TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

October 17-18, 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. Kichline, Associate Economist
Mr. Zeisel, Associate Economist
Mr. Truman, Associate Economist

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Meeting of Federal Open Market Committee

October 17-18, 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 Monday and Tuesday, October 17-18, 1977, beginning at 3:00 p.m. on Monday.

PRESENT:
Mr. Burns, Chairman
Mr. Volcker, Vice Chairman
Mr. Coldwell
Mr. Gardner 1/
Mr. Guffey
Mr. Jackson
Mr. Lilly
Mr. Mayo
Mr. Morris
Mr. Partee
Mr. Roos
Mr. Wallich

Messrs. Balles, Baughman, 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, R. Davis, T. Davis, Ettin, Kichline, Reynolds, Scheld, Truman, and Zeisel, Associate Economists

1/ Attended Tuesday session only.

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
Mr. Kalchbrenner 2/, Associate Director, Division of Research and Statistics, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Messrs. McIntosh, Moriarty, and Smoot, First Vice Presidents, Federal Reserve Banks of Boston, St. Louis, and Philadelphia, respectively
Mr. J. Davis 1/, Senior Vice President, Federal Reserve Bank of Cleveland

Messrs. Broaddus, Burns, Cox, Kaminow, and Keran, Vice Presidents, Federal Reserve Banks of Richmond, Dallas, Atlanta, Philadelphia, and San Francisco, respectively
Mr. Sandberg, Assistant Vice President, Federal Reserve Bank of New York
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis

1/ Attended Tuesday session only.

2/ Attended part of Tuesday session only.

Transcript of Federal Open Market Committee Meeting of
October 17-18, 1977

CHAIRMAN BURNS. Mr. Gardner is absent today. As far as possible, I would like to have the full Federal Reserve family present at a meeting where quasi-final decisions with regard to monetary policy are made. And in view of that, we can get through as much business as we can this afternoon and stop short of trying to reach any decision of monetary policy; and we have a great deal of work to do. We'll start as we always do, with the minutes of the last meeting, and I take it there is no problem.

MR. COLDWELL. I move that it be approved.

MR. MAYO. Second.

CHAIRMAN BURNS. And that's been accomplished. We will turn at once to a review of the condition of our economy, and we need to examine the condition of our economy with special care at this meeting, not only because this meeting precedes one of our quarterly hearings before the Congress but also because the state of the economy is less clear to many of us, certainly to many observers on the outside, than it was six months ago or perhaps three months ago. Mr. Kichline, would you be good enough to proceed in your own way.

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

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

CHAIRMAN BURNS. [Interrupting] May I just ask a question? I'm puzzled by that first chart. The black line is below the red line with a few exceptions. What does that first chart mean?

MR. ZEISEL. A very good point. And my first observation, it appears to me that there may have been a plotting error because one would think it would go directly through.

CHAIRMAN BURNS. That's the way it used to be done.

MR. KICHLINE. We've introduced some new techniques, but that's not one of them.

MR. ZEISEL. I can see it being off part of the time, but it seems to me that it's off the line far too much. Now we have to assume that the general configuration [unintelligible].

MR. MAYO. I'm wondering, though; it may be statistically possible because there is some slope to the curve. It's taking off of figures from the preceding year.

MR. ZEISEL. One thing we can do, obviously, is to ignore the three-month moving average.

CHAIRMAN BURNS. I think another thing we can do is to move on.

MR. ZEISEL. [Statement continues--see Appendix.]

CHAIRMAN BURNS. Do we have figures on the first third?

MR. ZEISEL. Yes. The auto sales on domestic was a 9.1 million annual rate in the first 10 days. We don't get foreign sales, however, on a 10-day basis.

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

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

CHAIRMAN BURNS. Thank you very much Mr. Kichline and Mr. Zeisel and Mr. Truman. We are ready now for a Committee discussion of the state of the economy and the outlook for the months and quarters immediately ahead, and I think we ought to take as much time as is needed to express our views individually and to educate one another to the best of our ability. Mr. Coldwell.

MR. COLDWELL. I'd like to [ask] one discrete question to start with, Mr. Chairman. Mr. Truman, in the material on net exports and imports, on this chart you're showing on the export side a very large increase in nonagricultural volume--I guess about a 10 percent increase in volume--if I can read it from the chart, which is terribly hard to do. What is there in the outlook that makes you think you're going to have such a dramatic increase in exports for nonagricultural?

MR. TRUMAN. Well, on the volume side we do expect, as that first chart shows, some resumption in growth abroad, or faster growth abroad--something around the 5 percent level in contrast to the 3 percent level on average this year. So that's been generating a good deal of the volume. And the value--I think there's probably more of an optical illusion than a particularly rapid increase in the value over that period; it is about the same, maybe a little bit higher, than we had this past year.

MR. COLDWELL. If I draw my lines over correctly, you're about $25 billion on a $100 billion base; that's 25 percent. Is that right? Start to the end of the period, now--I'm not talking about the whole forecast period.

MR. TRUMAN. Fourth quarter over fourth quarter, we've had about a 9 percent increase in the price of nonagricultural exports.

MR. COLDWELL. So you have a 9 percent price increase and 9 or 10 in volume increase, which would compound to be over 20 percent. Seems like a very large increase to me.

CHAIRMAN BURNS. Well, let there be a touch of optimism today.

MR. PARTEE. That does assume, as you say, that there will be some acceleration in growth abroad. Are exports pretty sensitive to rates of growth abroad?

MR. TRUMAN. Yes. In fact, the only thing we really have to go on are the growth projections in the major industrial countries, and there, at least in the past, our equations, somewhat to my surprise, are somewhat more accurate. [Export] projections tend to be somewhat more accurate and cyclically sensitive, especially for us, than on the import side, at least as far as accuracy is concerned.

Now, the other element which we try to factor in [in] the judgmental basis is the extent to which demand may pick up in other countries, particularly in the case of the United States and non-oil developing countries, where there has been a dramatic slowing and some very recent picking-up of our exports, and that is a question mark. Now, I would not say that if we got a boom, if I can call it that, in the non-oil developing countries, I would therefore then expect this to be a much more optimistic outcome. Though I haven't assumed the boom abroad in non-oil LDCs, we have assumed some rebound, especially in the Latin American countries, from the low rates of growth this last year.

CHAIRMAN BURNS. And you've also assumed that we will not have a repetition, as far as countries other than Japan are concerned, of what happened in Japan this year when real GNP rose but real imports diminished.

MR. TRUMAN. They didn't grow very much, that's right.

CHAIRMAN BURNS. No, according to the latest report from your staff, it's been an actual diminution. I think that's reasonable. Any other questions in this area?

VICE CHAIRMAN VOLCKER. On this point, how do you assess the competitive position and the changes therein in the past two years or so?

MR. TRUMAN. Judging against the other industrial countries, our price competitiveness has improved somewhat over the last two years by about 2 percent; and the decline of the dollar, in this respect in dollar terms, would add another 2 percent. In the parlance of the day, that is a real exchange rate depreciation. It is not within the realm of any significance, I think, in terms of gross changes in these kinds of figures.

VICE CHAIRMAN VOLCKER. You're looking at overall indexes.

MR. TRUMAN. Right. Did I answer your question, or did I not hear the second part?

VICE CHAIRMAN VOLCKER. There is no question. I just commented, you're looking at overall what, wholesale price indexes?

MR. TRUMAN. And consumer price indexes, and wholesale price indexes for manufacturers.

CHAIRMAN BURNS. I think what Mr. Volcker is saying is that, if your comments were based on the price behavior of items that enter foreign trade, you might reach the same conclusion or a different conclusion.

VICE CHAIRMAN VOLCKER. I don't know what conclusions you would reach on this basis.

MR. TRUMAN. Well, with respect to Japan and Germany, which are the only places where you really get good price data, their export price data showed less of a rise than their domestic price data.

VICE CHAIRMAN VOLCKER. And ours showed more.

MR. TRUMAN. And ours show the same to a little bit more, right, in our unit value, and then to the extent you use that [then we have less] deterioration with respect to those countries.

MR. COLDWELL. One other question. Does your agricultural forecast take in the new information concerning the drop in production estimates for Russia?

MR. TRUMAN. Yes, I think that we have already [included] to the extent possible a fairly heavy demand from Russia and the overstock here starting the first of October. They had come in [unintelligible] and requested the upping of the ceiling to 15 million tons. Now, it is true that no one has been able to confirm the orders for that amount. One of the reasons we have a pickup in volume over the period is that we expect that it will [come from] some more demands from Russia and from parts of western Europe, where the wetness at the time of the harvest has cut into certain kinds of grain, and therefore we could stand a little bit more to gain--

MR. COLDWELL. Is that speculation about a 20 million ton demand from Russia out of the picture or is that realistic?

MR. TRUMAN. I just don't have the information to judge. I think the 15 million probably is consistent. The piece that was in the paper, I think it was down to 205 million tons during harvest--that was, in fact, what we were using as a basis for projecting.

MR. WALLICH. Is there any sort of a guess as to the extent to which existing U.S. import limitations and foreign countries' export restrictions imposed at our behest influence the total volume of imports?

MR. TRUMAN. I think, on the first point, we tried to put together an estimate of how much the recent or current trade restrictions by the U.S. might affect imports, and I think an optimistic number on the high side would be $1 billion, and probably the true number is something more like $500 million.

CHAIRMAN BURNS. I don't understand. $1 billion refers to what?

MR. TRUMAN. How much higher our imports would be in the absence of the kinds of recent--over the last year or so--measures to restrict our imports.

CHAIRMAN BURNS. May I ask a question of our New York Bank representative, Mr. Pardee? What is the opinion of the New York Bank's staff about the prospective value of the dollar in foreign exchange markets?

MR. PARDEE. It depends on who you talk to within the New York Bank staff.

CHAIRMAN BURNS. Well, I'm talking to you now.

MR. PARDEE. All right. I'm not a forecaster. I think that most economists would come up with a forecast very close to what Mr. Truman has just outlined. I'm skeptical, myself, of any forecast on the trade account. In recent years we've had errors on the order of $20 billion--in '75 and '76.

CHAIRMAN BURNS. Well, I'm talking about the value of the dollar, not the value of our foreign trade.

MR. PARDEE. Yes, but the people in the exchange market are following these numbers, [and] to the extent that the trade balance does improve or weaken, this will influence thinking about the dollar.

CHAIRMAN BURNS. All right, any other questions or comments about our foreign trade or the prospective value of the dollar in foreign exchange markets?

MR. WINN. Mr. Truman, what element have you factored in with respect to the challenge of steel dumping? The possibility of some change being--

MR. TRUMAN. No we had not, we had not. We have enough trouble dealing with things we think we know something about rather than that. To the extent you have this lower growth in steel, for whatever reason, and that would not have been [unintelligible]. It is true that, over the recent months, the growth has leveled off--particularly the Japanese. Whether they say it or not, it seems clear from the data that Japanese steel exports to us have been very much held down, and growth is coming from western Europe this year rather than from other countries. But we have not factored in anything.

MR. PARTEE. You don't have any protectionist, any explicit protectionist stuff at all.

MR. TRUMAN. No, no new measures.

VICE CHAIRMAN VOLCKER. Just a couple of comments on the international situation, since you asked. I rather share the feeling Governor Coldwell already expressed--these export figures look pretty optimistic against the background of the prospective growth trends abroad, as I see them, and I think that points up the probability that downward pressures on the dollar are more likely to appear than upward pressure. And I think that's part of our problem. We're living in a world in which that can be financed, and maybe fairly readily financed. But while the current account is so far in deficit, unless it shows decided signs of improvement, we're vulnerable to psychological weakness, which could be self-reinforcing until these figures turn around. And I don't think there is any clear prospect that they're going to turn around in the next 12 months.

MR. PARTEE. Now that, of course, Paul, would mean that it would also tend to hold down the recovery anyway.

VICE CHAIRMAN VOLCKER. Well, I don't think it will hold it down to the same extent it has. It will tend to level off.

MR. PARTEE. It's an algebraic subtraction.

CHAIRMAN BURNS. Well, to the extent that the recovery here languishes, our imports could also grow less rapidly, and therefore the outcome as far as our trade balance is concerned is quite uncertain--the trade deficit may diminish instead of increasing.

MR. WALLICH. The trade deficit would presumably improve if we had imports diminished, but the dollar would still be influenced probably by interest rates as well as the improved deficit, and so one really doesn't know--whether that works on the upside, too. Cannot be sure of the deterioration of the trade balance--and if interest rates rise simultaneously and inflation remains under control, may not be harmless.

VICE CHAIRMAN VOLCKER. I think that's what's been happening, might continue--if not--

CHAIRMAN BURNS. You've got the trade balance, you've got the interest rate differentials, and you have the broad economic prospects for the country. You would think that the U.S., a country in which it's desirable to invest because the prospects of profits look good and improving--even with low interest rates, money will flow here.

MR. JACKSON. Or the consequences abroad, or the lack of growth, could produce political instability, which would produce inflows regardless of the rate.

CHAIRMAN BURNS. Well, all right, we've come close to a catalog of the possibilities. Now we move on to--

MR. JACKSON. May I ask a factual question in that regard? What price in imported oil did you include in these projections?

MR. TRUMAN. We have been assuming--and there's some basis for it but not much--[that it] will rise by 5 percent over the course of 1978. So it rises approximately from the $13.44 per barrel in the fourth quarter of this year to $14.11 in the fourth quarter of next year. That is roughly in line with the rate of inflation--stays constant in real terms.

CHAIRMAN BURNS. All right. Mr. Mayo, may we hear from you?

MR. MAYO. Thank you, Mr. Chairman. First, on the international [outlook], I spent the week before last in Japan and was faced with this very question, time and time again, as to the dollar-yen relationship, and mostly with reference to what pressures were going to be within the two governments. And my answer was the very simple-minded, "Well, we have departed from Bretton Woods, we have a relatively free foreign exchange market, and indeed I have faith in that market determining the proper relationship between the two," and the yen moved from 263 [yen per dollar] to 253, and I didn't get my name in the paper.

On other things, the forecast, I'm a little troubled by the staff's estimate of housing starts being, I think, too optimistic for 1978. Many of our people, not just analysts, but the economists of suppliers in the building industry, feel that we may already have topped out in terms of the new housing starts. And also, I note that the consensus, for what it is worth, for ’78--at least around our area--is under 2 million, not--what’s yours, 2.15 or something like that? And so our chart on housing starts would look quite different from yours. This is the only place where I find a significant departure on the analysis side, and I was wondering if there were any particular factors that gave you this optimism.

MR. ZEISEL. Nothing outstanding. The most recent news has been on the good side. Housing starts have held up somewhat better than we had anticipated, and there seems to be a certain sense--indications of continued demand. It’s true that there are some suggestions that some of the overheated aspects of housing demand in California and a few other areas have dampened, but that’s not necessarily a bad thing. The commitments figures are quite high, the savings flow figures remain high, and it just appeared to us that there was enough in train to keep us moving at a reasonably good rate over the next few quarters.

MR. MAYO. Well, the range that I saw, the very highest, was something like just slightly over 2 million, and the average was well under it, say 1.8 to 1.9, and your figure seems to be a little above the top of the range of quite a few economists that we’ve talked to.

MR. PARTEE. Is yours a supply constraint?

MR. MAYO. Yes.

MR. PARTEE. That is, then starts can’t stay up because there are shortages.

MR. MAYO. Partly, they have no wallboard; there are all sorts of shortages that are holding things up. It was different from the shortages three years ago that held a lot of things up--for instance, you couldn’t get plumbing fixtures, but you could build most of the house and put in the fixtures at the end. This type of building material shortage now means you don’t get the house up to put the plumbing in in the first place and don’t have walls.

MR. PARTEE. Insulation, I guess, is important.

MR. MAYO. Insulation is a problem, wallboard is a problem, and I am not up to date on this, but I have the impression that some forms of framing lumber are in very short supply.

CHAIRMAN BURNS. Well, this would not necessarily slow down starts. If they slowed down completions--[increased] the length of the period under construction--thereby running up costs, and negative effects on starts stemming from that source--actually, I would not be surprised if, in the multifamily sector, experience were a little better than our staff projection. Mr. Jackson, do you have any view on that?

MR. JACKSON. That’s my point, I don’t have the facts on which to base a projection, but it appears that apartment housing and [federal] urban development multifamily programs perhaps are a little stronger than some people originally estimated it. There was a push in the fall of last year to accelerate the rate of starts temporarily. What it appears is that their programs are a little more on track and have a more rational basis of future growth than they had been for the last several years. At the same time, there have been some real rates of increase in gross rents, with oversupplies in many communities being worked off. And I believe our flow of funds would indicate that the historic group of lenders that have concentrated in the multifamily sector still have strong supplies of funds, which would tend to support that market.

CHAIRMAN BURNS. The strong supplies of funds, and I hear stirrings on the demand side that I didn't hear a few months ago.

MR. JACKSON. Well, the demand side has improved. Unfortunately, we got the opposite side of that equation. Gross rents may go up, but it takes net rents--as we keep reminding ourselves--to go up before you get any production that comes along behind. I do think that the one thing that should be the follow-up question, Bob, is that the chart on three-month Treasury bill expectations combined with the domestic private mortgage borrowing would presuppose that the continued flow into the historic mortgage institution would at least stay positive if not strong, or relatively strong.

MR. MAYO. Yes, I think that's right, Phil. And furthermore, our people have come to the conclusion that, as far as the impact of disintermediation is concerned on the thrift institutions, it isn't the 6 percent breakpoint, it's a higher point than that because most of the new money has gone into CDs and a lot of it into six-year CDs, where the penalty of getting out would raise the entire breakpoint of disintermediation.

MR. JACKSON. I think your best news there was the most recent sales figures that we saw both in existing and in new housing. We had several months where it looked like production exceeded the sales, but there was a quick one-month catch-up in that, and it occurred during a part of the year where you normally have heavy sales. So while I don't know the actual sales figures--we see the seasonally adjusted sales figure--but I suspect the actual sales figure would be very strong. Sometimes in the winter months you can get a sales figure that looks real strong, but when you analyze the actual rather than the seasonally adjusted, it doesn't make that much difference. But when you get an August or September sales figure that looks very strong, I think it has much more meaning for the whole market tone than we would if we saw, say, a January or February sales figure that was strong.

MR. MAYO. I have two other observations, if I may. This is relating--

CHAIRMAN BURNS. Relating to what subject?

MR. MAYO. This is relating to agriculture.

CHAIRMAN BURNS. Well, let's pause for a moment. Is there any other observation on the housing market?

MR. BLACK. Mr. Chairman, one interesting thing that's come to our attention lately, which seems to fly in the face of some of the things others have been saying, is a report from the vice chairman [of our Bank's board], who is involved in all sorts of wood and wood products industries. And he reports that since about Labor Day, lumber prices of all sorts--southern pine, fir, plywood, you name it--have been coming down quite rapidly. In view of the publicity given to the role of lumber prices in pushing up wholesale prices in September, this suggest that either next month you're going to feel some of these effects--they've come down about 15 percent or so on southern pine, which is pretty good--

CHAIRMAN BURNS. That's just within the past--

MR. BLACK. Starting about Labor Day, yes sir.

CHAIRMAN BURNS. Thank you. Mr. Roos.

MR. ROOS. Mr. Chairman, on last Thursday, we were in Louisville with the individual that heads up the appliance division of General Electric. And their projections are very much in terms of what they anticipate for the housing industry, and they were almost indescribably positive in their attitudes for the next year to 18 months. They were programming on very, very strong housing and setting their production schedules of major appliances accordingly.

CHAIRMAN BURNS. All right, Mr. Partee.

MR. PARTEE. Well, I might say that I talked to the economist with the National Association of Home Builders recently, following that convention. He talked to a great many builders in the course of that convention, and his impression is that single-family building is likely to come down in the year to come, but the multifamily might well go up, and it might be above, even--that is to say, the figure might not be so far from the overall figure that the staff has got here, but there might be a little less single-family and a little more in multi. And if I may, I'd like to ask Jerry the same question I asked Bob Mayo, and that is, in your projection, are supply constraints holding starts [down], or are demand constraints holding starts down, or is it money?

MR. ZEISEL. It's money and demand rather than supply.

CHAIRMAN BURNS. Money and what?

