include the value of farm property?

MR. KICHLINE. As far as I know, we include, yes, all of that, and debt instruments as well, and equity values.

MR. MAYO. I would have expected, Jim, that you would have placed more weight on the effect of the stock market on capital spending plans than on personal consumption. Because the small man is out of the market. Granted that he has a psychological factor of watching the market go down, but I would have thought that you would have placed even more weight on the seriousness of the effect on the managers, not only of investment portfolios but also of capital spending plans [in] a deteriorating market.

MR. KICHLINE. I perhaps didn’t emphasize that enough. I did refer in my briefing to cost of capital. And what I had in mind there was both the cost of physical capital and the cost of capital implied by low equity values. I might note that there are a couple of ways in which we think that enters into the calculation. One is, as you had mentioned, in terms of expectation. Another is in terms of providing an incentive to acquire existing firms rather than reach out for new investment, and that activity has clearly been picking up this year.

MR. COLDWELL. Well, Jim, it’s a matter of interpretation and to some extent expectation, I guess. My net result, looking over the data, is a somewhat different pattern of GNP real growth than you have. I think you’re over-optimistic in the fourth quarter. And [will] perhaps be surprised a little bit with a higher rate--partly by expectations, partly by government expenditures--in the first half of next year. That’s all I have.

CHAIRMAN BURNS. All right, thank you, Mr. Coldwell. Mr. Eastburn, may we hear from you?

MR. EASTBURN. Thank you, Mr. Chairman. I reported, I guess about three meetings ago, about a meeting that we had of businessmen which produced a very pessimistic tone. We had another meeting last week, which Governor Lilly attended. And there, I think, they were considerably less pessimistic. It wasn’t actually bullish--I think this reflects the region in which we are operating--but I think indicates that despite a great deal of uncertainties, businessmen are feeling better about the outlook. As far as the projections for the economy are concerned, ours are quite similar to the Board’s staff, and we feel reasonably good about the outlook, as far as we can see it.

There is one difference that we have with the Board's projections. This is not a major one, but there is a difference in the assumption about the productivity increases that underlie forecasting. We're lower than you are, and we note that DRI and Wharton are closer to us than they are to you and that all three of us are closer to the recovery and the average recovery period. You might want to explain.

MR. KICHLINE. That comes out largely as a result of what's happened to man-hours in the past two months. Particularly in August, when man-hours declined roughly 1 percent. If you discount those man-hour figures somewhat, as we have, the only way you can get something like a 4-1/2 percent rate of real growth is if you get large gains in productivity, and also better profit performance, than you would otherwise. But productivity numbers have been jumping around a good deal, and they're difficult to make sense of, so I am not surprised by having a fairly large increase, as we do this quarter.

I'm more concerned about what has initiated the problem--mainly the man-hour side. And as I say, we discounted that. We did receive late yesterday a preliminary projection by the Commerce Department of the increase in GNP for the third quarter--the first number they come up with, and it's never published, is subject to substantial revision, but they have 5 percent real growth estimated--which seems to us clearly on the high side--and even larger implicit productivity gains. So they have discounted even more than we have the man-hour numbers. I suspect, though, that what our forecast hinges on importantly will be September performance, man-hours and production, and perhaps some revision of these man-hour numbers so that they are not so deeply negative.

CHAIRMAN BURNS. Perhaps I might comment at this time on the cloud that seems to surround our numbers. You may recall [that] last year we looked at successive quarterly figures of real GNP. The increases showed progressive diminution, and there was great concern toward the end of the year about the slowing of the economy and about the possible onset of a recession. And that of course gave rise to the expansionist program developed by the new Administration. Now what analysts at that time overlooked was the inventory adjustment that was under way in the economy. And real final sales showed continued strength. In other words, the basic movement of the economy did not show any deterioration.

And apparently a similar development is under way this year. If we look at the real GNP figures for successive quarters--the first quarter, an increase at an annual rate of 7.5 percent; second quarter, 6.2 percent; third quarter 5.0 percent estimated by the Commerce Department and 4.4 percent estimated by our staff. So you have a progressive diminution of rates of increase. But once again, if you look at final sales, again in real terms, you find an opposite picture. In the first quarter, rate of increase of 3.8 percent; in the second quarter, 5.1 percent; in the third quarter, 5.3 percent according to Commerce and 5.4 percent according to our staff.

And you know, one of the reasons for a dialogue such as we have is that we see the world differently. Each has his own pair of lenses; we look at different statistics. When I want to judge the underlying trend, I like to take inventory movement out of the picture. Now, of course, I don't forget about it.

There is one other statistical exercise that I had the staff engage in [over] the last few days. We see the world through seasonally adjusted figures, and the art of seasonal adjustment is highly imperfect. And I've been somewhat uneasy about the seasonal adjustment factors that have been applied to our unemployment series. I asked the staff to undertake some experiments. The seasonal adjustment factor seems to be distorted by very sharp cyclical movements that we had in 1974 and '75. And if you use the seasonal that was applied in 1973, the picture on unemployment, whether you looked at insured unemployment or total unemployment as reported by the Census Bureau, changes dramatically. And the deterioration that you see in the published figures vanishes. And I haven't had a chance to follow this up sufficiently, but the member of the staff who made this calculation told me that, using another seasonal calculation--a constant seasonal that covers the past 11 years--you get precisely the same results, as I understood it, that he obtained by using the 1973 seasonal.

Gentlemen, I'm not reporting the truth, I'm merely recording another way of looking at the facts in a search for truth. We'll move on to Mr. Wallich, please.

MR. WALLICH. Mr. Chairman, I thought your comments on final sales very well taken, because there is a difference now, and one has to bear that in mind. But overall, as I look at the change in our projection from here through the end of 1978, I am struck that for some one-year periods, mid-'77 to mid-'78, end-'77 to end-'78, there are pretty substantial reductions--in the first case, as much as 1/2 percentage point. If I look at the projections for final sales, they [increase], as you indicated, up to the third quarter; and then, however, from the fourth quarter on, with one exception, final sales are below GNP figures. So apparently they've been counting on some inventory accumulation more than would reflect the growth of inventories at the growth rate of the economy.

So my impression is also that we are at the high end of the spectrum of forecasts on GNP. Certainly that was the case some time ago. It may not be, now that we've pulled down our forecast, and I don't know whether other forecasters have pulled down theirs, but there has been a general tendency, I think, to pull down 1978 forecasts. I realize that this happens usually as a function of the latest quarter's events, and one extrapolates over time instead of considering the possibility that there may be an inventory oscillation in it.

I'm concerned about the very low reduction in unemployment that our projections show, even given the very modest increases in GNP over the years end-'77, end-'78--less than 1/2 percent. It looks as though Herb Stein was right--but I think, for people who are concerned about inflation to say that 7 percent unemployment is full employment is a little like people who are concerned about unemployment saying that 6 percent inflation is zero [inflation].

I am troubled by the outlook, and that is why, in my own thinking, I've concluded that we ought to move to some kind of incomes policy. This is not going to happen overnight, and so the fact that I argue for discussing it now doesn't mean that I think it would or should go into effect this year. But I do think that the data, the experience, so far show that the high unemployment doesn't bring inflation down. Our projections say that it doesn't have that effect, and I think that we could begin thinking about trying something else.

CHAIRMAN BURNS. All right. Mr. Morris next, please.

MR. MORRIS. Mr. Chairman, on this business of full employment, I tend to define where we are in terms of the unemployment rate for married men and for heads of households. And if you look at that, it suggests that we're about 1-1/2 percent from full employment, which means that full employment would be measured around Bob Mayo's 5-1/2 percent level because, with a decline of 1-1/2 percent, you'd have the unemployment rate for married men down to 2 percent and for heads of households down to 3 percent. And I think, historically, those levels have been associated with full employment.

On the forecast on the outlook, we still tend to be a little more pessimistic than the staff, and I think our difference lies primarily in the consumption sector. That is, we think it's improbable that automobile sales in '78 will exceed the '77 levels, which the staff has projected. It is true that, if you look at the relationship of installment credit to income, we are still well below the peaks reached in '73. But I think the current level of installment credit relative to income is extremely high relative to any other period. If you exclude the '73 period, that relationship is already very high. And whether, starting out from that point, we can sustain a further increase in automobile sales seems questionable to me.

And the other factor we're giving some weight to is the one you mentioned earlier--the wealth effect, on consumption, of the decline in the stock market. And I think that while it may be quite appropriate to weigh in other types of wealth, such as land and real estate, I think our observation is that the impact of the stock market is disproportionately [large] in its effect on consumption [relative] to real property and that sort of thing because, for the reason you mentioned, Jim, people look upon stocks as being a liquid instrument, and they typically don't look upon real property in that sense. So, for the year beginning in the fourth quarter of '77, whereas Board staff is projecting a 4.7 [percent] real growth rate, we think it would be more probable, given our outlook on consumption, to have a figure of 4 to 4-1/4. So we're marginally more pessimistic.

CHAIRMAN BURNS. I'd like to comment, if I may, on what Mr. Morris has just said. First, one point where I basically agree--I think consumer credit is in a dangerous area, and I don't agree with Mr. Kichline one bit. I read the evidence quite differently. Secondly, the contrast between stock exchange securities and dwellings: There, I differ with both Mr. Kichline and--well, I think they're right, but I think they're exaggerating the difference. Dwellings have become a major source of liquidity for consumers; refinancing of mortgages is taking place on a very extensive scale. Second mortgages at high interest rates are being entered into extensively, and those who've engaged in this refinancing activity or getting the second mortgage, they talk to others, so that what used to be an illiquid item of wealth is increasingly taking on a liquidity dimension. And I think we ought to keep that in mind.

VICE CHAIRMAN VOLCKER. Let me just interject a question here, Mr. Chairman. I think it's true that the figures show mortgage outstandings going up very rapidly now, for the reasons you suggest. I'm just a little puzzled, and I don't know whether the staff would want to comment on it, as to whether this is basically a favorable or unfavorable factor? You're suggesting it may be favorable because the basic values are going up and therefore there's a lot of room to borrow.

CHAIRMAN BURNS. Well, favorable from one point of view, very unfavorable from another. But I wasn't commenting on that; I was merely commenting that it has taken on liquidity dimensions.

VICE CHAIRMAN VOLCKER. I don't think there's any question about that aspect. The question that puzzles me a little bit--I just pose it in the form of a question against the background of the consumer credit picture that exists--whether this is something we look to basically as a sustaining factor to the economy through the kind of forecast period you have, or a kind of danger signal, as something [sustaining] at the moment but, over the course of the next 12 months or more, might suggest that one element of support at present will be diminishing because people will have borrowed to the extent that the borrowing figure gets too high. It may be an unanswerable question. But do you have any comment on that?

MR. KICHLINE. Not much. I think it has mixed effects. Actually, in our forecast, we assume for 1978 that there will be less borrowing per start in given dollars than there is today, that we will be [cutting back] some of this withdrawal of equity from the housing market. In fact, that's implicit in our forecast, in a way, in which a relatively high level of starts continues to be financed even though deposit flows are shrinking, and we relied more heavily on the Federal Home Loan Banks; in part, it's a tighter posture on the part of lending institutions, squeezing out some of the refinancing.

Just one other comment, though, and that is that, if you think in terms of mortgage borrowing as a source of funds for other than housing finance, which it clearly has been, it's quite costly. And one, I think, has to properly connect that idea to the turnover of houses rather than thinking in terms of refinancing a mortgage regularly, or as a source of funds, because that is a very high-cost operation. So, in connection with high sales of existing homes and purchases of new homes, I think clearly, that's where the bulk of the extra funding is coming from--rather than thinking of housing as a liquid source of funds.

MR. JACKSON. I do think, Jim, though, that you're running into a situation--as I recall, in the California area, [according to] one of the banks that I talked to that was active in the second mortgage area, about 28 to 32 percent of the second mortgages extended were for the purpose of refinancing existing consumer debt, to reduce either the monthly payment burden or extend maturity or something like that. So we may be in a situation where you're having consumers contract debt to purchase automobiles on short term but are refinancing it on the 15- to 20-year [mortgage] plans. Now, unfortunately, though, I think we've run into the problem where much of this debt is still recorded as consumer installment debt on our consumer installment charts that you see at the end of the room, rather than real property debt, so I'm not sure that our figures are clear as to what's really going on, as being influenced by that other type of consumer credit.

MR. BAUGHMAN. Mr. Chairman, if I might just make a brief comment on this real estate situation. It seems to me that what we have going here in both the residential and the farm real estate picture is something more or less comparable to an inventory situation in the business sector. And when it's building up, it's a strong stimulative element, and it seems to me [to be] what we had in both these real estate markets in the last couple of years. And I think it's still expanding in the residential sector but probably getting ready to top out in the farm sector.

But so long as people expect that those prices are going to keep going up at a faster rate than it costs to carry, your demand for the property rises, and we see it in the farm real estate market and we see it in the multiple holdings of new houses, both completed and in process. Somewhere along the way, presumably, there is going to be a diminished number of people who want to be in the situation, and at that point, the supply relative to demand in the market is going to shift, and presumably you will get a topping out of the rising price, or maybe even a decline. And I don’t think it’s possible to predict the length of run of that sort of development.

CHAIRMAN BURNS. Mr. Gardner, please.

MR. GARDNER. I don’t know whether this will help or not, Jim, but I have some concern about your analysis that indicates that the credit demands aren’t likely to show much change over the balance of the year. I’m a fugitive from the crowding out theory. And as I look at this situation, I have to try to find the perspective that said that the economic shock to consumers and businessmen which ended in ’74 or early ’75 is now some ways away from us. It has given people faced with tenuous employment, debt accumulations, and businesses with heavy inventories a chance to reestablish their financial positions. And I think the majority of people in businesses have had enough time to reestablish their financial positions. So I have to look now at the attitudes and the propensity of people and businesses to incur indebtedness.

And if I first look at the demand side, I find strong consumer demand. I think your figures will show that. I find strong mortgage demand, and that’s been commented on extensively. And I think that indicates that there will be strength in consumer spending, both in major durables and automobiles. I don’t agree with you, Frank. I think there are some exciting new automobiles coming out. And we are locked into an energy crisis [that] will generally inspire people to attempt to buy cars that are not yet in the marketplace to obtain better mileage figures and prepare for the modern energy crisis. I find state and local governments having weathered one of the most serious crises in their history, beginning with a revelation that New York may go bankrupt, that Massachusetts credit may disappear in the marketplace, and so I think that offerings at the state and local level, or the needs to borrow there, may well continue.

I think the demand at businesses is something we should look at very carefully. The restructuring of balance sheets has clearly had plenty of time to go on. We used to have a seasonal in this country, and I’m not talking about an adjusted seasonal but a heavier demand for bank credits into the fall and through the Christmas season. And that seasonal has largely been absent for the last couple of years as inventory positions became a burden. And people dealt with those conditions as best they knew how, including, last year, probably not having enough goods on hand to meet the Christmas demand or the year-end demand and so forth.

So I think that farm credit, surely, Roger and others, is backed up, and there won’t be any diminution in the demand of farmers to borrow. I think we may see a stronger use of seasonal credit by businesses returning to a pattern that’s existed for two decades. I think capital expenditures, while obviously weak and obviously not being a major factor in recent years, may become more of a factor. When I look at all of the demand side from state and local government, consumers, individual businesses, and I don’t--

CHAIRMAN BURNS. Federal government--

MR. GARDNER. --federal government, I haven't mentioned that--I thought I was the fugitive from the crowding out theory. But nevertheless, I look at the demand side, and then I look at the supply side, and it's also true the banks are offering more competitive terms. They've had time also to deal with their internal problem. We see evidence of cap loans, we see evidence of fixed-rate loans. Now, I look at the money flowing in here from other countries, the money and competitiveness of foreign banks in the U.S. and foreign investment in the U.S. I look at the insurance companies and the pension funds and their propensity to find investments. And I find the condition in total that suggests to me, Jim, that I can't quite be comfortable with your idea that total credit demand is likely to show little net change over the balance of this year. In fact, using all of this evidence, I would come to the modest conclusion that we are going to see some expansion of credit.

