TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

October 19, 1976

Prefatory Note

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

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

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

Staff Statements Appended to the Transcript

Mr. Sternlight, Deputy Manager for Domestic Operations

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Meeting of Federal Open Market Committee

October 19, 1976

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, October 19, 1976, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Volcker, Vice Chairman
Mr. Balles
Mr. Black
Mr. Coldwell
Mr. Gardner
Mr. Jackson
Mr. Kimbrel
Mr. Lilly
Mr. Partee
Mr. Wallich
Mr. Winn

Messrs. Baughman, Guffey, Mayo, and Morris, Alternate Members of the Federal Open Market Committee

Messrs. MacLaury, Eastburn, and Roos, Presidents of the Federal Reserve Banks of Minneapolis, Philadelphia, and St. Louis, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Axilrod, Economist (Domestic Finance)
Mr. Gramley, Economist (Domestic Business)
Messrs. Brandt, Davis, Keran, Kichline, Parthemos, Reynolds, and Zeisel, Associate Economists

Mr. Pardee, Deputy Manager for Foreign Operations
Mr. Sternlight, Deputy Manager for Domestic Operations

Messrs. Coyne and Keir, Assistants to the Board of Governors
Mr. Gemmill, Adviser, Division of International Finance, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Messrs. Balbach, Boehne, Doll, Eisenmenger, and Scheld, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Philadelphia, Kansas City, Boston, and Chicago, respectively
Mr. Green, Vice President, Federal Reserve Bank of Dallas
Mr. Sandberg, Assistant Vice President, Federal Reserve Bank of New York
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Hall, Economist, Federal Reserve Bank of Cleveland

Transcript of Federal Open Market Committee Meeting of
October 19, 1976

[Executive session]

CHAIRMAN BURNS. Let me call, at the outset, on Mr. O'Connell for the brief report [unintelligible]. Is Mr. O'Connell here?

MR. O'CONNELL. Yes, sir. I'll briefly report, Mr. Chairman, on the two pieces of litigation that are pending in our federal courts. [The first is] the Merrill versus the FOMC [case], which the Committee will recall involves the suit, [based] on the Freedom of Information Act, calling for--and I'll use general terms--immediate public access to the Committee's Record of Policy Actions, its policy statements, and interpretations. The court's order required publication immediately in the *Federal Register* of policy actions and the immediate availability to the plaintiff of the Memoranda of Discussion of January and February 1975.

Now, as the committee has been informed, certain aspects of this order were appealed immediately, particularly as it related to the [Record of] Policy Actions availability upon adoption. With respect to the Memorandum of Discussion, you will recall that, pursuant to the court's order, the Committee gave to the plaintiff reasonably segregable facts. We extracted those facts from the two Memoranda requested [and] furnished them to the plaintiff. Further pursuant to the court's order we furnished to the court the complete Memorandum of Discussion, in which we had interlined the material given to the plaintiff and the materials withheld, telling the court that there were certain facts that we have not given to the plaintiff but that we felt could not be reasonably segregated and given to the plaintiff without destroying what we believed to be the defensible withholding of certain policy determinations and discussions which under the law we felt were exempt from disclosure under the Freedom of Information Act.

[After] that document [was] submitted to the court, we heard no more until, on October 5, Judge Waddy issued an order saying, upon his review of the Memoranda as submitted to him, he determined that the entire Memorandum of each date, January and February, should be made available in its respective entirety to the plaintiff, and he said that such should be effected within 10 days of his order. That order was signed and dated on the 5th of October. We learned of that order on the evening of the 14th of October, the night before our appeal time would expire and before the effective date of the order.

I'll just comment briefly that the postmark on the envelope containing that order showed marks of a mailing in Washington on the 6th of October; a mailing from Frederick, Maryland, on the 7th of October; someplace in Gaithersburg on the 8th; and then delivery to the Department of Justice on the 12th, with notice to us on the 14th.

Because of the time sequence, and the fact that our time had expired, and my inability to contact the Committee, I directed that a notice of appeal be filed that evening in the Court of Appeals and that an emergency motion for stay of the effectiveness of the lower court's order be filed with Judge Waddy. A letter to that effect was transmitted to the Department [of Justice].

The notice of appeal was filed on Friday, and we have pending before Judge Waddy a stay of his order. At this time, that is the status of this matter.

I will go to the Court of Appeals today or tomorrow to try to work out a Court of Appeals stay of the effectiveness, and I will advise the Committee of the first action we have with respect to that stay. At this time, I believe it's in status quo. The notice of appeal has been filed, and it will then go to the Court of Appeals. There is no further word with respect to the portion of the court's order we appealed.

We had oral argument three weeks ago on this matter. The court was a good court. A three-judge Court of Appeals court. I think they had read the pleadings. We had a very responsive panel. A good chief judge of the panel, Judge Leventhal, asked some very penetrating questions of both counsel, I thought. And the court ordered the matter submitted for decision. We have filed one supplemental memorandum with the court as requested, and that matter now is before the court for decision.

A few words on the Reuss suit, designated Reuss v. Balles et al., against the Presidents. The last information I gave you was a matter of pleading into position, namely, that we had filed various pleadings, the latest of which I think you had knowledge. We had filed an opposition to certain of the plaintiff's pleadings. You recall that we filed a motion to dismiss this suit on jurisdictional grounds, particularly the lack of standing of Mr. Reuss to bring the suit. In response, Mr. Reuss, through his counsel, filed a rather lengthy reply to our motion to dismiss. He filed opposition to everything we had filed and further filed a motion to interplead as a defendant the Federal Open Market Committee as a body.

So there is now pending a motion to interplead the Federal Open Market Committee as a body--the [members who are] Presidents, [who] were in the original suit, [plus] the Board [of Governors] members--[the court has] now been asked [that the Governors] be joined as defendants. And this, the pleadings [make] clear, is for the plaintiff's intent that the court have jurisdiction over the Committee to enjoin any decision involving the Presidents should that be attempted. It's a ploy on his part. We have filed an opposition. And we have filed appropriate responsive pleadings, including a reply to the plaintiff's pleadings.

As of Friday he has filed a further motion for oral arguments on all pleadings and asked that argument be had particularly on his motion to join the FOMC [to the suit as a body]. I advised the Committee at the last meeting that we were going to seek a protective order against a request for admissions--the plaintiff had filed a very lengthy request for admissions. We did file for a protective order, and some two and a half weeks ago, the District Court granted our motion for protective order and ruled that we did not have to reply to these requests for admissions. At this point, that's about where that matter stands. It's a matter of pleadings, and we are due to file more responsive pleadings this Friday. Mr. Chairman, I believe that is a summary of both matters.

[End of executive session]

CHAIRMAN BURNS. Thank you very much. Any questions? Very well, we now need to act on the minutes. And Mr. Broida has submitted a memorandum to the Committee, dated

October 13, indicating that it would probably be desirable to invite the Committee to approve the minutes with the understanding that a paragraph would be added regarding the recent arrangement with the Swiss National Bank to pay off our debts.

Now is there a motion to approve the minutes subject to that understanding? That is to say, the understanding that a paragraph be added of the technical details worked out by our staff with the Swiss National Bank [that] are [to be] approved by me by October 22? I've looked into the matter some, and I want to make a final careful check [unintelligible] with almost certainty be able to do that before [unintelligible]. Any questions about this action? [Will] anyone be bold enough [unintelligible]. The motion has been duly made. Anyone bold enough to second? It has been duly seconded. And any objections?

Let us turn to the report from Mr. Pardee on, well, before that report, perhaps a word or two would be appropriate on the Manila meeting and certain additional travel that I just concluded. The one outstanding event in Manila was the meeting of the [unintelligible] committee which, as you know, consists of representatives of industrial countries, representatives of developing nations in, well, equal numbers. Every finance minister [who] was at that meeting expressed the view, unequivocally, [that] the number one problem facing the economic world is the problem of inflation. I have [said] strong policy measures to deal with inflation are essential, and that the unemployment problem will not be solved unless inflation is brought under control. Now this was to me an event of [unintelligible] and such unanimity or even a rough approach to it would not have been possible five years ago or two years ago or even one year ago. Apparently finance ministers around the world, which means financial people generally, have arrived at this conclusion. The summit meeting undoubtedly [unintelligible] the significant part of helping to shape financial opinion. [At] that meeting, as you may recall, the several heads of state indicated that the objective that they intend to work toward is the complete [eradication] of inflation, not merely a reduction of [unintelligible], but achievement of general price stability. Now I think that was the main event at Manila, but perhaps Mr. Volcker and Mr. Wallich would like to make some additional comments. Mr. Volcker.

VICE CHAIRMAN VOLCKER. Well, I think there was a fair degree of harmony displayed. That's the only thing that surprised me, in a way, even among the LDCs [less developed countries] in terms of not pushing for unrealistic assistance programs. I was impressed by the degree to which they didn't seem to object to the relatively hard line [conveyed] from the United States to other countries. These are the financial representatives of the LDCs and not the political representatives.

CHAIRMAN BURNS. I remember at earlier meetings how these financial representatives fought for the [unintelligible] and abundance and favoring the less developed countries and the link which means printing up extra money for LDCs.

MR. WALLICH. [Unintelligible] I think the growing differentiation of the middle- and higher-income LDCs from the others that brings about its improvements so long as they want to present a common front, which they've always done up 'til now. They've got to drop these demands for a [debt] moratorium, demands for guarantees, which have been so troublesome. I also was impressed that there's relatively little criticism of the comfortable [unintelligible] that the U.S. now occupies in the international monetary system of a floating dollar, reserve currency, [unintelligible] no convertibility obligations. It's a nice spot for the U.S. to be in, and I thought there'd be some criticism of this, but I didn't hear much.

CHAIRMAN BURNS. Thank you. Now, regarding my visit to China and Japan, [unintelligible] I learned something about China. It's fascinating. Reminded me most of the people of Israel--as Leviticus records, Moses was able to call on the people of Israel to become a holy people. That is a move in the nation [that] I thought I detected. How widespread it is, I can't say. Certainly it isn't universal within the struggle between the so-called idealists and the [unintelligible] if it were universal.

What has been taking place in China--essentially, I think it is terrible to change human nature. I think that's what has been happening in China under Chairman Mao. Here is a country that asks its people to build up the strength of China on their own and without foreign assistance of any kind. And they will do it on their own; if it's worth doing, they will do it on their own. They don't want any grants, they don't want any loans. And [for] that enormous earthquake disaster, which according to various estimates--and I should say these are not wild guesses--easily exceeded 500,000 deaths, China refused to accept any medicine, any help of any sort from any other country.

That's symbolic of the attitude. Individuals have been taught to believe that, first, this nation must rely on its own strength. That individuals are not to pursue personal goals or, to put it a little differently, the chief personal goal would be to serve one's neighbor and to serve the nation. And it's a highly [egalitarian] society, to the point where everybody seems to dress alike, men and women included. The incomes are almost equal.

The economy, well, it's a preponderately agricultural economy--80 per cent of the people are engaged in farming. The farms are enormously productive, as far as I could judge. Every square inch of land has been utilized, cultivation is very intensive. In Peking, right in the heart of the city, they have one farm after another. In Shanghai, at the airport, they have concrete strips, and they have grass in between, and the grass was being harvested--what kind of grain was being harvested, I couldn't gather. The people seem to work hard.

The shops [unintelligible] thoroughly impossible to get much useful information in talking to economists and government officials. Actually, I was denied access to the university. But that's not unusual. I went from shop to shop to see what was being sold at what prices. And the shops are filled with merchandise; you don't see empty shelves. And much of the merchandise is of high quality. You can now buy in a Chinese store a Swiss watch, a rather expensive one, if you've got the money, very few do, but the watches are there. You can buy a fur coat, you can buy a television set, you can buy a radio, buy photographic equipment. One thing is clear about [unintelligible] and Chinese people do buy bicycles. Bicycles cost about $75, and with an average wage, quite typical wage of $30, that means two and a half months pay.

Now the prices to Americans are--I do have a Chinese bug, stay away from me--the prices to an American are extraordinarily low. I took a party of six to dinner, and including beer and wine and 10 sumptuous courses, $25. The price of a serviceable pair of shoes is about $6, and that is close to a week's wage. The prices are not low to a Chinese. When I got off the plane in Tokyo on the way back, John [unintelligible] who was with me [unintelligible] namely he'd just gotten a haircut in Tokyo, and it cost him $10. I told him I had news for him, [in China] I got a haircut and a shave and it cost me 30 cents. Well, I could go on and on.