MR. ZEISEL. And demand rather than supply.

CHAIRMAN BURNS. Why do you say money--not much has happened to mortgage interest rates.

MR. ZEISEL. It's the projection.

MR. KICHLINE. In the projection, Mr. Chairman.

MR. PARTEE. It's this bill rate

CHAIRMAN BURNS. I see. Well, now wait, are you projecting significantly higher mortgage interest rates?

MR. KICHLINE. Well, we have mortgage rates, for what they're worth, sort of middle of the next year in the 9-1/4 percent area, so up a quarter or half, depending on where you are in the country. But more importantly than just the rate constraint, we have implicit in our forecast what we believe to be some constraint on funds availability and that nonprice terms will probably be tightening, and that will tend to squeeze some potential borrowers out of the market.

CHAIRMAN BURNS. I'm a little puzzled. I would have said that, in view of the liquidity of the thrift institutions and their enormous borrowing potential from the Home Loan Banks, etcetera, I would not expect a shortage of funds, say, over the next 12 months, even if you have a significant reduction in the inflow of funds to thrift institutions.

MR. KICHLINE. Well, we think the near-term factors are quite positive on the financial side as well as elsewhere, and hence we do have, what I think is--quite right, President Mayo--a fairly optimistic housing forecast relative, certainly, to the ones I'm familiar with. But if you look ahead, as consistent with our bill rate forecast and our financial side, we think that S&L and mutual savings bank deposit growth in the second half of next year would be something around the 7-1/2 percent annual rate. That's roughly half of what we've been experiencing now. In our flow of funds forecast, we have the thrift institutions actually liquidating liquid assets to fund their outstanding commitments in the shorter run and relying quite a bit more heavily on Home Loan Bank borrowing.

But traditionally, that sort of process begins to take its toll [on] attitudes and terms on mortgages, and what we have in our forecast is a peaking out, if you will, of construction early next year and a slight trending down. It's not by any means a collapse in the housing market. I would view it as still a very strong market but one that has lost its steam, in large part from the factors induced on the financial side, but as well [from] the demand for housing, [on] which, in the single-family area, we are certainly not optimistic.

MR. JACKSON. Even if we get a mix, Mr. Chairman, of slightly lower rates of single-family starts or construction and slightly higher rates of multifamily, the net total constant-dollar effect of the two would be flat, or maybe even a reduction, because of the difference in the cost per unit. So you need to be very careful between looking at units figures versus total put-in-place dollars.

CHAIRMAN BURNS. Mr. Kimbrel, please.

MR. KIMBREL. Mr. Chairman, we have not had a chance to pursue this to great lengths, but there have been several indications in the last two, three weeks that life insurance companies are indeed beginning to invest in our area, in single-family investments, mortgages.

CHAIRMAN BURNS. Single-family mortgages?

MR. KIMBREL. Single-family mortgages in our area. Now, whether that could be characterized yet as a major decision, I'm not sure, but there are known instances that that is beginning to happen.

CHAIRMAN BURNS. Well, the large life insurance companies are not doing that.

SPEAKER(?). Mr. Chairman--

MR. JACKSON. That may have opened up in the last 60 days--first time in over 15 years.

CHAIRMAN BURNS. Well, I asked the head of Prudential whether he had any interest, he said absolutely not. Just the other day.

MR. KIMBREL. But his neighbor across the street is doing that, though. Equitable is, indeed. Because this happens to be one of those that we're familiar with.

CHAIRMAN BURNS. How are they doing it? How do they assemble the mortgages?

MR. KIMBREL. Well, now this--

CHAIRMAN BURNS. Are their field offices doing it or do mortgage bankers?

MR. KIMBREL. I believe they're having their normal brokers.

CHAIRMAN BURNS. Mr. Winn, please.

MR. WINN. The last 30 days has seen a marked upturn in demands for motels, hotels, office buildings, apartment houses in the insurance industries. Demand really has gone up. A shortage, which we don't talk much about, is the fact that the union bottlenecks with respect to electricians, pipe fitters, plumbers, and that sort of thing. Before anything is started in Cleveland, they're reporting now that they're fully employed. They've had a big hiatus, a lot of people have dropped out of the unions, and you've got a big bottleneck here in the labor factor in terms of construction.

MR. PARTEE. Could they come back in?

MR. WINN. To a degree, but it's always at a price and slow, and they've got some problems--they shifted off in different areas. Our unemployment figures are very deceptive. There's a big structural problem that's not going to be cured by pouring money in there. And then some of the other shortages--I think they're going to take time to work themselves out.

In the ghetto housing area, there's real problems. We've used the mortgage device, I think, quite foolishly, and we've financed people that really shouldn't be in the private ownership of homes. And people with incomes of $300 with 5 children haven't any business with $30,000 mortgages, in my judgment. I think society is going to have to find a different way to house them, and there's problems ahead for us, I think, in that sector of the mortgage market.

CHAIRMAN BURNS. Mr. Baughman, please.

MR. BAUGHMAN. I had reports with respect to the Houston market that, I think going back a month or two, insurance companies were a source or an outlet for single-family residential mortgages from that market. Another point I was going to make, Mr. Winn has just made--that there are significant markets in which the supply of labor is a significant limiting factor on the rate at which residential structures are going up. And this one, I hesitate to mention because I haven't checked it out, but we picked up a few comments at the end of last week that the mortgage rate in the Dallas market was having a little difficulty being maintained. Just a little whisper of softness coming into the rate.

CHAIRMAN BURNS. All right, thank you very much. We will return to you, now, Mr. Mayo, and you were going to comment on the agricultural area.

MR. MAYO. Just briefly, Mr. Chairman, one of which is on the subject that we're all following but wasn't mentioned in the forecast. I don't think anybody tries to make a forecast of this, but it relates to the valuation of farmland, sales of farmland. We have had an astronomical increase in many of our Midwestern states in farm values. We have preliminary results, which we haven't published yet, on our own survey at the Bank on the value of farms in our five states, and we find a decline for the first time in Illinois of 8 percent, a decline of less than that in Indiana and Michigan, no decline in the other two states.

CHAIRMAN BURNS. A decline over what period?

MR. MAYO. A decline over the preceding quarter. For the first time since 1960 for the District as a whole.

MR. PARTEE. Is that an annual rate?

MR. MAYO. No, there isn't really any--this is a decline in sales prices of land.

MR. PARTEE. 10 percent.

MR. MAYO. 8 percent in Illinois. But Illinois rose more, it rose 41 percent in '76 or--

CHAIRMAN BURNS. What is that--through forced selling or what?

MR. MAYO. This is estates selling property at auction, in part, and just the open market price, Mr. Chairman, of farmland. And this is what's in our survey, and this is the first downturn in the value of farm land in our district since 1960. Quarterly.

CHAIRMAN BURNS. You're saying that the price of land is finally reflecting farm income?

MR. MAYO. Yes, I am.

MR. LILLY. Not quite yet.

MR. MAYO. Well, no, but a corner has been turned.

MR. LILLY. Got a few more percentage points.

MR. MAYO. Oh sure, but a corner has been turned, and we haven't had a corner for 17 years. The second observation relates to the credit side. Many more of our banks are recording some worry about the need for a renegotiation or extension of loans that are current loans on farm operations, that the situation is growing rapidly. I'm not saying it's serious, but I'm saying that there are a lot more loans that they're just going to have to extend that are not going to be paid off this year. That's all.

CHAIRMAN BURNS. Any other comment on agriculture? Mr. Guffey.

MR. GUFFEY. I'd only verify what Mr. Mayo has already said, and that is in this renegotiation time on the extension of loans, which really doesn't arise in our area until November, December, January, because the farmers are out harvesting their crops now. We have seen some improvement in the ratios within the banks in those agricultural areas; to be sure, still very high. But there is a projection that, when you get into that December-January period, the banks are going to be reluctant because of some slight showing that the agricultural prices are turning down a little bit. They say that they're going to accommodate the extensions and some new credit for the upcoming year, but they're doing it more reluctantly than they have before.

MR. PARTEE. How do you feel, Roger, about the outlook for farm products and supplies?

MR. GUFFEY. Well, looking at our District only, as you know, there is a very good, very big supply now unsold. It's encouraging to hear the forecast for potential exports markets, particularly in wheat. But we're looking at very favorable conditions for 1978 crops--that is to say, throughout the District it's far advanced from this time last year, and last year was almost a near record crop. So productionwise, absent some catastrophe such as insect disease, or otherwise, it looks like another good year. We have to get rid of the some of the excess.

MR. PARTEE. That's in wheat.

MR. GUFFEY. That's in wheat and corn.

CHAIRMAN BURNS. Any other comment on agriculture?

MR. JACKSON. Is agricultural land continuing to be effective for foreign investment, which would influence our discussion?

MR. GUFFEY. Yes, in our part of the country, it is, although it's a fairly small percentage of total sales--they happen to be big block sales that you hear about, but there are not that many of them. But it is still an attractive investment, particularly for West Germans that have come into the Midwestern and Southwestern areas.

MR. MAYO. I've heard less of this recently than a few months back, but that may not mean anything.

CHAIRMAN BURNS. All right, Mr. Black is next.

MR. BLACK. Mr. Chairman, mine's related to something we have not gotten to yet. It isn't on agriculture. Do you--

CHAIRMAN BURNS. Well, we're ready to shift to another subject.

MR. BLACK. Earlier, either Jerry or Jim, I've forgotten which, mentioned that inflation for '78 would be 1/4 percentage point lower if you assume no imposition of the well-head tax. Have you done like computations on real GNP?

MR. KICHLINE. Well, we've done that computation on GNP for the House-passed bill, which includes all of the major features of the President's program through 1985. And in total, I think our best guess was a reduction in real GNP from the full program averaging about 4/10 percent per year. And the well-head tax alone--I know that was not viewed as the bulk of the problem. It was the tax on commercial and industrial users which caused the decline in real GNP. So I would suspect the well-head tax would be quite unimportant in the aggregate, maybe 2/10 at most, 1/10 or 2/10, which, given the errors associated with forecasting, I think would pretty much drop out. On real GNP, it's not a major factor.

MR. PARTEE. When you say less without the well-head tax, you mean but with the continuing control program and all? I mean, what's the alternative to the well-head tax?

MR. KICHLINE. The existing situation.

MR. MORRIS. Have you seen this Rand Corporation study that I've read about in the press, which suggested that the current market price of oil products in the United States, excluding taxes, is about the same as in Europe. And therefore the implication is that the control of oil prices at the producer level, which was designed to average--to bring us halfway between [the United States and Europe] on consumer prices of oil, is not working. Have you been able to analyze that?

MR. KICHLINE. I am not personally familiar with the details of that. We have had it analyzed within the staff in our international division. And the staff views on this entire energy program, I must admit, are quite split. But one portion of the staff, in effect, suggests what the Rand Corporation study came to, which was that, if you impose a tax, it would do nothing in terms of the average level of retail prices; that, in effect, refiners are now paying the world price for oil, on average, and if approved, the well-head tax would do nothing. I guess I can't comment more than that, except that I'd be delighted to send around for your information the staff analysis of this particular argument. We can do that promptly.

MR. MORRIS. I'd like to see it.

CHAIRMAN BURNS. Any other question, Mr. Black?

MR. BLACK. I had just one minor one, Mr. Chairman, the question of the meaning of a chart back here on international [developments]; it's very minor. This second chart in international shows the ratio of foreign real GNP to U.S. real GNP. What is included in that foreign? What is included in that chart?

MR. TRUMAN. The six big, the big six countries, Germany and--

MR. BLACK. That's what I assumed.

MR. TRUMAN. We've used this trade weighted.

CHAIRMAN BURNS. All right. Mr. Winn.

MR. WINN. Mr. Chairman, just one comment on the consumer area. In the tire business, the shift to radial tires led expansion of capacity. It's also led to a rather high-priced tire. Now the tire industry today is faced with big demand for tires both for new cars and for replacements. And the replacement demand has shifted rather dramatically toward the old bias tire, and they're now on allocation while your radials are evident. You see this, if you look at Sears and Roebuck advertising and their failure to sell a high-priced radial. You see it with a major tire company in terms of their sales here in the last two months. Now does this represent a shift in consumer preference towards lower prices, or [a decision that] a [used] car that only goes 20,000 more miles doesn't really need a 50,000-mile tire? But it's a strange market.

MR. BLACK. I think it's a failure of the radial tires to achieve their 40,000 miles guarantee in most instances.

CHAIRMAN BURNS. Any observation on the consumer market more broadly? Yes, Mr. Baughman.

MR. BAUGHMAN. [Some of] our directors are in the retail business, and we happen to have a rather broad representation there at the present time. General merchandise retailing. They've been inclined to feel that the strength of the auto market has had a negative effect on their sales during this past year. And so they in fact are looking forward with some optimism to a leveling or some moderate weakening of the demand for automobiles, and this shows through in their projections and plans for next spring. They talk largely in terms of next spring. So they're talking in terms of about a 5-1/2 percent increase in sales in real terms, and this is general merchandise.

In the consumer credit side of the picture, the question is raised--I can't say they're forecasting it--as to whether, with the strong rise in housing starts, we may not have a strong surge in credit demand for furniture and other household durables. And so total consumer credit might not slow down even if we do get some slowing in the automobile sector. In fact, it seems to me that, as one looks at the prospects for wages and employment, unless there is to be a substantial rise in the consumer saving rate, that we [are almost assured of having a] pretty strong consumer expenditure picture ahead of us for next year. This doesn't necessarily lead anywhere, Mr. Chairman.

MR. COLDWELL. It does lead into something I was curious about, Jim. If you take a look at the real personal consumption expenditure chart and then you go back to the retail sales chart--and admitting that it's difficult to do this because one's on a seasonally adjusted annual rate basis on a real term and the other one's on billions of dollars--there seems to be a difference of perspective, at least in my mind. Adding to that the consumer attitude surveys, there seems to be a kind of a flattening of the retail sales picture in at least the pictures we have here. But then a sharp upward tilt to the real personal consumption expenditure picture. Now is services going to do all of this for us?

MR. KICHLINE. I'm not sure it's going to do all of it, but we're planning on a good deal. I think the major difference between the sales and the personal consumption expenditures chart is indeed the component of services in personal consumption expenditures.

CHAIRMAN BURNS. Yes, but I think there is another factor, purely statistical. Your retail sales figures run currently through September; your real personal consumption expenditure chart appears to run through the second quarter only, and the rest is sheer projection. I don't know why you don't have a third-quarter figure plotted.

MR. KICHLINE. We will get the Commerce Department figure on Wednesday, but we're running right now with our own estimate of the third quarter.

MR. PARTEE. So that the retail sales is a more current look, you mean?

CHAIRMAN BURNS. Yes, that's it; does the third quarter show an acceleration?

MR. ZEISEL. It shows an acceleration from the second quarter rate of increase, although not an extremely strong rate of growth in real personal consumption outlays.

CHAIRMAN BURNS. This chart shows the retardation through the second quarter, and then some acceleration starting with the third quarter.

MR. KICHLINE. That's right in terms of our projection. These are quarterly numbers, as you know, in the real personal consumption expenditures chart; the other numbers are plotted monthly. But indeed, on average in the third quarter, we anticipate that they will be higher. But I might note that the recent retail sales data for September, as Jerry mentioned, and the downward revisions for August were not available when we made the forecast, so that if we were to do it today with the information now available, we would have a lower third quarter.

CHAIRMAN BURNS. Yes, that's what I would think.

MR. ZEISEL. The second quarter was extremely weak, Mr. Chairman, and in real terms, personal consumption expenditures rose by less than 2 percent at an annual rate, and even with a reduced estimate for the third quarter, we probably may see a gain. I certainly hope so.

MR. COLDWELL. You mean you're pinning that advance on the basis of real disposable personal income?

MR. ZEISEL. That is the projection, yes, Governor. We have the rate of growth in the real personal consumption expenditures at a rate of somewhat under 4 percent during the period. It's not very rapid, and that's manifested, of course, in the tendency for the saving rate to rise, at least over the next couple of quarters. But the major factor supporting our projection in personal consumption expenditures is our projection of real disposable income.

MR. PARTEE. Yet there is some circularity there, isn't there.

MR. ZEISEL. Absolutely.

MR. PARTEE. And Ernie was saying earlier, with the income and employment that was being projected, you have to have very strong consumption; but on the other hand, if you don't have the consumption, you might not have any income.

MR. ZEISEL. You're absolutely correct.

MR. BAUGHMAN. This raises a related question, if I might inject, Mr. Chairman, as to whether we are anticipating anything unusual in terms of labor strife. It seems to me that that could be a factor in the picture. We have a substantial strike going on in Houston at the present time, where the union has unequivocally rejected a 40 percent proposed increase over three years [as] being inadequate.

CHAIRMAN BURNS. Union of what?

MR. BAUGHMAN. Hughes Tool employees, Hughes Tool Company.

CHAIRMAN BURNS. Any broad observations on the prospects for retail trade and consumer markets? All right, then let's move on, then. Mr. Winn, do you have anything else?

MR. WINN. A comment, Mr. Chairman. In terms of all the projections, you really haven't factored anything in with respect to the so-called tax revision law, or what have you, in terms of--

MR. KICHLINE. No, we have not. We would not know what to put in there. I think a dose of uncertainty in terms of our thinking about business fixed investment has implicitly crept into the forecast. Other than that, we don't have an explicit assumption.

CHAIRMAN BURNS. All right.

MR. WINN. One more comment. Several of our major companies in the area have at long last released their string on capital expenditures after running overtime and a very tight ship and all other means to avoid making the expenditures. But their demand has been so strong that they are now planning rather major capital expenditures, and this is a change in the last 10 days.

MR. WALLICH. These are capacity pressures, Willis, in which industry?

MR. WINN. These are a couple of our major firms.

MR. WALLICH. Which industry?

MR. WINN. Well, they're electronic equipment and machine tools, this general area, auto parts business.

CHAIRMAN BURNS. These expenditures that are being projected now, are they large?

MR. WINN. Yes, these are going to be plant expansions. They've done everything with respect to improving tooling and that sort of thing to increase capacity, and they're just faced with market demand that they can't meet without breaking water.

MR. WALLICH. Do you happen to know how long it would take to bring that into operation?

MR. WINN. Probably several years.

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

MR. MORRIS. Mr. Chairman, I'd like to pursue something that we started talking about a little earlier, and that is the vulnerability of the thrifts in this cycle. We made a survey of the Boston savings banks this morning, trying to find out how they have been doing in October. Now in the past, the Boston savings banks have been very sensitive--their deposit flow has been very sensitive to interest rates. And in the past, at a time when the federal funds rate was at 6-1/2, they were howling and screaming, [as] I recall. Today, the results of the survey showed that, while they didn't think they would do as well as they [did] last October, they were really doing pretty well.

It seems to me that--and I suppose this is reflected in your projections here--the thrift institutions are in a different position than they were in the last period when we were tightening the rates, and this is suggested by the fact that you're projecting the Treasury bill rate to rise toward 8 percent, while, at the same time, you're not projecting anything but a modest decline in housing starts after the second quarter of next year. I suppose in part this is due to the fact that a lot of the interest-sensitive money that was sitting there in ordinary savings accounts is now structured out [in time deposits] and is not likely to leave until the maturities come due. But my question--one thing this Committee needs to know is--from the present level of rates, how much room do we have with the thrift institutions as far as putting them in a position where they're likely to suffer net outflows of funds? How far away are we? Do you have any comment?

CHAIRMAN BURNS. Well, if I may interrupt, I heard Phil Jackson say the other day that we've never had a net outflow; that all that we ever have is changes in the degree of intermediation, and we've never had any disintermediation. And I asked you, Mr. Axilrod, to look into that for me.

MR. AXILROD. Well, we did.

CHAIRMAN BURNS. Checking up on my colleague, Mr. Jackson.

MR. AXILROD. On a seasonally adjusted basis, there appears to be a very small net decline in deposits, that is, a net outflow, at S&Ls in January and February of 1970, and there was a similar--very small, 1 percent annual rate--decline in August 1966.

CHAIRMAN BURNS. Well, it's very rare then, on a seasonally adjusted. Is it--well, now wait, before seasonal adjustment--

MR. AXILROD. I don't have those figures here, but I'm sure there are some more.

CHAIRMAN BURNS. Don't be sure; you've got to take a look.