MR. KICHLINE. I think perhaps we expressed our idea incorrectly. You are quite right. In fact, total credit demands in our forecast are rising in the second half of this year compared to the first half. But that is largely associated with the substantial increase in government borrowing. In our flow of funds forecast, for example--in the first half of this year we had total private credit demands of about $244 billion; we are forecasting about $252 billion in the second half of this year, which is an increase to date. So it's not much, you are right. For the balance of this year, we don't anticipate substantial increases. That comes about largely because of a reduced demand, in the forecast, by businesses for short-term funds, reflecting our downward revision of inventory investment and a stronger profit performance this quarter than we had in our forecast before.

And secondly, in our forecast we have consumer installment credit rising at about a $3 billion or $4 billion dollar annual rate less in the second half of this year than in the first half. As we go into 1978, however, our forecast calls for substantial increases in demands for credit by the private sector and a maintenance of quite high borrowing by the federal government, so you are ending this year on an upward path and going into 1978 with historically large demands for funds, and it requires that the households pick up some securities for these markets to clear. And associated with that process and in our forecast is some further increase in interest rates from current levels.

CHAIRMAN BURNS. All right, we will move on now to Mr. Partee. We will hear from you.

MR. PARTEE. Well, Mr. Chairman, I have a couple of comments. First, I'm very agreeable to your view of the current situation, that with the continued expansion in final purchases through the summer--and as far as I can see, right up to date--we don't have to be overly concerned about the signs of slowing of the economy that show in such things as output and employment. Probably a temporary thing. It might be [a] faulty seasonal or it might be that we are having, as you pointed out before, a little inventory correction of the sort that would occur repeatedly over this period. So I'm not nearly as concerned about a downturn in the economy as I was a year ago, when I think it was a more moot point, since retail sales were so weak at that time.

Therefore, the current situation, I think, is adequate. I thought Jim gave a very persuasive briefing, and I have difficulty in complaining about it or quarrelling with it, but of course that's our job, I think. And so I would--

CHAIRMAN BURNS. Except that I quarreled only with one point, his comment on consumer credit.

MR. PARTEE. Well, I was going to make the point about consumption generally. As I look at possibilities of the projection being too high, it seems to me that an awful lot is being asked of the consumer. If I understood you, Jim, you said you have a projected real increase in consumption of about 4-1/4 percent above the trend.

MR. KICHLINE. No--4-1/4 percent real increase over the next five quarters.

MR. PARTEE. And that's above the long-run trend.

MR. KICHLINE. Well, the longer-run trend is somewhere [between] 3-1/2 and 3-3/4 percent.

MR. PARTEE. It's a rather good performance in real consumption.

MR. KICHLINE. Oh, yes.

MR. WALLICH. Excuse me, 4-1/4 percent over an annual rate or--

MR. KICHLINE. Annual rate.

MR. WALLICH. Annual rate.

MR. PARTEE. Annual rate of 4-1/4. That's strikes me--as I recall [how] the last few years have been--a pretty good number following on what has been an unusual surge on durable goods purchases. I'm not so sure--I think I would be more inclined to agree with Frank than you, Steve. I think [we] probably won't repeat the current car year next year, partly because of the high level of consumer debt. Also, you have prices going up a little faster overall, and I presume for the consumer sector, so they are not only financing real purchases of goods but they are also financing larger inflation, and the saving rate is rising over the period. It seems to me an awful lot, somehow, to have more real consumption, more price inflation, and more personal saving altogether. The arithmetic, of course, checks out--that is, the income is there. But I would point out that if, of course, the consumption didn't occur, the income wouldn't be there, and the saving rate wouldn't necessarily be any higher. I'm a little troubled by the strengthening in the consumption sector.

I also note that exports seem to me to be rather strong. The increase I've just calculated from third [quarter] to third [quarter] is 13 percent in exports of goods and services, and there is a 6 percent inflation there. It's a real [rate] of about 7. My perception of the international economy is more like Alan's--that is, of considerable weakness--than it is like that of the staff here. So I suggest, perhaps, the exports wouldn't do as well as we had projected here.

On the other side, it seems to me that a possible area of greater strength than we foresee is business investment. Now you only have a 14 percent increase in BFI [business fixed investment] over the next year. With a considerable rate of inflation in there, it seems to me that if investment sentiment should [strengthen] as the economy improves or as people start to see the capacity limit being reached or as inflationary expectations increase, you could have more BFI than you had projected. And, finally, I think you could have more federal expenditures than you projected, particularly if the unemployment rate does as poorly as is projected here. I think there could be new programs beginning in the new Congress shortly after the first of the year that would cause a larger increase.

So what I come down to, I guess, is I can see reasons why the actual might be a little lower than projected. I can also see the possibility that it might be a little higher than projected, so I don't quarrel with it greatly. I think it's a dead-centrist position. I would, however, want to echo Governor Wallich. If this projection is realized, and you have a roughly 4-1/2 percent growth rate over the next five quarters, then at the end of that period the unemployment rate is still forecasted to be 6-1/2 percent, which is not full employment unless you are in the Herb Stein school. And the capacity utilization rates, although higher, are not uncomfortably high in either total manufacturing or in materials. So it seems to me we are talking about an expansion in this forecast which, if realized, is about minimally acceptable, but not more than minimally acceptable to the society, to the government as the government now looks at things.

CHAIRMAN BURNS. Thank you, Mr. Partee. Mr. Winn, please.

MR. WINN. Mr. Chairman, the two big uncertainties that hang over the forecast as far as I'm concerned are with respect to the energy bill and with respect to the tax bill. The unknowns in the energy bill have really held up major investments in transportation, mining, a whole series of activities that really would give a tremendous impact if they could be unleashed. The whole electric utility company construction [sector] has really kind of ground to a halt here. The bill seems to be deteriorating as it goes through. I get more questions about this in certain sectors.

And then the unknowns in terms of the tax bill really are showing up in investment decisions, both financial and real, and I don't have any idea when that's going to be clarified.

But those could be two major impacts to affect our projection. Some concreteness could be added to this, and I gather you haven't factored it into your fiscal projections or anything else in terms of looking ahead.

MR. KICHLINE. On the tax bill?

MR. WINN. Yes.

MR. KICHLINE. No, we have done nothing yet.

MR. WINN. And I haven't any idea how that's going to come out, but there's really more discussion of this in terms of the consumer sector, the capital gains area, and a stimulus for investment; and these are going to be major developments to affect the outlook.

The third thing I'd mention is the status of the steel industry. Business is really better than they talk about, in terms of their physical volume. [But] the profits are terribly poor. They are facing up to fact that they have a very obsolete plant. And yet funds to provide the investment, the incentive to provide the investments, and so on--now they are focusing completely on the import situation, but I really don't think that's addressing some of the basic problems they have. The threats of really major shutdowns in Youngstown, Cleveland, and other places are very real. And as you know, there have been substantial cutbacks in employment in this area. So the fact that the picture looks as good as it does [despite] some of these negative factors, I think is really an underlying source of strength.

CHAIRMAN BURNS. Thank you, Mr. Winn. Mr. Willes, please.

MR. WILLES. Thank you, Mr. Chairman, just one quick question and then two comments. Are you going to circulate that little analysis that was done on the seasonal adjustment of the unemployment rate?

CHAIRMAN BURNS. Yes, I will be glad to.

MR. WILLES. I would like to see it. I don't know if anyone else would. The two brief comments I would make are, first of all, the discussion relating to using property values as a form of liquidity. One area that I think has been misunderstood rather broadly is the area of using farm land as a source of liquidity. In our part of the country, we get in the press almost every other day a story of how awful it is that farm lending is going up so rapidly. And the fact of the matter is that they really are just taking what has become the greatest increase in their net worth--the value of their land--and converting that into tractors and new homes and swimming pools and other sorts of things.

And the debt-equity ratio for the farm sector as a whole has not changed one bit in spite of the tremendous increase in farm lending--the total value of farm land has gone up so much that the ratio has not changed. In fact it got to the point where, in Minnesota, they were going to have a little demonstration in favor of higher price supports, and so they went to the state capital and drove around the capitol in their tractors. And they were then going to drive to Washington, but they decided that their point might lose its value if they had a great big long string of brand new $50,000 tractors driving around the Capitol in Washington. And I think they are right. They have held up remarkably well in what's considered to be a disaster.

With regard to capital spending, one of our industrial directors made the comment that if he didn't listen to anybody else he would be very optimistic about what's going on. And so to follow that up, we had the leaders of all of the large corporations in the Twin Cities area in for lunch one day, [firms] like 3-M and Honeywell and Control Data and Toro and so on. And this story was very interesting; they universally spent the first half of the lunch complaining about all of the uncertainties--energy and taxes and everything else that they could think of that was wrong. And I was about ready to conclude that they weren't spending any money on anything, so I just asked them what their capital plans were, and the lowest increase in the group was 75 percent. Most of them hovered around a 100 percent increase in capital spending for the year ahead.

MR. PARTEE. 100 percent increase from the year passed?

MR. WILLES. A 100 percent increase from the year passed. Now interestingly enough, they all admitted that they were not building new physical facilities [and] that the kind of investment they were engaging in [was] new equipment, new ways of making their physical plant more productive. But they are looking at very large numbers. No, we don't have the steel and so on in Minneapolis. But we have a rather broad cross section of the rest of [industry], and I think if anything we may be pleasantly surprised by the amount of capital spending that we [will] see over the next year or 18 months.

CHAIRMAN BURNS. Well, you know, on a global basis, the successive surveys have been showing increases in the expected rate of increase in business capital spending. Now, the progression has had a modest upward slope, but it definitely has had the uniform upward slope. But what you say about Minnesota sounds as if Texas is going to take second place.

MR. WILLES. We are trying.

MR. LILLY. You have become converted.

MR. WILLES. It doesn't take long.

CHAIRMAN BURNS. Mr. Guffey.

MR. GUFFEY. Well, lest the euphoria about the agricultural sector get out of hand, I think it is important to note that the productive capacity of the agricultural sector has added nothing to the farmer's or the rancher's wealth--that the wealth in and of itself has come from the increase in land price. To be sure, some sales are taking place, [but] if [that increase is] real [it is] being absorbed to maintain liquidity of that sector of our economy, and [it is] really adding nothing to the wealth in terms of the new tractors as Mark has suggested [it has]. Those came two or three years ago following the Russian wheat sale. That sort of thing.

The soft part in our economy in the mid part of the country is indeed these agricultural areas, where, for example, the farm implement industry is having a rather sharp turndown [because] the farmers and ranchers are not able to replace [agricultural] equipment. My point is that that can go on only so long; you can rely for your liquidity needs on the increase in land prices only so long. If you don't have some contribution from what you are raising, then this will become increasingly worse. It is showing up again, as everybody around the table knows, in the bank loans. They are relying upon this increased land value. I don't like to throw total cold water, Mark, upon how you characterize [it], but I don't think we would share totally that euphoria.

MR. LILLY. You are only reflecting the differences in your crop structures. You have a very large wheat percentage in total agricultural output, whereas Mark has substantially less.

MR. GUFFEY. No, I think that's not true.

CHAIRMAN BURNS. Clarifying--this discussion has also served to clarify the distinction between the capital and the income. In terms of capital, many farmers have become millionaires recently. On the other hand, as far as income is concerned, income has been on the low side and declining. I think Mr. Guffey is right that scissors move. That inequality can't last forever. At one point, either income will rise to justify the capital value or capital values will go down. But it may take a long time before that happens.

MR. GUFFEY. Banks, though, and other sources of financial strength to the agricultural economy, could likely feel a real squeeze if things indeed did turn down in [the sense] that land value was not realized. And that, I think, is what we have more concern about.

MR. BLACK. Roger, has the appreciation of land prices caused a commensurate increase in taxes on farms?

MR. GUFFEY. I don't believe that the governmental units are quick enough to have picked it up yet, but certainly as those sales occur, then reassessments will be made, and taxes will increase. But it isn't something that's going to come tomorrow.

MR. BLACK. That's another part of the squeeze, to the extent that begins to happen.

MR. BALLES. These farmers that have become millionaires, I might hasten to add, it's on a before-tax basis. In Idaho, where my wife happens to have some relatives on a farming business, they are very concerned about how they are going to pass on their farm to the children after the death taxes. It appears they may have to liquidate a part of the landholding just to raise the cash to pay the taxes.

CHAIRMAN BURNS. That's right, but honestly, I don't know what is wrong with people. Why don't they enjoy it now? Mr. Balles, may we hear from you on your views on the economy, or any questions you may want to put to the staff.

MR. BALLES. I have several comments and several questions, Mr. Chairman. I think your point on real final sales being steadier than the GNP quarterly changes is a very good one. I draw one additional conclusion from that analysis, and that's that the trend of real final sales may in fact be a better guide to policy than the quarterly changes in GNP as a whole as long as we have these mini inventory cycles. And I conclude that we are experiencing another one this year quite similar to the one we had last year--a very strong first half and then a weaker second half largely because of inventories.

CHAIRMAN BURNS. Incidentally, the point is now being made about the so-called $50 rebate. If that had gone through, the inventory adjustment would have been all the sharper.

MR. BALLES. Exactly.

MR. COLDWELL. Maybe it's a good time to start thinking about it.

CHAIRMAN BURNS. To start thinking; not about that.

MR. COLDWELL. Something else, maybe.

MR. BALLES. As far as the outlook is concerned, our staff in San Francisco has a very similar view to that of the Board staff through, say, to the middle of '78, but as Frank Morris commented, we are somewhat less optimistic about the second half of '78 for much the same reasons that he cited--less optimistic about the strength of consumer spending and inventories in the second half. Having said that, I don't place an awful lot of faith in the accuracy of projections when we get into the second half of next year.

But I do want to make one comment generally in respect to the differences that may occur within the [Federal Reserve] System, of the [Federal Reserve] Board versus the [Federal Reserve] Banks in their forecasts. For some months, I have been noticing [among] our board of directors on the West Coast a phenomenon that I'm not sure how to explain. It's clear that, by and large, our business directors are showing less confidence than the business statistics would warrant. And whether it's because of the factors cited by Mr. Winn or what, I'm not sure--that is, the concern over the energy program, tax proposals, and all that sort of thing.

Whatever the cause, I think there's another element that's not yet been commented on but may be worth a question and a comment by Mr. Kichline and his staff. I assume that you monitor the forecasts of the leading private economists and their firms. Fairly recently I have noticed what is perhaps an unusual divergence of views among the private forecasters' fraternity versus the government, generally including the Federal Reserve. There are some outfits--not that I place any credence, particularly, in their views--such as Chase Econometrics or what have you--they are viewing a real stagnation if not outright recession for 1978. And I suspect that to some extent this is having an influence on the thinking of leading businessmen.

This came to my attention most recently just last week, when, in San Francisco, there was the quadrennial meeting of the International Industrial Conference, with CEOs present of many leading U.S. companies--indeed, leading companies around the world. And the U.S. heads of companies were considerably less optimistic in terms of the expected pace in the U.S. economy than our staff in the System, and the chief economist for the Conference Board was considerably more pessimistic, I might add, than our staff. And I was wondering, Jim, if you pursue this matter to the point of identifying the specific factors that lead to this divergence of views. Because whether we like it or not, the private forecasting fraternity does have some influence on the thinking of the heads of these companies, and hence on, oh, their general state of confidence or lack thereof.

MR. KICHLINE. We do look at them, not so much in terms of trying to form our own judgments but rather after the fact as a check to see where the differences occurred and what's happening. And as the point has been mentioned earlier, in the last two months or so, most private forecasters have been adjusting their forecasts downward. Our own forecast, I would judge, is at the high end of the range on real growth and at about the middle for price prospects, or perhaps a bit better than average on the price side. I have before me a selected group of the forecasters, but Chase, for example, has been very bearish for some time, and I would tend to discount that; they are talking about 1 percent real growth or so for next year. But it's quite clear that, for the end of next year, the Conference Board is around 3 percent, Argus 2 percent, DRI 3.2 percent, and so in this 2-3 percent real growth--

MR. PARTEE. For the year, Jim?