But let me say two very brief comments. I had a three-hour meeting with the officials of the Bank of China, and it was a friendly, candid meeting, and this is something I was told couldn't happen in China [unintelligible] and terribly nonpolitical. And propaganda or anything [unintelligible]. I found the central bankers extremely well informed about traditions of this country and [elsewhere] abroad. Very well informed about the gold market, foreign exchange markets around the world. The [unintelligible] as interested, perhaps neither one of us is, and prospective economic trends in this country and prospective developments.

In fact, you know, I was fascinated, it was so clear to me [unintelligible] of the news breaking about the U.S., I knew so little about China. Of course, they get the *Federal Reserve Bulletin* and other publications, and we are not given access to their statistical records. We don't know what they have. I will make available to the Committee in due course a report on how this conversation took place, particularly the inference which was expressed [unintelligible] of exchanging information and developing contacts in a free country. I found that very heartening.

In Japan, I saw the leaders of the Japanese government, Mr. [unintelligible] and [unintelligible] and also their central banker, what's his name [Mr. Morinaga]. [I had] a particularly valuable discussion with Mr. Makuda, who almost certainly [will] very soon [be] the next prime minister of Japan. He is a sound financial banker and fully understands that Japan now faces a new environment, that growth rates of 10 or 12 percent, such as Japan experienced during the postwar period, are out of the question for at least the near-term future. And [he] fully understands the need to curb inflation, which is running at a rate of close to 10 per cent or thereabouts in Japan. [The] business community is unhappy [unintelligible] economic policy, and they'd like lower interest rates. They would like a cut in taxes and the [unintelligible] almost certainly will exist.

I think that's about all I can usefully say at this time. As I say, as soon as I can get around to it, I will distribute some notes on the conversations I had with the officials of the Bank of China. Mr. Wallich, you did some traveling, would you like to say a word or two on your travels outside of Manila.

MR. WALLICH. There are two. I went to Hong Kong, [unintelligible], Sidney, and Canberra. I inquired wherever I could about banking arrangements with respect to two things: the foreign reaction to the proposed foreign banking legislation in the U.S. and examination and supervisory arrangements of American [unintelligible] subsidiaries representatives. I found no great excitement about the U.S. banking legislation. With respect to the examination arrangements, I found on the whole that they seem to be going forward, at least one would assume that they [unintelligible] that is not the case. How complete they are, obviously I can't say, [unintelligible] that there was a degree of normality about what was reported and was encouraging.

A less encouraging element is what one hears about LDC indebtedness and the attitude of bankers. Apparently, American bankers [were] traveling around, which is no great surprise, after Manila. But what is surprising is that apparently they [were] pressing loans upon countries. And here at home we hear that they can't place loans [unintelligible] prices of raw materials rise, the exports of these countries rise, their credit capacity seems better, and there's pressure for more lending. This is just the opposite, of course, of what we've been telling the LDCs and telling ourselves in Manila. That this is a time for adjustment rather than financing, that too much financing of large balance of payments deficits has been going on, that the stronger countries must now take on their part of the deficit burden that the [oil-price increase] is imposing on the world. So I think here is something that one needs to worry about, both the level of indebtedness, the prospects for rolling over, and apparently the view, I'm not saying [of] all bankers, but just a general report, the banking pressure to place more loans rather than to bear down on [unintelligible].

CHAIRMAN BURNS. Well, I'm very much interested in that, and I had been hoping by now our bankers, who I think have gone hog-wild on lending to LDCs and to Eastern Europe, would be becoming more cautious. From what you tell me--that they're traveling around and trying to drum up demands for credit and to unload the facilities that they have on others--I find that terribly disheartening. I think we're building up [unintelligible] possibility to recover. [Unintelligible] any comments on additional travel?

SPEAKER(?). Well, I'll make one additional comment on your comment and Governor Wallich's comment. I don't know if it's a fair generalization or not, Henry--I found the ones that are most aggressive [unintelligible] loans are the underwriters, the middlemen, who would like to place some loans of developing countries with the banks. But they don't have any continuing exposure; when they get their commission, they get out. I find the banks, I don't think it's uniform, but some of them anyway are feeling a bit more nervous and cautious than they were, but they [unintelligible] selling by now, I don't.

I just have the impression that the most aggressive ones at the moment are the investment bankers. The commercial bankers were getting a little more cautious. But [unintelligible] I do know there are some aggressive investment bankers going around. I just stopped at a very few countries quickly on the way to Manila, mostly in the developed world. I observed that India was doing very well. Production is up, prices are the same as they were a year ago, reserves are increasing by 100 million a month. [Unintelligible].

CHAIRMAN BURNS. Profits are being made--

SPEAKER(?). And they feel a little better about investment, I think--they won't admit that, yet--about foreign investment. Help [unintelligible], but the observation I wanted to make was, I was struck by--I got two [unintelligible] in every stop I made, however brief. They could all quote precisely Mr. Carter's quotation from *Playboy*, that was fact number one. Fact number two, very quickly on the heels of that was last week's money supply figures, whatever last week was, down to the decimal point. Whatever distant place in the world [unintelligible] followed this quite so closely.

SPEAKER(?). Is that because the *Wall Street Journal*'s out there now?

SPEAKER(?). Well, whether it's done by telex, well, in one meeting, somebody came running, "It's just been published," the last money supply figure. Whatever [unintelligible] to know right away. Everybody up and down in those central banks looks for it.

CHAIRMAN BURNS. Well, facts that rule the financial world [unintelligible]. Well, we're finally ready for you, Mr. Pardee. You've waited patiently.

MR. PARDEE. I hate to break the mood with my usual list of horrors from the exchange market here.

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

CHAIRMAN BURNS. Thank you very much. Any questions? Yes, Mr. Black.

MR. BLACK. Mr. Pardee, do you share what you described as the market's assessment of the revaluation of the mark as being too little too late?

MR. PARDEE. In order to resolve the current situation, yes. But I wouldn't know how far to go in order to resolve the current market situation. I think more depends on the other measures that have been taken over the course of recent months to deal with the underlying problems: the tightening of monetary policies, the tightening of fiscal policies. There have been a number of measures in dealing with the basic wage cost push that these countries have. But they had hoped to buy some time with this; I'm not sure that they did--that they bought sufficient time.

CHAIRMAN BURNS. Any other questions? All right, you have no recommendations? Very well, the motion to approve the transactions of the Desk will now be in order.

SPEAKER(?). So moved.

CHAIRMAN BURNS. Motion has been made. Seconded. I hear no objection. I'm rearranging the agenda some. Let us move on to a report by Mr. Sternlight on domestic open market operations.

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

CHAIRMAN BURNS. Thank you, Mr. Sternlight. Any questions? Yes, Mr. MacLaury.

MR. MACLAURY. I want to ask Peter about the comment that he had made on the volume of repurchase agreements and reverse repurchase agreements. Did I understand that now these are made in some rather sizable amounts, not only to even out what we think we know about technical factors in the market, but also the market's perception of what the reserve availability is? It seems to me this is one step further that we are going in the direction of maintaining a constant fed funds rate. Is that the intent of these additional repos?

MR. STERNLIGHT. I think there is an element of that, Mr. MacLaury. I don't think it's all that new. We have sometimes engaged in operations to head off a change of market sentiment or to foster a change that we thought was warranted, even when the reserve projection that we were looking at didn't seem to call for that action. But there seemed to be several occasions, a few occasions of that type, that called for rather large-scale action, and this, I thought, was of sufficient magnitude to call it to the Committee's attention.

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

MR. EASTBURN. Peter, I would have inferred from your action that the Desk gave more weight to what happened to M1 than to M2. Is that a correct inference?

MR. STERNLIGHT. No, President Eastburn. We were combining the two, giving weight to both as weekly information comes in, comparing the performance of both of those measures to the ranges set for them. Had we looked at M1 alone, I think the responses would have been earlier and more pronounced. The relative strength of M2 was a tempering influence on the extent of our responses.

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

MR. KIMBREL. Mr. Sternlight, what was the general market reaction to your determination to try for no option for early redemption of [unintelligible].

MR. STERNLIGHT. I believe it was quite favorable. The market well understood the reasons for which we wanted to do this. We got what we thought were quite good rates. We were concerned that perhaps we would have to accept considerably lower interest rates in order to impose that no-withdrawal condition on the market, and we found it did not call for a major differential. Just a few basis points seemed to be sufficient, and it gave us a greater measure of assurance for that portion of our repurchase agreement injection.

CHAIRMAN BURNS. Mr. Wallich, please.

MR. WALLICH. With respect to the nonborrowed reserve experiment, which apparently would have produced a somewhat perverse federal funds rate behavior toward the end of the period--is that on the basis of an unchanged path of nonborrowed reserves enunciated at the beginning of the period? Or could the path have been modified in the light of evolving developments?

MR. STERNLIGHT. That would be with respect to a path that was developed at the start of the period. We did not consider modifications of the path as we went along. One could map out a procedure for modifying that path if one wished.

MR. WALLICH. Yes, so that it is perhaps not quite as negative a comment as it appears from this experience.

MR. STERNLIGHT. Depending on what procedure one followed in modifying the paths. Yes, I think that's right.

MR. WALLICH. Yes.

CHAIRMAN BURNS. Any other question? Any comment? You know we’re indebted to you, Mr. Sternlight, for your report, and the motion to approve the actions of the Desk can now be in order.

SPEAKER(?). Moved.

SPEAKER(?). Seconded.

CHAIRMAN BURNS. The motion’s been made and seconded. I take it there is no objection. Let’s turn now to Mr. Gramley’s report on the state of the economy.

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

CHAIRMAN BURNS. Thank you very much, Mr. Gramley. Well, we are now ready for our evaluation as a Committee of the state of the economy, and I think it’s particularly important that we indicate agreement or disagreement, and the reasons for such agreement or disagreement, with Mr. Gramley’s report. We’ll hear first from [unintelligible] and then from Dave Lilly. I’m sorry--Mr. Black.

MR. BLACK. Mr. Chairman, I just want to ask a few questions of clarification. Lyle, what do you estimate to have been the effect of the auto strike on industrial production in September? You combine this with a settlement of the rubber strike and the bituminous coal strike.

MR. GRAMLEY. Right. We estimated that the auto strike reduced industrial production by 1/2 percent in September. And there was a 2/10 offset because of the settlement of the rubber strike and the bituminous coal strike.

MR. BLACK. And my second question, do you have any figures on the implicit price deflator for the third quarter or the fixed-weight deflator?

MR. GRAMLEY. The implicit price deflator is lower than we had estimated, and this accounts principally, in the mechanical sense, for the difference in real GNP estimates for the third quarter. The nominal increase in gross national product published this morning is almost identical to what we had estimated as a staff. But the GNP deflator, according to these figures, went down from 5.2 percent in the second quarter to 4.4 percent in the third.

MR. BLACK. What about the fixed weight? Do you have that?

MR. GRAMLEY. The fixed-weight deflator also was lower than we had estimated. I just got that number a moment ago. Their figure is 4.4 percent also for the gross business product fixed-weight deflator.

MR. PARTEE. What kind of increase do they show for business fixed investment?

MR. GRAMLEY. In nominal terms, it’s quite close to ours. In nominal terms, nonresidential investment goes up from 157.9 to 162.5. So that’s 4.6, if my arithmetic is right.

In real terms, it goes up from 114.9 to 117.0. Those figures are very close to what our staff has been using.

MR. PARTEE. About a 7 percent rate of increase.

MR. GRAMLEY. Something like that.

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

MR. LILLY. Well, as some of you know, I have been concerned about the uneasiness and the uncertainty in the economy for the last several months, and I asked Lyle and Jerry if they would not modify some of their near-term assumptions and construct a new scenario which would be more consistent with a straight extrapolation of what we've been experiencing in the last--since about last June.

Well, their first exercise, they persuaded me, was perhaps a little too strenuous, so they came up with some modifications of their near-term [unintelligible] assumptions, which may very well be more consistent with what's going to happen than what we assume is going to happen. In this they came up with a saving rate to rise slightly in '77, business fixed investment to rise 10-1/2 percent, 6 percent real, rather than the 15-1/2 percent which they have now; net exports reduced by about $4 billion--1/3 of what we have in '77; and residential construction activity in real terms continues to rise early in '77 but edges back later on.