MR. AXILROD. I take that back, sir.

MR. MORRIS. Mr. Chairman, I think the aggregates figures cover up a great diversity of experience. But the Boston savings banks, for example, [in] ’73 and ’74, had net outflows in every month for 18 consecutive months, while at the same time, the savings banks outside of Boston were recording net inflows every month. I think there is such a thing as disintermediation.

CHAIRMAN BURNS. There is disintermediation for individual institutions and regions, yes, but for the country as a whole, apparently it’s an extremely rare and minuscule phenomenon. And the right term ought to be, not disintermediation, but reduction in the degree of intermediation.

MR. JACKSON. Isn’t October one of your taxpaying months, also?

MR. MORRIS. Yes, it is.

MR. JACKSON. So, therefore, if your people had a good month this month, at least a reasonable month, it would be an even stronger month than you might expect.

MR. MORRIS. Yes, but they were comparing this October to last October, and they expected some outflow for tax reasons. But by and large, they’re not terribly unhappy.

MR. JACKSON. Usually, in a taxpaying month you go negative in Boston, as I recall.

MR. MORRIS. That’s right.

MR. BLACK. Frank, does your survey show where the funds are coming in? Are they coming in the long areas, where you wouldn’t have incentive for disintermediation that you would have in some of the shorter areas?

MR. MORRIS. Well, we didn’t make it a very extensive survey--just trying to find out if they were beginning to get alarmed yet or not. I thought it was a little surprising.

MR. PARTEE. You were beginning to ask a question.

MR. MORRIS. How much room do we have?

MR. PARTEE. I was interested in the answer to the question.

MR. BLACK. I think he was going to give him another month to get it.

MR. KICHLINE. Well, let me indicate what we have in our forecasts. We have an annual rate of growth for S&Ls and mutual savings banks in the second half of 1978 that averages a 7-1/2 percent annual rate. At the same time, we have a bill rate there that’s 7-3/4 percent. Now there, a couple of cautionary notes that I’d like to throw in: One is, probably at least 6 percent of the 7-1/2 is interest crediting; it’s sort of internally generated--obviously available for use, but it’s not as though you’re getting direct new inflows. Secondly, about a third of total deposits at S&Ls now is lodged in four-year accounts, which obviously is quite important since they began in July 1973; they were rather small during the 1973-74 episode, nonexistent for ’66, the ’69-’70 period. Now we’re just beginning to get the first maturities of those four-year accounts.

So, institutions may feel a little comfortable now, [but] depending on what happens to yield spreads in this four- and six-year area, next year is where the withdrawals at maturity begin. And it’s very difficult to estimate, but our own thinking right now would be that the bill rate probably has to get near the 8 percent before you’d be talking about a situation comparable to ’73-’74, in terms of disintermediation, if you like that phrase.

MR. BALLES. Mr. Chairman, I wonder if I could break in here and pursue the same point that Frank has been talking about, because it’s a question I wanted to raise myself. Last week, I happened to be up in Seattle on business; I asked all the banks that I visited whether they’d seen any signs as yet of savings flows decreasing, and the answer was almost entirely no. In fact, all the banks up there are paying 4-1/2 percent on passbook except one bank that’s paying only 4. And strangely enough, all of the banks have a very relaxed view about their savings picture at the moment, at least for the immediate period ahead, because they are convinced that if there were interest-sensitive money in their passbook accounts, [it] long ago would have left.

That is to say that savings and loans, and especially a very large mutual savings bank in the State of Washington, have been aggressive over the years in going after savings accounts. So the banks, at least in the Seattle area where I had a chance to quiz them, were not worried. I did get a chance to talk to the head of the Federal Home Loan Bank in Seattle at a luncheon meeting that we put on, and he reported to me in just general terms that they were beginning to see some slowdowns now, some observable ones, in the S&Ls in his particular district.

In terms of the question Frank asked, that’s a very difficult one. I have asked my own staff to do some work on what the experience was on the West Coast in the last crunch. Which, of course, may or may not be applicable at all to 1978, as we all recognize, studying the experience in the West Coast, we do have some giant S&Ls that do go after very interest-sensitive money from all around the country--as you know, a number of multibillion dollar S&Ls in California, for example. The past experience would indicate, for what it’s worth, that a three-month Treasury bill rate of 150 to 200 basis points over the S&L passbook rate appears to be a zone or a trigger point that very sharply reduces the inflow of savings to the S&Ls. If that experience were to prevail in the future--it may not--that would indicate a T-bill rate of somewhere between 6-3/4 and 7-1/4 percent as a zone where they really begin to feel something. Now, offsetting that, of course, is the fact that they’ve got a somewhat longer average structure of maturities than they did three or four years ago.

But nevertheless, all things considered, I would simply want to observe that our own staff, for example, is a little less optimistic than the Board’s staff on housing starts. We’re looking--not that our forecasts are any better than yours--at about 1.8 million units in ’78 versus 1.9 this year. Your forecast is 1.97 this year and totaling up next year to 2.14. I did examine a very recent set of forecasts among leading private forecasters published in *Euromoney* for the last month--oh, 30 or so [forecasters]--and I think the average of those came out to about 1.83 million units in 1978. In general, I would gather that the private sector of forecasters are less optimistic than you are here at the Board on this matter of what the level of interest rates may do to savings and also to housing starts.

MR. KICHLINE. I think that's fair; probably in most cases they are assuming lower interest rates and getting somewhat lower housing starts.

CHAIRMAN BURNS. Gentlemen, I think the time has come to state what views we have with respect to the outlook for the overall economy. And I think it's particularly important that members of the Committee indicate whether they agree substantially with the broad projections made by the staff, putting details aside, or whether there are sharp, significant differences. And it's these that we want to articulate. And who would like to comment at this time? Mr. Willes.

MR. WILLES. Mr. Chairman, we agree with the optimism of the Board staff, even though it is somewhat more optimistic than many others that we read. And even though we had the snow in October, in fact we're slightly more optimistic than the Board's staff. We think that there's a little tendency on the part of many observers, as they see a particular economic statistic come out, to read more into that than perhaps is warranted.

CHAIRMAN BURNS. I think we'd like to hear you argue the case for greater optimism.

MR. WILLES. Well, we find, for example, that in each of the areas that we have been talking about so far today, consumer spending, housing starts, and so on--while a particular number may be low for a month or two, the feedback we keep hearing from our retailers, from our businessmen who are making their plans for capital spending, and so on--very much like Willis Winn reported--we just see things continually coming on line out there that almost seem to belie the general pessimistic statements that we seem to hear from professional forecasters.

CHAIRMAN BURNS. Yes, but are you commenting on the economy of your own region or on the national economy?

MR. WILLES. No, we're getting this feedback from around the country. And precisely because of our geographic peculiarities, we have asked our own staff as well as our directors to reach out elsewhere to make sure we weren't being overly influenced by the things in our District. I do have one question that we find a little difficult to deal with. And I don't know whether you or the staff would care to comment. We would like to know what the best guesses are as to whether there will be additional protectionist measures over the next 12 to 18 months and how significant they will be, because that will have a rather significant impact both on output and prices.

CHAIRMAN BURNS. My guess would be, or my judgment--we will not have any significant protectionist measures in this country over the next year. Do you have a different view, Mr. Truman?

MR. TRUMAN. No, I, it's only a guess. Yours may be a judgment, mine's a guess. I'll agree that you're not going to see much--

CHAIRMAN BURNS. Well, I'd like to pursue your comment. Mr. Willes has indicated that he feels that, if anything, the staff forecast understates prospects of the economy. Are there others within the Committee who take a similar view--who feel more optimistic than the staff apparently does? Mr. Roos, first, and then Mr. Winn.

MR. ROOS. Whether I feel more optimistic or equally optimistic, we have met with businessmen in our District, some of whom have national and international operations, in the last couple of weeks. And literally none of them cite any weaknesses or any significant weaknesses. By and large, most of them are optimistic, most of them report having inventories well under control. Loan demand in our area is strong, and basically, I would share in readings we get, which are both Midwest--Eighth District--as well as national reflections. Nothing that would make me other than reasonably optimistic.

CHAIRMAN BURNS. All right, thank you. Mr. Winn and then Mr. Kimbrel.

MR. WINN. Mr. Chairman, I think my optimism is in part based on the hope that some of the psychological malaise may be lifted. It's a kind of a commentary on our times when last week a New York Stock Exchange seat sold for $35,000, and a taxi medallion in New York sold for $52,000. So our out-of-work brokers can't even buy a cab. But I have a feeling that the current market malaise is in part psychologically affecting attitudes in a whole range of areas, and somehow I think that both the Washington scene and the New York scene may be clarified before the year is out. And with those two lifted, I see greater strength than has been indicated in some of these numbers. Now, if I'm wrong, they may pull down a greater segment of consumer expenditures in some of these other areas and factor them into our forecasts.

CHAIRMAN BURNS. Okay. Mr. Kimbrel.

MR. KIMBREL. Mr. Chairman, I guess I should [say that] the negative features that relate to us are entirely, at this moment, apparently strike related. Lockheed, of course, yesterday voted to strike in the Atlanta area, which is a significant employer. On the other side, the New Orleans dock workers apparently have voted reluctantly for going back to work and eliminate some of that bottleneck there. The concern also is about the activities of coal miners in Alabama, Tennessee, and they work a day [on] and a day off, so at least those are clouds. But east Tennessee barely remembers that there's been any change because their employment there is full speed ahead. The west coast of Florida is experiencing the same sort of rebound that is difficult to comprehend in the real estate, housing area. The Louisiana and south Alabama oil exploration people are almost uncontained. They just can't get enough rigs and enough people to work. They are as excited about their future as [unintelligible]. Even in the Atlanta area, the feeling is one of optimism. So, Mr. Chairman, we just simply must come out in our area with a feeling that things do not look blue over the next few quarters.

CHAIRMAN BURNS. All right, in the interest of orderly discussion, before I call on other members of the Committee, I would like to have a show of hands on the part of those members of our family who believe that the outlook for the general economy is less favorable than our staff has suggested.

MR. COLDWELL. Over the full projection period?

CHAIRMAN BURNS. Well, define that as you may. All right, then, we'll hear from some members of that--

MR. BROIDA. [Unintelligible] count five, Mr. Chairman.

CHAIRMAN BURNS. Well, no, I wasn't ready to count. I wanted the individuals rather than a count of the numbers. Mr. Partee, let's hear from you now.

MR. PARTEE. Well, Mr. Chairman, I guess I would veer in the direction, I think, in the probabilities of a somewhat lower increase than the staff has. And I do this with some temerity because I think it's awfully hard to know what's likely to occur. And I do it also with a clear understanding that I don't anticipate an actual recession in the period, at least not until the very end of the period that we're forecasting.

But it seems to me that, in area after area that has been discussed here this afternoon, the staff has been inclined to take a figure a little on the high side. Now in some of these cases, the figure will probably work out, but in other cases it seems to me that a lower figure is probable. For example, we've mentioned net exports--it seems to me that chances are that net exports will be weaker than are being projected, rather than stronger than have been projected, and that will weaken, to a degree, the size of domestic output related to that aspect. We mentioned housing starts, and I think maybe a 2.14 million rate is a pretty high rate for the year. Even if you get 2.14, I want to agree with my associate, Governor Jackson, that it's likely to be more in multifamily and thus involve less spending than would be the case in the staff mix. I see that we still have automobile sales next year of 11.4 million units, up from this year. And it seems to me still unlikely that that will be the case. In general, I wonder whether personal consumption will be that strong.

In the area of plant and equipment expenditure, well, it may well be that the staff will be right. They have a 13.6 percent increase indicated in business fixed [investment], but I would remind you that the surveys we've seen to date are a good deal below that. Now, it's often said, and I've heard it said just today, that the surveys tend to underestimate spending during the periods of expansion. But I want to point out to you that that has a certain amount of circularity in it. If this in fact does not turn out to be a period of high expansion, I think the surveys indicate that they usually overestimate rather than underestimate. So that there is a presumption that you're thinking about, that you're reading from, when you say that it's likely to be more than the surveys. That's not a tremendous difference, but it is on the order of 3-1/2 percentage points in that area.

Perhaps there could be more of an increase in inventory than is being projected. But business seems to be very conservative with regard to inventory, and I haven't seen as yet what I would call speculative exuberance in acquiring inventory. Therefore, if business is conservative with regard to inventory practices and we do get a larger rise, that would be a sign of weakness for the immediately following period rather than a sign of strength.

So, I wouldn't want to say each one of these areas will be weaker than the projection, but I think there's enough of a prospect that some will be that I think we'll come out on the low side of this. I will point out to you that what we're projecting is a real GNP, the rise in which is tending to diminish from a 5 percent rate to 4-1/2 percent rate over the projection period. Thus, a lower number would get us down into an area of danger and an unemployment rate that is dropping very little from where it has been--to 6.6, I guess, at the end of the projection period--which is also much less progress than has been planned in that area over the coming year.

As far as prices are concerned, I am inclined to think they're going to come in a little better than the staff has projected. And I think I'm inclined to do that partly because I believe that food prices will continue weak in the projection period, relatively weak, and also because there's not going to be enough worldwide demand for industrial raw materials to drive those prices up very much. So I think those two somewhat exogenous elements in our price determination picture will tend to give us lower increases rather than larger. I don't really dispute the idea that the basic underlying rate of inflation marked in terms of unit labor costs will remain 6 percent or slightly above.

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

VICE CHAIRMAN VOLCKER. Well, Mr. Partee has pretty much made my speech at this point. Let me say that I think the staff forecast doesn't seem at all unreasonable to me. But it is higher than what my people have been forecasting in New York by about 1 percent[age point] for calendar year 1978. And while I think it could reach the staff's projection here, I think there are grounds for being more cautious.

And let me just state pretty much what Governor Partee just did in a slightly different way. Consumption is most of the GNP. Everybody pretty much anticipates that the saving rate is going to go up, and the staff knows, as we do, that it has been pretty low. You've got to generate income at a faster rate of speed and consumption to keep this thing going. If that's correct, are all these other sectors going to generate the income that's necessary to reach that consumption figure? When you look down at the items that are crucial, you come up with the same ones that have just been questioned. We're particularly lower on housing, although I think a good defense has been made of the housing projections here. That's the biggest single difference we have. But we are lower in all these other things, marginally, right along the line.

The investment thing, it seems to me, is being affected at the moment by about as sour a business climate in relation to the political scene as I remember in a long while. And that may not last--I think it's being overdone. But I certainly get a strong feeling of discouragement reflected by the businessmen that I talked to about what they think they see going on in Washington, and exaggerated or not, I'm beginning to think it's had some impact in what they're saying they're going to do about capital spending next year. I still hope that that will evaporate, but the stock market thing complicates the situation too. It doesn't make anybody feel happy, and I think both those situations may have to improve to get as good a business investment picture next year as the staff has projected.

You already mentioned net exports, but in the short run I do think the key is inventory. The thing there is a little more mixed than I thought it was a while ago, in the sense that you can read the retail figures at least as being a little high, mainly because the retail trade has leveled off--not drastically so. The rest of the inventory picture looks pretty good to me, but I think we are counting, even in our projection, even more so in the staff's projection, on a pretty prompt turnaround in the inventory picture here, and we haven't seen it yet, and before I get too optimistic, I want to see it take place. That, combined with the settling down of this political thing, may bring us around to the staff's view pretty promptly. But we're not there yet.

I might tell Mr. Winn that the medallion price wouldn't be so good if the taxi industry was regulated by the SEC [Securities and Exchange Commission], I suspect, and they thought the [unintelligible] was going to go out of business.

CHAIRMAN BURNS. Mr. Balles now, please.

MR. BALLES. Well, our staff forecast is very close to that of the Board in broad terms up through about the middle of next year. We're considerably less optimistic for the second half of the year. And largely because of the reason I alluded to earlier, we expect a downturn in housing to occur, principally in the single family--[unintelligible] apart by what will go on in the multifamily. But nevertheless the total picture on housing is likely to feed back on purchases on household durables and also on inventories, and that's why our staff has, for the second half of next year, a real GNP increase averaging less than 3 percent. I admit that the farther you get out of this forecast horizon, the greater becomes the margin of error, but that's just the way we happened to come out.

CHAIRMAN BURNS. Thank you Mr. [Balles]. Mr. Wallich, please.

MR. WALLICH. Well, this is of course a contingent forecast based on there being no further action on the policies that are in the pipeline so far. I would also say that it is not a very high forecast--4.3 percent in the fourth quarter is not very much, and final sales of 3.8 in the fourth quarter is really quite modest. Also, I'm making the case for the downside here, and I'm starting off by saying that even the staff is not very high. Nevertheless, the staff is higher than most forecasters, particularly toward the end of 1978. There are some [forecasts] for early '78 that are above us. But [for] late '78, I'm afraid, we're at the peak. It may be that economists typically see things that are strong petering out. There's always a good reason for that, like housing. It's difficult sometimes to see things strengthening, and that's what lends a bias to these forecasts beyond the area of visibility.

Now, I think if one wanted to make the realistic assessment of the situation, it is that we may very well get a stimulus from the Administration during the course of the year. The Administration talks about a 5 percent rate of growth during 1978--that is well above what we think. They say that action would be taken if we fell below that, but what that action would be, how effective it would be, how long it would take to get it enacted, and how soon it would become effective is all very uncertain. I would guess that the evolution of the numbers that we have here in the staff [forecast] might trigger quite early pressure from the Administration for some kind of fiscal action. If one factors in that probability, one--

CHAIRMAN BURNS. And assumes great wisdom.

MR. WALLICH. --assumes great wisdom--I was going to say this raises other risks. It raises risks of acceleration of inflation; it reduces, I think, the chances of a downturn. So all that I wanted to say is that, in the absence of new action, I think that the staff is more on the high side than I would be.

CHAIRMAN BURNS. Gentlemen, I scheduled this meeting for a two-hour period, and the two-hour period is at an end. I wish we could carry on; I hate to interrupt the flow of thought. But I've got to go to another meeting, and I believe the Bank Presidents have scheduled a meeting to start at 5:00. So we will resume our discussion of the economy tomorrow morning, and those that haven't yet spoken will be afforded the time; and I will want to make a statement or two regarding the condition of the economy and our economic prospects as I see them.

MR. COLDWELL. Is this the meeting of the Sunshine [law] now?

MR. LILLY. Yes, this is Government in the Sunshine.

October 18, 1977

CHAIRMAN BURNS. We had, I think, a reasonably thorough discussion of the economy, the way in which we do it, individually, but several members of the Board did not express their views. And we decided at the end of yesterday's meeting to continue our economic discussion--at least for a little while. We'll start with Mr. Coldwell, and then I'll call on Mr. Lilly, and then on Mr. Jackson, and on any others who want to speak. Mr. Coldwell, please.

MR. COLDWELL. Thank you, Mr. Chairman. We were talking yesterday, as you may recall, about any questions of difference on the projection period. And I don't find myself, on balance, over the period to mid-'78 on a net basis a whole lot different than the Board staff, although I think they're a bit optimistic. But my pattern of projections seems to be fairly different from theirs. The third quarter, fourth quarter shift--I think they're overly optimistic for the fourth quarter of '77, and I'd say a little bit less optimistic than I am for early '78. But then in later '78, I have a pattern which fades and perhaps fades more rapidly than theirs. It seems to me that early '78 could show some strength in the inventory, government spending, and some personal consumption elements of the economy, countered to some extent by net export weakness and sluggishness in the construction area. For the latter part of '78, I think we're going to get additional sluggishness or weakness out of some inventory cutback and possibly also further construction weakness.

So I guess what I have to say to the Committee is that, looking down the path, my little scenario runs to weakness in '77 with more early strength in early '78. And it's a balancing act. As I said, I come out on net balance not much different than the Board staff, forecasting through the summer of '78.

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

MR. LILLY. Well, last month, as you remember, I was nervous about the economy, and I'm a little more nervous this month. I think the growth of the economy is dependent on consumer expenditures, housing markets, and an increasing rate of capital expenditure, and I haven't seen any of those factors improve somewhat. In fact, I think it's going the other way, if anything. Beyond that I'm very much concerned about the life of its own of the structural inflation [unintelligible]. Every time I pick up the paper, I hear of something else that has been done to add to these hard-core inflation pressures--7.05 government pay increase, some of the wage settlements that are coming through, the minimum wage action, the protective trade quota noises that I hear--all giving me great concern, and I'm wondering if monetary policy--well, I'm getting a little ahead of myself at this point.