MR. KICHLINE. No, in the latter half of '78. Most of the contour of the forecast in the current quarter is much weaker than we have it; fourth quarter, roughly the same.

CHAIRMAN BURNS. I'm going to make an extreme comment. I think these fellows ought to be ashamed of themselves, because they don't have a shred of fact to support any of this. And they are just playing a con game. I think it's a disgrace.

MR. KICHLINE. Well, that's--any help?

CHAIRMAN BURNS. That's just what I firmly believe.

MR. KICHLINE. I would only say I think the major areas of difference are in personal consumption, which has been mentioned earlier, [and] inventories, [which] are projected to have accumulated at a much slower rate than we have. And I think there are policy differences which are not always clearly specified. But consumption and inventories account for the bulk of the difference.

VICE CHAIRMAN VOLCKER. I was surprised on this point just the other day hearing [that] the New York bank economists [had] just met with our people, and apparently they were rather consistently above what I would have expected in terms of more or less optimistic talk. And they were, as I recall, all around 4-1/2 percent for next year on the average, which is pretty close to where you are.

MR. BALLES. That's a good point, Paul. I think the commercial bank economists are generally more optimistic than the economists working for industrial firms.

CHAIRMAN BURNS. You know--I don't know, I don't know. I sometimes get discouraged. When are we going to learn that we don't know how to attach numbers to future events?

MR. WALLICH. Isn't that the way in which we've got to work--

CHAIRMAN BURNS. No.

MR. WALLICH. We're not doing very well [at quantifying], but the direction alone isn't good enough.

CHAIRMAN BURNS. We can supplement an adjective with an adverb. Well, thank you, Mr. Balles. We will hear from Mr. Kimbrel, and we will break for lunch. I mean coffee--it might not be a bad idea.

MR. KIMBREL. I promise you it's not going to take that much time, Mr. Chairman. Just expanding, though, the ideas--the consumer installment credit. I guess our people are somewhat less optimistic about the total new automobile sales over the coming year than you would project, and I recognize that these numbers, if we read them correctly, are pretty close to what General Motors is saying. But I guess we are looking at the likelihood that used cars are going to be somewhat less as a trade-in, and if indeed [unintelligible] anticipating an increase next year. I guess we are wondering how firm you feel your projections are.

MR. KICHLINE. Well, we've been quite high for some time on auto sales and have been pretty much close to the mark relative to other forecasters. So we did reasonably well in the past. The argument that we felt was quite important was this notion of replacing the stock because of the downturn in sales in '74, '75. That effect is wearing off, clearly, as we go on. We still think there's some of that there. We also believe that we can't quantify it. But we also believe there will be some demand for fuel-efficient cars, and American producers, on average, will probably have a reasonably attractive product. So we do have a high number. For 1978, it's doubtful that it would be exceeded, and the risks are probably on the downside.

MR. GARDNER. Jim, the average car in the United States is six years old?

MR. KICHLINE. I don't have the foggiest idea. I'm sorry.

MR. GARDNER. Oh, it is.

MR. KIMBREL. I don't feel so bad about mine as I did before.

CHAIRMAN BURNS. Well, gentlemen, we'll break for coffee.

[Coffee break]

CHAIRMAN BURNS. Mr. Black, would you be good enough to lead off the second installment of our discussion of the national economy?

MR. BLACK. Mr. Chairman, I'm sort of embarrassed to raise my question because the others have made such interesting observations, but I'm glad you didn't ask me to ask this question so that I would stand between us and adjournment. So I do just have a question, it's a technical question. I share your proclivities, and Mr. Balles's, for looking at final purchases and trying to assess the underlying strength of the economy.

And Jim, I was just curious about your inventory changes that you're projecting. You've got a kind of zigzag projection for changes in inventories from the third quarter on through the second quarter of next year. That's probably as accurate as anybody could be, and I know I couldn't do it any better, but I was just curious, is there some particular reason for that? I can see why you have liquidation or slowing in the rate of accumulation in the third quarter and a speed-up in the fourth. But when we get to the first, is that a [unintelligible]?

MR. KICHLINE. The major element accounting for those marginal changes is the performance of fuel imports, and if you look at the net export line, you'll find that that is bobbling around quite a bit, too, and it's the related side of the coin. Namely, in the third quarter, we are assuming a rundown of stockpiling that occurred in the second. Built into this projection in the fourth [quarter] is some enlargement of fuel imports to, if you will, beat the imposition of the well-head tax in January of '78. And then, as you get into '78, those imports, those stocks, are run down again. So it's the mirror image of what's happening on net exports.

MR. BLACK. Well, thank you. I was just curious about that one.

CHAIRMAN BURNS. All right, thank you, Mr. Black. Mr. Volcker.

VICE CHAIRMAN VOLCKER. Just a few comments, Mr. Chairman, mostly reiterating what other people have already said, I suppose. I do think this somewhat more restrained view of the outlook that the staff has presented this time is reasonable. We're actually a bit more restrained, but I wouldn't argue about the difference between them. As I look at the outlook, I think the favorable side is, it's very hard to see stagnation or recession in the outlook; some kind of growth ought to continue. So far as final sales are concerned, I'm not totally reassured when I see personal income rising more slowly, as it has been, which may reflect back on final demands at some point. But I certainly do not want to cast any doubt on the basic hypothesis--the economy is going to continue to expand at a moderate rate of speed, which I think is what we're all talking about.

The unfavorable side has already been explored--that it doesn't do much for unemployment, doesn't seem to do much for inflation, either, if we believe all these forecasts. And you think pretty hard [about] what we can change in terms of the approach toward monetary policy to [achieve] this sort of more favorable balance. I don't think there is much which is exercising your imagination anywhere in other directions, and that's already been mentioned by several people. If I had something really constructive to say in these other directions, I'd say it, but I don't think I do at this point.

In terms of the kind of risk to the economy and the uncertainty--we've already explored this debt situation. I just want to repeat from my viewpoint what has already been said by one or two others, beginning with Alan Holmes--the foreign economic situation looks distinctly less favorable. I don't think we can forever be an island of expansion [if] the rest of the world isn't expanding. I think the rest of the world may be still expanding, but it looks pretty marginal to me. I'm not quite sure [how much] foreign expansion is built into the staff's projections. Therefore, I don't know whether you fully allowed for the degree of potential weakness that I see there, which could feed back on us directly through the trade picture; and that does not look very optimistic in your projections, so I assume you've got a good part of [the] feeding-back anyway.

I think there's always a danger in this situation of some exchange market unsettlement when the current account deficit gets as big as it has been. We've been pretty well shielded from that just because of the coincidence of our interest rates firming a bit, while in many European countries they've been declining. I think one of the things as we move ahead, [and] we may have to worry about it at some point--I think it's worked out fine so far--is what weight we give these interest rate relationships in terms of shading our own policy in one direction or another. I do feel we're somewhat vulnerable to what could be psychologically disturbing fluctuations in exchange rates anyway. I'm not going to predict that's going to happen, but I think we're on a little less certain ground than I would like to see when this foreign trade balance reaches the size deficit that our projections [show will] continue.

MR. JACKSON. Mr. Volcker, can I ask you a question, please? Do you see foreign prospects as being dim versus immediate circumstances as being flat?

VICE CHAIRMAN VOLCKER. Well, I suppose what I see is [that] the immediate circumstances are a little flatter than I foresaw. And I wonder what that portends for the future.

I don't see many sources of confident optimism about what's going on abroad. I don't have a good feel, and maybe somebody in the staff does, for the impact of the German program.

CHAIRMAN BURNS. I'd like to comment on the question. I think the immediate prospect has been well described by Paul and by others, but what I see happening around the world is a basic improvement. It may not express itself quickly, but a financial foundation for improvement in real economic activity, a financial foundation, has been laid. Now that's clearly true of Great Britain, it's true of France, it's true of Italy, it's true of Mexico, it may or may not be true of other countries, which I haven't been following closely. The rate of wage increase is coming down. The rate of inflation is coming down, the rate of increase in the money supply is coming down. The foreign trade balance improving, the exchange rate position improving. So I don't feel unhappy about the sluggishness of the outside economy, because I think the basis for later improvement is in the process of being laid.

VICE CHAIRMAN VOLCKER. It's true of the U.K. I don't think that was true of France.

CHAIRMAN BURNS. Well, it's true of the U.K. clearly. It's true to a lesser degree of Italy, but it is true of Italy, it's true to a lesser degree of France. I went over the French record very carefully the other day. I think it's true of Mexico, though the evidence there is less clear. I think we ought to keep that in mind.

MR. JACKSON. It looks like Brazil is another major foreign borrower whose prospects are looking up.

CHAIRMAN BURNS. I have not followed developments there. I think I'd like to have--Mr. Truman here?

MR. TRUMAN. Yes sir.

CHAIRMAN BURNS. I'd like to have the outside economy reviewed from the viewpoint I've just presented. What the staff has a habit of doing is looking at the real economy, that's good. But I think that the financial foundation of real economic activity--never mind whether your interpretation is the same as mine, you see--whether these countries around the world are or are not in process of straightening out their financial position. Would you be good enough to undertake a survey like that? Cover not only the obvious countries but some of the lesser?

MR. PARTEE. Turkey, Spain, Portugal.

CHAIRMAN BURNS. Well, we've got to stop somewhere. I'll leave that to the discretion of our staff.

MR. WALLICH. Those are the countries that there are major problems in.

MR. JACKSON. I think the point that Governor Partee has, though, is important--an evaluation should include prospects for shock effect of a serious situation that might develop with an individual weak country.

CHAIRMAN BURNS. That's true. But I don't think the world is going to change because of what happens in Turkey. It may change because of what happens in Italy or France. Thank you Mr. Volcker for your comments. And now Mr. Lilly.

MR. LILLY. Well, I have little that I can add. I agree that business is good, but I would point out, in the practice of medicine, that after a certain time in life, doctors are more concerned with the maintenance of the patient than his growth. And I think that's a problem we're faced with for this patient, which is somewhat beyond the point where you're worried about its growth. I would agree with Henry that an incomes policy would seem to be appropriate, but I don't quite see how the [Federal] Open Market Committee can get into the incomes policy--

MR. GARDNER. And I'm delighted.

CHAIRMAN BURNS. Well, I agree with that, except we have done it in the past, you know, by making recommendations. I'm not suggesting that we do that.

MR. LILLY. But I'm suggesting we consider it--not at this time.

CHAIRMAN BURNS. We consider recommending. If and when we do reach that point, and I hope we don't reach it in any near future, but if and when we do, then the recommendation would be useless unless it becomes specific. The fellows over there, you know, they're struggling with that question, you see. And they don't know how to develop an incomes policy, a specific incomes policy. They'd like to do it--a specific incomes policy that would be workable and that could have fairly wide support. This is the [unintelligible].

MR. MORRIS. Well, I can't think, Mr. Chairman, of anything that would put a further damper on capital spending plans.

CHAIRMAN BURNS. At this time.

MR. LILLY. I can. A much higher funds rate.

MR. MORRIS. No, I disagree.

MR. BAUGHMAN. I would hope, Mr. Chairman, if there's a serious consideration given to recommending alternatives, that addressing ourselves to market structure be on the list as a possible alternative to an incomes policy.

CHAIRMAN BURNS. Well, the incomes policy has so many facets. I see nothing wrong with continuing to fight the mad minimum wage proposals and some of us die-hard conservatives--they still exist--almost won a victory in the House of Representatives. The sentiment is changing. People are beginning to learn. In fact, we had a Secretary of Labor for the very first time declare publicly that an increase in the minimum wage will cause unemployment. Of course, since this is a scientific or pseudoscientific age, he had a precise number--90,000 will lose their jobs. Now the rest of his prescription is something else again. Well, I'm praising Secretary Marshall. I do that very rarely, and I'll stop at this point.

MR. BAUGHMAN. You lifted that slightly out of context too, didn't you, Mr. Chairman?

CHAIRMAN BURNS. Beg your pardon?

MR. BAUGHMAN. You lifted that praise slightly out of context, too, didn't you?

CHAIRMAN BURNS. I did. I did. And in fairness to the truth, Mr. Marshall went on to say, the fact that the increase in the minimum wage will cause unemployment is no reason for not doing it. On the contrary, justice requires that we do it. And we being a government all powerful, having created unemployment, can set about methodically to offset the unemployment that we ourselves have caused by spending several billion dollars on the Youth Corps and whatnot. Well, I've told the whole story now.

MR. PARTEE. A minor clarification, Mr. Chairman. Dave, about "maintenance of the patient"--you didn't mean that you are now seeking a zero growth rate for the economy?

MR. LILLY. I didn't. Maintenance of the present growth rate.

MR. PARTEE. Maintenance of the present growth.

CHAIRMAN BURNS. Mr. Guffey, please.

MR. GUFFEY. Yes, Mr. Chairman, two additional brief comments. One is that as we surveyed our directors and businessmen for this Redbook, it seemed that, for perhaps the first time, absent the agricultural sector, that businessmen were rather optimistic, [with] some evidence that they're beginning to enjoy the recovery for the first time, and in particular in the last 2-1/2 years. And I think that's a plus. Lastly--

CHAIRMAN BURNS. By "enjoy" do you mean they really believe it--

MR. GUFFEY. Oh, yes.

CHAIRMAN BURNS. --or do you mean more than that?

MR. GUFFEY. They're not only willing to believe--the only drags on that kind of confidence level, it seems, are the lack of a tax policy and the lack of an energy policy. But absent those two factors, it seems generally that the businessmen in the midsection of the country are happy with what they see and are looking forward to continued good times. And that's the first--all comments previously had been more in the line of uncertainty of the future--this time they're beginning to enjoy it a little bit.

The last comment that I would make is that you've heard from me and from John Balles and others about the drought situation from the Midwest on to the West. I would say that it came to the attention, particularly, of the people in Kansas City that the drought has ended as of last Monday, [when] there was a flood in our city that did an estimated $100 million in damage and some 26 lives lost. And that is true generally throughout our District up until you get to the western slope of the Rockies. They have begun now to get some moisture, but they're two years away from restoring the moisture level that they've lost over this drought period. But from the eastern edge of the Rockies on into our area, and I'm sure on to the east, the drought has ended, and, as a matter of fact, we may even have too much water now. Certainly we've had too much at one time in Kansas City.

MR. PARTEE. Moderation.

MR. GUFFEY. Moderation. The fact of the matter is, the loss in Kansas City is very substantial, and the loss of lives of course is something that cannot be [unintelligible].

CHAIRMAN BURNS. How did the loss of lives occur?

MR. GUFFEY. There is what's called Brush Creek that runs through a very fashionable area of Kansas City, that one of our politicians in the past, Mr. Pendergast, cemented the bottom of simply because he was in the ready-mix [concrete] business. When the creek comes up--it is a drainage area--it's normally a very small trickle. But when you have a very heavy rain that comes up very rapidly--this doesn't [normally] get out of its banks to cause any damage--[but] this was described as a 500- year flood. That is to say, the moisture that accumulated in that short 24-hour period was what you would expect to occur once every 500 years. It is a very unusual occurrence.

CHAIRMAN BURNS. And that--were people drowned?

MR. GUFFEY. People were actually swept away. They were in businesses, restaurants, other types of businesses, and the water came in as they tried to exit. It came up very quickly. As they tried to get out they were swept away, or the alternative was that they actually drove into the waters and their cars started bobbling down the stream and they were carried away. They were like lemmings going to the sea. There was no thought that they couldn't make it across a lower area that they've never seen water in before. And it occurred all over the city.

There was damage that occurred, of course, where the flood waters cascaded through the plaza [Country Club Plaza shopping center] area, and on east, but also there was great damage in the outlying areas simply because the storm-sewer drains could not carry off the accumulation of water. The homes, businesses throughout the city sustained damage, and there is very little flood insurance in that area. So these are personal losses. I know there has been some concern about making available the same thing the Board did for the [July 1977 flood] situation in Johnstown [Pennsylvania]. We'll perhaps propose a push for that--

MR. JACKSON. Did this adversely financially affect the Nichols company that owned all that area?