The effect of all of this, and the reason that I had this done, was to give me a downside risk factor, and the effect of it is a real growth of GNP at about 2-1/2 percent annual rate over the next five quarters, versus the 5 percent in the Greenbook. And it leaves the unemployment rate at 7-3/4 percent at the end of '77, about 1 percentage point above the projected level. This is closer to my view of what is likely to happen than the staff's projections.

CHAIRMAN BURNS. It might be of interest to--I have before me this morning's release by the Commerce Department on the national income accounts. Let me read one sentence which indicates the margin of error that attaches to your current estimates: "Based on past experience, it is likely that the third-quarter change in real GNP, now estimated at 4 percent at an annual rate, will not be revised above 6 percent or below 2.6 percent next July." Well, that's well worth keeping in mind. In other words, there is uncertainty not only about the future, but there is significant uncertainty even about the very recent past. So, the kind of difference that Mr. Lilly has suggested [between] his own view of the economic future and the staff view should not be surprising. Mr. MacLaury next, please.

MR. MACLAURY. I have a couple of questions, Lyle. The extent to which the housing starts in the multifamily area picked up [in] the latest month reported was surprising, and I wondered whether artificial stimulus from government programs was playing any major part in explaining why multifamily starts seemed to be racing ahead?

CHAIRMAN BURNS. Are you referring to the August figure?

MR. MACLAURY. I'm trying to remember which are the latest starts figures. I think we would have September by now, wouldn't we?

CHAIRMAN BURNS. September figures to be released at 2:00 p.m. today.

MR. MACLAURY. I do not have those. It must be August that I had in mind.

MR. GRAMLEY. All I can say in response to that question, President MacLaury, is that I have heard that story only very recently. We have begun to look into it, and we will plan to report back to the Committee as soon as we ascertain anything definite.

MR. MACLAURY. My second question was--

CHAIRMAN BURNS. May I--before you go on--I have the September figure, but I'm honor bound not to release it. I can say, however, that a truly dramatic increase in both housing starts and building permits will be reported this afternoon and what the interpretation may be is another question. Mr. Partee called my attention to the possible disturbance in these figures arising from governmental actions I was not aware of, and you referred to the same thing. And as yet, our staff has not analyzed the figures and whether it would be possible to segregate the housing starts attributable to governmental programs or not. I don't know. I don't have sufficiently precise command over those figures to be able to say, but our staff is going to look into it. They probably will not have an answer today.

MR. MACLAURY. My second question, then, had to do with the lag in government expenditures, which Lyle has already told us he has not been able to pierce the veil on--as others apparently have not--as to why this $13 billion rate of lag. I suppose that makes it impossible to say whether this is likely to be reversed, whether we're going to come back to sort of a trend path, whether we're going to make up for past undershoots without knowing what's the cause of it. I suppose there's nothing that can be said in that respect, but I'm still very curious, and the effect of that lag on output and the lag in the economy as a whole. I thought that the Greenbook was implying that the lag was in interest payments on the national debt and in transfer payments to state and local governments.

MR. GRAMLEY. I believe it's fair to say, President MacLaury, that the lag is quite widespread. It is not primarily concentrated in purchases, it's in other things besides purchases. But it's quite widespread. We do think it's had something to do with a slowdown in economic activity in terms of the impact on disposable income much more than through its impact on purchases. As to why it's happening, we are at a loss to give any definite answer.

The best explanation that I have heard, but it's a hypothesis for which I have no support, is that government agencies generally did not take into account the decline in the rate of inflation on their expenditures. But I don't know that that's the case. If that's the case, we might well see some continuing shortfall from expectations go on. Now, we have reduced our projected level of unified budget outlays for fiscal 1977 by $2 billion. But that would mean some rebound in the rate of spending over the remainder of the fiscal year, and that may prove to be inaccurate.

MR. MACLAURY. Thank you.

CHAIRMAN BURNS. Just as an informational item, this morning's national income report reads as follows on governmental purchases: "The Federal Government purchases of goods and services rose by $3.2 billion in the third quarter, compared with $2 billion in the second quarter. Spending increased $1.7 billion on defense, and $1.5 billion on the rest. State and local government purchases, on the other hand, were up $4.2 billion in the third quarter, compared with $5.4 [billion] in the second quarter." A fuller story will be needed. You'd have to go back to the first quarter to see the recent developments in governmental spending as reported in the national income account; you'd have to go back a little earlier to judge the magnitude of the restraint on spending that has been in force. Mr. Coldwell please.

MR. COLDWELL. Mr. Chairman, I find myself in a kind of an in-between position [relative to] those who have already spoken. I sense a feeling of unhappiness in Lyle's report, but not nearly so deep as Governor Lilly's position. I don't think, from my viewpoint, the economy is going to roar [during] the rest of '76. I'm just optimistic that what will happen in '77 will be an improvement for us. I don't think that we face a recession in the real growth rate, and yet I'm not terribly happy with the prospects that the staff gives us and certainly not that which Governor Lilly portrays. The unemployment rate is much higher than I care to have it, and yet the inflation rate continues also.

It seems to me that if you look down the road, we've got a pause. The pause is disturbing. It's been disturbing in the past, and perhaps we may be saddled with this for the rest of 1976. But I'm basically optimistic about what happens in '77, and I didn't want to be associated with quite as strong a position as the staff portrayed last time or this time, but neither do I want to take on the recession scenario that Governor Lilly seems to be showing.

CHAIRMAN BURNS. Well, I thought he stopped short of that.

MR. COLDWELL. Not short of a recession. Well, in my view, that's almost a recession, from the pointing out of a problem.

MR. LILLY. I have a recession scenario if you'd like it.

MR. COLDWELL. I thank you for it, but I don't believe I want that either. No, I think the economy is not doing as well as I'd hoped it would, but that's been my story for several months. I've been hoping that we would find a little more room to expand. But we'll talk about policy later on.

CHAIRMAN BURNS. Well, we're in the midst of a discussion that should and will take a significant amount of time. But perhaps we ought to break now for coffee and then return.

[Coffee break]

CHAIRMAN BURNS. We are engaged in a very important discussion today on the state of the financial economy, and in the course of our discussion we may want to broaden our analysis and look at the international economy. Mr. Kimbrel, let us hear from you now, please.

MR. KIMBREL. Mr. Chairman, I believe my question was answered in the response to President MacLaury with regard to the possible injection of additional expenditures for the shortfall and [unintelligible], and I believe Mr. Gramley suggested that the projections do indicate some slight [unintelligible], but that was my problem.

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

MR. MORRIS. Mr. Chairman, until about two weeks ago I was willing to accept the slower growth rate in the economy as a normal cyclical phenomenon which often occurs in the stage of an expansion as the thrust of the inventory cycle diminishes. But it seems to me that the evidence that's come in the past few weeks suggests that there is a basis for somewhat more concern than I had a month ago. I was quite surprised at the breadth of the weakness in the leading indicators in August. Only housing indicators showed any strength, and the breadth of weakness in all of the other indicators was, I think, evidence that we ought to be alert to the possibility that the economy is going to go more slowly than we had talked about.

I have been looking into the little evidence that we have as to what has been happening in September and October for some sign that this August weakness was being reversed, and I have yet to see any real evidence that, apart from the housing sector, we are seeing a turnaround. It seems to me that, even though Mr. Gramley is not a devotee of leading indicators, we have arrived at essentially the same position by a different means. I do agree with the analysis that the risk of forecast error on the downside is more serious than I had thought in the past two months.

And one other thing. Of course, it disturbs me, looking at the new projections which the staff has given us, that--granted all the problems in projecting to the end of '77--we are looking at a number of 4.7 as the latest staff projection of real growth in 1977. I think that, for the first time, we have a projection from the staff that is too low to be acceptable by this Committee as a target. I think a 4.7 percent real growth rate is slower than we need to deal simultaneously with the inflation rate. Obviously, if you are talking about 7, I'd be concerned that it is too high, but I think 4.7 is too low.

Now, the problem, it seems to me, is not the threat of recession. I don't think that we have any of the characteristics in the economy that would lead us to have a concern for that. I think the problem is a sluggishness in the rate of growth. And it seems to me that the risk there is much higher than I would have contemplated a month ago or two weeks ago.

Finally, on this reference to the Michigan survey of consumer sentiment, I'd like to point out that not all the surveys are showing these results. The Sindlinger survey, which is done on a weekly basis, is showing a continued deterioration in consumer confidence.

CHAIRMAN BURNS. Which survey?

MR. MORRIS. Sindlinger.

CHAIRMAN BURNS. Well--

MR. MORRIS. Could I say something about Mr. Sindlinger? Now, Mr. Sindlinger is in many respects a crank. He takes these numbers and tries to forecast the stock market, the rate of growth of the money supply, and so on. And so as far as his analysis of these numbers, he verges on the absurd, if not going beyond the line. But nonetheless, [for] all of the weaknesses of Mr. Sindlinger as an analyst, I have found his numbers, bare of his interpretation, to be extremely useful and quite sensitive to the current mood of the consumer. For this reason I would tend to downgrade, or at least water down, the findings of the Michigan survey, which are considerably older.

CHAIRMAN BURNS. Well, I too have followed this Mr. Sindlinger, and I have made an effort to interest our staff in Mr. Sindlinger. They have made studies, which I have not reviewed, and I have been informed of their conclusions repeatedly, and their conclusions with regard to Mr. Sindlinger's work in this area and others remain negative. Therefore I continue to look at his indicator of consumer confidence [unintelligible] view with staff opinion. The value of that indicator--I would not announce that publicly because I think you're taking a certain risk, you see, for your reputation, just as I am now taking similar risks with you by announcing any interest at all in Mr. Sindlinger.

MR. MORRIS. Well I, let me say I didn't work--

CHAIRMAN BURNS. And I must say that I like to look at nuisances from all directions and pay attention to crackpots--after all, the wise people of this world have misled us over the years and maybe the crackpots will lead us on to a path of rectitude.

MR. MORRIS. Well, I just wondered, Mr. Chairman, whether the staff was biased because of the absurdity of his interpretation.

CHAIRMAN BURNS. Our staff does not know the meaning of bias.

MR. MORRIS. I've been following his numbers for a few years, and I found them very useful.

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

MR. BAUGHMAN. Mr. Chairman, just a couple of quick observations which may be of interest. One: We had expected by this time to see a return flow of dollars from Mexico, that's not materialized, and we continue to see the reverse, actually--a fairly sizable demand for dollars--

CHAIRMAN BURNS. Say, incidentally, did you inform the Committee, in your report, about the entire Mexico payment back to us?

MR. PARDEE. Yes--that they paid us and that they drew on the Treasury line.

MR. BAUGHMAN. It appears that even at the current exchange rate, there are some holders of pesos who still desire to get into dollars. With respect to the generally weak loan demand, we are seeing a reverse in the agricultural areas, with strong loan demands. And the country banks, of course, are rather happy about that because they have both strong deposits and strong loans.

Turning to the current economic outlook, it seems to me a very difficult problem is captured in Lyle Gramley's comment that he doesn't think we can [deal with] the current lethargic situation in the economy through monetary policy. I think I agree with that. But it doesn't give one any peace of mind. Particularly, there is a little different situation in the outlook we are looking at currently than what we've been looking at in the past. Mainly that we were looking at a rising rate of inflation rather than a diminishing rate of inflation. Now, it just seems to me that the possibilities of continuing very low levels of performance, or maybe of even what you call stagnation--if we are in fact looking into a fairly extended period of rising rather than declining prices, [those possibilities are] substantially increased. And unless we can find some way of impacting upon that trend in prices, that the possibilities of moving the economy toward that desired objective of full employment and price stability become more and more remote.

Well, all I'm doing here is expressing, I guess, frustration and concern and what I think is the major aspect of the additional concern that I see in our current projection. That's all I have, Mr. Chairman.

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

MR. MAYO. Mr. Chairman, first of all, an observation. As an ex budget director, I think Lyle is on the right track in his feeling that the most logical explanation of the underspending at the federal level is, if I may use the term, budget padding by the agencies in terms of their inflation assumptions that are never stated, probably, even by the OMB. And again I have no knowledge of this, it is just surmised, but it seems to me a very logical chain of events that would lead to an explanation of the present underspending level.