CHAIRMAN BURNS. All right, thank you, Mr. Lilly. Mr. Jackson now, please.

MR. JACKSON. I think the staff's projection is a very rational, thoughtful, and appropriate effort about the expectations for the economy. Unfortunately, though, at this stage of the economic recovery of the United States, at least, I think we are entering an area where it's not what is or what is expected to be but the reaction to these events that may be the determinant of change. For example, if the expectation comes forward, I would judge that there would be a substantial segment of our country that would consider the rate of progress grossly unsatisfactory and would advocate all sorts of governmental or other efforts to make radical changes in the rates of growth as a result of the unemployment situation having effectively stagnated at about its present level. And so the public perception of our economy may well be deteriorating as a consequence of political rhetoric and those other members of our society that don't view it as being satisfactory. I think that the same thing is unfortunately true in the business community about action of government. It appears that we are about to embark on a very serious series of discussions--energy being the first of them, the tax, other aspects of the business community. [These] will be the subject of intense government discussion, much of which is very likely to lead to a sense of discouragement on the part of the public. Our staff illustrated the consumer confidence series, and things of that sort.

In short, I think the proposal is a rational one, and one that is most likely to be achieved. I do think, however, that the risks are definitely on the downside rather than the upside as a result of the deterioration in general public confidence and the economic prospects that we have--led on, unfortunately, by many people who will give an emotional reaction to a series of facts or a philosophical reaction to a series of facts that will distort the real event, which will in turn erode confidence to the extent that you'll have real changes on the downside. I think, therefore, that to that extent our responsibility on this whole equation will be even more sensitive--to do our best, not only to do the right thing but to try to ensure that it is understood in the right way--to that extent we have a more than normal responsibility to contribute toward the recovery, not only in real terms but in emotional and psychological terms.

CHAIRMAN BURNS. All right, thank you, Mr. Jackson. Anyone else?

MR. ROOS. May I inquire, Mr. Chairman?

CHAIRMAN BURNS. Yes.

MR. ROOS. Are we relating our projections, our opinions as to future economic activity on the premise that was used in the staff projections of 5-1/4 percent M1 growth from the third quarter of 1977? My question is, it would seem to me that monetary policy decisions should have some effect on any economic projection, and are we assuming in this exercise that we're buying, for purposes of our opinion, the staff [forecast] based upon 5-1/4 percent M1 growth, which is considerably below what we've had? Is that the rules of the game, Mr. Chairman?

CHAIRMAN BURNS. Well, the staff projection is based on that assumption of the 5-1/4 percent rate of growth. I think it would be fair to say that many economists who have arrived at similar projections of the economy have done so without taking that restrictive or that explicit monetary assumption. In other words, while the staff believes they have arrived at their projection by using that assumption, I am not ready to say that that projection necessarily rests on that assumption. So much for the staff; as for members of the Committee, each one would have to speak for themselves. Is that a fair answer, Mr. Kichline?

MR. KICHLINE. I think so.

CHAIRMAN BURNS. He said with a little sigh. Any further comments? Well, if not, let me say just a few words about the condition of the economy as I see it, and I'm not going to take much time because we want to move on, and I will have more than a little to say about monetary policy later on. I think the staff projection is reasonable, but I think that a larger margin of error attaches to the staff's projection today than it did to the staff's projection three months ago or six months ago. Would you agree with that, Mr. Kichline?

MR. KICHLINE. Very much so.

CHAIRMAN BURNS. As I see it, we have a depression in some major branches of our national agriculture. We have a significant recession in the metal-producing industries. On the other hand, we have considerable strength--we had a long discussion of that yesterday, and I diverged a little from the thinking that was expressed around the table--I think we have considerable vigor in the housing sector. I think we are having something of a revival in large-scale industrial and commercial construction that started only recently in the first quarter. I think that machinery trades continue to be strong.

But certainly retail trade in the past few months has followed a horizontal trend, even in dollar terms, and a somewhat declining tendency in physical units. There is a very considerable uneasiness in the business and financial community, and I think it's reflected in the stock market. I found businessmen in a very uneasy mind during the recent meeting of the Business Council which I attended. I think that the economy could have a marvelous recovery or reacceleration if economic policy made by the Administration, particularly the new tax proposals, were sensible, realistic, well designed to foster capital investment in our country. I think that there is great vitality in the private economic sector. The fact that we've added nearly 7 million jobs in our country since the spring of 1975 attests to the dynamism of private enterprise in our land. New business are being formed at a rapidly increasing rate.

But I think that a series of actions and inactions of the governmental sector and the rather indifferent performance of profits is gradually sapping [the] vigor of optimism, [and] I think [that condition] has come to characterize businessmen around the country. Now, if I felt confident that the Administration would come forward with a sensible, practical set of tax proposals, I would say to you that I look forward to a rapid and sustained increase for economic activity. But I don't have that optimism at the present time. And on the basis of what I know about Administration plans--they're still in process of being shaped up and not yet final--I cannot be very optimistic. And I think that puts a burden on us and a certain responsibility on us, to which all of us are sensitive.

Well, I take it, unless someone else would like to speak about the economy, its general conditions and prospects, I think we're ready to move on. And we haven't yet heard from Mr. Pardee on foreign currency operations. I hope you bring good news today, Mr. Pardee. The markets didn’t behave too badly today. Why don’t you express the good news while it lasts for an hour or two.

MR. PARDEE. We’re about where we closed last night, but the dollar was lower earlier today and other central banks [unintelligible].

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

CHAIRMAN BURNS. [Interrupting] Did Secretary Blumenthal make the latter statement?

MR. PARDEE. It was taken out of context. This was a press conference on other matters, and someone asked him [paraphrasing], “Well, what do you think about the rise in the Japanese yen lately?” And he said, “Well, there hasn’t been much rise, has there?” And they said, “Oh yes, it’s gone up such and such,” and got into a discussion of the appreciation, which has been only about 1 or 2 percent. He said, “Well, that’s not very much. If you really want to have an effect on the trade balance, you need a very large appreciation.”

CHAIRMAN BURNS. Did he say the latter? Are you sure?

MR. PARDEE. Yes. It was in an “if” clause, however, rather than a--

CHAIRMAN BURNS. I didn’t see that.

VICE CHAIRMAN VOLCKER. He didn’t say he wanted a large appreciation--

MR. PARDEE. He said “if.”

VICE CHAIRMAN VOLCKER. --but that’s the way it was interpreted.

MR. PARDEE. That’s right, but it’s the way it was interpreted, and it was yanked right out of context. It’s like any--

MR. PARTEE. He says if you want a large effect you need a large change.

VICE CHAIRMAN VOLCKER. He was making an analytic point and got interpreted as a policy position.

MR. PARDEE. That’s right.

CHAIRMAN BURNS. And on the basis of what little I knew, I thought it was misinterpreted.

MR. PARDEE. Well, he was making an analytic point, that, if you’re going to have an effect on the trade account, you’re going to need an awfully large change in the exchange rate under the current circumstances. But he wasn’t advocating that, it’s just the point he was making. But the Reuters people, who weren’t there at the time, went over the transcript and yanked these two or three sentences out of the transcript. Everything else that he said disappeared--was not used by the press. And it came at a particular time when the market was quiet. You have this tendency of the press to use these things.

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

CHAIRMAN BURNS. [Interrupting] Would you tell us about the good news that has been ignored by the market?

MR. PARDEE. I have a brief bit later on. The economy is not performing that badly; we have growth here. Other countries don't have much growth. Our rate of inflation is lower than in most other countries. We've had currencies that are rising--their rates of inflation are 10, 12, 15 percent. The market has lost perspective on many of the fundamentals with this exaggerated focus on the trade deficit and what the United States government is going to do about the trade deficit.

MR. BLACK. Rise in interest rates--

MR. PARDEE. And interest rates have risen.

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

CHAIRMAN BURNS. Thank you. Mr. Black.

MR. BLACK. Scott, I gather from what you said about the market's tendency to ignore any good news, that your assessment of the positive effects of, say, an increase in the discount rate or moving the federal funds rate up still further would not make much difference.

MR. PARDEE. At the moment, the market is not focusing too much on interest rates. At the moment. But if some of these other fears were calm, then they would be focusing on interest rates. The general feeling, perhaps, is that there might be further firming of interest rates here, but I don't think people expect much further rise.

CHAIRMAN BURNS. Any other comments? Mr. Wallich, please.

MR. WALLICH. And what's been the response to our recent interventions? Do central banks abroad feel that we've done our share of the job, or do you still get pressure to do more?

MR. PARDEE. Well, at the Desk we haven't had any pressures to do more. We've been working very closely, of course, with the Bundesbank, the Swiss National Bank, but there have been some rumblings from the Swiss, particularly, that the U.S. ought to do more. But that's again in the context that the Bundesbank had done $900 million and the Swiss $1 billion, and they still haven't really resolved the problem they face in the market. The Swiss have a particular problem because their currency is rising against everyone, once again; it moved above parity with the German mark just today. So they're more concerned. But I think in this episode we have less pressure on us now from the others than we have had with earlier episodes. But at the same time, we're on a spot, since it is U.S. policy which is in question, and a number of times the market participants have called us and said we're glad to see you in the market today.

MR. WALLICH. Can you tell from their reactions whether this enormous amount of intervention, I think on the order of $20 billion supporting the dollar, whether they're disappointed in that it hasn't had more of a stabilizing effect?

MR. PARDEE. Oh, yes, disappointed.

MR. PARTEE. Shouldn't you say they spent $20 billion on holding down their own currencies?

MR. WALLICH. Well, I just want to bring out the fact that $20 billion was spent and was not enough to hold the dollar.

MR. PARTEE. No, I'm just referring to the phrase "supporting the dollar." I don't think that was their motive. Their motive was to hold down their own currency.

MR. WALLICH. Oh, yes, I think that is probably so. But if you thought of it--suppose we had done this, nobody else supported the dollar; we had, let us say, very large reserves of some sort and had to spend $20 billion in support of our currency, it would not have been sufficient to prevent this decline. And that impresses me very much, whether things were going back to a stable system, what kind of reserves would be needed in order to maintain stable rates.

MR. BLACK. There is some indication that stable rates really aren't a viable permanent system.

MR. WALLICH. Under present inflationary conditions I would say, not otherwise.

CHAIRMAN BURNS. Well, when you have intervention on such a scale, that means to me that a number of countries in the world are conducting their affairs in a way suggesting that they believe they are or should be in the fixed-rate system. And of course, they're doing it in the interest of protecting their foreign trade, and that's why Scott is not having many complaints from the countries that have been intervening on such a great scale. They're appreciative of the minor intervention that we make because we're helping them to protect their foreign trade. That's the way they look at it. Scott is wondering whether I'm right.

MR. PARDEE. At base, this is one of the elements, but I think as central bankers, we're all more concerned with the financial flows and the relative stability of our market. To have these vast amounts of money moving across the market is a problem for any central banker. I think, though, in response to Governor Wallich's point, that if the market felt that we would be prepared to do $20 billion, then that amount of intervention would not be needed by anybody. And it's a part of the question whether we are prepared to support, defend--whatever word you want to use--our own currency. And any indication coming out of Washington or anywhere else that the U.S. wants to see a particular result starts a new wave of selling the dollar.

MR. WALLICH. You're saying that effect of intervention depends to some extent on who does it?

MR. PARDEE. Right. The British, if they buy another dollar today, it'll just go right into their reserves and into our bond market. If we were to buy another dollar today it would have more effect on market psychology. This is what we're facing--psychological markets.

MR. JACKSON. Is there any change in the psychological attitude of foreign official institutions that are a major holder of the dollar reserves, other than these major trading people?

MR. PARDEE. Well, it's hard to measure. At the request of the Chairman a few months ago, we have been watching very carefully for any concrete indications of shifts of funds by the OPEC central banks, in particular, and it's very hard to trace this because they are very sophisticated in the manner in which they carry out their transactions. I had a feeling, [during] this last go-round of big payments to some of the OPEC [countries] at mid-month, that more of the funds were converted out of dollars into marks and Swiss francs than we've had in recent months. But this was more from comments we heard from the market and the reaction we had when we went into the market ourselves--that it took more intervention on our part to quiet the market on a particular day than we would have otherwise.

CHAIRMAN BURNS. Well, had you asked the central banks and the leading OPEC countries what they may be doing?

MR. PARDEE. Yes, and we don't get very concrete answers either. But they do point out that they are concerned about the dollar and point out the scenario that, if the dollar continues to decline, then they have no other choice but to continue to diversify to Swiss francs, marks, and other currencies, yen, in order to maintain the value of their international reserve.

MR. COLDWELL. You say continue to diversify. How far has this moved?

MR. PARDEE. It varies with the country.

MR. COLDWELL. Or do you know?

MR. PARDEE. But in some cases I think they're just not telling us the [truth]--they say they're still in dollars, investing in dollars, and so forth, and yet we hear from the market that they've been buying other currencies. Since they operate in the Eurocurrency markets, no one can see them very well, even the others.

MR. COLDWELL. So your impression is, this is more than a threat, then?

MR. PARDEE. It's a process. It's a management process. These people are all studying and have advice from consultants in the U.S. and London on how to manage their reserves. And you're talking about portfolio management.

CHAIRMAN BURNS. That's not what they tell me. What they tell me is that the dollar becomes weak and that will put great pressure on the price of oil, and they accent that development rather than going out of dollars into other currencies.

MR. PARDEE. Well, this is what the policymakers are saying. I'm talking more about the ones who are managing the portfolios, or funds, whoever deals in that area. Sometimes it's the same person, but we're talking about two different questions.

MR. WALLICH. But if there were such a move, we would have to be able to observe an increased proportion of Eurocurrency loans made in D-marks and yen, and that's the Eurocurrency, and so on. Somebody's got to create assets if he's going to assume liabilities in those currencies. I'm not aware that one sees that, actually.

MR. PARDEE. That's one of the manifestations, I think.

MR. JACKSON. To what extent could these shifts in currencies be a reflection of the change in the currencies in which they're buying their imports? For example, that trade with Japan and Germany has picked up relative to that in the U.S.?

MR. PARDEE. Yes. This is part of the reason why it's so difficult for us to say categorically that, at one given week or one given month or quarter, there's more purchases of D-marks by OPEC central banks then at other periods. We don't have a link to the direct transactions picture. The problem in the market is that there are certain banks that operate for these fellows. Any time those banks appear as heavy buyers of Swiss francs or marks, everybody rides on the back of us and says okay, here we go, the dollar's going to decline again because we've got OPEC in the market. And so we do have the psychological reaction to something, whether it's real or not.

CHAIRMAN BURNS. Yes, Mr. Black.

MR. BLACK. Could I ask Scott one more question?

MR. PARDEE. Certainly.

MR. BLACK. Scott, has this diversification by the OPEC countries out of dollars accounted to any significant degree for the movement in the dollar?

MR. PARDEE. It's perhaps a contributory factor, but I would not call it a major factor.

MR. BLACK. [Unintelligible.]

MR. PARDEE. To the extent that we have seen, there is some, perhaps some increase, it is a factor. We're not calling it a significant factor. I'd rather place the policy concern on these other matters that I outlined.

MR. BLACK. Well, that was my guess. I just wasn't--

MR. PARDEE. But the fear of this--we're dealing with market fears. We're not dealing with facts, we're dealing with fear. People worry about all of these things to the extent that these fears [arise], some of them confirmed, then the market jumps. At this stage, the market is jumping to sell dollars at any opportunity, at any event that somehow can be interpreted as a negative for the dollar.

MR. BLACK. So a good part of that could stem from fear of [unintelligible] past week or so?

MR. WALLICH. May I make one more comment?

CHAIRMAN BURNS. Yes, please.

MR. WALLICH. At the risk of taking too much time, I'm disturbed by Scott's comment that if we intervened on a very large scale, this would have a different effect from others doing it. I suspect, if that is true, it is true for a reason that we might not want to accept, namely that all our other policies would be bent toward maintaining the dollar. In other words, if we got into such a situation where we were trying to support the dollar by operations of the market, if that is to be successful, the market has to be put in a frame of mind where they think we're going to raise interest rates, tighten the budget, maybe do other things, in order to support the dollar. And we might find that we would be putting ourselves into a difficult box in order to assure the effectiveness of that kind of operation.

MR. MORRIS. I'm not sure, Henry, that's the only interpretation the market places upon our intervention. I think there's also the simpler interpretation--that we in the Federal Reserve think the market has gone too far, and we don't think there's a lot of risk involved in increasing our level of intervention.

MR. PARDEE. It's just a matter of erasing the market's worst fears rather than turning upside down all the rest of our policy. The market needs reassurance in this.

MR. WALLICH. Because you think the market thinks we want it down positively.

MR. PARDEE. Well, they're afraid that we want it.

CHAIRMAN BURNS. Where "we" means what?

MR. PARDEE. Well, this is more the U.S. Treasury than the Federal Reserve.

MR. PARTEE. Well, you can't erase the trade deficit, which is growing by leaps and bounds. That certainly would seem to indicate the direction for the dollar, other things equal. And for us to try to resist that in volume--I mean, at first it might seem that we know something that they don't, but later it might just seem that we're being foolish.

MR. PARDEE. Well, we can't devalue against the Saudi currency or the [unintelligible] currency or [against] all these other countries that we're having a deficit with. The Japanese [unintelligible]. We have a surplus with Western Europe. And you get into the argument as to whether a devaluation at this stage would help us. The Treasury's thinking at this stage is that it won't. And this was the point Secretary Blumenthal was trying to make, but the press twisted it and made it sound as if he was talking about the dollar.

CHAIRMAN BURNS. I would endorse the comment made by Mr. Pardee. I think that if Secretary Blumenthal had not said one word, the market would behave in much the same way. Of course it is. And I don't think that we can correct that to any appreciable degree by raising interest rates in this country. After all, take a look at where interest rates were in Britain, where they were in Italy and various Latin American countries, and what happened to their foreign exchange rate.

I do think that there are certain actions that can be taken, that I hope will be taken, outside the Federal Reserve, action of a constructive kind that would improve matters at least for a few months. And if in the meantime the outside economy began moving up, that would certainly release forces that would help to bring down our foreign trade deficit. And if we also got an energy policy that meant something, well, that would have not only a large psychological influence on the part of the exchange markets, but it would improve the underlying situation significantly.

Gentlemen, I think we’re ready to move on the transactions that have been made by the Desk during the past month. Is there a motion to approve these foreign transactions?

MR. COLDWELL. So moved.

CHAIRMAN BURNS. The motion has been made and seconded. I hear no objections. Do you have any recommendations to the Committee, Mr. Pardee?

MR. PARDEE. I have no formal recommendations, but I would briefly note the situations which could lead to requests for swap drawings by other central banks.

[Situations noted by Pardee not recorded.]

CHAIRMAN BURNS. All right, thank you. I think we’re ready to move on. Mr. Sternlight, may we have your report now on the domestic Desk?

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

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

MR. WALLICH. Well, as you saw these aggregates coming toward you, Peter, were you--I’m trying to get a sense of your timing. Evidently you have to make decisions--whether today, tomorrow--how soon you move with the rate. Were you comfortable with the way things worked out, and was the directive as given helpful, capable of being executed properly?

MR. STERNLIGHT. I think so, Governor Wallich. Well, both the directive and the sense of the discussion at the meeting gave us what we thought was a course of normal procedure to move in a gradual fashion. The strength was apparent, as I said, just within a day or two after the meeting, and we just about immediately moved from 6-1/8 to the 6-1/4 midpoint, and then, as we had that initial strength confirmed and then got further indications that we were not just at the top but slightly over the top of the ranges, then we moved up in a measured way to the top of the funds rate [range] that the Committee had specified.

MR. WALLICH. When New York and the Board don't have exactly the same estimates, how do you proceed?

MR. STERNLIGHT. We give primary weight to the Board's estimates. We look at the New York estimates just as a kind of measure of, well, it's just kind of a reminder that these, after all, are projections, and not necessarily the final word on the subject.