MR. GUFFEY. It will, of course, because it was all owned by--the plaza area itself, and I don't want to suggest that that the damage was in the plaza area only, because it was city-wide--[but] that's the place where the greatest volume of dollar assets can be seen and where a great deal of damage did indeed occur. But that area is essentially all owned by one company, and there will be a great loss because it was all uninsured.

MR. MAYO. I could add, Mr. Chairman, that as far as the Seventh District is concerned, it's rained just about every other day since the first of August, and not in the concentrated form in Kansas City, but it has basically restored a good share of the subsoil moisture lost, and the farmers are now shifting their worries to whether they can get the corn harvested because the fields are too muddy.

CHAIRMAN BURNS. All right, any other comment on the economy? Well, we've ended our economic discussion on a note of sadness, but I think this is one of the most interesting economic discussions we've had in recent months. Well, we'll move on with Mr. Sternlight's statement.

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

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

MR. BLACK. Peter, as interest rates move up closer and closer to the point where we could expect some disintermediation, do you think it's likely that volume in foreign purchases, maturities selected, will give us any additional leeway toward moving the funds rate up without incurring disintermediation?

MR. STERNLIGHT. I think these foreign purchases seem to be a steady force in the market. It's hard to predict what might lie ahead. A lot depends on just what the U.K.'s fortunes are. There have been other foreign buyers. Some have been going in the market. A number of them of them have been just taking amounts directly from the Treasury on new issuance. But I think there, too, it tends to relieve what could otherwise be upward rate pressures as we come to a point where disintermediation might be a factor.

MR. BLACK. You would guess there would be some marginal effect, anyway?

MR. STERNLIGHT. I would think so, yes.

CHAIRMAN BURNS. All right, thank you. Mr. Wallich now, please.

MR. WALLICH. A couple of points, if I may. One is, as I look at today's call, you're in one of those situations again where you are making matched sale-purchases with foreign accounts and then have to compensate by supplying funds to the rest of the market. Does that kind of situation give you any problem?

MR. STERNLIGHT. It has not provided a serious problem to us. We have been asking foreign accounts to hold down the volume of these repurchase agreements until we get clarification of just where we stand on this situation that was reviewed by the Committee earlier as far as the Internal Revenue [Service] is concerned.

MR. WALLICH. The market knows about these operations, doesn't it? So that it doesn't get a false signal?

MR. STERNLIGHT. That is correct.

MR. WALLICH. When we had that wide spread between discount and funds rate, was the increase in borrowing more or less in line with your expectations? Were you able to make a good forecast of the rise in borrowing?

MR. STERNLIGHT. I would say it exceeded our expectations, and we kind of played it by ear from day to day. It was a complicating factor in the conduct of operations during that period.

MR. WALLICH. Of course, you would say that the expectation of a rise in the discount rate soon would intensify the borrowing, but that would be true of any such situation where a wide spread tended to develop.

MR. STERNLIGHT. Yes, it did seem to proceed with particular speed this time, based on past experience. It seemed to move quicker that way.

MR. WALLICH. Thank you.

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

MR. COLDWELL. Peter, in your contacts with dealers, do you get the impression that they're looking for higher rates?

MR. STERNLIGHT. I think, on balance, they would expect higher money market rates, particularly. There would be more division of views as one went out on the maturity curve.

MR. COLDWELL. Is there any significance to the change in the dealer inventory position, particularly bills?

MR. STERNLIGHT. Well, the bill positions have increased in the last month, a good part of it, I think, because of the Treasury getting back into some net additions to bill supply, whereas they had been, since the earlier part of this, paying off bills or, well, since about the beginning of the summer, just holding steady on bills. And their coupon positions--they were holding net short positions in an anticipation of higher rates to come, and the size of that short position has varied as that expectation has varied.

MR. COLDWELL. Well, that short position is almost liquidated now, isn't it?

MR. STERNLIGHT. They've moved out of the short position into about a small net long [position] in early September, but now they've reestablished a moderate net short position again in the last figures we've had.

MR. PARTEE. You did say, Peter, that the year bill is not up at all from where it was a month--

MR. STERNLIGHT. I mentioned that the six-month bill remained unchanged. I think the year bill was also--

MR. PARTEE. Six-month bill. So that it's really the very short end that has risen.

MR. STERNLIGHT. Yes, that's right.

MR. PARTEE. That's interesting.

CHAIRMAN BURNS. Any other questions or comments? Yes, Mr. Black.

MR. BLACK. Mr. Sternlight, there are not many foreign purchases in the very short end are there?

MR. STERNLIGHT. There have been some. And there's also been some liquidation by some of the foreign accounts that are moving out of bills into the intermediate coupons.

MR. PARTEE. I would have thought that you would have responded to Governor Coldwell's question, that that very stable [unintelligible] deal would suggest that the market as a whole is not expecting rates to rise.

MR. STERNLIGHT. Well, I think they're troubled by--they're trying to sort out their own analysis. I think if you polled them, they would talk about expecting some rate increases.

MR. COLDWELL. Have you gone back to look at the shape of the yield curve in prior recoveries of this? Where are we in regard to that shape of the yield curve, the slope of it?

MR. STERNLIGHT. Well, there certainly has been a flattening of the yield curve. I wouldn't want to venture, offhand, where we stand. These are the views--

MR. AXILROD. I happen to have some figures on that, Governor Coldwell, for the briefing I thought I was going to write, but it didn't work out too well. I discarded it. We have a much steeper yield curve now than we did in comparable stages of past recoveries. For example, the 20-year Treasury constant maturity is just about 2 percentage points above the three-month bill rate. In previous expansions that lasted this long, it was between 40 and 70 basis points above the three-month Treasury bill rate at this stage. And there are similar relationships when you compare the triple-A corporate bond rate to the four- to six-month commercial paper rates. So the yield curve is still much steeper, reflecting, I believe, the strong liquidity demands we've had in the course of this recovery.

MR. EASTBURN. Isn't it also because interest rates didn't rise for so long, contrary to expectations?

MR. AXILROD. That also, but this is--I was comparing a 20-year issue to the three-month issue. Of course, if credit had been much tighter, well, short-rates would naturally rise more than longer rates just because of the economics and arithmetic of that. But I think that we've been affected by the demands for short securities by banks, thrift institutions, for a time, and corporations and by the desire to lengthen on the part of corporations, state and local governments, and others, and this has contributed to keeping the yield curve as it is. Of course, your other point is also true. If we had much tighter credit, the yield curve would have been shifting.

MR. COLDWELL. Steve, can you jump to the conclusion that the Committee still has a considerable margin [for] tightening in the short area without impacting on that long-term yield?

MR. AXILROD. I think that you would have, in effect--if you tighten considerably, if short rates went up a percentage point--I believe that in that process, long rates would go up.

MR. COLDWELL. It depends on your timing.

CHAIRMAN BURNS. You've got to watch time--

MR. AXILROD. That's what I was going on to say, Mr. Chairman. In the process of tightening, long rates may go up, but after that tightening is accomplished and those who have been caught with positions in the process of tightening have adjusted [to] it, then I think that the long rates would tend to drop back and be only slightly higher than current levels. That's how I think it would tend to work.

MR. PARTEE. Do you include mortgage rates in that?

MR. AXILROD. No. I think mortgage rates would tend more than the corporate bond yields to rise permanently because you begin somewhere to have some effects on--

MR. PARTEE. –intermediation?

MR. AXILROD. --intermediation. But then Regulation Q adjustments might be a factor there.

MR. COLDWELL. But you have a timing question on the rate at which you change the short rate, too.

MR. AXILROD. That's how I started off.

CHAIRMAN BURNS. Mr. Roos, please.

MR. ROOS. In our efforts to hold short rates down, the present tendency of the aggregates to increase persists. Isn't it logical to expect that long-term rates will move upward in anticipation of inflation?

MR. AXILROD. That's one possibility, President Roos. It hasn't happened thus far.

MR. ROOS. Don't you think that it's partially due to the fact that the market believes that we are determined to avoid inflation?

MR. AXILROD. I think that's right. And if the recent rates of growth in M1, for example, continued for some months, it's quite possible you would have feedback effects on long rates. However, I ought to amend that because, if it continues at that rate, and it becomes evident to the market that this is not being associated with an acceleration of inflation or due to demand factors but the economic indicators that we get, it might be interpreted as simply a reversal of the process that has occurred over the past two or three years where people have been desiring to hold less money, that they're simply readjusting. And if that interpretation becomes prevalent, then people would not expect inflation to accelerate, [and] you would not have a reason for long rates to rise. I'm not sure exactly which interpretation would become prevalent, but the risk you point to is certainly there.

CHAIRMAN BURNS. Well, there is also the question of what has been happening to the monetary aggregates. If you look at M1, which I think is what you did tacitly, Mr. Roos, the story is very disconcerting from the point of many of us, certainly mine. But if you look at M2, we can take a little comfort. Let's not take too much comfort, but look at the evolution. On page 4 of the Bluebook, you have a useful summary. Look at M1 during '75 and '76; the rate of growth was 5.2 percent. For the past 12 months, 7.1 percent; past 6 months, 9.1; past 3 months, 9.5. It's a very uncomfortable record. Well, now, look at M2 at 1975 and '76, 10.4. For the past 12 months, 10.9; past 6 months, 9.9; past 3 months, 10.5. There you have a record of remarkable stability.

MR. ROOS. Mr. Chairman, but isn't the monetary base expanding in an alarming fashion, 6.6, 7.9, 8.8, 9.6 [unintelligible]?

CHAIRMAN BURNS. Well, without accepting the "alarmingly"--I don't get alarmed easily--it's disconcerting, but I attach more importance to monetary aggregates than I do to the monetary base. Now I may be mistaken about this, but that is the way I have become accustomed to using monetary statistics.

MR. PARTEE. Well, I think functionally, what's happened is that M1 is growing more rapidly, and the time deposits that are added to make M2 are growing less rapidly, and M1 has a much higher reserve requirement than M2. There's a time deposit component of M2, that's why the monetary base is growing more rapidly.

MR. COLDWELL. May I ask one more question of the Desk? Peter, given this dialogue that Steve and several others have been having, is there strength in demand at the short end of the market which the Committee would have to resist in a rate advance?

MR. STERNLIGHT. Strength of demands for credit?

MR. COLDWELL. Strength of demand largely for investments is what I was thinking of.

MR. STERNLIGHT. I'm still not sure--do you mean the strength of demand for credit or demand for investors?

MR. COLDWELL. Well, I'm thinking of investors demanding short-rate bills.

MR. STERNLIGHT. I'd say there's a good bit of demand there of liquidity and demand for a variety of instruments.

MR. COLDWELL. --which would be a resisting factor for your moving the rate up very rapidly.

MR. STERNLIGHT. It could work to slow that effort, but I think the rates--as I think that we would still be able to have a--

MR. COLDWELL. Well, I'm not saying that you couldn't do it. I'm merely saying you've got a resistance factor built into it.

MR. STERNLIGHT. It's pushing, yes.

MR. AXILROD. I think another way of putting that, Governor Coldwell, is that that's been a factor in the course of this recovery and has kept the three-month bill rate below the federal funds rate.

MR. BLACK. You could view that as giving a little more leeway to move your federal funds rate without disintermediation, too.

CHAIRMAN BURNS. Well, there are no further questions to Mr. Sternlight--

MR. COLDWELL. I move to ratify the Desk actions.

CHAIRMAN BURNS. Motion to ratify what Mr. Sternlight has told us we're doing.

SPEAKER(?). So moved.

CHAIRMAN BURNS. That motion's approved. Then let's listen to you, Mr. Axilrod.

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

CHAIRMAN BURNS. All right, thank you, Mr. Axilrod. Any questions?

MR. ROOS. Mr. Chairman, may I ask a question of you? I find myself confused again hearing some of the explanations as to exogenous factors that may have caused the aggregates to perform as they did. We frequently explain after the fact certain things that have happened that have caused these things to fluctuate beyond our targets and our goals. Aren't we, in conducting monetary policy--and I ask this sincerely, I'm new and I really am mixed up on this--aren't we supposed to really exert some control on these events, or do we in effect react after the fact to things that have happened that we're sorry happened? In other words, is it not possible, by the adroit conduct of monetary policy, for this Committee to have a very real effect on the trend of M1 and M2 instead of explaining afterwards why they did expand beyond what we wanted--what were our targets. I don't know if I'm making my question clear, but I find myself frustrated sometimes in this regard.

CHAIRMAN BURNS. Let me rephrase your question, and I may run the risk of misrepresenting your thoughts, but do stop me if I do that. We set, let us say, a certain goal for ourselves for the rate of growth in M1. And if we were determined to achieve that rate of growth without regard to other factors or consequences, I think we could come very close to that. I don't have much doubt about that. Now let me turn to Mr. Axilrod. Would you dispute what I've said?

MR. AXILROD. I wouldn't dispute it over a three- to six-month period. I would [dispute it], Mr. Chairman, over a one-month or two-month period.

CHAIRMAN BURNS. I think that's a useful qualification. I think we could do it. But I don't think that we have that degree of determination with regard to a given targeted figure. And I would question whether we should. Our job is not to worship at the shrine of a specific number that we agree upon at a given time. To the extent that we are going to worship at any shrine, our shrine is the performance of the economy. And we're doing our very best, you see, by tolerating some excesses, tolerating shortcomings, using our best judgment, which may be mistaken.

MR. ROOS. Mr. Chairman, I'm not--if our stated and, I assume, understood objective is to gradually inch down the rate of inflation, and this has been often repeated, don't we have some commitment to that goal even if it means some temporary dislocations of interest rate levels and things like that? I mean, in other words, isn't that part of our mission, too?

CHAIRMAN BURNS. I'd say it is, but there is a question as to how much dislocation you'd be willing to cause, and at what time.

MR. PARTEE. Well, it's just not interest rate levels either. It's output and demand and employment and profits and the whole fabric of the economy that has to be taken into account.

MR. ROOS. And inflation.

MR. PARTEE. Yes, in dealing with the inflation problem, which was your question.

CHAIRMAN BURNS. Mr. Wallich.

MR. WALLICH. Well, I'd like to get some light on the nature of the shocks that money supply has recently received. The rule of thumb says that if it's a monetary shock, ignore it, and keep interest rates constant. But doesn't that imply that--

CHAIRMAN BURNS. Now I have to stop you. What does that mean?

MR. WALLICH. It means that if there is a shock from the financial, monetary side--

CHAIRMAN BURNS. No, no I still have to stop you. What does that mean?

MR. WALLICH. What does that mean? A rise or fall in the demand for money--technically known as the LM curve.

MR. MORRIS. Well, take, for example, the Penn Central crisis situation.

MR. WALLICH. That would be a very clear example. But I'm thinking simply of occasions where we've got a $3 billion increase in one week or a $5 billion increase in one week and don't have much of an explanation. But they bring us to very high growth rates, and if we take our long-term ranges seriously, we would have to go to very low growth rates in money supply over a year in order to make these targets. Now the rule, as I understand it, is if it comes from the monetary side, there is some change in the demand for money--don't let that affect the real sector. And the way to avoid an impact on the real sector is to keep interest rates constant because the money supply works presumably to interest rates, and that channel of transmission can be blockaded if it's not appropriate to have that transmission.

But what I'm trying to get your reaction on, Steve, is, doesn't this theory imply that shocks are stochastic and random? That if we got a bounce up of $3 billion or $5 billion over time, we'll get a bounce down of that [amount]? If that doesn't happen, if we're carried to a permanently higher level of the money supply, then it may not have been a random shock. It may have been something fundamental in the economy and maybe it should not be ignored but should be allowed to have its influence on higher interest rates and the real sector.

CHAIRMAN BURNS. Well, Henry, I still don't know the question. You don't know which it is at any given time with any certainty--whether it's a random movement or the beginning of a new trend or a continuation of an existing trend.