I find that I share substantially Lyle's comparing the Greenbook forecast of just several months ago with the very little changed Greenbook forecast today in terms of risks that are involved--he felt we were likely to exceed our estimates of two or three months ago, with the risk much greater on the downside now. I like this formulation in my own mind because it gives me a separation of a--granted--judgmental forecast, but with an added fillip of judgment that can't really be quantified at all.

On the other hand, while defending this approach, I must say, well, that's an economist for you. Why doesn't he change his figures instead of just reappraising the risk as being greater on the one side in one case and greater on the other side in the other case? He is telling us, in effect, that the outlook is not so good as it was two or three months ago, and it's not nearly as good as the comparison of the figures would indicate. I was wondering if Lyle had any comment on that.

MR. GRAMLEY. I object to that interpretation, President Mayo. I do think one needs to distinguish between one's best-guess forecast and what probability he attaches to it and the probability distribution that you've had with various forecasts. Our best-guess forecast is what's in the Greenbook now. If we thought that the best guess at this point was that the economy would be weaker than that, we would have weakened our forecast more than we did. This is our best guess at the present time.

CHAIRMAN BURNS. I think Mr. Mayo has raised a very interesting theoretical question, which I will rephrase as follows: Suppose that the probability attached to successive forecasts is held constant? In that case, assuming that this is possible, would not the forecast itself now be lower than Lyle has put it to you? That's essentially your question. And the real theoretical issue is whether you could hold probability constant.

MR. GRAMLEY. We have no probability.

CHAIRMAN BURNS. I know that. It's not what you've done, it's not what you're going to do, it's the question as to what you might do if it were at all a possibility--to hold probability constant. Is that technically possible?

MR. MAYO. That's my question.

MR. GRAMLEY. If I interpret your statements correctly, yes, I think the answer is yes, it is.

MR. MAYO. Is it operationally possible?

MR. GRAMLEY. It wouldn't be easy for us to forecast it that way.

CHAIRMAN BURNS. Well, I'm not sure it can be done at all, but [unintelligible] in the hour of leisure, if it ever comes, you would have thought this question through, and I would like to know your best answer. Any other comment, Mr. Mayo? Mr. Winn now, please.

MR. WINN. Mr. Chairman, I hate to be the voice of contrary opinion around here, but our actions remind me of weather forecasters taking barometric readings in August and September and predicting November weather. We did a very brief and unscientific phone survey of retail sales yesterday, and I was amazed to discover about a 20 percent increase for the first weeks in October. It was a surprise to the merchants as well as to everybody else. This is [relative to] September figures, and this is [relative to] a year ago, and October a year ago was quite good. There has been a lot of sales effort, but there are also some changes in merchandising factors underneath. For example, they are able to offer merchandise at $25 with a full markup that three months ago they were trying to sell at $39. That kind of change is very significant, and men's and women's clothing has been very slow [but] has moved very well in October. I'm not predicting any boom in any sense the term, but I am concerned with the [data] lag problem that we face here.

CHAIRMAN BURNS. This observation is based on precisely what interval during the month of October?

MR. WINN. These are up to yesterday's sales in October, the first two weeks of October.

CHAIRMAN BURNS. I see, the first two weeks of October. Now, the retail figures that we have; what's the latest public retail trade figure?

MR. GRAMLEY. The latest figure we have is for the week of October 9. We have two [weekly] figures referring to the month of October. One [is for] the week ending [October] second, which showed an increase of 1.4 percent, and that was heavily in the durable goods area. And the next week relative to the previous week showed a decline of 1.1, so that for the two weeks as a whole now, the latest figure would be up just a little bit.

MR. WINN. The sample may be different.

CHAIRMAN BURNS. You might have a difference in data, for October 9 and 14.

MR. LILLY. I brought this up at the business council. They were attributing it to the coal strike.

CHAIRMAN BURNS. When was the meeting?

MR. LILLY. Last week. Last Friday. They were hoping that it was more than that, but at this point they're attributing it to the coal strike.

MR. WINN. My second [question], Mr. Chairman, has to do with the automobile market, which has been basic here in terms of what's happening to us consumerwise. I'm personally still disturbed by the lengthening in the credit terms [that] are being evidenced as more widespread and the interest rates that are being charged in this area.

CHAIRMAN BURNS. Are interest rates being too low relative to--

MR. WINN. They've never come down very greatly, their interest rates on automobile paper.

CHAIRMAN BURNS. Why should they come down in view of the lengthening of maturity?

MR. WINN. Well--

CHAIRMAN BURNS. The risk is greater, so in effect they have come down.

MR. WINN. You're probably right, it's going to be a hard thing to sell the consumers when they realize what's happening, but I think that's something else again. But I think there's something also taking place, and that is that, with concern about fuel consumption and changing the size of cars, my guess is that instead of the second- and third-car kind of a family approach, you are going to see much more use of the leasing device as a way of providing transportation, with people leasing a large station wagon to take their vacation or their children to school, and not providing the second and third. So the lengthening terms and the basic underlying change may lead to a change in the automobile market down the road that hasn't in fact [unintelligible] replacements.

CHAIRMAN BURNS. With increasing reliance on leasing, the volume of sales to those same people should come down.

MR. WINN. Come down, and this sort of thing providing the same transportation almost.

MR. JACKSON. You're speaking of short-term leasing?

MR. WINN. That's short-term leasing, that is correct. That's right.

CHAIRMAN BURNS. We thank Mr. Winn for the interesting observations. Mr. Wallich now, please.

MR. WALLICH. I have two questions, if I may. One is very similar to Mr. Mayo's. I took Lyle's statement to mean that what was previously the probability distribution of outcomes of the forecast was skewed upward with a tail for the higher forecast, now it's skewed downward toward the lower forecast.

I heard it said that the inventory situation is such that it [limits] a downward spiral. And one could take Governor Lilly's simulation as evidence that [unintelligible] doesn't it seem to induce that kind of inventory liquidation? Is that a reasonably correct interpretation? Is the inventory situation putting a kind of floor under the situation, so that even in a relatively bad case we don't have to anticipate a severe downward spiral?

MR. GRAMLEY. Governor Wallich, I would say that the inventory situation would predispose towards avoiding a recession, but inventory-sales ratios are not extraordinarily low at the present time, particularly after you deflate them. I would say that [unintelligible] has sufficient weakening of final sales, particularly in business fixed investment. It often happens that inventories which look relatively low given the current basis of sales would look relatively high a few months later, when expectations of final sales are deteriorating. So I think in the situation [unintelligible] is not conducive to the production of recession, but it certainly doesn't make us recession proof.

CHAIRMAN BURNS. Well, if the general answer is along the lines that you've indicated, let there be a sufficient decline in spending--makes no difference what the spending is on--and the inventories that look normal today would look excessive later on. And then inventory liquidation would follow. This does assume--to turn from this abstract proposition to judgment about the economy--I think, more of a negative movement in the economy than Governor Lilly assumed in his projection. He still had growth of 2-1/2 percent.

MR. GRAMLEY. Mr. Chairman, may I take the opportunity to correct one remark that I made earlier. I said our mean probability--this is our best mean forecast. What I meant is the modal probability is still the one--the highest modal probability is the one we attach to the present forecast, not the mean. The one with the highest probability is the mode not the mean.

CHAIRMAN BURNS. Now you trouble me.

MR. PARTEE. Do you take votes among the staff?

CHAIRMAN BURNS. Are you that precise that you can distinguish the mode and the mean?

MR. GRAMLEY. In a technical sense, yes.

MR. WALLICH. This is very important in response to my question. I assumed that it was the mode and not the mean when I talked of the tail on one side or the other. If you take the mean, then it's somewhere on the downward sloping end of the tail.

You said, Lyle, that you did not think monetary policy was responsible for the slowdown; credit had been available, interest rates have been moderate. Have you weighed this against the fact that in this expansion, money has been created very largely against purchases of securities by the banking system rather than by loans, so that in the first round effect, as it were, money creation has not generated a demand for goods and services but merely increased the pool of available capital and then flows into other assets? Do you regard this difference in the form of money creation as a significant difference in the way the monetary expansion has proceeded?

MR. GRAMLEY. Governor Wallich, I believe the reason that banks are using their increased deposits to buy securities rather than loans reflects two things. First, the fact that businesses have wanted to [conduct their] external financing in longer-term markets.

Three things, I guess; three reasons.

Second, because their external financing needs have been small given what has been happening to internally generated funds and the rate of investment. Third, that banks have been unwilling to make the concession on the prime rate necessary to generate larger business loan demands. That latter point is the only element which would lead one to suggest, I think, that the degree of monetary expansion we have had may have been in some sense less expansive than if the banks had put their prime rate down and gotten additional loans. But my guess would be that if the banks had done this, the principal difference would have been in terms of the distribution of funds used by businesses--they would have borrowed more at banks and less in the open market. I don’t really think that’s an element which would be suggestive of monetary restraint.

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

MR. PARTEE. Well, Mr. Chairman, I’ve been gone for a little while, and I was disturbed about the economy, the outlook, before I left but hopeful that there would be improving signs. But now I find myself looking at what seems to be a softer economy than [in] the period before. Incidentally, as I read [them], the staff projections are materially lower. A few months ago we were adjusting to a second-quarter GNP increase that was a good deal less than had been anticipated. But we were saying that the third quarter would show good strength. Now we’re adjusting to a third-quarter GNP that is lower than had been anticipated, and we’re not expecting increased compensating strength further on out, so therefore the level of real GNP must be lower throughout the projection than it was six months ago. Is that right, Lyle?

MR. GRAMLEY. Well, six months ago we weren’t projecting out through the end of 1977. We made our first projection through 1977 in July. You are quite correct. At that time our projection for the third quarter and for, I believe, the fourth quarter, too, was higher than it is now. And indeed our projection for the four quarters of 1977 is a shade lower. No question that real GNP by the end of 1977 is lower than we were projecting in July.

MR. PARTEE. Well, I wanted to make that clear because I think we have to be concerned not only about the rates of increase in real GNP but also about the levels of resource utilization--in particular, labor force utilization--that the projection implies. And it implies a little less utilization than it did back awhile. And that’s somewhat associated with Frank’s comment about, well, it’s getting to the point where the projection isn’t really one that we can accept as a target.

Well, as I look at what's happened, I guess I have three main points that do disturb me compared to a couple of months ago. The first is that there is now pretty strong evidence of a slowing in personal income growth. Before, we had a low June, but then it was pointed out that July would be strong, which it was because of Social Security and then some other increases. Now we have August and September, which are also [showing] low rates of growth, so that in three of the last four months, the rates of growth for personal income have been distinctly low. To me that means that what's happened is that the weakness in the economy is feeding back into jobs and income. And when that begins to happen there's a possibility that the poor performance of income will feed back into the economy, and there is more chance of a slowdown than would be true if you just had a very temporary kind of a pause of the kind we have had in previous recoveries.

The second thing I think bothers me quite a bit is the marked decline in the stock market. That doesn't mean anything, really, by itself. It's, I guess, 6 or 7 or 8 percent depending on what index you look at. It isn't an awful lot, but it is, I think, perhaps as good an indicator of mood as Mr. Sindlinger's. And the mood that [the stock market decline] tends to convey is not a good one. Now with a rather protracted period of sluggishness in consumer markets on the one hand and a decline of some size in the stock market on the other hand, not massive, but some size, it seems to me that you have to raise questions about how strongly businessmen will pursue expansion on capital goods spending. We've been depending on a capital goods boom, and I wouldn't want to say that there's not going to be an increase, but it seems to me that those two developments make the odds less for a large rise in business capital. And so those two feed into that point.

The third thing that I'm terribly shocked by, I must say, because I really did lose sight of this while I was away, is the extremity of foreign responses to something--to weakness in their exchange rate, or defense of their system, or something. But as I look at the situation in many European countries I can't believe that it's possible there is not going to be a marked deterioration in real economic performance there compared with what we were expecting a few months ago. I thought there would be a very good recovery in Europe. But now with the bank rate 15 percent in the U.K., with Italy taking very restrictive actions, with France restrictive, with the Low Countries restrictive, I don't believe there's going to be a very good recovery, a continuing recovery, abroad. And that will have an effect on our foreign trade. There will be a deterioration there.