MR. PARTEE. Peter, as you say, you were coming to the upper limit on your ranges almost right away, which is not surprising, because the Committee biased the ranges downward last time. And then as I look at the Bluebook, why, of course, the latest estimates are well above the upper end of the range for M1 and somewhat above M2. Can I ask you, at what point would you notify the Chairman when you thought the instructions were inconsistent ordinarily? I mean how would the process go?

MR. STERNLIGHT. Well, I think there's a continual communication with the Chairman that includes discussion with senior staff members as we go along.

MR. PARTEE. You didn't regard this as being obviously inconsistent, at least until right toward the very end of the period. Is that right?

MR. STERNLIGHT. It was really only in the aggregates--by October 6--that we were really above the range, and at that point we were aiming for the 6-1/2 percent top of the funds rate, and this was--as these steps are taken as we go along, there's a consultative process in which we are in touch with senior staff of the Committee here.

MR. ROOS. Mr. Chairman?

CHAIRMAN BURNS. Yes, Mr. Roos.

MR. ROOS. Following that same line, and maybe this is too hypothetical for you to answer. What degree of increase in the aggregates would cause you to cease the--

CHAIRMAN BURNS. I didn't hear the question.

MR. ROOS. I said what--how far would the aggregates have to go before Peter pressed the panic button--

MR. STERNLIGHT. I think that if we were 1 or 2 percentage points above the tops of the ranges, this clearly raises a question that should be brought to the Chairman's attention.

CHAIRMAN BURNS. The Chairman, let me say, is really not asleep. And I think that the Committee, the entire Committee, should take very seriously Mr. Sternlight's very accurate description. There is a constant consultation and communication between my office and Mr. Sternlight. And therefore there's no need to press any panic button, because we are pretty much on the same wavelength as the period unfolds and as the aggregates march toward us or away from us. And very clearly, the aggregates were at or a little above the maxima. That became pretty clear last Thursday but didn't seem worthwhile in my judgment--didn't seem worthwhile. If the excess had been very large, I might have communicated with the Committee even on

Thursday. But that was not the case, and since the Committee was to meet on the following Tuesday, there seemed to be no point, really, in any such communication. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, can I address a question to Peter and possibly also Scott? Do you see any rather direct or more or less mechanical relationship between the accelerated growth in holding domestic balances and what has just been described with respect to the pressures on the dollar internationally?

MR. STERNLIGHT. I'm not sure what domestic balances you mean?

MR. BAUGHMAN. I was thinking of the money stock.

MR. STERNLIGHT. Yes. I'm not sure I do see any direct connection there. There tends to be a reaction in the exchange markets to our money supply figures, which Scott had commented on, though I gather this very last time there was less reaction than there had been on other occasions when we would have to show a big increase in the aggregates--the dollar tends to strengthen, but not so much this last occasion, I believe.

MR. WALLICH. May I add a word here? It seems to me Mr. Baughman's comment would be very appropriate in any other country in any other circumstances than those of rapidly rising interest rates. You create more money. There's an implication that money will flow out of the country, and under floating rates that means there'll be pressure on the exchange rate. The puzzling thing is that this happened in the context where evidently there was a strong demand for money because interest rates were rising, and so you wouldn't expect this effect, you know, of pouring water into a glass and having it spill over, which is the typical sequence of events in most other countries when you increase the money supply.

MR. PARDEE. But in an exchange market, there's no direct relationship between the money supply and what are demands for dollars. At 4:00 on Thursday afternoon, everybody's making a bet on what the numbers are going to be. It's just like betting on football games on Sunday. And then, when the numbers come through, they jump one way or the other. Now the reaction has been, definitely, the aggregates coming in strong, and this would have the implication Governor Wallich suggested, that interest rates sooner or later will rise, therefore the dollar would be stronger. But what I'm afraid of now, however, is that some market participants say that if [the monetary aggregates] continue to come in strong, then you have an adverse reaction that the dollar will be lower on the kind of considerations Governor Wallich mentioned.

CHAIRMAN BURNS. Yes, Mr. Balles.

MR. BALLES. Mr. Chairman, I was just wondering if Peter or perhaps later Steve might be covering this, as to whether the staff has any insight on that very large surge of the aggregates for the past period. What I'm getting at is, there seems to be a suspiciously strange pattern developing on quarterly dates with the big surge in April, July, and October, and this suggests all sorts of statistical problems, including the seasonals. Is this an appropriate time to raise that question?

CHAIRMAN BURNS. Well, the answer can and will be very short.

MR. AXILROD. I have no special--there has been, as you pointed out, this phenomenon, and it may very well be that our weekly seasonals are bad. To a lesser degree, our monthly seasonals might be bad because they'll revise somewhat. We don't have any special reason, but I would point out that these surges have tended to disappear. So it's not misleading in the sense you're getting an increase which is right away disappearing the next week. But I don't have any reason to explain why we had $4.6 billion rather than 2.5, which is what we were originally projecting.

MR. BALLES. I'm glad to hear you're as frustrated as I am in terms of explaining it. I'm not really glad; I wish you had an explanation, which I don't.

CHAIRMAN BURNS. Any other questions? Very well. Is there a motion now to approve the operations of the Desk during the past month?

MR. MAYO. So moved.

SPEAKER(?). Seconded.

CHAIRMAN BURNS. The motion has been made and seconded; I hear no objection. Let's turn very briefly to the lending authority under which we function, the lending authority to the Treasury. Mr. Broida, would you be good enough to say a few words on this subject?

MR. BROIDA. Mr. Chairman, we've distributed a memorandum to the Committee noting that--now that the need for the $3 billion limit has passed--you recommend that the Committee return to the $2 billion limit specified in paragraph 2 of the Authorization.

CHAIRMAN BURNS. I'd like to add just one word. The reason for that reference for the particular recommendation is that I hope it can be adopted without discussion. There's no great logic attaching to it, and I could go with $3 billion and I could go with $5 billion, but if I open up the question, we might have an extended discussion. We could function quite well under the present rule, and therefore my recommendation is that we stay with the present rule.

SPEAKER(?). So moved.

SPEAKER(?). Seconded.

CHAIRMAN BURNS. And there's no logic to support it.

MR. PARTEE. They don't hardly ever use it.

CHAIRMAN BURNS. And when they do, we can change the rules.

MR. PARTEE. I second it.

CHAIRMAN BURNS. The motion has been made and seconded, and we stay with the present illogical rule. Very well now, I think we'll move to the consideration of the longer-term ranges for the monetary aggregates and then have a few words by Governor Partee, who will tell us something about [unintelligible] the [Sub]committee on the Directive. And then we'll hear very briefly from Mr. Axilrod, and finally we'll make our decisions on short-term monetary policy. That's our agenda.

Now I'd like to introduce the subject of long-term ranges. We will be testifying on our longer-range targets on November 9. And we'll strive to arrive at a certain decision. There is a possibility, in view of the lapse of time, that we may want to reconsider the judgment we reach today. We did that once before when a long interval elapsed between Committee consideration and the date of formal testimony, and we may or may not want to do that again. I think that option should be held open.

Now let me make some introductory remarks to the difficult question that we face today. In studying longer-range targets--I permit myself to use the term "targets" here; I never use it in public pronouncements--but in setting longer-range targets, we should be clear about our objectives. I think we should have certain very specific objectives. First, to indicate to the Congress and to the general public that we at the Federal Reserve are as determined as ever to gradually bring down the rate of growth of the monetary aggregates so that they would once again be consistent with the maintenance of general price stability. I think we should have that objective clearly in mind. The second objective that we should have clearly in mind is that we need to assure the Congress and the general public that the monetary aggregates, to the extent that we can control them, will grow sufficiently to facilitate orderly expansion of our national economy. And our third objective in setting these targets, I think, should be to advise the Congress and the general public that satisfactory performance of our economy is the basic goal before us and that we do not have the slightest intention to sacrifice or compromise this goal or objective in the interest of attaining or approximating the particular long-range projection that we set.

Now next, in setting long-range targets, we should keep in mind the following facts, among others. First, that this year, M1 has exceeded by a sizable margin the upper limit of the growth range that we set a year ago, whereas on previous occasions, functioning under the concurrent resolution, M1 has fallen short of the target range or has fallen within it. A second fact that we should keep in mind is that the growth range that we set a year ago has been exceeded not only in the case of M1 but also in the case of M2 and M3. The third fact to keep in mind is that this is the first time that, I believe, functioning under the concurrent resolution--I have not checked these statements with any care, I didn't have time--all three growth rates have been exceeded. Check these statements of mine, Mr. Axilrod, as I go along.

MR. AXILROD. That's correct.

CHAIRMAN BURNS. The fourth fact is that, whereas M1 has been growing this year much faster than during 1976, both M2 and M3 have been growing more slowly this year than they did during 1976. The fifth fact to keep in mind is that the excessive growth of M1 has been confined to the past two quarters. Sixth fact to keep in mind is that, since the beginning of the year, short-term market interest rates have risen about 200 basis points. Seventh point to keep in mind is that long-term interest rates have remained substantially stable this year. Eighth point to keep in mind is that the stock market has been signaling all year that investors are uneasy about the profitability of our corporations or about the direction of the national economy.

The ninth factor to keep in mind is that the economic outlook is less clear than it was three months ago or six months ago. The tenth fact to keep in mind is that, while the advance of prices has diminished somewhat in recent months, the underlying rate of inflation has remained stuck at about 6 percent, or a little higher, per year. The eleventh point to keep in mind is that the anti-inflation policy announced earlier in the year by the Administration has, I believe, not been carried out and, in my judgment at least, is a shambles. And the twelfth point to keep in mind is that, in view of what I've just said about the Administration's anti-inflation policy or what has happened to it thus far, we at the Federal Reserve continue to have a very heavy responsibility in making our influence felt on the inflation front.

This statement of objectives and this recital of facts do not point uniquely to one or another decision with regard to the longer-range targets. But I do think these facts and objectives do narrow our choices. I think, more specifically, that a good case--in fact, an excellent case--can be made for lowering the ranges of M2 and M3. Doing that would help to indicate that we are continuing on course as far as gradual reduction of our monetary targets goes in the interest of helping to restore these monetary aggregates to levels that will once again be consistent with reasonable price stability. Certainly short-term market interest rates have risen materially this year. They may rise further, and since market rates of interest are in process of becoming more attractive than interest on savings or time deposits, it is very reasonable to expect that the growth of M2 and M3 will be somewhat lower in the year ahead.

I think that the proper target range for M1 is more difficult to determine. And much will depend, among other things, on our judgment of the reasons for the spurt here in the past six months in M1 growth. I believe that two factors were mainly at work. First, changes in financial technology--such as the growth of passbook savings by business firms or resort to passbook savings by business firms, growth of NOW accounts, etcetera, which served to diminish the growth of M1 last year by perhaps 1-1/2 percentage points--these changes in financial technology have become recently less powerful. Hence M1 is again feeling more of the effect of the increasing demand for transactions balances.

But I believe another significant factor has been at work. At a time of growing economic uncertainty such as we've been passing through, some piling up of cash is virtually bound to occur. The unexpectedly rapid growth of M1 thus also reflects, in my judgment, the uncertainties that have accumulated in recent months about the job market, about securities prices, about foreign exchange rates, and other factors in our economy. Now I'd like to make a third observation. The exceptionally rapid growth that has occurred in M1 is partly responsible for the slowdown of income velocity during the third quarter, but this slowdown of income velocity reflects more fundamentally the recent sluggishness of the economy. And if the economy should start moving rapidly once again, and that possibility is by no means excluded, we in this Committee could be quite sure that velocity will rise once again, and rise very sharply.

Now if the analysis that I've just gone through is broadly accepted, and if we keep our basic objectives in mind, our recent monetary history in mind, I think this Committee could reasonably reach any of three decisions about M1. We could leave the range of M1 unchanged; we could lower the upper limit of M1 by, let us say, 1/2 percentage point; and third, we could lower the lower limit of M1 and simultaneously raise the upper limit.

I think a significant argument could be made for maintaining the present M1 range. And of the various factors that could be cited, I think the most important is that economic activity has recently appeared sluggish. The rate of growth of the economy is visibly diminishing, and until it becomes clear that this process will not go far, it would be prudent, wise, not to adjust monetary growth ranges in a way that would be widely construed as a tightening direction. And one might make the further point that the rate of growth of M1 has not diminished during the past two years, 2-1/2 years--that has not been the trend--while the ranges adopted by the FOMC have been gradually lowered, and a further lowering of the range for M1 in the face of this performance may lead some members of the public to believe that the Federal Reserve is not taking growth ranges at all seriously.

As for the second reasonable possibility, lowering the upper range of M1 by 1/2 percentage point, let us say--making the range 4 to 6 percent--I think that again is in the zone of reasonable, responsible behavior. In view of the magnitude of recent overshoots in the growth of M1, one could argue cogently that the credibility of the System's intention to clear up inflation would be damaged unless that range is reduced. And a reduction of the upper limit would underscore the System's determination to work toward--gradually, imperfectly, by bits and starts, perhaps--toward a lower rate of expansion of M1, and such an assurance may indeed have a positive effect on economic activity by tending to encourage business and consumer spending. And this observation could be reinforced by the consideration that the rapid advance of M1 over the past two quarters represents trouble that is stored up for the future unless slower growth follows in the months ahead.

Now to turn to the third possibility, that of widening the range by lowering the lower limit of M1 or raising the upper limit--possibly going to a range of 3 to 7 or something like that--I think such a possibility or such a move would be logical in view of the greater uncertainty about the behavior of M1 that exists at the present time. There's greater uncertainty today in our own minds than existed 6 to 9 or 12 months ago. However, I would strongly urge this Committee not to confuse logic with that which is reasonable and wise. If we were to raise the upper limit of M1 at this time, I think this would be interpreted by many observers to mean that the Federal Reserve has either given up the fight against inflation or that its determination to do so has weakened. And also, if we lowered the lower limit, I doubt that many people who follow monetary events would find such a reduction credible; and those who did believe it might be frightened by what the Federal Reserve was up to in the sphere of monetary policy.

So, in conclusion, my suggestion to the Committee is that we lower the upper limit of M2 and M3 by 1/2 percentage point, which means that in the case of M2, we would move from a range of 7 to 9-1/2 percent to a range of 7 to 9 percent; in the case of M3, we would move from a range of 8-1/2 to 11 percent, which is the present range, to a range of 8-1/2 to 10-1/2 percent. As to M1, I, for one, could be reasonably comfortable either with maintaining the present range or lowering the upper limit of M1 by 1/2 percentage point.

Gentlemen, the hour is 11:00, and Mr. Broida informs me that coffee is ready, and I think it would be well to take a break now and resume in 10 to 15 minutes and continue what I hope will be--expect will be--a constructive discussion of our longer-range targets.

[Coffee break]

CHAIRMAN BURNS. We should be returning to our duties. I introduced the subject of longer-term ranges, and now we're ready for what I trust will be a thorough discussion by the Committee. Who wants to be first? Mr. Mayo, Mr. Morris, then Mr. Wallace.

MR. MAYO. Mr. Chairman, I think you have given at least all of the reasons for various alternatives that I have thought of. I think your narrowing of them to the two is quite appropriate. I find myself strongly in favor of leaving the M1 range unchanged. I believe that the achievement of our basic objective of lowering the monetary aggregates ranges can be best achieved by a reduction, perhaps even more than you have suggested, on M2 and M3 and let that stand as our monument, if you please, to our dedication to a reduction over a period of time of our monetary ranges.

CHAIRMAN BURNS. We're not ready for monuments.

MR. MAYO. Well, monument isn't the right word. Okay. I accept that, Mr. Chairman--let's say as the illustration of our dedication to principle here, and the principle is, I think, very important. I would find that to change M1--in my book, at the moment--runs significant risks of misinterpretation without any compensating substantive value. To reduce M1 in the light of our experience over the last two quarters, I think, would be widely interpreted--whether properly or not may be beside the point--as an exercise in, well, maybe even stubbornness in view of our failure in the eyes of many people to achieve performance that matches our ranges.

I would not feel it appropriate either--as apparently you have concluded in your disposition of the third alternative--I don't think that widening the range on M1 really buys us anything but trouble--misinterpretation of both the reduction of the lower [end] and great puzzlement or even giving up on inflation on any rise on the upper end. So I come down fairly strongly, Mr. Chairman, for holding the line on M1; as showing, again, our dedication to a monetary range--which, I think, for M1 alone is an adequate representation of our determination--to keep the rate of M1 growth, with all of its frailties--at least the midpoint--roughly equivalent to the real economic growth, with only a small accommodation for inflationary factors. But I would reduce M2 and M3 perhaps as low as suggested in alternative B, 6 to 8-1/2 percent for M2, 7-1/2 to 10 for M3. Thank you.

CHAIRMAN BURNS. Thank you, Mr. Mayo. Mr. Morris next, please.

MR. MORRIS. Mr. Chairman, I come out in the same place that, although I would find alternative C acceptable, I think alternative B, in which we retain the present range for M1 and adjust M2 and M3, is preferable. I think that we have a prima facie case over the past seven months that perhaps we may be returning to the relationships between money and GNP that existed prior to 1975, and if that is the case, I think that we may well be hard pressed to stay within the 6-1/2 percent upper limit. So I think on balance that I would prefer that solution, although, again, I wouldn't object to move to alternative C. I don't think that they're all that much different.

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

MR. WALLICH. Well, I was heartened by your emphasis, Mr. Chairman, on pointing at the economy rather than at the aggregates, because the two seem to have parted company, and also pointing to the overshoots. I think that reduces our credibility problem. I think we have some credibility problem no matter what we do. The best thing is to lay it on the table and explain the facts. I don't think anybody would believe that we've given up fighting inflation. Now--

CHAIRMAN BURNS. I wish that were true.

MR. WALLICH. At any rate, I don't think we're going to maintain that belief by setting low ranges, then allowing the base to drift up and overshooting them. That, I think, doesn't help us, nor does it help us really to have unrealistic targets that people don't think we can attain. I do think we need to see what has happened. These are not just numbers that are changing around. Our research people tell us that, for the time being, the shift in the demand curve for money on which we've lived for two years has ended. It may resume again; if it doesn't resume, that still doesn't mean that velocity instantly has to return to its old rate of growth of about 2 percent at constant interest rates but with a lag. The demand curve continues to shift, and there is some reason to think that it will, somewhat, in any event, if not as fast as in the past; then we will get somewhat higher velocity gains. But I do think we have to take into account the possibility that the period of high velocity gains of 4-5-6 percent is over.

Now, I think in terms of a concept of effective money growth, which is the usual money growth plus that increase in velocity that you would get at constant interest rates--we're not forcing velocity by higher interest rates, and in the long run, I find it hard to believe that 5-1/4 plus velocity gains will finance an 11 percent GNP increase. It just asks too much of velocity, and we ought to prepare for that eventuality, which may be upon us now.

That brings me to my choice among your proposals. I think pulling down the M2 and M3 upper limits is a reasonable action. I think in the statement that might be made, greater stress could be placed on M2--assuming we recognize that in subsequent discussion also. On the M1, I do feel that we ought to take into account what has been happening to velocity. We don't know what will happen hereafter, but I am reluctant to rely on higher velocity gains as a matter of certainty, so I prefer your proposal of a 3 to 7 percent widened range, even though it lowers the midpoint growth of M1 slightly from 5-1/4 to 5. One could point to that as a small move in the direction of greater restraint.

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

MR. BLACK. Mr. Chairman, in considering our new longer-run targets this time, we took a little more careful look than we ordinarily do at the recent behavior of aggregates and continue to be quite puzzled by this behavior in M1. It just is very perplexing. It's almost never that you have anyone moving at the same sort of rate as M2 as we've had, as shown for the last three months and the last six months, for example, on the Bluebook. The only time you get to this kind of thing is in a period of pretty substantial disintermediation, when M2 has dropped down to the M1 rate, so it's very unusual.

We puzzled about it, and I'm inclined to agree with the staff that it's due, to some extent, to the strengthening in the underlying demand for money. And I think the point you made about the flight in money because of uncertainty has a good role in that, certainly, but nevertheless I don't think the full answer has yet been found. And this being the case, we've been focusing most of our attention on the behavior of M2, and I frankly think that behavior is pretty good now. [I] welcome this slowing that we've had, and I believe that we will have slowing in the future.