MR. WALLICH. Well, if it were a random movement, in my opinion, it should over time be offset by some other--

CHAIRMAN BURNS. But what I'm saying is, if you could identify these movements as random or otherwise, our problem would be very simple. Our problem is so difficult precisely because we don't quite know how to do that.

MR. WALLICH. Well, I agree with that, yes.

CHAIRMAN BURNS. Yes, but then I don't know what your question is. I thought your question assumed that we're able to distinguish and identify properly.

MR. WALLICH. Well, I am trying to distinguish, and I say one of the distinguishing characteristics should be that a series of shocks in one direction upward should eventually be followed by movements in the opposite direction, indicating--

CHAIRMAN BURNS. If you know that they are random. But if you don't know that, that's where you have your problem.

MR. WALLICH. Well, if they're not random--we need to distinguish, this is right. I'm assuming when you get a shock like that, at first sight, that it is random. Now we have to examine was it or was it not. If it wasn't, then we've got to take it seriously and not ignore it.

CHAIRMAN BURNS. Mr. Axilrod, the baby is yours.

MR. AXILROD. Governor Wallich, one point I would like to make is that I think the size of the monthly disturbances we've had is a strong random element in an 18 percent and a 13 percent [move]. It may seem supernatural that many of them are occurring on the first month of the quarter, but we have not been able to think of a reason why that should occur or at least why it should account for such a large number. So I think there's a large random element in the behavior of the monthly numbers. And it's clearly in the weekly numbers. I don't think the random element--if I may use that word, it's shorthand for a number of things--is that clear if you go back to successive quarterly numbers or the development thus far in ’77. To me, that indicates that the shortfall in money, so to speak, relative to the ordinary demand curve, the one that economists have been estimating year after year, that that shortfall--it’s been getting less, coming close to an end.

For example, and this is, again, sort of fragmentary evidence, and that’s the only kind of evidence we can have, at least in the background, but our quarterly econometric model had been underpredicting M1 given GNP, given the actual short rate. The [M1 prediction of the] money demand equation of that model was always a lot higher than the actual M1. We never used it literally, but it was always a lot higher. By the second and third quarters of this year, it’s no longer doing that. It’s no longer underpredicting. The increment in money is about what it’s been predicting. That is some fragmentary evidence that people have become willing now to hold more money relative to GNP than before. Now what I can’t answer, and I don’t believe anyone can, is whether this trend is simply accommodative to the growth in GNP and therefore does not imply a stronger rate of inflation ahead, or whether it, too, will prove to be somewhat transitory, and in the period ahead the public will say, well, I do have more money than I need, therefore I’m going to spend. Therefore velocity will go up, therefore GNP or prices will be higher than are otherwise being projected. That could occur. I don’t know of any precise way to answer that. Monetarists have models which in effect say that. I mean, you have a long-run rate of growth, and if you go above that, you’re going to get a price effect.

I’m going at too much length, but the other implication is, of course, if it’s purely accommodative to current GNP, it doesn’t have implications for the future. Then, if the Committee doesn’t permit that accommodation, interest rates will rise much more rapidly and you’ll cut short the recovery. In our staff analysis, we have taken a middle course. We have assumed that interest rates will not rise quite as much as a literal reading of an econometric demand curve would suggest; and therefore, the Committee could come within its target range, maybe not the midpoint, but come within its target range and not seriously affect the economic projections that Mr. Kichline has presented.

MR. COLDWELL. May I pursue this just one minute, Mr. Chairman? Steve, had you looked into--and [can you] give me a good explanation for--the correlation for currency increases with the precise months when M1 goes up?

MR. AXILROD. No. We have noticed that, of course. Currency is a small number.

MR. COLDWELL. Well, I understand it’s a small number with a huge increase, but what’s the correlation in your reasoning, why currency moves up.

MR. AXILROD. If I could relate it all to transactions in that month, it would be an obvious correlation because currency tends to reflect transactions. You can’t quite do that, so we don’t really have an explanation that I know of for that, Governor Coldwell. We could try to think about it, but we simply do not. It could be just simply a reflection of a bad seasonal in the month, equally for one or the other. Again that’s just--there’s nothing I can defend rigorously.

MR. PARTEE. Well, as you look through the monthly ups and downs, I think one would have to conclude, and maybe you said this, the evidence is that the number on M1 growth is working higher.

MR. AXILROD. Yes.

MR. PARTEE. It's a high number.

MR. WALLICH. I think we need to make up our mind whether this is the kind of unexpected increase which one should ignore and stay with interest rates or whether it is one that one should take as an indication of future movement, future aggregate demand, prices and output, and should act accordingly to restrain. If one thinks it--

MR. PARTEE. It's a question of whether to accommodate what we're now getting or is this more than needed, so there is no question [unintelligible].

MR. COLDWELL. Henry, in either case, isn't it a permanent build in the stock or supply of money?

MR. WALLICH. If it is a truly random shock, I would say it would be offset by a move in the opposite direction in time.

MR. COLDWELL. It hasn't been.

MR. WALLICH. Right. Since it hasn't been, it raises this suspicion that it is not [random]. Now there are two possibilities. One is that people have changed their demand for money so that with a given GNP, they want more. If that's the case, we should accommodate it, because it doesn't mean anything to GNP. But if it means that--

CHAIRMAN BURNS. I don't know that I would accept that. The people may change their habits once again and in the process of building up too much money, that money will do its work later on without raising [unintelligible].

MR. PARTEE. Just to a degree.

MR. WALLICH. I was postulating the possibility that they had changed their demand function so that they wouldn't do this--

CHAIRMAN BURNS. You mean a permanent change.

MR. WALLICH. --permanent change in their demand function, just as we've had a downward shift.

CHAIRMAN BURNS. I know, but the trouble is, in the real world these changes are short lived and we have oscillation.

MR. WALLICH. Well, you know, we had a downward shift of the demand curve of about $30 billion. Had we believed in that demand curve, we would have driven interest rates into the floor, trying to push the money supply on that demand curve. We didn't. We kept interest rates at reasonable levels and therefore reduced the supply of money relative to what was expected relative to GNP on a very substantial scale. Now, if we did exactly the symmetrical thing on the way up, we would then not worry about a $30 billion increase in money supply relative to expectations and relative to GNP and just avoid interest rates from going to the roof. I'm not asking for a symmetrical action, but I think we should realize that we went largely with interest rates when the money supply was falling short of expectations. And I'm now trying to think out what we should do on the upside.

MR. AXILROD. Governor Wallich, so I wasn't misunderstood, let's say the shortfall ended up totaling around $40 billion. There's no evidence that I can see that the public is trying to recapture that. The evidence that I see is that the shortfall may not get bigger. That is, there's no--

CHAIRMAN BURNS. And that evidence is short lived?

MR. AXILROD. Very short lived.

CHAIRMAN BURNS. Evidence for six months?

MR. AXILROD. Two quarters, that's correct. Very transitory. It's not very [unintelligible].

MR. PARTEE. If they should try to recapture it, the growth rates would be staggering.

MR. AXILROD. Yes, oh, it can be impossible. You'd have a 15-20 percent.

MR. ROOS. Mr. Chairman, is it not possible that, with our preoccupation in keeping interest rates down, we're pumping an awful lot of money into this--

CHAIRMAN BURNS. Well, did you say preoccupation of keeping interest rates down? I'm not aware of any such preoccupation on the part of this Committee.

MR. ROOS. Well, can we have it, sir, can one have it both ways? In other words, can we have low interest rates and low rates of aggregates growth, or are these things inconsistent and doesn't one have to make a choice sometimes of not trying to have the best of both worlds?

MR. PARTEE. They're consistent in a recession, Larry.

MR. ROOS. They are?

MR. PARTEE. Yes.

MR. WALLICH. If I may go back to Steve's--

CHAIRMAN BURNS. We could make a choice. When you speak of a choice, one certainly can avoid either extreme. There is some middle ground one may want to choose. And it may be the better part of wisdom. Before we're through this morning, I'm going to urge just that.

MR. WALLICH. If I may pursue this one moment further, Mr. Chairman, if we're back on the old demand curve at a lower level, the slope is the same but the level has been reduced by $40 billion. That would mean, then, that we would not be able to count on the same velocity gain on which we've counted so far to finance an 11 percent increase in GNP with a 5 or 6 percent increase in M1 or 9 percent increase in M2. This is the meaning of being back on the old demand curve.

MR. AXILROD. The demand for money in relation to income in your case.

MR. WALLICH. Yes.

MR. AXILROD. We had not assumed that we're back on that, Governor Wallich. We have not assumed that the demand curve--

CHAIRMAN BURNS. Well, neither has Mr. Wallich, if I understood him correctly. It was an "if" proposition.

MR. WALLICH. I meant to say we're on the same slope, not on the same path, because the path is down $40 billion from where we expected to be.

CHAIRMAN BURNS. And you put even that in "if" terms.

MR. WALLICH. Even that is an "if."

MR. PARTEE. Well, let's be clear. The staff has not assumed the same slope. I presume that you have a much higher interest rate in the early part of next year.

MR. AXILROD. Now we're getting into technical things of slopes and demand curves. One way of putting it is, I don't know whether the slope has ever changed, but you relate money to GNP as a curve, given interest rates. I assume that curve isn't shifting down. I'm assuming that the shift from money to other liquid assets is not occurring to the same extent as it occurred in the previous two or three years. Therefore, somewhat more of a money increase in relation to GNP will be revealed because whatever the increase in money in relation to GNP was before, it had been reduced by just this shifting of levels of money away.

MR. PARTEE. But not back to the previous relationship, I think. Henry was making the point that it would be back to the previous relationship. That is, your model, let's say, would be right on the increments from now on out. If the model were right, to get that objective of monetary growth that you have, you would have to get considerable interest rates.

MR. AXILROD. I think the clearest answer I could give is that you're right.

CHAIRMAN BURNS. We talk about money, we talk about monetary growth, and implicit in all of this is acceptance of M1, whereas this Committee decided some time ago to attach equal weight to M1 and M2, which means we've moved away from M1. And there is some thinking in this Committee, which I share, that we may perhaps want to move further in the direction of M2. So let's not implicitly wed ourselves to M1 in view of the fact that we've abandoned exclusive reliance on M1.

MR. MAYO. And let's pursue further, Mr. Chairman, the development you reported on last time, of the development of M1.5 or whatever we care to see.

MR. BLACK. What was it in August, Mr. Chairman?

CHAIRMAN BURNS. Mr. Black?

MR. BLACK. What figure do you have on that new one for August?

CHAIRMAN BURNS. Well, I've got that here, and I'll look it up. In the meantime, let's have Governor Jackson's comments.

MR. JACKSON. My question pertained to that subject, Mr. Chairman. Mr. Axilrod, to what extent do we better understand the ramifications of the Regulation Q ceiling interest rate on the growth rate of M2 and M3, and how much they may have impacted on the high side in earlier periods, and to what extent they may impact on the lower side in the period which you are projecting?

MR. AXILROD. Well, we are projecting somewhat higher growth rates in the time and saving deposit components of M2 and M3, beyond the next month or two, than we would have had at current interest rate levels. We're projecting a somewhat higher interest rate than now, and one of the reasons is that because of the inflation that we currently have relative to other periods, nominal income is rising faster, and there is some elasticity of these deposits. These deposits relate to income flows as well as to interest rate levels, and so the higher income flow, which we believe has sustained growth rates of these time and saving deposits at rates like 7, 8, 9 percent--rates that in the past, at least the low end of those ranges--would have been associated with crunch periods and the need to raise Regulation Q.

So in a sense the flows may give a somewhat artificial feeling that all is well and good when read literally, but the other part of it to remember, I believe, is that inflation is also increasing the nominal amount of financing that will be needed with these flows. So there may become a Regulation Q kind of problem even with flows in the 7, 8, or 9 percent area. Thus far, the interest rate relationship between time deposit ceiling rates and market rates are not at the point where, in the past, the [Federal Reserve] Board has raised Regulation Q ceiling rates. We seem to be some distance from there. And we have not assumed the need to raise ceiling rates under our alternative B set of assumptions, even into the first half of '78. But I'm trying to raise the very cautionary note on that.

MR. JACKSON. Do you think that the implication of the Regulation Q ceiling will make the use of M2 as an operational target more imperfect, or will it be sufficiently distortive to make it worthy of reconsideration of the use of M2?

MR. AXILROD. All of the aggregates have problems as targets. And when you adjust the ceiling rate, or even when market rates get near the ceiling rate whether you adjust it not--both [circumstances] create the need, I believe, for special and careful interpretations of M2 and M3. That is, if you raise the ceiling rate, you have to accommodate temporarily to a large rise in M2. If we fail to raise the ceiling rate, I think you're implicitly saying that you're willing to see a much lower growth in M2 in this period when the deposits are shifting out and going into market instruments. I think that's just a judgment that the Committee makes at those times. So there can't be a mechanical, in any event, M2 or M3. There would have to be adjustments as you get around ceiling rates.

MR. JACKSON. But you don't think you would destroy the operational effectiveness of it.

MR. AXILROD. It makes them more uncertain around those times because we can't be very certain as to what extent the public is or isn't going to shift deposits. We'd have to rely on historical relationships, and they're very imperfect, as you know.

CHAIRMAN BURNS. Mr. Black raised the question about the rate of growth of a modified M1, the one that I referred to at the last meeting, for the month of August. Now the modified M1 concept is as follows: You start with our conventional M1 magnitude, then you add to it deposits of state and local government, and then you add to it business savings deposits, and then you add NOW accounts. These three items are added and then you exclude two items--demand deposits due to foreign commercial banks and demand deposits due to foreign official institutions. That is the definition of a modified M1, or one of the modified M1s that I referred to at the last meeting.

Now you may recall that the present M1 [growth] figure for June was 4.5 percent, and the modified M1 figure was 1.8. For July, our M1 figure was 18.3, and the modified M1 figure was 11.9. For August, the relationship, or the direction of the differential, is reversed. Our M1 figure is 5.5, and the modified M1 is 6.8.

Gentlemen, it's approximately one o'clock. And I think it would be best to postpone our discussion of current monetary policy, what it should be. And if that is agreeable, unless there are further questions to Mr. Axilrod, let us break for lunch now. And we should reconvene at--not too late. Is two o'clock realistic or is 2:15 more realistic?

MR. WALLICH. A realistic 2:15, really.

CHAIRMAN BURNS. Let's say at two o'clock, and we'll start promptly at 2:15.

[Lunch recess]

CHAIRMAN BURNS. Gentlemen, no matter what that clock might say, it's 2:15, and now we're ready to start our monetary policy discussion. Let me say a few words by way of getting our discussion going. The Federal Reserve is passing through a difficult time in regard to policy, and I think the country is passing through a difficult time. We're urged by the monetarist school to stick to some predetermined rate of growth of something called the money supply and to forget entirely about interest rates. At the other extreme, we're urged by the Keynesian school to freeze interest rates or keep them low or not permit them to rise significantly--the Keynesians make great assumptions about our power with regard to interest rates--and let the money supply do what it may. I don't think that we can follow one theological school's advice any more than the other school's advice. Our concern is the economy; we have to pay attention to its behavior, to our ongoing institution, and we can't become victims of any particular theology.

I indicated earlier that, without arguing the case, I'm moderately optimistic about the economy. But if I were to argue the case, I would have to indicate that there are uncertainties, there are points of weakness that we should not ignore. And I would have to argue further that interest rates do matter, and that any substantial rise of interest rates, whether originating in causes independent of the Federal Reserve or originating in their own actions, should be of concern to us. I also would have to argue that the increase in the rate of growth of M1 is concerning, very troublesome--those I pointed out in the morning session. The rate of growth of M2 has been remarkably stable, and the like is true of the rate of growth of M3. Nevertheless, both M2 and M3, while their rate of growth has been stable, have been growing, I think, too rapidly.