So when I put it all together, I guess I have to conclude that I share a little bit in Governor Lilly's experiment, and I think the odds are that there will be a rather poor period of growth in the economy. Perhaps for three or four quarters. Whether or not there will be a recession, I don't know. I think the odds are against it because we don't have the imbalances that we had before. And so chances are that we'll have a modest continuing rate of real growth, I think, at least for several quarters. But it looks to me as though it's going to be below the rate of real growth we need in order to apply [more of] our resources. And so I think the Committee has to take that into account.

Now there is one other major uncertainty today that ought to be pointed out, and that is that we have more than the usual degree of uncertainty about government policy. And therefore we can't say whether there might be developments in government policy in the months ahead that would modify in one direction or another the kind of projections we're now making, and I think we ought to keep that in mind. Thank you.

CHAIRMAN BURNS. Thank you, Mr. Partee. I would like to comment very briefly on two of your comments. One is recent developments in personal income. Now Lyle, please correct me if I'm wrong on these if you will. I believe that the decline in the rate of growth of nominal personal income has been accompanied by, and is partly explained by, a decline in the rate of increase of wages.

MR. GRAMLEY. That's correct.

CHAIRMAN BURNS. Well, that's a healthy development. Now, second, as for the foreign economy, in the case of Italy, some restrictive measures have been taken, and perhaps Italy's gone as far as it can, given the political environment. But on the fiscal side, all that Italy plans to do is to cut expenditures approximately $100 million--it's as small as that.

MR. PARTEE. Their [unintelligible] situation is pretty tight.

CHAIRMAN BURNS. Yeah, it is being tightened. Now in the case of Britain, I don't know that my conclusions are any different, but I would certainly arrive at them in a rather different way than you did. Whether we like it or not, the fact of the matter is the financial people working around the world have very little confidence in the pound sterling. The only way in which confidence in the pound sterling can be restored is by resorting to a highly restrictive monetary policy, highly restrictive financial policy, stop all of the nonsense about nationalizing industry, recreate some incentives for business people, business managers, particularly in the intermediate classes. And that will mean a pinch in the real economy for a while, but it's the only way, in my judgment, that Great Britain can restore health to its economy.

MR. PARTEE. Well, Mr. Chairman, I was not commenting on the appropriateness of the policies of the individual countries. I'm really not in a position to judge them.

CHAIRMAN BURNS. No, that's what I mean, we arrived at the same conclusion.

MR. PARTEE. What I did mean to imply is that there are rather sharp changes in a good many countries--not just with the U.K. [but] in a good many of those countries, and that I think that we have to consider the possibility that this will affect our exports plan, directly and indirectly.

CHAIRMAN BURNS. I think adjustments that have been postponed in one country after another will have to be made. I think also that the sluggishness that we see in our own economy is worldwide. And when a phenomenon repeats itself in one country after another, there are only two lines of explanation. One is that sluggishness spreads from one country to others, and that undoubtedly is true in some part. But there is a second line of explanation which I think is more fundamental, namely that there are common basic causes [shared by] individual countries around the world. And the common basic cause, I think, is the fact that the world has experienced a very severe recession. It was unexpected. People around the world thought that was a thing of the past, it could no longer happen. It did happen. And as a result, businessmen here and elsewhere have become cautious in managing their inventories, they've become cautious in making plans for large new investments in fixed capital.

Now before, I think that we've been mistaken in thinking that the economy in our country and the world could rebound quickly from the sharpness of the recession. So I think sluggishness is a worldwide phenomenon now, and the need the world around is to restore confidence, and the remedy will vary one country to another. Britain's problem is certainly very different from ours. But classical remedies such as a liberal financial policy may no longer work in an environment in which inflation coexists with recession or with sluggish expansion in the economy. I don't disagree with your conclusion. I just wanted to comment on probably the great necessity for the kinds of readjustments that are taking place around the world that have been postponed too long.

MR. PARTEE. But it could also mean, Mr. Chairman, we have a sluggishness, an unusual degree of sluggishness, that you have to work hard to overcome.

CHAIRMAN BURNS. Which you have to try to overcome. You say working harder. Well, you have to work hard. I'd say there is still a question whether monetary and fiscal policy is the right answer to the kind of environment in which we live. To a degree perhaps. But my own judgment is that modifications of economic structure are probably necessary to restore economic health, and that highly expansive policies are the difficulties from which we have suffered.

MR. WALLICH. May I make a comment on this, Mr. Chairman? In the light of the financial situation of many LDCs and also of industrial countries, it seems inevitable that in one way or another they reduce their deficit. Now what Chuck foresees is a form of doing that. Whichever they do, in one way or another, it probably means that a larger part of the OPEC-induced deficit is going to shift to the United States. We've already taken a sizable amount, but we may have to take more that has to be factored realistically into our prospects.

MR. PARTEE. Yes, that is a good way to put that, I agree with that totally.

CHAIRMAN BURNS. Thank you, Mr. Wallich and Mr. Partee. Mr. Eastburn, may we hear from you.

MR. EASTBURN. I'd like to follow up on the comments you just made, Mr. Chairman, and also refer to Lyle's very intriguing comments about the efficacy of monetary policy in this current situation. I think this includes Ernie and Henry as well. I guess I'm less prepared to give up the faith in monetary policy in the situation we seem to be confronting, as Lyle indicated--that there are two disadvantages, one is that you may stimulate inflation if you ease further and that in any case you wouldn't have any effect in the short run. And I think those same arguments would apply at any time and may raise the question, even if the economy were to worsen, whether those two objections still wouldn't exist. Second comment is, if, in the present situation, monetary policy cannot be very effective, the question might be whether fiscal policy might be used to step in here. Would you care to comment on that Lyle?

MR. GRAMLEY. I'll be happy to. I'd first like to make certain that you understand that my statement of my position was a good deal more moderate than the way you put it. That is, I think monetary policy would have some positive effect on economic activity in the near term, but that its effect in the near term would be less than a similar dose of monetary expansion would have produced in the comparable stage of earlier cycles.

I think the housing industry is not one that is likely to respond much to easing monetary policy. That is the area that, normally speaking, we expect the most stimulus to come from. I think the stock market would be less likely now to respond to a decline in interest rates than it would have in the past four or five years. I don't see the evidence of credit restraint in the availability sense that one could counter by easing monetary policy. I don't see a lot of thrust in the short term.

I want to make sure you understand that my comments about the inflationary impact are over the longer term, not in the short term. I don't know of any way that money can affect prices without affecting economic activity.

Turning to your second point, if I had the responsibility for moving over to the levers of fiscal policy, I would be inclined to move on the fiscal front. And the direction in which I would move would be tax cuts. Tax cuts which could be possibly of a temporary kind, perhaps a $50 tax cut for each dependent. Each taxpayer. Something that would provide a stimulus, get this thing going again, get consumption moving without undercutting the tax base for the longer run and without leading to the sorts of increases in expenditures which continue on and on and on because they're very difficult to stop. I do think fiscal policy would be very helpful.

MR. EASTBURN. May I respond to the first part? Seems to me, Lyle, the question is--and I don't disagree with you, what you've [said] about the immediate impact of monetary policy--seems to me it's a matter of tradeoff. If the economy were to worsen--if your forecast were to get progressively more pessimistic--this does not foreclose the use of monetary policy, even given some of those weaknesses.

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

MR. BALLES. I just wanted to make a brief comment, Mr. Chairman, underscoring Lyle's conclusion that, all things considered, the risks are predominantly on the downside at the moment. My comment is to the effect that I am seeing growing evidence of this among directors of our Bank. They come from very large companies whose inventory planning is now quite cautious as a result of what they consider a sluggishness feeding on itself and who are also inclined to keep revising their capital spending plans in a downward direction or to at least defer them until they see more concrete evidence of this pickup that the forecasting fraternity has been promising.

In short, I think this is an area that we need to keep a very close eye on because these inventory plans and capital spending plans are not set in concrete. As we all know, in the real world, they're subject to ongoing revision and reassessment, and I think that's probably the area of greatest concern to me: what might happen if we don't get some rebound in consumer spending following the sluggishness of the past several months, what this might do to revise or at least stretch out what we've been hoping for in the way of a fairly significant rebound in capital spending and some improvement in the strength in inventories. I don't think that's necessarily going to happen in view of the current skeptical attitude on the part of a lot of large concerns. At least the ones that I'm familiar with.

CHAIRMAN BURNS. Thank you, Mr. Balles. Mr. Guffey, may we hear from you.

MR. GUFFEY. Lest the impact of a couple of statements in the Redbook be lost, I'd like to observe that one of the problems we're seeing develop in the central part of the country involves prices and not growth to the extent that [prices of] cattle and agricultural commodities are again at a very low level. And as a result, this translates into retail sales at a lower, progressively lower phase. We have cattle in the feeder area, for example, that are now losing money again on each head that's sold. Wheat prices, for example, are at a low level, and the growers are holding on to the wheat rather than selling it, in anticipation of a higher level sometime in the future, and this is putting pressure on particularly small [unintelligible].

But I think that all translates, at least in my mind, to the effect that since we have been through a growing season, we would not expect retail sales to pick up or make any great contribution in the near future because of the low prices [nor] spending for agricultural equipment or agribusiness-related capital spending. I don't think you're going to see the mid part of the country make much of a contribution in this area.

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

VICE CHAIRMAN VOLCKER. The advantage of coming late, Mr. Chairman, is that the observations that one was going to make have already been pretty well made. Mr. Guffey's comments remind me--I think it's a fact that the slowdown in personal income has probably been more directly related to the slowdown in agricultural income than anything else in the last couple of months. Is that correct?

MR. GRAMLEY. Yes. That certainly has been a factor, particularly last month, and in August also. If you look at personal income in real terms, though, the slowdown goes back quite a ways. The rates of growth of real personal income begin slowing about April. We've had only a moderate rate of expansion from April on. Prior to that, personal income was going up at quite a good clip. I think the basic reason for the slowdown in real personal income is traced to the slowdown in production. That's the most important factor.

VICE CHAIRMAN VOLCKER. I was going to make some observations on the international situation, which we really covered pretty completely between Governors Wallich, Partee, and yourself. Let me just add that I think the most critical country is certainly Germany, which was not mentioned, and, there, things seem to be moving a bit sluggishly. The sense one has is that, if anything, they are going to tighten up a bit because they don't like the growth in their aggregates, which poses a bit of a problem, particularly in terms of the vulnerabilities of the exchange rate, which I wouldn't like to see further upset at this point--it's just an additional complication in our own policymaking.

In the U.K. situation, it does seem to me that things in the production sense will get worse before they get better. It is almost inevitable in their situation. I'm not so sure we can absorb so much more of these deficits very easily. I'm just not sure it's going to work out that way.

Particularly with our exchange rate being as weak as it is and with production here slowing down, it only points up the vulnerability of the international financial situation.

With respect to the LDCs, it's going to be hard as hell for them to cut down on their deficits and therefore cut down on their external borrowing, which is already too high. It's an additional real financial and economic risk in this situation, as I see it. So the stakes get raised all around.

One point that I would make that I don't think has been commented on may be fairly obvious. I think part of the more depressed mood that seems to be rather general around this table and in the economy is partly related to the oncoming election. People are not terribly happy with the way that campaign has developed, to say the least. Which raises at least the possibility that, whoever gets elected, people may feel a little better after November 2nd. Feeling that uncertainty is behind them, in the little sense that maybe some more coherent program or policies will be emerging. I don't know if that's true, but I do think that part of the throes of uncertainty is fairly directly related to the malaise in the political environment.

None of this tells me very directly what to do in terms of policy, and I also want to raise a question Mr. Eastburn made and Mr. Gramley commented upon. My first instinct would be that the economy needs a further push that might more efficiently [come] through the tax avenue. But that might not be a very realistic way of getting it, under all the circumstances, very promptly anyway, given political [unintelligible]. We could be basically dealing with the kinds of structural confidence problem that are commonly found, which raises some question about any of the traditional knee-jerk kinds of reactions.

CHAIRMAN BURNS. That's very helpful, Mr. Volcker. Mr. Black, please.

MR. BLACK. I wonder if I might ask Mr. Gramley one more question? Lyle, if you had known that real GNP for the third quarter was going to come in at 4 percent instead of 3.3 percent as you assumed, would that have significantly affected your projections?