And in accordance with your suggestion, I think it would be wise to reduce the ranges on M2 and M3. I would go a little further, however, than you suggested, by cutting the ranges of both of those a full 1/2 percentage point. And I would prefer to leave the rate on M1 at 4 to 6-1/2 percent. I think cutting that would represent a little bit too much deceleration, although if you win on the other point, I guess I would prefer then to go 4 to 6.

CHAIRMAN BURNS. Thanks, Mr. Black. Mr. Coldwell.

MR. COLDWELL. Mr. Chairman, it's a very difficult decision because we're looking at an interpretation of what we come out with. My interpretation is slightly different from yours. I think we have a question of credibility in practice versus policy prescription that we put forth to the general public. And I don't believe that lowering the range at the present time is going to give anybody a whole lot of comfort, in view of what's gone on in the past six months. It seems to me that we are better off, given the uncertainty of the data which is before us and the uncertainties which we clearly have seen in our projections of these aggregates, to widen the ranges which we put before the Congress.

We have had a history, I believe, in this Committee [of] 2 and 3 percent range widths on the long-term objectives, and I would prefer to move toward that upper limit and perhaps even exceed it. I would be perfectly willing to accept a 4 percent lower [limit on M1] and widen that up to a 7; and then on M2 to widen again, and here I would prefer to go to a 6 to 9-1/2, and the 7 to 10-1/2 [on M3]. I do this largely because I don't believe in what I'm hearing. I don't think we're going to be able to outguess these aggregates over the coming three months, and I don't think we really want to be in the position of being caught out on a limb again.

But on the other hand, I don't really have that much attachment to aggregates anyway. It seems to me that our interest rate position is going to have to be taken into account, not only in terms of a longer-range picture but more importantly the short-range area. So it would be my preference, Mr. Chairman, to widen these ranges and give us a little more leeway so we do not have to move in much of an interest rate pattern in the next three months.

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

MR. BAUGHMAN. Mr. Chairman, I don't know whether it's because I hold a little more optimistic view of the general business climate than some that have been expressed around here and whether I am possibly more impressed than some with the tremendous surge in the growth of these aggregates in recent months. But I was inclined to move toward alternative D as listed in the [Blue]book and to take into consideration the rate of growth that we've had in these aggregates recently or, as an alternative to that, just a reduction of, say, about 1/2 to 1 percent in all of the measures of the current range, which comes very close to your preferred suggestion, Governor, but differs in some respects.

I may say that, on Saturday and Sunday before coming down here, in view of the fact that the American Bankers [Association] is meeting in the 11th District, I went to Houston and wandered around there and visited with bankers from all around the country, and first thing raised in the conversation was, are you fellows going to do your job or are you going to throw in the towel. Everyone seemed to be fully aware of the difficulty of the problems confronting us, and with only two exceptions, everyone that I talked to seemed to be concerned that we would not give some indication that we will resist what they see as an indication of an accelerated inflationary development. So I would think it's quite important that our records show and that your testimony show some reduction in these growth rates, and it seems to me it would be desirable to give some acknowledgement to the higher base from which the growth rate targets are postulated. So as a minimum, I would hope that the Committee would come out along the line of your suggestion, and I personally would feel better if it came out with a somewhat lower growth rate than your suggestion.

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

MR. GUFFEY. Yes, Mr. Chairman, it seems to me that we're running into a potential credibility problem if we do indeed lower, particularly, M1 again. If we haven't been able to hit the current target ranges, then to lower even further implies much more, I think, than maybe we want to imply at this point. As a result, your suggestion to retain M1 at its present level seems to me to be a very good one. With respect to M2 and M3, however, I believe your suggestion was to lower only the upper limit of that, thereby narrowing the ranges of those two targets. And as a result, it would be my preference to lower both the upper and the lower ends of those ranges to maintain the historic spread that we have had. And I believe, as it's already been expressed, that we have a real chance, maybe, of hitting M2 and M3 within those ranges in the period ahead and restoring a little bit of credibility without doing great damage with a sledge hammer instead of some other means.

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

MR. WILLES. Thank you, Mr. Chairman. I find your arguments for both cases very persuasive; wish I'd made them myself. You indicated that on M1 you had an open mind, and to the extent I can, I'd like to nudge you in the direction of the 6 rather than the 6-1/2. I found the argument that you gave for that particular alternative very compelling. The question has been raised about credibility. I guess I just assume, if we drop it down to 6, we're going to do, to the extent we can, what we need to do to get money down so that we will have credibility. So I don't give that argument as much weight as perhaps some of my colleagues.

I am disturbed by the comment that Ernie made at the end of his remarks. And that is that, over the last three quarters, with the growth in the aggregates, the base [for M1]has moved [up] about 1-1/4 percentage points. And if we don't continue to move down the range for M1 as well as the others, by not doing that, in fact, policy will be moving in a more accommodating direction than I think this Committee has wanted. Now I know that's a difficult point to make and have understood by the public, but nevertheless, I would feel more comfortable, if in addition to moving the upper ranges for M2 and M3 down, if we also made that modest move that you suggested on M1.

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

MR. JACKSON. Well, gentlemen, they say a little humble crow is one of the most therapeutic medicines that any individual can have. Having led the argument for reducing the ranges three months ago, I'll have to eat a little of my own medicine and say that I don't share that judgment today. Why? First, I recognize that we have got this problem about this so-called overshoot in M1, and I think it does run the genuine risk at this stage of the growth of the economy, where, as we said yesterday, we see capacity pressures beginning to show up. And if we built this potential inflationary pressure into the economy, that we accept and don't do anything about, we are running the risk on the upside of inflation, and we have to recognize that. I also recognize that if we don't do something about it, there are certain of our critics who will enjoy criticizing us and questioning the validity of our commitment toward reducing inflation.

Nonetheless, it is my judgment that alternative B would be the appropriate course of action. Why? First, I do think we have to recognize that if we look at our rates of growth since the third quarter of 1975 for M1, they have been gradually up almost quarter-by- quarter in most of the periods that we've had. So I do think that we have to recognize that there is a real potential that changes in velocity that we talked about have taken place. I think that if we adopt the 4 to 6-1/2 percent for M1 under alternative B, that it should not be misunderstood. The likely consequences, in my judgment, are that this is going to be a relatively restrictive monetary policy on our part--not an expansionary monetary policy, but a relatively restrictive monetary policy. If these changes in money demands have in fact taken place, that may be a very restrictive monetary policy, and the base drift would be only a very modest change in how restrictive it would be.

Next, I think that, to reduce the ranges in M2 and M3 recognizes that there are many things that we as a body, in our regulatory function, could do to achieve arbitrary targets for any one of these Ms. Let's face it, we can take some regulatory changes in the Board of Governors today that would make M1 come out about 4 percent, and all it would do would be to transfer the concept of time and savings deposits and let them be [for] transactional use. And we could produce any sort of artificial thing like that we wanted by regulatory changes, but that's not the business we're in. Our business is to try to conduct the monetary affairs of this country so that the real economy will operate properly. For that reason, I think that our credibility is better stated by addressing ourselves to the broader ranges, which encompass all these potential regulatory changes and encompass, to a certain extent even some of these artificial price mechanisms we call Regulation Q. I recognize that even M3 does not take that into consideration. However, I think a reduction in those will state not only to the country, but to the world, our commitment to long-term price stability.

I think that raises a valid question, what will the consequences of such reductions of a full percent[age point] be to those sectors of the economy that are most sensitive to the flow of funds into the thrift industry and into the time and savings deposits at commercial banks? I realize that any staff projections have to be mechanistic and use arbitrary assumptions about various components of measures of money. But I asked the Board's staff what the consequences would be of using the midpoints of currency and demand deposits growth under M1 and then the consequences for actual thrift industry growth [if we have] time and savings deposit growth in commercial banks. And it was their judgment that if that were assumed and the alternative B were assumed, it would still allow the thrift industry to grow at a 10.3 percent rate for the coming year, from third quarter to third quarter, and the time and savings component to grow at 9 percent, which I believe would be consonant with maintenance of real economic activity in those sectors of the economy which [are] so dependent [on] such types of money. Mr. Chairman, in short, I would advocate alternative B just like it's stated.

CHAIRMAN BURNS. Thank you, Mr. Jackson. Mr. Kimbrel now.

MR. KIMBREL. Mr. Chairman, in our visits and contacts, we seem to be encountering about as many people who think that we, the Federal Reserve System, are going to fail in our mission of trying to maintain some inflation control as there are those who think that we may overdo. So with that, I guess, I personally then become regretful that the visibility of these money numbers has attained such a stature and that we toy with them so. But having gotten there, then I think we have to maybe share what you commented on earlier--that our major emphasis should be on facilitating the orderly expansion of the economy.

In that vein, I guess I personally feel that we ought to, at this juncture, reaffirm our determination to accomplish some slow growth in these monetary aggregates. Consequently, I'd like to see us with alternative B pretty much as they appear, with a single exception of M1, and that to 4 to 6. And the basis for that extra 1/2 percentage [point] reduction there would be, as has already been mentioned, that we're going to be [starting] from a higher monetary [base], [so] it would be helpful if we also indicate there that we are contemplating some restraint.

CHAIRMAN BURNS. Thank you, Mr. Kimbrel. Mr. Gardner, please.

MR. GARDNER. I'll be very brief. The procedures that we have set for ourselves are to determine the long-range proper course of action followed by monthly deliberations to achieve those targets. It seems to me entirely appropriate to reinforce our dedication to the principle of moderate growth consistent with the expected performance of the economy, and I think as a layman, philosophically I would not quite understand the Fed widening its range on M1, the Fed severely lowering its range on M1 for the next four quarters. The Fed has not been able to manage M1 within the accepted long-run targets for some time this year. Therefore a rededication to that principle seems to me entirely wise, and to couple that with a modest lowering of the M2 target [and] M3 target seems entirely appropriate.

I'll have more to say when we get to the directive to the Desk for the period immediately ahead, but I also say all of this in recognition of the fact that we have two great imponderables today: the usual one, the economy--fortunately we have to go through the fourth quarter of '77 before we get to '78, so we'll know a little more--and secondly, what's happening to the velocity at which M1 is moving through the economy. I would strongly support a hanging commitment on M1, and because of the difference in performance of the aggregates, a modest lowering in M2 and M3--the upper end of the range.

CHAIRMAN BURNS. Thank you, Mr. Gardner. Mr. Balles next.

MR. BALLES. Mr. Chairman, as a lot of others around the table, I have found your 12 points very persuasive, especially with regard to the real economy being our ultimate goal and also how we have to maintain credibility with the public. And I think you have been wise in your testimony to follow the strategy of gradually lowering the growth ranges, indicating that that is our long-term game plan to a point that is consistent with economic stability. As we've all noticed, these ranges that we have, the 12-month ranges, are getting more attention now, and especially when we overshoot them, as we've been doing recently--as we've seen in the recent criticism coming out of two sources in the House Banking Committee, I guess it was Mr. Reuss and Mr. Mitchell, [and it was] especially ironic that on the other side of the coin the Joint Economic Committee has criticized us in effect for starving the economy for money.

One of those two schools of thought has obviously got to be wrong. Or maybe both. But in terms of my own view, I am leaning increasingly toward the belief that there is little if any real tradeoff between inflation and unemployment, based on some work that has been done by various sources, including our own staff. But any stimulus one gets from the supply side of the economy, in view of expectations of inflation, gets quickly undone by reactions on the demand side, with consumers saving more as a percent of their income when unanticipated inflation occurs, spending relatively less, and that feeding back on orders and production and business incentives to spend on plant and equipment.

So all things considered, in view of the significant overshoots that have already occurred, say, in the third quarter, or even for the past year, [and] that our new ranges will be occurring from a higher base for both M1 and M2, I would come out net net for the specifications of alternative B. But as in the case of Mr. Kimbrel, I think I'd go a little step further as a preference to lower the upper end of the M1 range to 6 percent instead of the present 6-1/2.

CHAIRMAN BURNS. Thank you, Mr. [Balles]. Mr. Partee.

MR. PARTEE. Well, Mr. Chairman, I'm in a real quandary today. I look at the economy and I wonder whether it's the kind of an economy in which we want to have a substantial rise in interest rates, a substantial shift in the flow of funds away from the thrifts and the banks into the market, and the characteristics of a tightening in the old terms, a tightening financial environment. On the other hand, I look at the aggregates and I see that we've clearly been over, and way over in M1, for a couple of quarters. I guess this is the time, or very close to it, when you really have to test [people's] confidence in the guides by which they run, and I have to admit to you that my confidence in the aggregates is very badly shaken. And if I had my preference, I would not specify aggregates because I'm afraid we've gotten ourselves into a trap.

I'm particularly concerned, as Governor Wallich is, that what's going to happen, regardless of what we specify in the way of aggregates, is that the demand function for money has shifted. And if we're going to continue to have a fairly rapid--although not as rapid as it has been here over the summer--increase in M1, and I dearly hope that President Willes is wrong, and then we wouldn't, in an environment like that, seek to get down within the target range for M1 regardless of the consequences for the economy.

Because the economy simply, in my view, is not strong enough to support a substantial rise in interest rates. I sit here right across from the chart on selected monetary indicators. I find that the third quarter saw an increase of about 150 basis points in Treasury bills, from about 4-1/2 or maybe slightly more, to something over 6 percent. It is true that long-term rates haven't moved much this year on balance, but they have moved since the last meeting. They are tending up a little.

CHAIRMAN BURNS. Very little, and they still compare favorably with where they were at the beginning of the year or April.

MR. PARTEE. Yes, I understand that. I've done all those calculations, and I have them from the lows and for what they've done this year and so forth, but I'm afraid that we may be at a point where markets, with another 150 basis point rise in bills, would move and would move considerably.

Now the question is of strategy. I suppose that, if one looks at the real economy, the conclusion that Governor Jackson reached is probably most appropriate. There are a few bottlenecks, a few tightnesses in the market. They tend to be in the housing sector. They are in materials and in some places in labor, partly for structural reasons such as Willis mentioned yesterday. And so it might not be unreasonable to tighten up a little bit on the flow of funds that we would logically expect to be going into housing. And that would call for--quite aside from the question of interest rate relationships--a little bit of restraint in the growth of M2 and M3.

I think I prefer Bob Black's idea that we should reduce both the top and the bottom end of [M2 and M3] by 1/2 point rather than just the top, and maintain the 2-1/2 point spread, because we have no reason to think that we've become better in predicting what is likely on M2 and M3. And we are at the point [in the interest rate relationship where] we're more likely to be wrong, and the exposure to error grows as these market rates become quite competitive with Regulation Q ceilings.

So I think I would prefer 6-1/2 to 9 for M2 and 8 to 10-1/2 for M3 for the year ahead, and that's considerably below where we have been going this year. I believe Peter said that the two-year issue was expected to go up to 7-1/4. I think we're probably about at the point where we begin the impact on that rate of inflow. That's a very sensitive rate, that two-year rate; 7-1/4 is fairly competitive, 7-1/2 is quite competitive; [at] 7-3/4, we really would begin to have an impact, an effect on the thrifts.

That leaves M1. I think there's a lot of logic to Governor Wallich's proposal that the range be broadened. Because we really don't know what's going on in M1, and we don't know what the demand function may do in the period to come. The trouble with that is that, if we were to give a broadened range for M1, we would indicate, I think, by so doing, a degree of knowledge about what's going on that we don't possess. One could say, why, you take a 3 percent low end in case there has been some kind of a surge in money demand, and it now relents, and we can get this 3 percent, we would accept it. But I don't know, it's quite low to maintain that for the whole year, and it really suggests to me that what we would be doing is moving into a recession, and we wouldn't be comfortable at 3 percent in a recession environment.

We could take 7 as the top, but on the other hand, our recent experience, Henry, is that 7 isn't enough. And if that demand function stays where it has been over the last two quarters on average, [it] will require more than a 7 percent increase in M1. And I think we would look particularly bad if we were to specify a higher top and then not live up to it, and therefore I'm inclined to say that we ought to stay just exactly where we were at 4 to 6-1/2, but with the caveat to the [congressional] committee in our pronouncement that we're not certain about what's going on here.

Now the Chairman really said that last time. I reviewed his testimony because I had to testify before [Representative] Parren Mitchell's committee, and he said that, with regard to the third quarter, that is, the specifications a quarter ago, that we were expecting a continued more-than-normal increase in velocity, and that assumption was built into those numbers. We haven't had it. And it seems to me that he could very naturally follow up on that previous testimony by saying we haven't had it, we don't know why, but we haven't had that increase in velocity quite recently. Secondly, he made the point that our concern, as I think [he] always has done in these things, that our concern is the behavior of the economy, not the behavior of the aggregates, and that we would be alert to changes in the economy and would be quick to change what we were prepared to accommodate, depending on what the economy required. And I think that could be repeated again.

So I know it's unsatisfactory, very dissatisfying, but I think our very best position, given the degree of uncertainty we have, would be to stay right with the same range on M1 that we had before and to reduce slightly the M2 and M3. Mainly, I wouldn't give so much the [reason] that we want to cut back on housing, but mainly on the basis of interest rate relationships and past behavior and to say we would continue to watch the situation quite carefully. As far as the overrun is concerned, I know it's very substantial. We've had previously offsetting quarters of overshoot and undershoot, and now we've had two quarters of consecutive overshoot, and that's what makes it look as bad as it does, Mark. It's partly that this pattern was broken, but I think we simply have to accept it on the grounds that to do otherwise would just be too debilitating to the near-term prospects of the economy.

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

MR. WINN. Mr. Chairman, I'd like to note to the Committee that this is the period in our discussion when time is standing still.

I'd like to follow Chuck's comments--

CHAIRMAN BURNS. Let me just interrupt. Now, somebody on earth or in Heaven, is, I think, sensing the mood of the Committee and controlling the clock.

MR. LILLY. We are now a legislative body; they do this all the time.

CHAIRMAN BURNS. Strange things have happened in this room. Now, Mr. Lilly, you got this room cooled off.

MR. LILLY. You want the time to march forward now. We've got this one back here--we can put the chimes on it.

CHAIRMAN BURNS. Time stands still for a little while, but not indefinitely. Yes, Mr. Winn.

MR. WINN. I'd like to join Chuck a little bit in looking backward, in the sense that we are now making projections on assumed relationships, and yet we really haven't accepted these relationships in terms of the overshoot, in terms of any kind of future economic or price behavior that I saw in terms of our projections that we talked about last night. And I think that raises some questions for us. In view, however, of the process we're going through, I'd like to urge us to take a real thorough look at what's gone wrong in our activities--that is, a reexamination of our estimation procedures. I think we ought to take another look at our lagged reserve procedures, and I don't attribute a great deal to this, but maybe this is part of our problem here in terms of control. Take a look again at our federal funds spread that we prescribe. Velocity has impressed me as a rationalization for what happened, but I don't find it a very satisfactory device for estimating the future because I don't really understand it in the sense of the term. So I think we need to take a thorough look in this area. And in view of all the emphasis that's placed on the quantities, and in view of our overshoot, I think we owe it to ourselves to take a real thorough look as to what's happened, and I don't feel we've done that.

With the uncertainty with which we have factored in comments about our overshoots with respect to future activity--whether it's economic activity or prices, what have you--it seems to me that we're really focusing on the real issue as to whether perpetuating this is the right way to go. But since we're sort of hung with this at the moment, I would accept your recommendations on M2 and M3. I would like to see a little recognition of the overshoot in the sense of a small change in M1, just to indicate that we are cognizant of it. We're really not changing; we're staying with what we were--all the uncertainties, but recognizing the overshoot.

CHAIRMAN BURNS. Thank you, Mr. Winn. Mr. Volcker now.

VICE CHAIRMAN VOLCKER. We obviously face the most difficult dilemma that we've had for a couple of years in deciding what to do here. I must confess, as I look back just a little bit, not understanding everything that's been going on, I am not unhappy with the actions we took over the past three or four months. If, in effect, we have to compromise between two kinds of consideration, and that it was, in the end, correct to compromise between them, and we get criticized from both sides, as Mr. Kimbrel suggested--I don't think that's assurance that we took the right path, but it's not inconsistent with that notion.