Now I think the best that we can do in the present circumstances is to find some middle ground, and that is my own thinking. I would suggest that, in working on instructions to the New York Desk, we might proceed as follows. As far as M1 is concerned, the rate of growth might be 2 to 7 percent, or 3 to 7 percent for the September-October period. We might aim at that. M2, perhaps 4 to 8 percent, and the federal funds rate might be 5-3/4 to 6-1/2 or 6 to 6-1/2. I think it would be wiser to do the latter. The federal funds rate now is 6-1/8. In view of the rapid increase in the money supply that we've had, it would probably be unwise to let it slip back to 5-3/4 even if the rate of growth of the monetary aggregates were very low in the next few weeks. I think we could live very comfortably with extremely low rates of growth in the money supply over the next few weeks. Well, that's my best thinking, [so] let's turn to the Committee. Mr. Jackson, please.

MR. JACKSON. I think philosophically I would agree with you that, particularly where the ramifications of our operations are so uncertain, particularly as to the mechanistic definitions of what constitutes money, and particularly as we may be entering a phase where there's a new relationship between supply and the real economy, which I would read as our goal--that to purely take either approach would be a mistake.

Speaking to the issue of the ramification of two months of instructions to the Desk, in view of the fact that staff projections for the two-month period are effectively 7 percent, I do think that issuing instructions to the Desk in the 3 to 7 percent range would most likely produce instructions to increase the funds rate even though there might be only a very small divergence in the result of such. And I don't think such an overt intentional move to raise funds rates today, based on the uncertainty of our knowledge, would be appropriate. And for that reason I would suggest that, while I would be perfectly happy to see the lower end of M1 down in the 3 percent range--be perfectly happy to see that, in fact--I'd even buy zero, except it'd look foolish on the statement when we published it, and I'd admit that. I would say 3 percent would certainly be acceptable, but I would argue for an 8 percent ceiling in light of the staff's projection because we're now significantly into September; we have a pretty good insight as to what that might be. And the staff projections for October exceed 7.

Another thing, I don't know how to implement this concern, but the truth is that every 90 days we've had a surge. And we've had a surge in previous Octobers. While I would be the first to hope that we don't have another one, at the same time I recognize that, given our recent experience, the prospects of having another one aren't ridiculous or remote. And therefore, seeing such a low limit in contrast to the projections, [it] strikes me [that] the result would be an intentional increase in the federal funds rate with relatively little change in the relationship between money supply and economic activity.

For that same reason, I would be inclined to go 4 to 9 percent on M2. However, having made such an expansion on the top, I would be willing to see a 6 to 6-3/4 percent range for the funds range rather than a 6-1/2 top limit so that if we get another massive movement in October--

MR. PARTEE. Then it puts it over the top range.

MR. JACKSON. It puts it over the top of the range, which then I think would justify a stronger move in the federal funds rate--

MR. PARTEE. You don't need to specify that [higher federal funds rate range] because the directions would be inconsistent and there would have to be new directions issued.

MR. JACKSON. That's an operational question that I'm not sure I agree with, based on my understanding of the way we operate. But at any rate, I would prefer to see the 6-3/4 percent top limit so that if the Desk saw significant increases beyond the 3 to 8 percent that I'm suggesting, that we would go as high as 6-3/4.

CHAIRMAN BURNS. All right. I'm a little troubled, not by your prescription, but by the route that you get there. That is, I'm a little troubled by your reasoning. Let's say that the rate of growth--let's just look at M1--is 7 percent, which was my suggested upper limit. Then presumably Alan and Peter at that time would be 6-3/8, 6-1/2 perhaps, well--

MR. JACKSON. Excuse me, I overlooked the fact that I would propose the 6-1/4 estimate for the midpoint. It was a 6 to 6-3/4 percent range.

CHAIRMAN BURNS. Well, 6-1/4, they'd have to move on the federal funds rate immediately, which my suggestion would not involve, and that goes contrary to your own reasoning. You don't want to disturb the federal funds rate too much.

MR. JACKSON. In my own viewpoint, I wouldn't view an eighth of one percent as being a significant change.

CHAIRMAN BURNS. Well, I don't think any of us would quarrel with that. Mr. Partee.

MR. PARTEE. Well, I agree with a good deal of what Governor Jackson had to say, but when he finally got to the prescription, why, it wasn't then the same prescription I would have suggested. I think he's right that it biases the outcome too much to take a range as low as 3 to 7 [on M1] if I understood you; 4 to 8--I didn't understand what you said on M2.

CHAIRMAN BURNS. 4 to 8.

MR. PARTEE. 4 to 8. Now given the fact that September looks as if it's developing to be rather significant, and the possibility of October--well, October could be double digit on M1, given the previous performance. And so I would rather also see a range that encompasses a somewhat higher number--I would propose 3 to 8 [and] 5 to 9 for M1 and M2. Because I don't see any harm, I don't see any great desire to see M2 significantly lower; 5 to 9 is a very reasonable range for M2, as I see it. And I would accept your second funds rate suggestion, 6 to 6-1/2 with 6-1/8 as the beginning point.

CHAIRMAN BURNS. Yes, I had that in mind.

MR. PARTEE. Now if we do get an October that is quite strong, we will undoubtedly go over the 7 percent, the 8 percent top on M1. And when we go over the top, I would assume that the Manager would report to you that the instructions were inconsistent, and then the question would be changing the instructions, considering whether to take the funds rate above 6-1/2. But if M1 came out, let's say, close to 8 percent for the two months, which is not far from the midpoint of the staff forecast, and if M2 was also relatively strong, as I understand it, we would be at 6-1/2 percent by the end of the period. That is, if the aggregates were both at the upper end of their ranges. And going beyond 6-1/2 would be a discrete decision based on overly strong performance. So I would, I guess, accept your funds rate range, but I would have a somewhat more expansive M1 and M2 range than you suggest.

MR. LILLY. I'm not sure I understood what you both are talking about on the funds range. You were talking about 6-1/8 and then--

MR. PARTEE. 6-1/8 is the midpoint of the 6 to 6-1/2

MR. LILLY. Asymmetrical.

CHAIRMAN BURNS. All right, thank you. And Mr. Mayo now, please.

MR. MAYO. Mr. Chairman, I want to subscribe to your preamble. I must say, though, that I also come out with a slightly higher M1 upper end and M2 upper end, as Phil Jackson did. Otherwise, I find that we may be pushing ourselves up a little too soon if, indeed, we have a late September as well as an early October that gets us a little out of bounds. So I would prescribe 3 to 8 for M1, 4 to 9 for M2. This may not seem consistent, but I guess I have enough of a monetarist leaning--if I redefine a monetarist leaning to embrace what has happened to the Ms over a period of a year, which I'm trying to do here--I think I do become more sensitive to the monetarist leaning when we get over a year of over-target performance.

But I would go to 6 to 6-3/4 for the federal funds range and would not find it uncomfortable if, indeed, we used the 6-3/8 midpoint, making it symmetrical. I think the time has come when we have enough evidence, if that's the word, vis-à-vis the targets that have been announced and so forth, that I would not object, let's put it that way, if the Committee's objective on federal funds were perhaps a little higher than those who have spoken thus far. But only marginally.

CHAIRMAN BURNS. All right, thank you, Mr. Mayo. Mr. Coldwell, please.

MR. COLDWELL. Well, Mr. Chairman, I guess I am going to round out these various alternatives, using the same figures, but come out just slightly different from Mr. Mayo. I would be perfectly willing to accept your prescriptions in M1 and M2, putting the cap of 7 and 8 percent on the two respectively. I think there's room for a little bit more restraint here. In the short run, I think real growth [is] going to be a little lower than what staff or the others have forecast at 5 percent in the third quarter, 5 in the fourth, or 4. But I'm optimistic for the first part of '78. And the longer range, I don't think, is satisfactory, both on an unemployment and an inflation basis. I'd like a policy mix shift here, with the Federal Reserve tightening [and] fiscal policy easing. How that fiscal policy ease is achieved and the particular instruments used are matters beyond our control, at least within our range of advising somebody as to the direction it should move. I've reached a point where I think the Federal Reserve needs to limit the liquidity advances in this economy and I think we need to pay a little attention to these monetary aggregates.

So I'm perfectly willing to use your cap level of 7 and 8. I would use the 6 to 6-3/4 percent as the range for federal funds, but putting the 6-1/4 as the asymmetrical midpoint. I think we've reached a point where we will come up pretty soon here to the problem of confidence if this thing doesn't turn a little bit. But I believe it's going to turn again, and I'm making a policy recommendation with the assumption it will turn. Establishing a cap on M1 and M2 is a bow in the direction of the monetary side, but looking over a long range, I really don't care if the thing does go down to zero. I'd be happy if we got a little retrenchment in the total level, and whether you want to put it in a prescription or not is immaterial. But I don't want to go down below the 6 percent range on the federal funds. So with those comments, I'm willing to stand on these particular prescriptions.

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

MR. KIMBREL. Mr. Chairman, my reasoning is almost identical with Mr. Coldwell's. Just expressed the numbers exactly. I'm not sure [whether], on the federal funds, we would even want to enunciate the asymmetrical note, but I think I'd be much more inclined to let the market forces take the funds rate up as soon as practicable. I have the feeling that up to now, at least, the increases in short-term interest rates have had only a modest impact on the long-term rates or on the flow of mortgage funds. Considerable liquidity remains. I continue to be something less than impressed with the progress we're making on this inflation, the energy costs, and the ripple effects or [unintelligible] upward thrust, or however you want to word it. With the minimum wage possibilities forthcoming, and our lack of impressive productivity gains, I really think we still have to apply some further modest restraint and get back to, say, with your numbers, 2 to 7 [for M1], 4 to 8 [for M2], and 6 to 6-3/4 [federal funds rate].

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

MR. EASTBURN. Thank you, Mr. Chairman. I certainly agree with you that the increase in M1 is disconcerting and that the increases in the other Ms are higher than we would like to see them. I think these indicate that it's a matter of judgment, and my own judgment [is] that these are more than random shock developments and we need to deal with them. I would disagree, I think, with Governor Jackson, that no overt moves should be made by the Desk to raise the funds rate. The Bluebook points out that, to meet our longer-term goals, a substantial increase in the funds rate will be necessary and that the increase probably will be greater if it's delayed than if taken earlier.

So I think the Desk should move fairly promptly to move the funds rate up, and my own preference for the range is for 6 to 6-3/4 with a 6-1/4 midpoint. But I would settle for 6-1/2 if it's understood that there would be a discussion if the aggregates were coming in exceptionally high. On the ranges for the aggregates, I would buy our 2 to 7, which you said first on M1, but I think the same kind of logic that you used last time to use the zero floor would apply this time. The only difficulty is that a 0 to 7 percent range is a very wide range. But I think in terms of our intention we should really think of a zero floor. And even though we may publish it as 2 to 7. That's my view.

CHAIRMAN BURNS. I would accept the last comment. Thank you, Mr. Eastburn. Mr. Volcker now, please.

VICE CHAIRMAN VOLCKER. Well, I was going to start with the comment that Mr. Eastburn ended up with. I think it's easier to figure out what we want to do on the low side of all these things than perhaps the upside. Although the general intention is clear enough all around, I guess, to make the end as low as you can stomach for presentation purposes; and I certainly buy yours--a little lower, if people want them. And I wouldn't want to see the federal funds in this period, I think, go below 6--so that [covers] all the low ranges. I think we ought to bias the presumption of what's going to happen against the current projections in the way you've proposed initially.

I can't get too excited whether the upper end of the range is 7 percent for M1 and 8 percent for M2, because the difference of 1 percent seems to be very small compared with the fluctuations we have anyway, from week to week and month to month. I certainly could accept, and I think prefer, the ranges you proposed initially. I feel comfortable with a 6 to 6-1/2 percent range; I feel comfortable with a 6-1/4 percent midpoint there, too, implying you go there relatively soon if nothing else changed. And I accept the personal corollary of that, that I feel quite comfortable with a 6-3/4 percent high end of the range at this point, given the way we biased this to go up within the range anyway, and saying we're very likely going to then hit 6-3/4 percent. I'm not all that sure I want to hit 6-3/4 percent unless we had a really big bulge, in which case we could reconsider. So I feel the upper end of that range should be 6-1/2 percent. I also am sympathetic, given what's happened in the rather erratic movements of M1, putting more weight on M2 somehow or another here.

CHAIRMAN BURNS. Well, that is something that I don't think we ought to try to do at this time. I have great sympathy with that suggestion. But I think that's something that your [sub]committee, Mr. Partee, should bring a recommendation on very, very soon.

MR. PARTEE. What, the [Sub]committee on the Directive?

CHAIRMAN BURNS. Yes. Aren't you chairman of it?

MR. PARTEE. Yes, yes. But that was the subject that we had proposed to study, and we were told not to study it.

CHAIRMAN BURNS. Well, as the Chairman of the Committee--in view of my responsibilities, prerogatives--I speak in behalf of the entire Committee when I counsel you to get busy on that promptly.

MR. PARTEE. I will try to have some preliminary work done for the Committee next time.

VICE CHAIRMAN VOLCKER. My problem is, Mr. Chairman, I am not sure I would take the same view in the long run. My comment is directed for the particular short-run situation.

CHAIRMAN BURNS. Well, I don't think we can afford to change our procedure. We can change our goals from meeting to meeting, [but] I think we need some stability with regard to procedure. We'd be lost if we don't. As to the outcome, I'm leaning increasingly in the direction of giving more weight to M2. But I want that to be weighed by our staff, I want this to be weighed by our [sub]committee. I want the decision to be reached, and then we live with that decision for some time before changing again. Well, the Committee will do what it chooses to do. I have expressed my view. Anything else?

VICE CHAIRMAN VOLCKER. No. I think that is essentially it.

CHAIRMAN BURNS. Thank you very much. Mr. Morris next, please.

MR. MORRIS. Well, Mr. Chairman, I have been doing a lot of soul searching for this meeting. Particularly because I feel that, near term, the economy is not going to be as strong as the staff has projected. On the other hand we've got the fact that we've had two quarters of back-to-back growth rates substantially in excess of what we were shooting for. And I personally found the August numbers rather disappointing. I was hoping for a reaction from the July bulge, and it didn't happen.

It seems to me that we've got to make a move at this meeting if we're going to maintain credibility in Federal Reserve policy, particularly in the light of the fact that next month we'll have to set long-term targets. I think our setting of the long-term targets next month will be very awkward if we act as if we were not terribly unhappy with the excessive rates of growth we've gotten in the last six months. So I would buy two-thirds of your prescription, Mr. Chairman, in that I'd buy the 3 to 7 and 4 to 8, although I would certainly be amenable to lowering the lower level. I'd be happy to see for that period a smaller number than 3 or 4.

But the thing I'm unhappy about is the proposition that we should leave this meeting instructing the Manager to adopt a status quo policy on the funds rate until such time as he sees the numbers moving out of the range or approaching the end of the range. I just don't think that's appropriate in the light of six months of overshoot. I buy the 6 to 6-3/4 range, but with a proviso that the Manager be instructed to move to the 6-3/8 midpoint by next week to demonstrate to the market and to the business community that we are not satisfied with what's happened. I think maintaining our credibility here is very critical. And I think we're on the verge of being where the market is going to judge us pretty soon one way or the other if we show a tendency to drag our feet here.

CHAIRMAN BURNS. To maintain our credibility, what does that mean? First, we want the market and the country at large to take seriously our protestation, since we believe in it seriously, as we are determined to do what we can to help unwind the inflation. All right, that's essential to maintain credibility. [It] is equally essential to be alive to what is happening in the real economy; to the extent that you have elements of weakness in the economy, if we ignore those, there will be no gain in credibility for the System.

Responsible people across the country will scratch their heads and say, Don't these people know what is happening in the real economy? Don't they care? So it's not a one-way street. Credibility requires that we work on both dimensions and achieve as wise a compromise, if that be the right term, take into account both factors, as we just have. I think each of us is trying to do that in his own way. But I just wanted to define the two dimensions of credibility.

Thank you, Mr. Morris. Mr. Black now, please.