MR. GRAMLEY. No. Particularly not given the source of the difference between our projected growth of real GNP and that by the Commerce Department. The difference between our projected figure for real GNP growth and that put out by the Commerce Department this morning lies primarily in the estimate of increase in consumer service expenditures. Now that doesn't have any implications for the future at all, so we would end up with the same projections.

CHAIRMAN BURNS. Which is one of the least reliable elements of the national income accounts.

MR. PARTEE. Do they have a big increase?

MR. GRAMLEY. They have a bigger increase than we do. We have a moderate increase, ours could be too small. I just don't know.

MR. BLACK. Do you know what real private final purchases look like? Do you have that figure?

CHAIRMAN BURNS. Yeah, it's, I remember, an increase of 4.4 percent in the third quarter.

MR. BLACK. That's faster than it was in the second, if I remember right.

CHAIRMAN BURNS. I don't have the figures.

MR. BLACK. It is, it was, let's see. Second, 4.7, so, you said 4.7.

CHAIRMAN BURNS. 4.4

MR. BLACK. 4.4.

CHAIRMAN BURNS. That's my recollection, I don't have it here. But it's higher than the increase in real GNP--I believe it would come out 4.4. All right, thank you, Mr. Black. Mr. MacLaury.

MR. MACLAURY. Just a very brief comment. Paul Volcker has already brought out the fact that nonagricultural income has been rising in the last couple of months--I don't know, I would say by a rather decent rate. The 8.6 percent in August and 8.9 percent in September--that has very mixed implications for our District, as it does for Roger Guffey's. It means that the agricultural sector at the moment is, I think, bearing the brunt--and [with] the drought in our area in particular. We see a very substantial difference in retail sales in the purely agricultural areas of our District from the more industrialized or evenly spread industry of the Twin Cities.

CHAIRMAN BURNS. You say you see a large difference?

MR. MACLAURY. A large difference, yes. Retail sales are definitely sluggish in those centers that depend upon the agricultural sector, including, of course, sales of farm implements, as I think Roger mentioned. That's sluggish. On the other hand, I'd like to give one other straw to Willis Winn's point about retail sales. One of our directors mentioned last Thursday that, in the first two weeks of October, one of the national retailers based in our District has seen a substantial pickup in retail sales. Not just in our District but, I assume, in the stores around the nation. His stores around the nation doesn't add all that much. And one other straw on that same side. Capital spending by one of our large computer firms based locally had been held back substantially. And the member who's on our board who had been pessimistic about capital spending up until now said that he was beginning to see a turn, in that the orders for computers were coming in rather substantially, and he was feeling better about that than he had up until now.

CHAIRMAN BURNS. Thank you, Mr. MacLaury. Any other comments on the economy? Yes, please.

MR. ROOS. Mr. Chairman, I don't share the pessimism that has been expressed by some, and I base my impressions on some very extensive and real contacts that we've made in recent weeks throughout our District. While some of you have traveled the distant lands, we've gone to such exotic places as Evansville, Indiana; Columbia, Missouri; Quincy, Illinois. In these tours, which we refer to as our Autumn Grand Tour in the Eighth District, we meet with bankers and with businessmen, usually substantial businessmen. I'd say that we have touched base with maybe 150 to 175 such people in the last five or six weeks, and we get a relatively optimistic reaction from these people.

Retailers in this area, oh, they are not setting records, but they look forward to expanding sales later in the year. Our chemical firms, which are substantial, large, multinational firms, are optimistic as they look into 1977 for maybe a 10 percent increase in their business in the 12 months ahead. A large manufacturer of motors is operating at full capacity. They've got a full backlog, and generally, the input that we get from these sources is not one to result in discouragement. And I wonder whether our problem might be that we are tending to be somewhat shocked by comparing what has happened recently with what happened with the rate of growth and the rate of the recovery after the trough of the recent recession.

If you take, for example, GNP, and if our economists are correct, I'm told that over the past five years, real GNP has grown an average of maybe 2.7 percent and that, over the past 40 to 50 years, the average has been, and I can't substantiate these figures, about 3-1/2 percent annual growth. So if we're growing at 4 or a little over 4 percent, I'm not sure that this is the time to pull the panic button.

I might close by just pointing out one matter--maybe it should be reserved until our next item on the agenda--but at the end of each of these meetings, we poll these people in a similar way. We give them three mythical, or general, or simplistic alternatives: stimulating the economy, or greater restraint, or holding the line. There was not one individual who indicated a desire for economic--for monetary stimulus. The majority of them said, don't rock the boat. And if there was any deviation from that, it was a little bit on the side of greater monetary restraint. And for whatever it's worth, those are real people and this is a recent--I did not mean that, sir, in a--

CHAIRMAN BURNS. Well, you've contrasted the thinking of people as over against the numbers that we've been concentrated on heavily, and I'm thinking your comments should help all of us in restoring perspective just a bit. Mr. Balles.

MR. BALLES. I wonder, Mr. Chairman, if I could ask Lyle for some additional clarification on this statement that he doesn't think the present situation lends itself--I think he used the word amenable. Lyle if the present situation is not amenable to correction by monetary policy, does that mean--

MR. GRAMLEY. I believe I said not readily.

MR. BALLES. I was trying to find out whether you meant that an extra dose of monetary stimulus for some period like say six months, a year ahead would have no good effects, or if it would be an inferior way of getting , or just what? Because, in a nutshell, my staff did a simulation using our version of the FRB-MIT model. And cranking in an assumption that, for a year ahead, [there is] an extra 1 percentage point growth in M1 than we have had, they did come up with different results.

It showed some measurable increase in real GNP next year, to a growth rate of 5.9 percent for the year instead of 4.7 percent. Showed the unemployment rate by the fourth quarter of 1977 ending up lower, at 6.3 percent, than it would otherwise have been at 6.7 percent. And with little effect in that period on the rate of inflation. So that I would like to, perhaps this is not the point to do it, but to examine this possibility of a one-shot short-term action in the way of extra monetary stimulus that could be withdrawn so that we don't get ongoing inflationary effects from having done something to try to pick up the rate of capital spending and housing and whatever. In other words, I'm not inclined to your conclusion, if it was in fact a conclusion, that we can't do anything meaningful. I guess I'm now back to the question that I asked you when you clarified just what you had in mind.

MR. GRAMLEY. I'll be happy to try. I certainly would not wish to argue that additional monetary stimulus now would have no effect at all. I do think it would have some effect. I think it would have an effect that is small relative to what would have been produced by an equivalent amount of monetary stimulus in earlier postwar cycles at this same stage of the expansion. I think it is, at this juncture, an inferior way of trying to get stimulus. I, too, had some simulation runs done on the model to assess what the model has to say about this problem. The runs that I looked at seemed to me, as I would interpret them, to be less optimistic in terms of the amount of stimulus to real activity. What they said, in effect, was that, four quarters down the road, an additional 1 percentage point growth of M1 would give you about 0.6 percentage point in real GNP.

The point of my argument, however, is that the model is based on average conditions in the past; that I do not think the conditions prevailing at the present time are like those in the past; and that therefore you're just not going to get that much monetary stimulus. Now if you say very well, but what harm is there from adding more money now--if it doesn't do any good, it just lies around idle. The point I would make is that if you can take that money out later on, then you've got no problems, but I think the experience is that once that additional money gets into the system, it's very difficult to retract later. So I do think you add to your potential problems of inflation later on.

CHAIRMAN BURNS. I not only want to thank you, I want to say Amen. Any other comment on the state of the economy? Oh yes, Mr. Gardner.

MR. GARDNER. I was interested in Governor Lilly's work. I briefly discussed it with Governor Lilly and Governor Partee. I felt at that time that I couldn't see a revival of great strength based on any factors that I knew might be present. I've been worried about that conclusion all through this meeting, and I must admit I think I've been helped. It is also true that when you study the possibilities for significant decline, you have to look, in my judgment, at what conditions might tend to resist that decline. Employment is still high, unemployment is high, true, but wage increases are not what we feared. Personal income isn't growing as rapidly as it had earlier. Inventories are not excessive except in terms of sales, nowhere near what they were at the time of that plunge in the sharp recession. There has been no huge expansion of bank credit. In fact there hasn't been any expansion of bank credit at all. We've worried about capital shortage crowding out.

What I'm trying to suggest is that, while we may find great discomfort in the situation we're in today--we're questioning some of the strength of the recovery at this point--I think if we applied our minds to the reverse scenario, we'd have some difficulty determining that the economy's ripe for a sharp decline. I've been hoping that this country would get back on stable growth patterns, away from some of our discomforts in the last few years. We may be unwilling to accept these stable growth patterns when they have all the characteristics that we've been discussing today.

All I'm suggesting is that we have been attracted to the idea that everybody may be wrong, that recovery may be petering out. I'm not so sure. I also think downside risk always exists, but the downside risk in my judgment at this point in the economy isn't the kind of downside risk that inspires a fearful scenario of a sharp drop all the way around. The conditions don't seem to be here anymore. I don't know what that means for our deliberations but--

MR. PARTEE. When you say downside risks, you mean risks of absolute decline?

MR. GARDNER. Yeah. There may be a risk of decline to some extent but not precipitous declines. Agricultural, I've heard about agricultural income, but I am also well aware that a lot of people consume, Roger, when agricultural prices are lower. [Unintelligible], and that of course ameliorates inflationary pressure.

CHAIRMAN BURNS. Thank you, Mr. Gardner, any other comment on the economy? Yes, Mr. Jackson.

MR. JACKSON. Mr. Chairman, I think Steve's comment makes me want to say something. We have been through a long period of declines in unemployment rates. Declines in inflation rates. Coupled with what in many people's judgment in our society and around the world has been relatively conservative monetary policy. And I think that the issue that Governor Gardner just mentioned is not that we're going to suffer absolute decline. I personally don't think that's a likely prospect.

I think the issue facing us is whether the rate of progress in the future will continue to be acceptable in our society and other societies--so that, while the concept of the ultimate solution being achieved through further control of inflation and further conservative monetary concepts will continue to be bought, I think the test will come as to whether or not our rate of progress becomes acceptable in our society, not whether we have an absolute decline. And to that extent, it may be even more difficult to continue to hold the world's feet to the fire, if I can put it that way, even though we may be convinced of the original wisdom of the concept, [and the] objective, and the approach to reach that objective. As I say, it may be much more difficult in the future.

Now, that brings up the question as to whether or not a temporary bow in the other direction might produce significant change as we continue to pursue the objective in the way that we've been going or, indeed, the way the world's going. But it strikes me as [being] relative rates of progress that we're talking about, and I don't share quite the pessimism in the tone that I hear around the table. I see a slowdown, but I don't see quite as pessimistic a rate of slowdown as other people have seen in general.

CHAIRMAN BURNS. Well, thank you very much, Mr. Jackson. Any other comment on the economy? Well, I just want to add one word. I'm disappointed, in the sense that I expected more progress on the unemployment front by now than has occurred. I feel increasingly that what I had to say in a paper that I presented some two years ago about a long economic wave which ended in a speculative phase--speculation first in the acquisition of business firms, the great merger [and] conglomerate movement; and then speculation in stock exchanges; speculation in real estate; and then speculation in inventories--that led to a severe recession in the economy. Where I feel that I probably made a mistake in economic analysis is in feeling perhaps more optimistic about the rate of recovery than I, for one, should have. It's a point I've made here before. I don't believe I made it in that paper. I haven't gone back to it.

Wishful thinking about the economy, unfortunately, is to some degree unavoidable; it's a hard thing to control. The thought that has dominated my own thinking during the past six months is that we have a new generation of businessmen, a new generation of bankers. They've gone through a severe recession. They were unprepared for it psychologically. Nothing that they learned at the university prepared them for it. Nothing that they read in their newspapers or magazines prepared them for it. And as a result, businessmen, bankers, have become cautious.

Now gradually, I think, confidence has been returning, though I must say that I share some of the feeling that Mr. Partee expressed with regard to the stock market. That seems to argue to the contrary. But in spite of that, I have the impression that, within the business community, confidence is gradually returning. But we should have expected a gradual return, whereas we didn't. Or at least I didn't. I thought the return of confidence would be speedier. And from the viewpoint of policy, the critical question is, what can best be done to strengthen the state of confidence. And for a country like Great Britain, I think the answer is pretty clear that drastic changes in economic policy are necessary. A severe cutback in expenditure, which could be accompanied by some easing of monetary policy and a stop to nationalization threats, etc.