In terms of where we go, I think my principal point would be that we should not reduce the upper end of M1 in these particular circumstances. I think if we did it, and we didn't meet it, we do have a credibility problem. If we did it, that really symbolizes--and we're really only talking about a symbol, I guess, when we're talking about a 1/2 percent[age point] difference--but given what's happened, seems to me if we reduce it, it implies a very aggressive action in the short run in terms of a new commitment to meet that lowered upper limit. Unless we're prepared to take it, I don't think we ought to reduce the upper limit. And I would not reduce the upper limit [because], pretty much paralleling Governor Partee's reasoning, we don't know too well what's going on; our best position may be to leave it unchanged.

I would reduce somewhat the M2 and M3 ranges, and there seems to be a consensus on that, and I suppose I can express my feeling that anything down to the B alternative here is all right with me. What you suggested, Mr. Chairman, is also all right at the other end, with a very modest change. I find myself, preferably I guess, right in the middle. I put down the same numbers as Governor Partee's just recited--6-1/2 to 9 and 8 to 10-1/2. I thought Governor Coldwell and Governor Wallich--particularly Governor Coldwell, I guess--had an interesting argument on widening these ranges, and I would accept his numbers, too. And I guess I'm happy any place in that area between the change that you recommended and the B alternative.

CHAIRMAN BURNS. All right, thank you, Mr. Volcker. Mr. Roos next, please.

MR. ROOS. Mr. Chairman I would prefer ranges roughly similar to alternative C, with a 4 to 6 percent for the M1 target and M2 and M3 reduced to either the alternative C proportions or others that have been mentioned. I would support a reduction of M2 and M3, and a maintenance of our current M1 range. I could not support a widening of the M1 ranges or an increase in the upper level of the current M1 range.

My rationale is as follows: First of all, I see emerging in this discussion today two issues--the attention we should pay to the real economy on one hand and the issue of credibility on the other. I really find difficulty in separating those issues because it seems to me that the credibility of the Federal Reserve, or the interpretation by the public of the extent to which we are determined to control inflation, will probably have as big an impact as anything possibly can on the course of the real economy. We have met with many industrialists in our District, and at the very top of their priority concerns, which they say have a very real impact on their economic planning, their investment decisions, is the question of where is inflation going to go, and this is what they inevitably say: "Are you really going to do what you say you're going to do? Are you going to come to grips with this, or are you going to equivocate?"

I believe, and I'm not nearly as experienced as the rest of you, that monetary policy, the decisions we make around this table, can in a real way affect the growth of the aggregates. I cannot accept what I've heard frequently today, that we're not able to manage the aggregates. I would support what I think was Chuck's allusion and Willis Winn's suggestion; I really think, if we find that we can't control the aggregates, or that we can't control the aggregates and at the same time control the fed funds range as we'd like to control it, then I think--not today--but I think we should give serious consideration to withdrawing from targeting aggregates. Because I think one of the most destructive aspects of our activities as far as credibility is concerned--and I repeat that our credibility is the only hope the real economy has of seeing business commit itself to future economic growth--I think that we harm our credibility terribly by setting these targets and either not doing everything we could do to achieve them--I'm talking about the aggregates targets--or in a very purposeful way setting these targets and really not doing everything we can to achieve those targets.

So with that pontification, which is probably not terribly impressive, I would say that alternative C would be the best in my judgment. That the maintenance of the current M1 rate, reduction of M2 and M3 would be acceptable. I would think that we'd be laughed out of the ball park if we do anything to raise the upper rate of M1 under these circumstances.

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

MR. LILLY. Well, I think that one thing that's come out quite clear in the discussion today, is that we really don't know what's going on in M1. And until we do know, it seems to me ill advised to be making any changes whatsoever in our longer-range projections. And I agree with Phil Jackson in the sense that I think we should [unintelligible] on M2, which I think is more indicative of what's going on in the aggregates at the present time. And I feel quite comfortable in your 7 to 9 on M2 and your 8-1/2 to 10-1/2 for M3 because, given historical velocity rates, I think that that's only slightly restrictive. I wouldn't change M1, simply because I don't know what we're doing.

CHAIRMAN BURNS. Thank you, Mr. Lilly. Mr. Smoot, it's only proper that you could have the last word for this.

MR. SMOOT. I've learned two things in sitting here for the first time. One is that my perspective is different here than it is back there; and secondly that there is some advantages of going earlier in the process. We considered the arguments relating to the credibility of the Federal Reserve, and we think that there's some merit in that argument. We agree, I think, somewhat with Mr. Roos that credibility will come when we vigorously pursue the aggregates targets that we set.

We considered the issue of base drift, and frankly, in looking at the kinds of adjustments that might be required, and also taking into consideration the uncertainty in the economy, we don't think that this is the time to attempt to make up too much. Putting all that together, and taking into consideration the arguments that have been made here, I think we came down on a position of favoring alternative B. We think that's a middle course, one which we can be satisfied with. We certainly go along with the narrowing of the M2 and the M3 ranges, and we would go along with a 1 point reduction on the top.

CHAIRMAN BURNS. Thank you, Mr. Smoot. It's pretty clear that there is a strong consensus in favor of retaining the present range for M1. It's pretty clear also that there is a strong consensus in favor of reducing one way or another the upper limit, or both the upper and lower limit, of both M2 and M3. Now the range of views expressed about M2 and M3 is fairly wide, but I think it narrows down pretty much to a choice between two possible actions.

One is to lower the upper limit of M2 and M3 by 1/2 percentage point. Let me call that alternative A, lower the upper limit of M2 and M3 by 1/2 percentage point. And alternative B would be to lower both the lower and the upper limit of M2 and M3 by 1/2 percentage point. Now, I think that is the zone within which this Committee can reach a definite consensus. And if I've made the choice between A and B clear--have I defined A precisely, clearly? Likewise with B? Then let me have a show of hands on the part of members of the Committee, how many of you would prefer alternative A?

MR. BROIDA. Four.

CHAIRMAN BURNS. How many of you would prefer alternative B?

MR. BROIDA. Seven.

CHAIRMAN BURNS. Well, I think that's pretty clear. Now we're ready for a vote unless one or another member of the Committee would like to make a comment.

MR. JACKSON. I take it that bank credit would be plugged in at 7 to 10?

CHAIRMAN BURNS. I beg your pardon?

MR. JACKSON. Bank credit would be plugged in at 7 to 10?

CHAIRMAN BURNS. Bank credit would be--I'll comment on that at the present. We'll be voting as follows: On a projected rate of expansion of M1 between the third quarter of this year and the third quarter of 1978, the range of 4 to 6-1/2 percent; and a range of 6-1/2 to 9 percent for M2; a range of 8 to 10-1/2 percent for M3; and a range of bank credit to be determined appropriately by our staff. And if that is clear, are there any questions? Very well, would you be good enough to call the roll, Mr. Broida.

MR. BROIDA.

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

Eleven to one.

CHAIRMAN BURNS. Very good. We'll move on now. A very brief comment, I think, is all that is needed at this time, Mr. Partee, on the work of your Subcommittee on the Directive. The work is not completed. You submitted a memorandum; the memorandum has been read, studied, and thought about by the Committee, and a very brief comment from you, a minimum of discussion at this stage, I think, would serve our purpose.

MR. PARTEE. I think, Mr. Chairman, that all we have is worth only a very brief comment. I believe the memorandum is clear and [properly] brief, and I assume you've all read it. What it amounts to is that we haven't been able to determine as yet with the assistance of the staff whether it is a desirable thing to change the approximately equal weights we give to M1 and M2, because we haven't been able to come close enough to approximating in the real world what we have done. What the staff has done, as a matter of fact, indicates that it rather argues against it. But I have some problems with the very rigid assumptions made in the way that that work was done.

As a more or less pragmatic view, though, we do think that it's not unreasonable to say that there could be a wider range in M1 and M2, reflecting the obviously greater noise and unpredictability that we've seen in that--increasingly with the passage of time. In the memo, the comment I think comes down to that on page 4, where it says, from 1974 to date, the average absolute error, without regard to sign, in the staff's forecast of two-month growth rates for M1 was 1 percentage point more than for M2, averaging 2.8 as compared with 1.8. And in 1977, the average absolute error for M1 has increased further, to 3.3, whereas M2 has been only 1.7.

Now, it could be argued that, well, the staff's inability to predict is a reflection of something going on in the economy. And over a long span of time, that may well be the case. But this year, it seems to me that our difficulty has been that there is just so much noise that we haven't been able really to take a great deal of confidence in the numbers that we were given and the numbers that we were looking at. Essentially that's what we were just talking about, although we were talking about it in connection with the long-range targets.

So I would have to also say, since he's not here, that I don't think President Eastburn feels quite as confident in this proposal as the rest of us, but I believe the [sub]committee does come up with the view--well, what [the FOMC] did last time [for the two-month specifications], more or less out of desperation, was not a bad thing, that is to increase M1 to a 5 point range and to leave M2 somewhere narrower, the 4 point range.

CHAIRMAN BURNS. We anticipated the results of your deliberations.

MR. PARTEE. Yes, that's right. Either that or [the FOMC] took guidance from what the [sub]committee had already done. But that's all I have to say. This is a very important issue, and we're going to be exploring it methodically and in a concentrated way over the next several months. But at this point, this is all the advice we can give. I don't know whether President Volcker, Mr. Gardner, have additional comments they'd like to make.

VICE CHAIRMAN VOLCKER AND MR. GARDNER. I do not.

MR. PARTEE. That's it.

CHAIRMAN BURNS. Well, the only comment I have is to urge you to push along with these studies, and to insure that you do that, we will give you as a minimum one minute, as a maximum whatever time you need, to report at the very next meeting. All right, would anyone else like to comment? Mr. Balles, please.

MR. BALLES. Just a question to Chuck. One of the things that was very revealing about your report, and I'm afraid too many of us have overlooked, is that when we give this equal weight to M1 and M2, that in effect M1 really accounts for 70 percent of the total. I haven't had a chance, Chuck, to do the arithmetic, but maybe your [sub]committee can do this for us in one of the options to consider: What sort of weighting would we have to give to M1 and M2 so that in reality the time deposit portion of M2 was given equal weight with the demand deposit portion?

MR. PARTEE. Well it's about 2 to 1. But I'm not sure that that's the right thing to do, you see.

MR. BALLES. Well, I'm not sure either, but if we were to go that direction, what we would have to do is to give M2 2/3 weight, you see.

MR. PARTEE. That's about right.

MR. BALLES. Okay.

CHAIRMAN BURNS. Well, gentlemen, I think we're ready to turn to our shorter-term targets. There are various possibilities, by no means exhaustive, set forth on page 7 of the Bluebook. Mr. Axilrod can help us on interpreting what is in the Bluebook, and his help will be at a maximum and he will be brief.

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

CHAIRMAN BURNS. Thank you, Mr. Axilrod. Any questions? Yes, Mr. Morris.

MR. MORRIS. Mr. Chairman, in thinking back on past periods when we've had bulges in monetary growth, if you look back historically in those events, say, last half of '68, last half of '72--it has been typical that the staff has been projecting for the months immediately ahead of us a marked slowing in monetary growth. And I think that the Committee has very often leaned excessively on these projections and have been disappointed when the bulge kept going. So I think it's important that we get from Steve some probability evaluation of this slowdown in the months immediately ahead of us.

MR. AXILROD. President Morris, I'd like to respond to that, and make two comments. In the first place, following each of the bulges, there has been a marked slowing in money growth. In April, M1--the latest numbers--grew 19.4 percent, in May it grew 0.7, and in June 4-1/2. In July, M1 grew 18.3 percent, in August 5-1/2, and in September 7.7. For October, at the last Committee meeting, we of course were projecting around a 7 percent rate of growth. In the policy period just ending, the Committee adopted a range with a midpoint that was considerably lower--around 5-1/2 percent. And the growth that has developed has been about a 1-1/2 above our midpoint, I think well within--better than the normal range of error, as Governor Partee's subcommittee's figures point out. So I don't believe that the staff has mislead the Committee in any way in this past year [on] what's likely to happen following these bulges. The underlying growth rate of M1 over the past six months, I believe, has been somewhat stronger than we had anticipated.

CHAIRMAN BURNS. A good deal stronger.

MR. AXILROD. That's right. It had been stronger than we had anticipated, and I have not gone back six Bluebooks ago to see what interest rate that we were projecting you would have to have had in the third and fourth quarters to hit your target. I suspect we're not very far off those interest rates right now, but I simply don't have those facts at hand.

On the other question, to assess the probability, I would be very cautious myself because this range here assumes that November is very low and that it is around 1-1/2 percent, and I think that that is our best estimate. If I were being uneasy, I would be uneasy, of course, that it would come in a little higher because of the strength in the aggregates that we've had very recently.

MR. PARTEE. You still do feel, don't you, Steve--staff still feels that there's a lagged response to interest rate increases? I think, if it's so, why, we ought to keep in mind that we are talking about a considerably different level of rates than we were three months ago.

MR. AXILROD. That's the basis for our analysis, that growth will slow down in November and December; indeed, even in January we have slower growth. On our money market models, you're beginning to get an effect of 50 or 60 percent in the third and fourth month and you begin to wear out your effect entirely by the sixth or seventh month. That's the analytic basis for this expectation. Also, I do happen to believe that there has been a lot of cash going out for one reason or another that is not permanent; but that's not going to be held there, and I think some of that will be unwound over the succeeding weeks. But if we were going to err, given very recent experience, it's possible that we would be erring by underestimating. Our average error in 1977 is an underestimating error--the average error in 1977 is an underestimate, just like the average error in '75 was an overestimate.

MR. MORRIS. Well, I think the only point I was trying to make is to caution the Committee that we shouldn't necessarily assume that the bulge is over, and on the basis of similar past experiences, where the Committee has acted on that assumption, we had made wrong decisions.

CHAIRMAN BURNS. All right, any other question or comment? Well, if not, I think that the Committee now has a decision to make. We can break for luncheon right now, or if we're in the mood to move speedily, we can get through with our business and still not be famished.

VICE CHAIRMAN VOLCKER. We've all had a cookie.

CHAIRMAN BURNS. What's the sentiment of the Committee? Do you want to work ahead toward--to help that process, let me suggest to the Committee that the ranges for October-November specified under alternative B look quite reasonable to me. I think I would prefer, a little, a money market directive; but the monetary aggregates directive would also be satisfactory, though less logical. And that is all that I care to suggest to the Committee at this time. Who would like to pursue? Mr. Lilly.

MR. LILLY. Well, in view of the uncertainty of the market and our trying to find out where we're at and whether these bulges are [so out of hand], I certainly like alternative B, but I'd like very much the money market directive.

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

MR. COLDWELL. Same thing.

CHAIRMAN BURNS. Thank you. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I can't buy the federal funds range specification of alternative B. I think we have to make a decision today whether to stand on the status quo, which I think is what alternative B is, or whether we ought to move toward more restraint. I come out--

CHAIRMAN BURNS. Alternative B does permit a little additional restraint. And if your feelings about the bulge that you expressed earlier were justified, that's the way we would be moving.

MR. MORRIS. Except that, given the record of the past seven months, to constrain us to a move of a 1/4 [point] I think is inadequate. I don't think the evidence suggests that we've hit a level of the funds rate which is conducive to getting the growth in the aggregates under control. So I would suggest a federal funds range of 6-1/2 to 7, with the Manager instructed to move to 6-3/4 next week. Now I grant you, this decision would be a lot easier if the economy were booming.

CHAIRMAN BURNS. It not only would be easier; I think you'd have to show of hands in that direction.

MR. MORRIS. But I've been asking myself the question, can the economy--is it strong enough to tolerate the prescription I've made? I think it is, in part because I think the thrift institutions are somewhat less sensitive to movements in short-term rates than they were in '73 and '69. But looking back to common earlier periods when we had these bulges, I find some common characteristics, Mr. Chairman. I'm taking advantage of my nine years sitting around this table, and these are the common characteristics.

First, the Committee never understood why the bulge happened. The staff did not forecast it. However, the staff did forecast that in subsequent months the bulge would be eliminated; if not eliminated, at least we'd return to a lower rate of growth. Second common characteristic was the fact that the Committee agreed that the economy was not too strong, that we had a lot of slack in the System. And in fact, looking back to '68, the Committee was concerned about overkill, as you recall, the 10 percent surcharge and so on. We have that common characteristic. We're convinced that the economy is not too strong, certainly.

Third, the Committee comforted itself during these bulge periods with the degree to which it had moved interest rates. You know, I think Mr. Partee has taken comfort in the move we've made recently. We did move interest rates sharply in '68, and we moved them sharply in '72. You see, the problem was that we didn't move them fast enough. The fourth characteristic of these bulges is that, a year later, the Committee agrees that [our slow reaction to] the bulge was a mistake, that we should have moved more promptly. Now this may conceivably be the exception, that this bulge is one that we won't regret, that this bulge may, as Steve suggests, be over. I find those comforting thoughts, but on the basis of past experience, I don't feel capable of giving them a high degree of probability.

So I think this Committee has to continue to move on interest rate policy until we reach a level--when we have some actual evidence--that will bring rates of growth that we all believe are excessive under control. And that's why I think the federal funds prescription of B is inadequate at the moment.

CHAIRMAN BURNS. Well, while I disagree with you today, I might agree with you next month, depending on how the economic information comes in. But I do want to say that you've made a very effective argument for your case, one that should be taken seriously. I'm not supposed to editorialize, but I speak from the heart, you see. Mr. Willis now, please.

MR. WILLIS. Thank you, Mr. Chairman. I agree very much with what President Morris said. I would add this one thought. There seems to be a rather substantial difference of view in the Committee as to what is most likely to jeopardize real economic activity. There is a cogent concern that a further increase in interest rates will do that, and I think if you accept that point of view, then the policy that falls from that is a perfect and natural consequence. We feel, and I think it's very much along the lines of what you mentioned in one of your points earlier, that it's the public's uncertainty and concern for inflation that is responsible for the building up of money balances, that is responsible for much of the concern that we see. And as a result, our feeling is that almost the best way to guarantee a slower rate of growth in the economy than we would like to see, a higher rate of unemployment than we would like to see, is to have the public feel that we really aren't going to control the aggregates and, therefore, inflation. As a result of that, I would much prefer the aggregates numbers given under alternative C, although I am not sure that I wouldn't be happy with Frank's suggestion for the federal funds rate, which would be 6-1/2 to 7 rather than 6-3/4 to 7-1/4.

CHAIRMAN BURNS. Thank you, Mr. Willis. Mr. Kimbrel is next.

MR. KIMBREL. Mr. Chairman, I come out very close to that [position] just enunciated. Earlier we had indicated that we feel slightly more optimistic than the staff had projected, and we remain hopeful, of course, that the money demands will ease off, but we are continuing to be anxious about the concern for inflation. I think we would accordingly prefer numbers associated with C, but we could accept B with the feeling that we would very much hate to see at this juncture the federal funds rate sink below 6-1/2. So for that reason, I think we'd like, maybe, alternative B numbers associated with the 6-1/2 to 7 percent federal funds.

CHAIRMAN BURNS. Thank you, Mr. Kimbrel. Mr. Partee.

MR. PARTEE. Well, I was going to be very brief, but I must say, Frank, you've challenged me, then, to speak a little more [unintelligible]. I've been in this room for a good many years also, and I find marked differences between this and the previous occasions where there have been surges. The first one is that we have a utilization rate much lower than it was either in 1968 or in 1972 in the latter part of the year. Indeed, it's a rather low utilization rate both for plant and for labor, except in just a very few industries such as paperboard and insulation and petroleum. Secondly, most of these earlier major surges you're talking about were times when there was speculative enthusiasm. In '68 there was a great deal of gunslinging in the stock market; you remember, in 1972, we were treated to a rising stock market, a great deal of speculative exuberance. The Japanese were buying inventories two years in advance, and there was a worldwide boom in process of development in that spirit; we don't have that now.

And then I would say, also, this is getting to be a rather old cycle. In '72, one couldn't have said that, and in '68 it depends on how you date it; if you consider that the Vietnam War sort of started a new cycle, it was still a relatively new cycle at that time. To me this is more like the fall of '62 than any other of the past occasions I can remember. You remember, in '62 the stock market dropped sharply during the spring and summer because of the confrontation on steel. You remember, in the fall of '62 there was great discomfort and lack of confidence in the federal government, and confidence was being very badly affected.