MR. BLACK. Mr. Chairman, I've got an eclectic approach, I guess, and I wish I could give proper footnotes, but so many things have been said by so many people, I'm not sure I can. I certainly agree with the feeling of most people that M2 has been projecting a different posture of policy than M1 has been. And I think the majority feels that M2 deserves a little more emphasis, and I certainly concur in that because of the recent changes in financial technology. And regardless of how we look at it, I think, clearly, both aggregates have been moving too fast, and we certainly want to resist any acceleration there and begin moving these things down gradually to a lower growth path. And I certainly welcome the sign that M2 is decelerating some. But I wouldn't want to see that deceleration proceed too rapidly. I favor a gradual downward movement in that. So far as the lower limit of M1 is concerned, I guess I am a little different here. I don't think anybody suggested, maybe someone did, going below zero. I wouldn't mind even going below zero on the lower end of M1.

CHAIRMAN BURNS. I would like to say something about the Chairman's role in advising the Committee between meetings. Let's make the assumption that I will continue to think the way I feel now. And if we were at 2 or 3 [percent on M1], and let's say that the federal funds rate at that time was 6 [percent]. I would certainly advise the Committee not to go below 6 even though, you see, you've got a zero monetary growth rate or small minus.

MR. BLACK. I certainly concur with that.

CHAIRMAN BURNS. And therefore, what I think is important is the point Mr. Volcker made and one other member of the Committee--presentation [of a zero value], I think, would be unwise, since our decision on ranges are all public. To have a figure of zero or minus--we can take care of that.

MR. PARTEE. If we stop on the 6, there can be hardly any backup?

CHAIRMAN BURNS. We can take care of that through the communications between meetings if it so happens we're at that point. I hope we are at that point.

MR. BLACK. And I wasn't going to suggest that we publish that, either; I want to make that clear. We've been playing around with the estimates on this thing and we're probably dead wrong. I pointed out once that we didn't have the experience, but neither did we have the long record of misses that some of the others [did]--we now have two records of solid misses, so I have less confidence; we are fast approaching that. I'm sure we'll go even closer, but we think that probably M1 may come in at 5 percent, or even less than that.

So I guess for the sake of symmetry more than anything else, the range I would have chosen would be 3 to 7, but I like your 2 to 7, although it doesn't have the symmetrical beauty of the 3 to 7. For the M2, I think 5 to 9 would be appropriate; [but] I have no particular problems with the 4 to 8. And for the federal funds rate, 6 to 6-1/2. As I indicated, I think a little bit earlier, I'd stay pretty much where we are regardless of what happened to M1, but if M2 should drop down below 5 percent, I think I'd be inclined to back away a little bit from the 6-1/8. I don't know what all exactly happened, but I would back down just a little bit from that. But if M1 and M2 begin to approach these ceilings, then I think we ought to move on up toward 6-1/2, and if they begin exceeding the ceiling--I guess there's certainly some possibility they will--I would hope we would be at 6-1/2 by the time of the next meeting.

CHAIRMAN BURNS. Thank you, Mr. Black. Mr. Balles next, please.

MR. BALLES. Well, Mr. Chairman, as I listen to this discussion, it seems to me that one of the obligations that I guess we have as a Committee is to make some judgments about the business outlook. It's true that the headlines quite recently have featured a number of pieces of bad news. But it also occurred to me--as I listen to the discussion, I share the consensus view that we do expect a continuation of a fairly good rate of growth, say, around 4 percent, which looks pretty respectable in terms of our long-term capacity to grow and our own long-term history. So in that sense, I wouldn't shrink from making policy news which we decide ought to be made in any event, apart from what might be considered adverse short-term public relations aspects in the sense of getting the public to understand what we are all about.

Reflecting back on your last two appearances before the [congressional] banking committees, putting the problems of monetary policy in the broader prospective; and in view of your calling attention to the fact that, even though we gradually inched down the growth ranges, it would take some 10 years to get to a point really consistent with price stability--and in the meantime we've had an actual increase in the rate of growth of the aggregates; in that kind of perspective, I am concerned along the lines that have been expressed by a number of my colleagues so far, that we need to take modest further action.

We all know the growth rate over the past year--M1 over 7 percent, M2 almost 11. And as I look at the Board staff's own projections as of September 8, going out to October 5, and measure those against our own current 12-month targets, it is quite clear that M1 is well above the upper end of our 12-month range by $2 billion to $3 billion. And it is very clear that when we move into the next quarter, we'll have an upward base drift of significant amounts, maybe $3 billion. As you look at the Board staff's projections for M2, again through October 5, it's clear that M2 will continue very near the upper end of that 12-month range, so we're going to have an upward base drift of M2 as well.

Now I don't place any magic significance to our ranges for 12 months ahead; they are very carefully thought about. But I do accept them as provisional targets that we ought to shoot at, [unintelligible] unless we've darn good reason to depart from them. And I haven't yet heard such reasons. And furthermore, as I study the Bluebook, especially on page 6--what we would have to do going into the second half of 1978 in order to achieve the present 12-month ranges--I'm extremely skeptical that this Committee could or would crank down the growth rates of either one, to about 2.6 percent for M1, or 6.2 percent for M2.

Well, having said all of that, I think it gives strong support to the ranges that you propose for M1 and M2, say 3 to 7 and 4 to 8. I'm concerned not what the lower end of our range is, but the upper end. Because if we go up to what was proposed in some of the alternatives in the Bluebook as to the high end of the range, whether M1 or M2, we continue to move further away from what our 12-month targets are rather than taking modest steps to bring the overshoots back in the range. I think the only point on which I differ a bit from you, Mr. Chairman, is on the federal funds range. I would prefer, as several members have spoken up here so far--Messrs. Mayo and Morris, as I recall--to go with deliberate speed toward a 6-3/8 midpoint within a range of 6 to 6-3/4 based on the analysis that I have already made.

CHAIRMAN BURNS. Thank you, Mr. Balles. We will hear next from Mr. Wallich.

MR. WALLICH. Well, I tried earlier to analyze our situation in terms of where the instability in situations came from--from the monetary side or from the real side. The predominant impression seems to be that it comes from the monetary side, whether it's just a stochastic shock, or whether we're back on the old slope of the demand curve at the lower level. Either way, it seems to me to argue that we should lean more on the funds rate than on the aggregates at this time. Now when I look at the economy, which I don't see to be very strong, again it seems to me--putting it in somewhat extreme terms--a choice of going with the economy or going with the aggregates. I am inclined to go with the economy, which to me means not making a great change in the funds rate. That does mean that one allows an overshoot on the aggregates in terms of our long-run ranges, and I fully agree with what John Balles said. It would be a tremendous job to get back on track from present levels; it would be harder even if we allow a further overshoot. Nevertheless, I think, under the circumstances, I'd be prepared to accept some base drift and consequently, in the short run, an overshoot.

Now also, I do have some concern for the expectational, the appearance effects of having a very high upper level to our short-run M1 range. I think that can be offset by lowering the other ends, so that we simply have a wider range. And that leads me to suggest 2 to 9 for M1. Now I would think, for M2--where, incidentally, we would also have to do a big job to get back on track because its velocity flexibility is less, precisely because it's been better numbers so far--we do need something like 3, 4, 5 percentage points growth of M2 in order to get back on track, and I doubt that we will be able to accomplish that without very high interest rates. So on M2 I'm prepared to go to 5-1/2 to 9-1/2.

And I'll support this also with the idea that we ought to have consistent targets, that is to say, to set low aggregates and not set a very high funds rate to match it leaves us with the immediate problem of resolving that conflict. I don't think much is gained by that. I would rather set the key targets--interest rates, aggregates--in a consistent way, the way the staff tries to do it. I think we can compensate for a wider range on the aggregates with the narrower range on the funds rate, although I don't like narrow ranges on the funds rate. But [given] that I want to go with the interest rate anyway, I would say, yes, we can have a narrower range, and I would say 5-7/8 to 6-3/8 on the funds rate. Now that really pushes me in the direction of a money market directive rather than an aggregates directive, and I'd be prepared to go with that.

CHAIRMAN BURNS. Thank you, Mr. Wallich. Mr. Lilly next, please.

MR. LILLY. Well, as I mentioned earlier, I share with Henry the view that the economy is not very strong, and the recovery is fragile, in my opinion. And I think that we are attacking a structural problem [with] a monetary shotgun, if I may create a phrase. The targets that I find at the high end, if not at the limit of my restriction and tolerance, are the 3 to 8 [M1], 5 to 9 [M2], and the 6 to 6-1/2 [federal funds rate] with the 6-1/8 asymmetrical midpoint. And I would really lean more toward Henry's prescription than that.

CHAIRMAN BURNS. Thank you, Mr. Lilly. Mr. Roos next, please.

MR. ROOS. Mr. Chairman, I would like to make several observations about what I've heard. First of all, it seems to me that there has not been any significant deterioration of economic conditions since a month ago, when we met here and adopted an M1 range of 0 to 5 percent. I'm at a loss [as] to [how to] accept the logic of that and then see us view conditions as a reason for adjusting the range significantly up from what it was [as a result of] the action we took a month ago. I think we ought to just look for a moment and at least be aware of the consequences--if we are going to be responsible in what we are doing--of anything like a 7 percent rate of growth of M1 for the next 30 days, for the next month. And I am using the staff projections.

John Balles touched upon the fact that the staff projects that for the first six months of '78, we'd have to pull M1 [growth] down to something less than 3 percent. I assume that we would be willing to do that to move this thing in the right direction. If we take the 5-1/2 percent [fourth] quarter projection of the staff, [and] if we adopt 7 percent M1 growth for the month of October, that means that in November and December we must be prepared to move down to something like 2-1/2 percent for both of those months to average out at [the staff's fourth-quarter projection of] 5-1/2 percent, which is a spectacularly remedial effort to readjust these bulges that we have been experiencing.

If we are concerned that taking strong action now would precipitate an economic trauma, I think we should be aware that, somewhere along the line, unless we are going to throw in the towel in what we are trying to do and on what has been our stated objective--to inch this inflationary problem down--we are going to have to do this sooner or later. And it seems to me that history is replete with cases of what happens when you let this thing continue to drift on an upward basis and then have to pull it down a year or two hence: We will have at that time the same type of traumatic consequence to the economy that we are so fearful of today. I think that there is no question in my judgment--I'm not an economist--that if we permit a continuation of the sort of growth of the aggregates that we have experienced the last two quarters, that just as sure as we are sitting here today, two years down the road we are going to have an increase in prices, we are going to have a resumption of an upward trend in the rate of inflation.

I think this matter of credibility is important. I think people are watching us. I think it is only due to the great respect, Mr. Chairman, that they have for you that the markets still believe that this Committee is serious in its attempt to do what is necessary to deal with this inflationary problem. If we let the upward drift of M1, and M2 to a lesser degree, continue, I think it's a matter of months, maybe, until they say [that] we are not really serious in what we say, we are really not as concerned about ultimate inflation as we say we are. And if we lose that credibility, I think we are going to have higher interest rates. Long-term rates are going to go up just as soon as people lose their confidence or disbelieve [in our] sincerity or our ability to do what we say we are trying to do. I think this is a very critical time.

I'm sorry, I apologize for making a speech. I didn't mean to do that, but I cannot buy a top range of anything like 7 percent [for M1]. I would recommend a repetition of the 0 to 5 percent M1 range that we had last meeting. I'm not terribly concerned--I would certainly agree with your M2 targets. And I think that if I had my druthers, I would like to see a fed funds range of maybe 6 to 7 percent, at least 6 to 6-3/4 percent.

I think this is a critical time, and I think we are going to have to bite the bullet ultimately, and I would like to bite it today.

CHAIRMAN BURNS. Thank you, Mr. Roos. We will hear from Mr. Gardner now, please.

MR. GARDNER. I guess you could have taken from my earlier remark today that I'm a little apprehensive about the projections we have for the demand for total credit in the economy. And clearly we have been experiencing higher growth rates than we have expected at each of these meetings. I am prepared to be quite conservative today. And I'm delighted that there is at least tacit acceptance of the fact that the economy is not going to fall apart, because there are so many other opinions expressed about appropriate lower monetary aggregates targets and letting the funds rate rise further. I think we are clearly in a period where action should begin to be taken. And [I would] reverse a statement I made many months ago that there were often periods when one need not be overly concerned. But this time I'm prepared to work overtime. I don't see any reason why, if we are at a key point in determining the continuation of the recovery and the strength of final demand and the like, we ought not to expect to make more decisions between now and our next meeting than we might normally make.

Therefore, I would not want to raise the upper end of the M1 proposal that the Chairman suggested. If anything, I'd be as happy with something a little less. I'd leave M2 on a 4 to 8 as recommended. And I will be perfectly agreeable with a 6 to 6-1/2 percent funds rate because I suspect that by having this rather unsymmetrical set of specifics, we may be called on to take some action between now and the time of the next meeting in October. And it wouldn't bother me a bit because we will have more information. But I do suspect that there will be a stronger demand for money, as there has been, and certainly, from my earlier statement, I suspect that conditions are favorable for expansion of credit. I can accept your proposal, Mr. Chairman, and I expect, if we did come to that, we would probably be hearing from the Manager sometime.

CHAIRMAN BURNS. Thank you, Mr. Gardner. Mr. Winn now, please.

MR. WINN. Mr. Chairman, thank you. To try to resolve the conflicting forces that we are dealing with, and at the same time as a historian looking at our records, I had trouble getting away from last month's actions, with the economy not being that much different in outlook from what we had. And so I would recommend an M1 range of 0 to 7, indicating some change, recognizing reality. Keep a 3 to 8 or 8-1/2 on the M2 again, thinking of last month's actions. And go to 6 to 6-1/2 [federal funds rate] [with a] 6-1/4 median, with the opportunity to use that in the period if these ranges are not met.

CHAIRMAN BURNS. Thank you, Mr. Winn. Mr. Willes now, please.

MR. WILLES. Thank you, Mr. Chairman. Just one quick comment. Almost everybody seems to agree that we need to continue to move. There may be some differences in timing, and in that regard I'd like to echo the comment that Dave Eastburn made, and that is, I am fairly persuaded by the staff report that says, in effect, if you move interest rates a little sooner, you can get by with a smaller overall increase in the rates over the course of the next year. So I would join those who have indicated that they prefer to see a relatively small but prompt move in the funds rate. And, of course, if the aggregates continue to go [unintelligible] the range that you mentioned, that they would move even further.

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

MR. GUFFEY. Thank you, Mr. Chairman. I guess my concern is shared by perhaps everybody around the table in terms of the aggregates growth. But let me say, first, that in our view the economy is healthy. It isn't as fragile as has been described today. And as a result, we perhaps should be taking some advantage of that to move our aggregates growth rate somewhat lower, which implies of course, a higher funds rate. I should also say I take some comfort in the comments you made--if we do get slow growth in the period ahead, that we will tolerate that and not go below perhaps a 6 percent funds rate.

Turning attention to the [top end of the growth ranges]--with regard to M1 and M2, I think that's the important figure--I would quickly buy the 7 and 8 for the top of both of those. I would also go with your prescription for the 6 to 6-1/2 [and] the proposal that we move to the 6-1/4 [midpoint] fairly promptly after this meeting. And I guess I would maybe prophesy that we will have, as Governor Gardner has suggested, an opportunity to review it in between, because I think we would expect that the growth rates will come in fairly strong, and it wouldn't make me unhappy if this time next month we were as high as 6-3/4. I'm just suggesting, with a narrow funds range of 6 to 6-1/2, that we would have an opportunity to take a look at it.

CHAIRMAN BURNS. Thank you, Mr. Guffey.

MR. BAUGHMAN. Mr. Chairman--I'm sorry--

CHAIRMAN BURNS. You started this meeting, and now you are in a unique position also of ending it, or ending the formal go-round, and now we are ready for your benediction.

MR. BAUGHMAN. It'll be very brief. It's in a sense belaboring the obvious to remind us all that the record we are building continues to look more and more procyclical, and also I guess to remind us that historically this has tended to move us into a position which resulted in a development which has come to be labeled a crunch. And it seems to me also that his has been going on long enough now so that--even though we can't point to the specific elements in the real sector which would explain this development--we can't really call it a random development and have a fairly firm basis for expecting that it's going to reverse itself.