In the case of our own economy, I doubt--this is a point on which I disagree with Lyle--I doubt that a more liberal fiscal policy would help matters. I do think that if we had a cut in taxes accompanied by a cut in expenditures, and if the cut in taxes were concentrated in large part in a reduction of business taxes, I do think that such a change in the structure of our fiscal budget would help to restore confidence--would work in our direction. Apart from that, a great number of structural changes in the economy with regard to the functioning of our labor markets, with regard to our environmental programs, etcetera, I think would be helpful. Now I think monetary policy can also be of some assistance to [conditions] like this as at any other time. But I would agree with Lyle's analysis that a given injection of monetary ease would have less effect in the current environment than it had in earlier business cycle expansions.

Well, I think we ought to turn now to our next subject. And let me say a word about how I think we can best conduct our meeting from this point on. As I believe members of the Committee have been informed, we will have to testify before the Senate Banking [Committee] on November 11 on our monetary policy. And that means that some 23 days will elapse between today and the date of the testimony. That is a much longer interval than the lapse between our decision on longer-range annual targets and the disclosure of those targets to one or the other of the banking committees.

In view of that, I think it would be inadvisable to try to reach a decision on longer-range targets today. I think we could usefully have a preliminary discussion, but that should be followed up, and probably by a telephone conference meeting which could best be scheduled [unintelligible] on November 8. And the reason for my choice of November 8 is that I have to be in Dallas on November 4 and will not be back until November 5, which is a Friday. I'd like to spend the weekend reviewing any fresh evidence that has come in, and therefore November 8, which is a Monday, will still give us enough time to reach a final decision and still prepare the testimony that has to be presented.

So I think what we ought to do today is discuss first of all the short-range targets for the two-month interval, as we do every month, and then turn to a discussion of the longer-range targets. Now before we turn to that, we just have enough time before we break for luncheon, we might have Mr. Axilrod's report on what the Bluebook has to teach us.

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

CHAIRMAN BURNS. Thank you, are there any questions or comments?

MR. PARTEE. I didn't hear you quantify the substitution question of Ml for time-type deposits. Is it pretty substantial, conceivably?

MR. AXILROD. Well, we had worked out various estimates of this or our best estimates of it. We had over the past year been working it out in detail, from the basis of the year ending in the third quarter of '76. We thought that something less than half--will be about 40 percent or so--of the rate of growth of Ml would represent the extent to which Ml growth had been dampened. This makes the allowance I have mentioned for business savings deposits. We ran this survey within the last week or so, asking the banks for the activity, the extent to which these savings accounts are used in transactions--these are overlapping questions--and the extent to which they are used as compensating balances.

And our judgment, from the results of this, were that about a quarter of the net inflows since February or March were a direct substitute for demand deposits. The allowance we had made earlier had really reduced that to virtually negligible proportions, that is, we had earlier assumed that the increase in business savings deposits was roughly at the same rate of increase as the increase in Ml, so that we weren't getting any real diversion out of Ml type deposits, you weren't getting a real bias in your estimate.

MR. PARTEE. Having the initial move.

MR. AXILROD. Right. After the initial adjustment, which has gone on for several months--we assumed that by now this was ending. So I can't give you the exact numbers, Governor Partee, because we haven't worked it out in as much detail as we did very recently, but we--

MR. PARTEE. You are supporting some of the increase for M1--do you mean by that an adjusted Ml--

MR. AXILROD. To be specific--

MR. PARTEE. 6-1/2 instead of 4-1/2?

MR. AXILROD. M1 grew at close to a 4-1/2 percent rate of growth from the third quarter of ’75 to the third [quarter] of ’76. Our estimate of the substitutes would add--well, it varies on how you like to do it--but I’d say between 1-1/2 and 2 percentage points to that. So now, so you would be between 6 and 6-1/2 percent, something like that, and with the most important [substitute] being business savings deposits in that period. But also there are a number of others. And I’m sure that’s more than we had allowed before, particularly in the business--

CHAIRMAN BURNS. Well, Mr. Axilrod has been unduly modest. I think that the little study you made for me should be expanded and, in due course, perhaps by our next meeting, distributed to the Committee. Now that little study shows the following, and the methodology is not described here, and there is inevitably a considerable element of hazardous estimation. But the results come out as follows: in the third quarter of ’75 and the third quarter of ’76, the growth rate of M1 is 4.4 percent. Changes in financial technology reduced this growth rate of M1 an estimated 1.9 percentage points, which means that in the absence of changes in financial technology, the growth of M1 would have been 6.3 percent. Also, Mr. Axilrod reports that in making these estimates we have attempted to be quite conservative, which means that, if there is known bias in the estimation, it is in the direction of understating the effects of changes in financial technology.

MR. PARTEE. If there were changes in financial technology also earlier, I would have the adjustments--

CHAIRMAN BURNS. Yes, but earlier I have no calculations on that. But taking the individual factors accounting for the 1.9, we know that these are very recent developments in the largest part.

VICE CHAIRMAN VOLCKER. What are the elements of these based upon?

CHAIRMAN BURNS. Well, you have the NOW accounts, you have state and local government accounts, you have NOW demand deposits at mutual savings banks in New York, I don’t know how widespread that is, credit unions, money market mutual funds, telephonic transfers--well, that would be business savings accounts. A rather large number of dramatic changes of financial technology concentrated within the past year, or year and a half, or a number of them go back four or five years.

MR. PARTEE. State and local savings deposits have ballooned in recent months--didn’t I read that in the Greenbook or someplace?

MR. AXILROD. That’s right, but we allowed very little effect--direct effect--on the demand deposits.

MR. PARTEE. I think it mainly would have come out of open market instruments.

MR. AXILROD. To give you a rough idea, these are preliminary estimates, judgmental, really, of the $2.6 billion increase in state and local savings accounts over the year ending the third quarter of ’76. We assume that only $600 million represented substitutes for demand deposits, basing that more on the experience of what happened earlier when there [unintelligible] interest rates effect. So we assumed virtually most of it was in interest rate effect, and we used this lower number. Whereas for NOW accounts, we assumed almost all of the increase, not quite all but almost all, say 70 percent, was the substitute. That was the sort of judgment we had.

VICE CHAIRMAN VOLCKER. There's another factor here that seems to be moving in the same direction, suggesting the effective increase in money supply has been bigger than it looks naked. I can't believe myself it hasn't had some impact. The outstanding characteristic of this advance [unintelligible], so far is the banking world is concerned, is the lack of loan demands. And when you look at this whole [unintelligible] of expansion, I can't believe that this has not significantly reduced the increase in compensating balances for loan demand to what is typical in earlier [unintelligible] deposits measured, but it seems to me it must have had some significant effect.

CHAIRMAN BURNS. There was some rough allowance made for that in this calculation.

VICE CHAIRMAN VOLCKER. In that figure that you--

CHAIRMAN BURNS. It's within that figure, a small component.

MR. AXILROD. We made an allowance of about $1 billion which, after much back-and-forth argument, really came out to be on the low side. And it's somewhat consistent with the evidence of what's happening to business shares in the demand deposits survey.

VICE CHAIRMAN VOLCKER. I don't know how you measure it, but I just can't believe this. The expansion is [unintelligible] component, it's from our advance--

MR. PARTEE. In addition, we get some indication from these surveys that they were limiting it on compensating balances, so that even under [unintelligible] you might have some insufficient incomes on the balance.

MR. WALLICH. Mr. Chairman, we shouldn't forget, on the other side, that CDs, which in corporations, after all, are highly monetary, were going down all along, so if the higher ends of 4 and 5 have a negative bias from that source, I don't know what to say about Treasury bills, which presumably have a very similar role [unintelligible] probably expanding.

MR. PARTEE. May I answer that?

CHAIRMAN BURNS. Well, I think that if this does nothing else [unintelligible] our staff, it helps to remind us that if you talk about the money supply, you're not talking about a unique [concept]. Mr. Morris.

MR. MORRIS. Mr. Chairman, for a number of months now, this Committee has been instructing the Manager to give equal weight to M1 and M2. And I think the continuing diversion [of] growth rates is a continuation of relative growth rates which are out of line with our past history. It seems to me that is going to give the Manager problems in continuing this kind of directive. I was wondering what advice Mr. Axilrod would have for the Committee on how we ought to proceed in the future [unintelligible].

MR. AXILROD. Well, President Morris, in the interest of time I cut out a last paragraph which went into that, not in any detail, really, but [unintelligible] I think implicit in the last paragraph that I did read. I would argue, I believe, that if growth rates in M2, for example, turn out to be lower over the next few weeks than were projected, that this probably should be discounted for two reasons: first, they have been very high recently, and [second] particularly [so] if it turns out this is occurring because of lagged adjustment by banks to the decline in market rates, so that they are simply becoming less aggressive in seeking out depositors and permitting those funds to move into market instruments rather than grabbing them for their own deposits. That sort of realignment of rate levels, with the transaction drop in the rate of inflows--if that were to occur, I would suggest you would not want to give half weight to M2 under those particular circumstances.

On the other hand, if M1 were growing very slowly, and there was collateral evidence that the economy was also growing much slower than expected, then it seems to me, because I believe M1 is more reflective of transactions [than] M2 under those circumstances, you might want to give somewhat more weight to M1.

So I would say that the key thing is not a mechanical rule of half and half, although that would certainly be a satisfactory starting point, but an analysis of the collateral developments in the economy that are occurring in financial markets while you're observing what is happening to M1 and M2, and that [analysis] would guide me. So it's an argument against strictly adhering to a rule, although I would start off with a half-and-half rule and modify [in] the directions that I've mentioned.

CHAIRMAN BURNS. The inference I draw from your comments is that, first, we've been wise in instructing the Desk to give approximately equal weight to M1 and M2 rather than to give identical weights to the two. [We] expressed the approximate part. Now the second inference that I would draw is that this is not a matter that the Committee can properly deal with. A fairly liberal interpretation of the adverb "approximately" should be left to the staff, to take account of the sort of considerations and to just mention--that would be my inference, and isn't that approximately or roughly what you have been doing?

SPEAKER(?). I think so, Mr. Chairman, yes.

[MR. BALLES.] Mr. Chairman, even on that basis, by definition if you go 50-50 in a very strict arithmetic sense, you're really, based on the present quantities involved [unintelligible,] have 72 percent in demand deposits and currency, and balancing the other components if we have to [unintelligible].

SPEAKER(?). John's right, it's because Ml is the major component of [unintelligible].

SPEAKER(?). I'm not that smart and just figure the [unintelligible].

CHAIRMAN BURNS. That is right, Ml is counted twice--by itself and second as a component of M2.

MR. PARTEE. That helps to the degree of substitution--then we get the offsets of substitution.

CHAIRMAN BURNS. Well, gentlemen, I wonder if this isn't as good as time as any--Mr. Black and Mr. Wallich still have questions they want to put to Mr. Axilrod.

MR. BLACK. I can make mine very brief, Mr. Chairman. I just want to commend the staff on this analysis with the 1.9 percent because I have been feeling for some time the M2 balances were assuming a lot of the [role] of transaction balances. I just want to point out that there would be a tendency on the part of this group to assume that you had also reduced the rate of growth in M2 by 1.9 percent, but it's over twice as large as M1. So the reduction in that rate would be maybe 7/10 of a percentage point, or something like that.

MR. PARTEE. [Unintelligible.]

MR. AXILROD. M2 would not be affected, President Black, because we're assuming these are demand deposits that go into savings deposits, not other market instruments that go into savings deposits.

MR. BLACK. Yeah, I guess that would be right--

SPEAKER(?). Only to the extent that other thrift institutions--

MR. BLACK. Well, I shouldn't have made even that brief remark, but I do commend them on that.

CHAIRMAN BURNS. Well, gentlemen, [unintelligible] this specific moment. Let us break for lunch and return at 2:30.

[Lunch recess]

CHAIRMAN BURNS. In the interest of brevity, I want to make some suggestions to the Committee with regard to the short-run ranges and with regard to the longer-run ranges. And then I think we ought to have a discussion of where we want to go in the short run, that is, with regard to our two-month ranges. And after that to a discussion of tentative preliminary discussion of our targets for the coming year.