Well, you might say there's a lot more money growth than there was in 1962, but if I look, I find that in this cycle to date we've had an increase in the money supply--narrow money supply--of 6.2 percent, annual average. I find also that we've had an increase in the fixed-weight price deflator, private price deflator, of 5.9. If you subtract and I don't mean to fall into the JEC [Joint Economic Committee] error here, but if you subtract the difference in the rate of inflation and the difference in money supply growth, we are having a slower money growth, relatively, than we were then, and so I don't think it's that kind of a situation at all.

Now, based on what I said about the long-term aggregates, Mr. Chairman, it's clear that I prefer a money market directive, because I don't think we really understand what the aggregates are telling us. I agree with Monroe [Kimbrel]. I don't think it would be a good thing to see the funds rate go down at this time. But rather than moving it from 6-1/2 to 7, I would suggest that it's quite consistent with a money market directive to have a range of 6-1/2 to 6-3/4; and that's where I would put it, and I would take the aggregates of the alternative B specification that you suggested.

CHAIRMAN BURNS. Thank you, Mr. Partee. Mr. Guffey next.

MR. GUFFEY. Thank you, Mr. Chairman. With all the recital of what has happened back in 1962, in these various eras, I feel a little bit inadequate, but I would like to associate myself with some of the comments that Frank Morris has [made] with regard to the ultimate prescription. I don't think I'd be quite as bold as he has been, in the sense that the only real problem that I have with alternative B is the federal funds rate. And I think I would prefer to see either one of two things: a 6-1/4 to a 7 percent, which gives you a 6-5/8 midpoint, or in the alternative--I share some of the concern mentioned by President Kimbrel with respect to going below the 6-1/2--a federal funds range of 6-1/2 to 7 percent with an asymmetrical midpoint of 6-5/8. I would like to see the Desk move promptly to the 6-5/8 within the upcoming week and before the Treasury financing that is going to inhibit us, perhaps--sometimes two weeks, three weeks, and before this Committee meets again.

CHAIRMAN BURNS. Thank you, Mr. Guffey. Mr. Volcker next, please.

VICE CHAIRMAN VOLCKER. I expressed some happiness earlier about [our having] compromised pretty well between different considerations. I am a little fearful, as some other people have suggested, that alternative B, taken straight out a little bit, ceases compromising and doesn't give enough weight to the risk that the aggregates are going to be high and a sufficient response to that. So I found myself preferring the aggregates numbers in B, as other people have said, the expectation being that we are more likely to be in the upper side of that than the lower side. The New York forecasts, for some reason, are quite a bit above the Board's forecasts. I am not going to attribute any more weight to them, but they are at least consistent with the suspicion that has been expressed around the table.

I had thought of combining that, maybe going to a kind of peculiar exchange here, to a 6-1/2 to 7 funds rate as other people have suggested. [Unintelligible.] I'd put the midpoint firmly at 6-1/2 percent [unintelligible] at the extreme. But I would still use the aggregates suggested because, if interest rates do go up, we're in effect putting the onus on the aggregates. That's the reason we're raising it, and you can convey that message a little better with an aggregates directive, but I don't think that's crucial.

And I differ from what President Guffey just said only in not going off to 6-5/8 immediately; 6-1/4 to 7 percent [also] looks all right to me, and I'd still leave the midpoint at 6-1/2. If you really put the funds rate as in the B alternative, then I'd put the aggregates ranges lower and bias it that way and kind of go for the C aggregates and the B funds rate. I could salve my conscience in the sense of biasing a little bit in that direction that way. But I basically think the 6-1/2 to 7 or 6-1/4 to 7, understood to be about the same [unintelligible] is the right way to do it. I am not very anxious to see [the funds rate] get to 7, but I could imagine these aggregates being high enough so that we might want to do even that during this period. It's a pretty high aggregate.

CHAIRMAN BURNS. Of course, if the aggregates were high enough, we would communicate with one another before the next meeting. Mr. Black now, please.

MR. BLACK. Mr. Chairman, I guess my position is sort of a cross between that of Mr. Guffey and Mr. Volcker. I had recently intended to suggest a lower range of M1 and leave M2 as shown in alternative B, but I guess really the thing that controls me most would be the adoption of a money market directive at this time, since the trigger point would involve either approaching or moving beyond those upper ranges. So I would feel rather strongly, in view of the uncertainty of the aggregates, [that] we don't have an aggregates directive this time; and Mr. Guffey's range of 6-1/4 to 7 with 6-5/8 as midpoint seems most appropriate.

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

MR. BALLES. Mr. Chairman, in view of our deliberations today on the long-term ranges, and reflecting back over the past couple of years on why we have overshot those ranges, and in view of my own judgment that, probably as a net result we have provided too much monetary stimulus, I am concerned about continuing to exceed in the future the 12-month ranges that were agreed on today, because I fear that the greatest threat to longevity in the economy would be a resurgence of inflationary expectations that would drive long-term interest rates up, which I think would be far more serious than what has occurred in the short-term interest rate area in the last several months. I say that because of what I view to be the greater sensitivity of housing expenditures, and to some extent plant and equipment expenditures, if inflationary expectations should push up long-term rates significantly.

And I have been concerned for some time, and I make this point from time to time--the Committee doesn't seem to have any systematic way of getting from here to there in terms of the 2-month range versus the 12-month range. And that's why I guess I'm unhappy about all of the upper limits specified in alternatives A, B, and C with regard to the present time because, [in] all of them, the upper limits would go beyond our 12-month ranges. I'll grant that [in] any 2-month period there can be fluctuations up and down that are more or less erratic and unpredictable, but when we get into a cumulative pattern of exceeding the upper end of our long-term ranges, we get into, after the fact, more monetary stimulus than some of us think is healthy from the standpoint of preventing a resurgence of inflation.

So I would make a plea for lowering the upper end of the ranges of both M1 and M2, especially on M1, to make sure that we don't get into a pattern within successive two-month periods of overshooting what we had agreed on would be appropriate long-term ranges, given the need of the real economy. And for that reason--and I think the fundamental issue is to what extent the Committee is prepared to see some further inching up of short-term rates to head off that future possible overshoot--I would prefer to see an upper limit on M1 and M2 of, say, 6-1/2 and 9, respectively, and a federal funds rate of 6-1/2 to 7.

CHAIRMAN BURNS. Thank you, Mr. Balles. Mr. Jackson.

MR. JACKSON. I think I would prefer, to get to the point, to leave the aggregates as indicated in alternative B, but I would prefer a money market directive with the federal funds range from 6-1/4 to 7 percent. The reason for that is, I think, while I would share the judgment that going below 6-1/2 would probably be a mistake, my limited understanding of the way all these figures are kept is, in order to get below 3 percent on M1, for example, we'd have to have a reduction in the money supply in the neighborhood of 4 percent for November, which I think is most unlikely. From what I can see of the way the estimates for October are developing, there is some risk that even the present projections for October may be low. To the extent that we do run into estimates exceeding 8 percent, I would not hesitate to go all the way to a 7 percent federal funds rate in response to that, and that's the reason I prefer the money market directive. Once we see it's clearly moving out beyond that range, I think we ought to get pretty good movement.

CHAIRMAN BURNS. Thank you, Mr. Jackson. Mr. Mayo next, please.

MR. MAYO. I'm not far apart from Governor Jackson. I think I would prefer 6-1/4 to 7 with a 6-1/2 asymmetrical midpoint. I don't share John's concern about the relationship of the upper ends of the short-term range vis-à-vis the long-term range because I think the same argument can be made on the lower ends, that we are below the ranges that we just suggested, so I don't think that I'm particularly worried about that. For M1, 3 to 8 is fine with me, or I don't mind the shading [of] 1/2 percent[age point], and M2 the same way. Either B or C ranges on M1 and M2 are, I think, satisfactory in these circumstances.

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

MR. WINN. Mr. Chairman, I am perhaps out of order, but I am concerned about the behavior of interest rates in the period ahead and the implications of that, and yet I think we have to react to what's happened in the aggregates area in the past as well as our concern about what the future projections would be. And I'd like to urge consideration of the use of this discount rate as a way of buying some time, without basically changing the rate structure, [to get] a better feel as to what some of these magnitudes would be down the road. Specifically, I would take the B suggestions; I think I would prefer the [federal funds] rate span of 6-1/4 to 7, with action on the discount rate first as a way of trying to temper this until we get a better fix with an aggregates directive.

CHAIRMAN BURNS. Thank you [unintelligible].

MR. GARDNER. Gentlemen, I listened carefully to Frank's description of our frailties, and I was pleased with Chuck's response, because he took into [account] the environments surrounding the conditions in the past. I have no memory of those conditions at this table. It seems to me we're dealing with a curious change in velocity. Aggregates are responding to something other than heavy demands for credit in the economy. We're really dealing with a reasonably technical and structural change. Now most of you are a little apprehensive about the future of the economy, but you're also willing to accept the fact that the economy may indeed improve and that you're not in a pause and not in a recession. I think we bear a very heavy responsibility, because there is a technical factor pushing the growth of the aggregates which we can neither understand fully nor explain to our own satisfaction.

There are ample supplies of credit in the economy; the inflation numbers published by the various agencies haven't shocked anybody recently; unemployment--the country has lived with it for some time; they just passed a jobs bill in the House; there's an ample supply of energy available for this winter, although we have long-range energy problems, as we've always had; and Congress is about to adjourn. Putting all those things together, I'd say our posture is to better understand our analysis of the aggregates.

I would accept B very strongly for a very specific reason. I don't want the Federal Reserve to tip the scales in this matter. When I listen to the public world, I hear more concern about rising interest rates than I do about inflation. Now we don't have 220 million monetarists in this country. And until I know a little more, I don't want to vote for a 7 percent funds rate, which will continue the recent basis point rise in the path. I think there's some merit for us at this stage--and I listened carefully to what Willis Winn has to say, too--to accept B. I strongly think that, in accepting B, I am prepared to come back to the table anytime in the next 30 days to decide that something else has happened and that we must take some further action or have the Chairman call the Committee again. But if we tip the scales, if we keep pushing because of the structural change in M1, we can bear very heavy responsibility. And I'm willing to bear that, but I just don't think the economy is bubbling like that, that we have to bear it at this time.

Maybe, in my own view, the rest of the fourth quarter is rather positive. I mentioned the congressional adjournment, which will remove some of the business uncertainty in the near term. I think the automobiles have been delayed this year, and I think they're going to be pretty good. And we are facing a Christmas season; building activity; commercial is now even beginning to move after a boom in residential. Net supplies of credit in the economy are ample right now. I don't want to go for a 7 percent ceiling at this time on the funds rate. So I would support B.

CHAIRMAN BURNS. Thank you, Mr. Gardner. Mr. Wallich next.

MR. WALLICH. I lean toward a money market directive because the aggregates seem to be hard to interpret at this time. I would go for the aggregates with B. On the funds rate, even if we have a money market directive that argues for a relatively narrow range, I would prefer to widen it a little. I think the arguments in favor of having a limit on the low side that doesn't permit much of a drop are not as strong this time as they are ordinarily. When we see that there may be an [upward] trend in the rate over time, then it makes sense not to backtrack with the rate. I don't necessarily feel that that is our present prospect. So I'd like to keep the lower end at 6-1/4. In case the aggregates do continue to bulge, I'm willing to go a little higher than 6-3/4 or come out at 6-1/4 to 7 percent; and I would stay at [the midpoint of] 6-5/8 initially until the aggregates begin to break out, if they do.

CHAIRMAN BURNS. You are in favor of an immediate rise?

MR. WALLICH. I would be in favor of an immediate rise. Well, we're really within that range, you know, 6-1/2 to 6-5/8.

CHAIRMAN BURNS. No.

MR. WALLICH. We have been over quite a few times, not with the weekly rate, but it's moved up to there. I would say 6-5/8.

CHAIRMAN BURNS. Thank you, Mr. Wallich. [Unintelligible.]

MR. BAUGHMAN. Mr. Chairman, it's been very difficult for me to visualize circumstances in which I would favor a money market directive. But it seems to me the unusual combination of circumstances has arrived. It seems to me that what might be a feasible, workable arrangement at this time would be a funds rate with a midpoint of 6-3/4; and I don't feel too strongly about the range. But with the idea that between now and this [next] meeting, unless something unexpected develops, we'd gradually move to that new midpoint. If you've got to put some numbers on them, I'd take those from alternative B. But I think the key thing would be the fed funds rate.

CHAIRMAN BURNS. Mr. Roos next.

MR. ROOS. I would suggest alternative B or C for M1 and M2, fed funds rate 6-1/2 to 7, and an aggregates directive.

CHAIRMAN BURNS. Thank you, Mr. Roos.

MR. SMOOT. Yes, I would like to lend support to alternative B in regard to the aggregates; I share the view, first expressed by President Guffey, that the range on the fed funds rate should be 6-1/4 to 7, and I'd like to move [the midpoint to] 6-5/8.

CHAIRMAN BURNS. There's a very strong consensus in favor of the ranges for M1 and M2, and there are minor differences with regard to the federal funds rate. There is a certain preponderance in favor of a money market directive, though not everyone has expressed his views. Now, I see a good majority in favor of a midpoint of 6-1/2 percent, and that includes those who favor a symmetrical range and those who favor an asymmetrical range extending beyond 6-3/4. But we are pretty closely bunched.

I'm somewhat at loss as to what to propose to the Committee. I do think it would be a mistake to contemplate a possible increase in the federal funds rate of as much as 50 basis points just on the basis of mechanical rules. I could see the Committee going to 7 percent. I could visualize the Committee going even beyond 7 percent, depending on the flow of new information. But to commit ourselves to a possible increase of 50 basis points on the basis of mechanical rules, when our ability to predict the growth of M1 is so very limited--I think that would be a mistake. I counsel against it. I don't know whether the Committee will support me in that or not; I hope they do.

The range of 6-1/4--let me have a show of hands, really. And this may involve a little shift on the part of this or that member of the Committee. We don't have the benefit of pronouncements from Mt. Sinai here, and these are shadings of 1/8 percentage point, 1/4 percentage point. Let me have a show of hands on the 6-1/4 to 6-3/4 percent range, whether that would be, while not preferred by some members of the Committee, more or less acceptable.

MR. BROIDA. Eight.

VICE CHAIRMAN VOLCKER. I understand the sensitivity [unintelligible] because in some ways I share it myself. But it would make me more comfortable, and I believe it would make some other people more comfortable, recognizing that everybody's first preference is for the [alternative] B--almost everybody's--for the [alternative] B M1 and M2 ranges; it would make me more comfortable with that federal funds rate to shade down the aggregates ranges and get a little bias in that direction while maintaining a 6-3/4 percent [federal funds rate] limit. Mostly symbolic, I suppose, but a little shading in that direction.

CHAIRMAN BURNS. And go to alternative C figures? I find that entirely agreeable, and I hope others do. The difference between the B and C monetary ranges is so small.

MR. PARTEE. Yes, I do.

MR. BLACK. I think it depends in part on whether you have a monetary aggregates or money market directive.

CHAIRMAN BURNS. Well, there seems to be a preponderance of views in favor of a money market directive--those who indicated. Several members of the Committee did not express a view on that, but they may wish to do that now. Mr. Guffey.

MR. GUFFEY. To follow up Bob's question, I would be closer to feeling comfortable with the 6-1/4 to 6-3/4 that you proposed, and took a vote on, if we went to a monetary aggregates directive, which would indeed permit--

CHAIRMAN BURNS. I see. Well, again, we're either being so reasonable or I am setting an example of reasonableness, that is, in the direction of conciliating such minor differences as this. What that means is, if we have a monetary aggregates directive, that we will be quite willing to accept 6-3/4. With a money market directive, we move toward that very reluctantly. That is correct, isn't it Peter?

MR. STERNLIGHT. Yes, that's right.

MR. PARTEE. The other possibility is to take Paul's suggestion but leave the money market directive.

CHAIRMAN BURNS. We'll get that straight. We'll test the Committee's thinking in a moment.

MR. ROOS. If strong credit demands push that fed funds rate up quite abruptly, then it can always be reconsidered. Is that the thought?

CHAIRMAN BURNS. No question about it. If the monetary aggregates came in very strongly, unless the news from the real economy was very unhappy, I think we might well want to consider--and I might in all probability recommend to the Committee--that we push the upper limit up a notch. Well, gentlemen, one possibility is to have a range of 6-1/4 to 6-3/4 with a monetary aggregates directive. That's one possibility. Another is to--What was yours, Paul, precisely?

VICE CHAIRMAN VOLCKER. I will make it a little more complete on the basis of this discussion: 6-1/4 to 6-3/4 with the C aggregates, and the money market directive if that makes more people happy.

CHAIRMAN BURNS. Just a minute now. Okay. Two packages now. And gentlemen, the differences between these, you would need a Solomon with all of his wisdom to be able to define the difference. I'll call these packages, respectively, A and B.

Package A would accept the specifications of alternative B and a monetary aggregates directive. That is package A. Is that clear?

Package B would accept the monetary ranges under C, a federal funds rate of 6-1/4 to 6-3/4, and a money market directive. Is that clear? Or shall I repeat the definition of these two packages A and B? No request for repetition.

MR. COLDWELL. No, but could I have just a little more clarification of what you said to Peter, that, under the money market directive, we hold the midpoint where we are now unless things really start moving out of the picture, as opposed to the other one, where we start moving the funds rate gradually.

CHAIRMAN BURNS. Peter, well, let Peter define it. You have a given range, just for purposes of illustration; the range is 6-1/4 to 6-3/4 and either a money market directive or a monetary aggregates directive, and you are being requested to specify the difference between the two.

MR. STERNLIGHT. Well, as I see it Mr. Chairman--maybe this is making it too mechanical. I think there's a zone of indifference in either case, but there's a wider zone of indifference with a money market directive, and if you want to try to roughly put a number on it, as I conceive--

CHAIRMAN BURNS. No, don't. I think that's in different language but substantially the same thought that I expressed.

MR. PARTEE. I think Peter is saying that he would probably be moving even on the money market directive if you were at the extremes.

MR. STERNLIGHT. If you got very close to the extremes.

MR. PARTEE. With [unintelligible] modification.

SPEAKER(?) Wording says, if you approach--

CHAIRMAN BURNS. Shall I redefine the packages A and B? All right, those in favor of Package A--

MR. BROIDA. Four, Mr. Chairman.

CHAIRMAN BURNS. Those in favor of package B?

MR. BROIDA. Six.

CHAIRMAN BURNS. Let's have another show of hands. Those in favor of Package A?

MR. BROIDA. Four.

CHAIRMAN BURNS. Those in favor of Package B?

MR. BROIDA. Six, and one abstention.

CHAIRMAN BURNS. Well, I'll accept--

MR. MORRIS. I'm not abstaining. I'm willing to vote, but I wouldn't vote for A or B.

CHAIRMAN BURNS. Gentlemen, these are very, very close, and I think the differences that separate us are pretty insignificant, considering.

MR. GARDNER. How do you vote when you are in favor of either one? The point is, the differences are small, and I'm not going to complain about package B even though I voted for A. If you put in the record somewhere that it was seven to four--

CHAIRMAN BURNS. This is not part of the record. This is simply an informal device for gauging the Committee's sentiment in preparing for a vote.

MR. PARTEE. May I ask, Mr. Chairman--Governor Wallich, you indicated a preference for A, although when we were having our discussion you indicated a preference for a money market directive.

MR. WALLICH. My choice, which is very marginal between the two, was that I did rely quite heavily on the aggregates specifications of being able to go up to 8 on M1.

MR. PARTEE. I, as a matter of fact, had a preference for B with a money market directive.

CHAIRMAN BURNS. Oh, well, we'll give you that option. We have alternative B with a money market directive. How many would feel comfortable with alternative B specifications and money market directive?

MR. BROIDA. Eight.

MR. PARTEE. That's the largest number yet.

CHAIRMAN BURNS. We've reached the point where I think we will run rapidly into diminishing returns. We've reached the apex of understanding now. Let's stay there for awhile. But these are very fine shadings, and I suggest we vote on the range for M1 of 3 to 8, a range for M2 of 5-1/2 to 9-1/2, a range for the federal funds rate of 6-1/4 to 6-3/4 on the money market directive. Unless there is a desire for further discussion, Mr. Broida will call the roll.

MR. BROIDA.

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

Eleven to one.

CHAIRMAN BURNS. To the best of my understanding, we have reached the hour of one.

END OF MEETING