As to the general economic situation, I'm inclined to think that, insofar as the staff projection might be off mark, it will be off mark on the low side rather than the high side. And this is in part because of what we are seeing develop in the fiscal area and also what has already developed in the monetary area and indications that we do have substantial liquidity in the economy. It seems to me, Mr. Chairman, that your suggestion has done a real good job pulling these diverse elements together, and I would not suggest any change at all from your proposal, with the exception that I think you suggested we start from our present posture--6-1/8, more or less--as a midpoint of the 6 to 6-1/2 range, and I would share the view of those who think we should take the bona fide midpoint of 6-1/4 and move to that posture rather promptly. That's all I have to say.

CHAIRMAN BURNS. Thank you, Mr. Baughman. Well, gentlemen, we've expressed a range of views, but the differences among us, with one or two exceptions, are quite small. The range of 2 to 7 or 3 to 7 for M1 would be acceptable, I think, to the majority of the Committee, and a range of 4 to 8 [for M2] would be accepted as well by most of us.

The range of 6 to 6-1/2 percent [for the federal funds rate] seems to be favored, though there's also significant sentiment for the range of 6 to 6-3/4. I think the main difference is with regard to the midpoint of the federal funds rate. Assuming that it were to be 6 to 6-1/2--let's just make that assumption--how many would prefer a symmetrical midpoint at 6-1/4 as over against an asymmetrical midpoint, namely 6-1/8? Let me repeat that. We will assume that the federal funds rate range is 6 to 6-1/2, making that assumption. Those who prefer the arithmetically true midpoint of 6-1/4 as over against the asymmetrical 6-1/8 will kindly raise their hands.

MR. BROIDA. Eight.

CHAIRMAN BURNS. Now there was no clear indication as to preference by members of the Committee with regard to the language of the directive. Mr. Wallich commented on that, and he made an unusual announcement. Mr. Wallich generally is in favor of monetary aggregates directives, but he seemed to favor a money market directive this time. Let's have a show of hands, assuming a 6 to 6-1/2 federal funds rate for the moment--we will come back to that--how many would prefer a money market directive? I'm going to turn this around. Assuming a federal funds rate of 6 to 6-1/2, how many would prefer a monetary aggregates directive?

MR. BROIDA. Six, Mr. Chairman.

CHAIRMAN BURNS. Now how many would prefer a money market directive?

MR. BROIDA. Four.

CHAIRMAN BURNS. Well, it will be a monetary aggregates directive. Are there any comments that the members of the Committee would like to make at this time?

VICE CHAIRMAN VOLCKER. My one comment is perhaps along the line which Steve Gardner already said. But where I balk with the 6-3/4 [percent federal funds rate], if that's still an open question--if you got an aggregate right on the margin of this range that we're adopting, 6-3/4 seems to me to be inappropriate. It wouldn't seem to me to be inappropriate if we had an October the way we had a July and April, and I would be prepared to go at that point. But the way we formulate these things, you can't make that distinction. It does seem to me that 6-3/4 percent is clearly too high, given the projection right at the top where the ranges--

MR. PARTEE. 7 percent at the top. 7 percent is pretty likely, pretty likely [the] outcome.

VICE CHAIRMAN VOLCKER. You'd almost have to say you go to 6-3/4 percent right away.

MR. PARTEE. As it is, it seems to me what that does, Mr. Chairman, is really raise quite high odds that we will be at or close to 6-1/2. And if October [rises sharply], of course, we will have to go above. Even if it doesn't, I think the odds are very high that we'll be close to 6-1/2.

VICE CHAIRMAN VOLCKER. With a 6-1/2.

CHAIRMAN BURNS. I don't know anything about the odds, and I marvel at your knowledge, but--

MR. PARTEE. I'm taking the estimate of 6.6 percent for the monthly growth rate for September as having some plausibility.

CHAIRMAN BURNS. That's a little softer. Gentlemen, I think the time for argument has passed; we need a decision. Let's have a show of hands now because we've had an opportunity to rethink our positions. As I indicated, there was some preference for a federal funds rate range of 6 to 6-1/2 as voiced by members of the Committee, and possibly there's been some rethinking. Those who would prefer, we've got to contrast 6 to 6-1/2 as over against 6 to 6-3/4. Those who would prefer a range of 6 to 6-1/2 will kindly raise your hands.

MR. BROIDA. Six.

CHAIRMAN BURNS. Well, I'll have to make that seven. Any other questions to come up?

MR. MORRIS. Have you settled on the midpoint?

CHAIRMAN BURNS. I think we have.

MR. MORRIS. 6-1/4--

MR. JACKSON. May I ask a question, Mr. Chairman?

CHAIRMAN BURNS. Please.

MR. JACKSON. If the Committee chooses to adopt the 3 to 7 percent range for M1 and a 4 to 8 for M2, and the staff's projection of approximately 7 percent increase in M1 and a comparable increase for M2 arrives, comes to fruition, to the extent that we will understand it as the period develops, could I ask Alan where you would move the federal funds rate?

MR. HOLMES. Well, I think if it really were at the very top of the range, we would gradually move toward that. But as you know, we get new projections each week. I wouldn't jump all the way to 6-1/2 in one week.

MR. JACKSON. That's the reason I predicated my question on the assumption that the results are what the staff projected. Namely about a 7 percent increase.

MR. HOLMES. I think we would move decisively at least to the midpoint, maybe a bit beyond, and then wait for another week to see if the next week's projections kept this at 7. But not jump in one fell swoop.

MR. JACKSON. Did I understand your answer to be that if, say, by the third week, it still affirmed a likely projection of 7 percent, you would likely be at 6-1/2 percent?

MR. HOLMES. Or very close to it.

MR. JACKSON. Well, that's what I concluded.

CHAIRMAN BURNS. Well, I think what Mr. Holmes is saying is that he would be following a standard procedure.

MR. BLACK. Clarification, Mr. Chairman, is it 2 to 7 on M1 or 3 to 7?

CHAIRMAN BURNS. Well, let's have a show of hands on this. How many prefer 2 to 7 for M1 as over against 3 to 7?

MR. BROIDA. Five.

CHAIRMAN BURNS. How many prefer 3 to 7 as over against 2 to 7 for M1?

MR. BROIDA. Two.

CHAIRMAN BURNS. Well, our arithmetic being what it is, we'll put 2 to 7 to a vote if there are no further questions or comments. Are there any further questions? Let's vote on the following: a monetary aggregates directive, a rate of growth of M1 of 2 to 7 [percent], a range of 4 to 8 for M2, a range of 6 to 6-1/2 for the federal funds rate, a true midpoint arithmetically of 6-1/4 for the federal funds rate range. That is what we will be moving on, and I hear no desire for further deliberation, so would you be good enough 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	No
President Mayo	Yes
President Morris	No
Governor Partee	No
President Roos	No
Governor Wallich	No

Seven to five, Mr. Chairman.

CHAIRMAN BURNS. Well, let's stop and deliberate it. I think that would be a very unfortunate vote. To me, the Committee is split badly. It would mean that this would excite a great deal of discussion that would not bring honor or credit to the Committee, and therefore I think we must seek to accommodate one another. I didn't think our differences were that large. Let's try again. Does anyone have a proposal to make, one of the dissenters. Yes, Mr. Partee.

MR. PARTEE. Mr. Chairman, if the range for the aggregates were widened [at the upper end] to accommodate 8 for M1 and 9 for M2, I would go with it.

CHAIRMAN BURNS. All right, was that--

MR. LILLY. I'd add one thing, and that would be an asymmetrical 6-1/8.

MR. COLDWELL. If we're going in that direction, I'd want a 3/4 [percentage point federal funds rate] range, too.

CHAIRMAN BURNS. Gentlemen we can't--these differences are minor. Let us practice a little humility and accommodate one another and not be all over the lot because of minute differences. I'm perfectly willing to put Mr. Partee's suggestion to a vote. I will accept Mr. Partee's suggestion changing the limits, the ranges of M1 and M2 and the other specifications being what I previously described, that is, the M1 being 2 to 8 and M2 being 4 to 9. Let's have another vote.

MR. BROIDA.

Chairman Burns	Yes
Vice Chairman Volcker	Yes
Governor Coldwell	No
Governor Gardner	Yes
President Guffey	Yes
Governor Jackson	Yes
Governor Lilly	No
President Mayo	Yes
President Morris	No
Governor Partee	Yes
Governor Roos	No
Governor Wallich	No

Seven to five.

CHAIRMAN BURNS. Well, I think that patience is an indispensable commodity all of us are in possession of, that abundant commodity, so therefore I will entertain another suggestion.

MR. COLDWELL. Well, let me try, Mr. Chairman, since I ruined the shift on that. Suppose we just take the M1 at 2 to 8, leave Mr. Partee's 4 to 9 on M2, use the 6 to 6-1/2 as the fed funds range, put a 1/8 asymmetrical position but with the understanding that it moves to a 1/4 if the figures confirm the staff projection.

CHAIRMAN BURNS. All right, I'm going to put that to a vote, Mr. Coldwell's specification: 2 to 8 for M1, 4 to 9 for M2, 6 to 6-1/2 for the federal funds rate, the midpoint to be 6-1/8, an asymmetrical midpoint, but of course depending on the evolution of the monetary aggregates figures as to when we move away from that midpoint. Would you put that to a vote please.

MR. BROIDA.

Chairman Burns	Yes
Vice Chairman Volcker	Yes
Governor Coldwell	Yes
Governor Gardner	No
President Guffey	Yes
Governor Jackson	Yes
Governor Lilly	Yes
President Mayo	Yes
President Morris	No
Governor Partee	Yes
President Roos	No
Governor Wallich	No

Eight to four.

CHAIRMAN BURNS. Gentlemen, the original vote stands. The first vote. We're divided. I think it's unfortunate, I think it's undesirable, and I don't know what has gotten into this group. But if that's the kind of life you want to lead, you have my blessing. You're a good group, but you've gone haywire today. Now, I've shown a willingness. I have convictions in these matters. I have gone along with each alternative suggestion. Is there any other proposal?

MR. BLACK. Mr. Chairman, I don't want to make a proposal, but I wonder if I might just point out, the midpoint for the 2 to 8 [range for M1] is 5 percent, if I figured that right. And this would trigger action if [M1 came] in above 5 percent. So, some of those who are worried about the 8 percent, I think, will be accommodated by triggering of the federal funds rate when that thing hits 5. And I have no problems--

CHAIRMAN BURNS. Mr. Roos.

MR. ROOS. Yes sir.

CHAIRMAN BURNS. You have been in the habit of bringing people together. Do you have a suggestion to make today?

MR. ROOS. Mr. Chairman, the trend during this patience operation has gone the opposite direction. My concern--and I would like to explain, to clear the air, that St. Louis is not falling into a maverick position. I have a very honest and sincere belief that we are doing the wrong thing. It's not a matter of a few numbers. I mean, in the case of my vote, the only way, sir, I could in good conscience vote yes on this would be if there were some lowering of the upper range of the aggregates, especially in the M1 category.

CHAIRMAN BURNS. Let me try the original vote once again, that is to say, the original suggestion I made--we haven't improved matters much. And let's try and really show a little more humility than we have at this meeting. I suggest an M1 range of 2 to 7, an M2 range of 4 to 8, a federal funds rate range of 6 to 6-1/2 with a midpoint of 6-1/4, and a monetary aggregates directive.

MR. LILLY. Before you do that, can I explore a little as to why the last proposal of Phillip Coldwell, which brought me around, picked up a vote, is not closer to the compromise than the first one?

CHAIRMAN BURNS. Well, I don't think it's sufficiently different, you see. That is, [votes of] seven to five, eight to four. Seven to five--that expressed, I thought, more clearly the information that I had about a broad sentiment as reported by Mr. Broida. Let's vote on that.

MR. BLACK. Mr. Chairman, may I make one more observation before we vote. I came in here with the intention of departing from my usual procedure and recommending a money market directive with a feeling of 5 percent [upper limit] on M1. That, to me, is the same thing as a range from 2 to 7 on the aggregates directive because it triggers as action on the part of the Manager at that point. Similarly on the M2, you trigger action at 6 percent. I think, later, with these you mentioned 5 percent as what you thought ought to be the ceiling, but if you reach 5 percent it does trigger action.

MR. ROOS. I don't know that this has been the history in the last few months. The action hasn't kept this thing from being at the very top of the range.

MR. BLACK. On an aggregates directive, you trigger action when it passes the midpoint; on a money market directive, you trigger action when it passes the ceiling. And I'm just trying to point out that I think this is almost equivalent to a money market directive with a ceiling of 5 percent on M1 and a ceiling of 6 percent on M2, which is a pretty hawkish position--maybe that's not helpful.

CHAIRMAN BURNS. Let's try the voting once again.

MR. PARTEE. Now, this is on the first vote?

CHAIRMAN BURNS. Yes. Shall I repeat the proposal? It's apparently understood. Would you be good enough 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	No
President Mayo	Yes
President Morris	No
Governor Partee	Yes
President Roos	No
Governor Wallich	No

Eight to four.

CHAIRMAN BURNS. Well, does anyone else have a suggestion?

MR. JACKSON. Mr. Chairman, if I sense the thrust of the discussion that we have had, it appears to be considerable concern that the adoption of a monetary aggregates directive with midpoints expressed the way they are would result in a relatively certain move to the upper ends of the federal funds range. [And] perhaps a greater likelihood than normal that there would be a call meeting of the Committee to take action beyond that.

I wonder whether there might be some sentiment for adopting the proposal made by Governor Wallich earlier, where you use a money market directive with the ranges, with the likelihood that staff projections are correct. The result would be that the aggregates would move beyond the expected ranges and action would be taken as a consequence of it, which would again give us the likely opportunity that we would have another meeting, and we would have another look, [and] perhaps greater knowledge could be brought to bear on our problem.

CHAIRMAN BURNS. Your suggestion, Mr. Holmes.

MR. HOLMES. Mr. Chairman, may I just make one comment. The Board projection really is at the top of the M1 range. I don't put this out as any solace, but the New York projection is 1-1/2 percent lower than that, or very close to the midpoint of that 2 to 7 percent. These are projections we are talking about.

MR. PARTEE. What about M2, Alan? What's your M2 projection?

MR. HOLMES. We'd be on the high side.

MR. COLDWELL. Mr. Chairman, I wonder if there is any possibility that we might resolve one or two votes. I doubt that we can resolve all of them because we have a conflicting viewpoint on both sides of the spectrum. But I wonder if it is possible to shift one or two by talking about a 6-1/8 [midpoint for the federal funds rate range] with a move to the quarter only with confirming.

CHAIRMAN BURNS. I thought we already voted on that.

MR. COLDWELL. No, we had 6-1/4. And if we changed that last specification to 6-1/8--

CHAIRMAN BURNS. That is, that M1 would remain 2 to 7. We will make another vote now: M1, 2 to 7; M2, 4 to 8; federal funds rate range 6 to 6-1/2, with the midpoint of the federal funds rate range to be asymmetrical to 6-1/8. Differing from the vote we have just taken in the specification of the midpoint. Is that clear? All right, let's vote on it.

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	No
President Morris	No
Governor Partee	Yes
President Roos	No
Governor Wallich	No

Eight to four.

CHAIRMAN BURNS. Well, any other suggestions?

SPEAKER(?). Let's stick with the original vote.

CHAIRMAN BURNS. Well, the original vote has been modified.

MR. PARTEE. I agree.

CHAIRMAN BURNS. All right, I want to be sure now, in view of all the voting that we've done, that we know how we have come out. Now, the vote to be recorded is as follows: this is voting on 2 to 7 for M1; 4 to 8 for M2; 6 to 6-1/2 for the federal funds rate range, midpoint to be 6-1/4; and a monetary aggregates directive. Those dissenting from that are Governor Lilly, [Presidents] Morris [and] Roos, and [Governor] Wallich, the vote being 8 to 4. Okay. Gentlemen, thank you very much. We have made an honest effort to reduce our differences, and after a long struggle, we did reduce [them] just a little.

END OF MEETING