Now turning first to the short-run ranges, I feel, without stopping to elucidate, that a slight easing move at the present time would be appropriate. I don't think that you would be taking a great risk. I think the movement should be very small. I can't find my notes, but I think I know what I want to say. I would suggest that the range for the federal funds rate during the months of October and November be 4-1/2 to 5-1/4. Which means that we would move down. We would lower the lower limit by 1/4 percent, and likewise the upper limit, from where it was during the preceding months. I would raise M1 somewhat as specified under alternative B--5 to 9, I believe; M2, 9 to 13. In other words, I'm recommending the specifications of alternative B with slight modifications.

SPEAKER(?). Did you say M1 4-1/2 to 8-1/2 under B, or 5 to 9?

CHAIRMAN BURNS. Well, I'm looking at alternative B, which I'm accepting fundamentally. But M1 I would make 5 to 9; M2 I'd leave as is; federal funds rate 4-1/2 to 5-1/4.

MR. MORRIS. Mr. Chairman, would that contemplate an immediate movement of the funds rate? Are you contemplating an immediate move of the funds rate to say, 4-7/8, which would be the midpoint?

CHAIRMAN BURNS. Well, the midpoint, I have an open mind on that. We could move to the midpoint in the near future and have a symmetrical range or we could retain the kind of asymmetry that we had last month. In other words, we have a 1/2 percentage point at the lower-end range and 1/4 percentage point at the upper end; we have the kind of asymmetry we had last month. But--

MR. PARTEE. Four to five, Mr. Chairman, I think that's a question of 4-3/4. What would be your starting point?

CHAIRMAN BURNS. On the symmetrical, if you move symmetrically, then the midpoint would be 4-7/8, which means that we would get there in about a week, and then move to the left or to the right depending on the behavior of incoming data on the monetary aggregates. A second possibility is to retain precisely the kind of asymmetry that the Committee agreed to last month: The federal funds rate would remain at 5 percent, for the time being, and then, depending on incoming data, would move toward 4-1/2 or toward 5-1/4.

MR. PARTEE. I guess my thought was, and I think maybe Frank thought, too, that really the funds rate ought to 4-3/4 now and--

CHAIRMAN BURNS. It ought to be what?

MR. PARTEE. It ought to be 4-3/4. We haven't used the full range available to us as specified by the Committee at the last meeting. I wasn't there. The aggregates would [unintelligible] being pretty large, pretty well down toward that.

CHAIRMAN BURNS. I have been away and I have not studied the incoming evidence, but I was under the impression that the Desk has operated strictly in accordance with the instructions of the Committee, and ending the month at a 5 percentage point was precisely where the Desk should have been, in view of the joint behavior of M1 and M2. I suspect that you're thinking mainly of M1, but I don't have these--I have not studied the figures as closely as I customarily do. Now, Peter, defend your own record or demolish it as you see fit.

MR. STERNLIGHT. I believe that we were right in following Committee instructions to come out where we did, at 5 percent. I think we did gradually weaken as we had the evidence, midway through the period, of weakness in Ml partly offset by reasonable strength in M2. The latest week of evidence that we had showed Ml still weak, but slightly less weak, and M2 picking up a little bit. I think if we had had the last week's numbers earlier on, I'm not sure there would have been as strong a case for going down even to 5 percent. But having gotten there, I don't think it was so different as to call for a reversal.

CHAIRMAN BURNS. As I look at these figures, they seem to confirm what I said rather than what you said, Mr. Partee. Giving equal weight to Ml and M2.

MR. PARTEE. I guess you're right. M2 crept up on me, without my realizing it. You were below, even on exactly equal weighing. It's below the midpoint--

MR. STERNLIGHT. Below the midpoint, but still within a zone of indifference as we--

MR. PARTEE. --below the lower point on Ml, and have been throughout. Perhaps I shouldn't have, but I was trying to join Frank in [unintelligible]. I'm inclined to think that I would prefer to see markets easing, and prefer to see them easing a little more than specified [unintelligible].

CHAIRMAN BURNS. The sum of the midpoints as specified would have been 16. The actual came out 14.7. The sum of the lower limits was 12. And therefore I'd say that on a very literal reading, the federal funds rate should have been a little above 5 percent. I don't think anyone would want to read it that literally, and the kind of arithmetic I've just done, I've done for the first time [as a] check on your observation. I trust my eye more than I do this kind of arithmetic. Well, that shouldn't detain us. I've made my suggestion, and members of the Committee will deal with it as they see fit.

Let me make a suggestion about the longer-run ranges. There, I would suggest that we leave the ranges for M2 and M3 where they are but that we modify the range for M1. At present the range is 4-1/2 to 7. And my suggestion to the Committee would be that we lower the upper limit of Ml to 6-1/2. In other words, a range of 4-1/2 to 6-1/2 instead of 4-1/2 to 7. Now, my reason for making this proposal is that I think it important that we continue making progress toward achieving monetary growth rates that are more nearly consistent with price stability. We've moved very gradually in that direction during the past year, year and a half. I would emphasize that our moves have been extremely gradual. If we continued the pace at which we have traveled thus far, it would take us perhaps 8 or 10 years to achieve monetary aggregates that are roughly consistent with general price stability in so far as we can now estimate it or as far as I can now estimate it. So I don't think I'm making a radical proposal.

Now, the criticism that might be leveled against us--that this points to a more restrictive monetary policy--that criticism would not be well founded. As things have turned out during the past year, year and a half--it wasn't a deliberate movement on our part, but as things have turned out--Ml has been at approximately the lower limit of our growth range--approximately at 5 percent. During the 12 months, it's been below that, a little below 5 percent. Therefore, while the target range is lowered, there would be ample opportunity for this Committee to increase the growth rate up to 6-1/2 percent, which is well beyond the zone that we've reached during any 12-month period. And, of course, at any subsequent meeting, we could readjust the growth rate.

What I'm saying in effect is that we've had a range for Ml that we haven't used. And cutting back a little at the upper end would be realistic, and it would be another symbolic move or demonstration on our part that we seek to return this nation's monetary growth to a level that eventually will be once again in harmony with, and not inconsistent with, general price stability.

Well, these are my suggestions to the Committee, and I believe it would make for a more orderly discussion if we talk first about the next month and what our target ranges should be for October-November, and then turn to a preliminary discussion of the one-year targets. I don't see any hand up. Mr. Volcker, why don't you start. Mr. Mayo will follow.

VICE CHAIRMAN VOLCKER. Well, I basically am in full agreement with the kind of philosophy that you expressed for both the short and long run. And I come up with the same federal funds range that you specified. I thought this worked out rather well last time in terms of sneaking in a little easing but not doing it very abruptly. I still think it is premature right now, given not only our economic conditions but also this time on the calendar, to give a really strong signal of easing, but I think it's appropriate to go in that direction. So, within that general specification, I would have some preference for the kind of asymmetrical treatment that we gave it last month, but that's perhaps marginal.

I do think the ranges that you have specified [for the monetary aggregates] just strike me as being a bit on the high side. I worry about that M2 range, for instance, which is not quite, but almost, entirely above the long-term range--a13 percent figures in the shop window, so to speak, worries me a bit. So I would be inclined to, say, knock 1/2 percentage point off of those numbers, so it would be 4-1/2 to 8-1/2 [for M1] and either 8 to 12 or 8-1/2 to 12-1/2 [for M2], but these are pretty small differences.

CHAIRMAN BURNS. I have no quarrel with that. I was influenced really by the estimates that your Bank is making, and they're above the estimates of the Board's staff.

VICE CHAIRMAN VOLCKER. Only slightly on the M2, they are significantly above it on the M1.

CHAIRMAN BURNS. That's why I raised [M1 to] 5 to 9.

VICE CHAIRMAN VOLCKER. That worries me a bit, but I suppose I am most impressed when you talk about these ranges, and Mr. Axilrod's very trenchant comments in general. The most trenchant one of all seems to me the clause that he began with, and that you can begin almost every one of these meetings with: "Contrary to the staff expectations..."

MR. AXILROD. I don't think I said that.

VICE CHAIRMAN VOLCKER. "…Ml and M2 did thus and so." In fact, I think you can make the case for widening this range, so this is the ground that we've gone through before. If you had said 4 to 9, I'd be happy. But I'm just worried about those ranges being a little on the high side given all--

CHAIRMAN BURNS. Ml as well as M2?

VICE CHAIRMAN VOLCKER. Yes, I'm worried about the M2 figure being too high when you say 13.

CHAIRMAN BURNS. What would you do? Where would you lower them?

VICE CHAIRMAN VOLCKER. Well, now, I'm just thinking in my mind, but if I really had my druthers, I'd say, I guess, 4-1/2 to 9 [for M1] and 8 to 12 for M2.

CHAIRMAN BURNS. All right, thank you very much.

VICE CHAIRMAN VOLCKER. I'm more concerned about the federal funds specifications. I think that does reflect the kind of approach that I'd like to see here.

CHAIRMAN BURNS. All right. Mr. Mayo, would you carry the discussion forward, concentrating, as we are at this stage, on the two-month range.

MR. MAYO. I also had written down, before you spoke, the same federal funds range--4-1/2 to 5-1/4. I share Paul Volcker's comments on how this worked out last time, and I think it worked out very well. I would be willing to try it again on much the same sort of approach that was taken by the Desk during the last month.

Maybe it's just a quibble, but I share some of the same problems that Paul has with the 5 to 9 [for M1]. I would prefer 4-1/2 to 8-1/2. I think I would rather see Ml go a little bit lower than the 5 percent--although this is terribly minor--before, in effect, we worry about our limits on federal funds. I feel less strongly on the 9 to 13 [for M2]--8-1/2 to 12-1/2 is fine with me.

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

MR. COLDWELL. Mr. Chairman, your formulation of the figures is precisely what I had written down before I came in this room this afternoon, so I am merely supporting what you said--5 to 9, 9 to 13, and 4-1/2 to 5-1/4. And on the Ms, I really don't care anymore. These things are violent--fluctuating so violently it's almost impossible to play with them. I'd rather focus on the interest rate itself, and I'd like to keep that between 4-3/4 and 5.

CHAIRMAN BURNS. Thank you, Mr. Coldwell. Mr. Eastburn next.

MR. EASTBURN. Mr. Chairman, I would agree with your specifications. I have some preference on the funds rate to having a range of 4-1/4 to 5-1/4, but I think your specifications are acceptable.

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

MR. PARTEE. Well, I find myself at variance with you this time, Mr. Chairman. I certainly can accept the specifications you suggested for the aggregates--5 to 9 and 9 to 13. I wouldn't cut M2, I don't think. I think M2 is very hard to specify at a time when interest rates are dropping, and there could be continued large reintermediation of funds from markets into the banks, or [into] S&Ls in the case of M3. And so, although the 13 [for M2] would be a high figure if we had it over a sustained period, I don't see any problem with it as a shorter-term matter. And on Ml, 5 to 9 seems to me quite appropriate, following a month in which we had [unintelligible], which we ought to give some weight to even though it's not in the average of the two months that we're looking at.

Now, I think that there is enough weakness in the economic situation that I would--assuming that the aggregates don't give us surprises within the next couple of weeks, coming in very low or very high--I would like to see us move down somewhat more in the money market. And I think the way to do that would be to specify a range [for the federal funds rate] of 4-1/4 to 5-1/4, with a midpoint 4-3/4. So that, unless we get some strengthening in the aggregates from the current expectations--I didn't know that the New York Fed already had it, and perhaps they'll be shown to be correct there--but unless we get that, it would imply a further gradual moving down in the objectives of the Desk, from the roughly 5 or slightly below what it has been quite recently, to about 4-3/4 over the course of week or 10 days, assuming that the aggregates don't come in strongly. So I feel that I would prefer that 4-1/4 to 5-1/4 specification.

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

MR. KIMBREL. Mr. Chairman, reluctantly, I guess, I'm prepared to accept some small monetary ease. I think I share the expression of Mr. Gramley this morning that I honestly do not believe that monetary policy action at this point is going to accomplish really what we would like to see. From our vantage point, I have not recognized lack of liquidity as a major reason that lenders are still being reluctant partners. I would obviously prefer to see some temporary fiscal stimulus, but I don't see that forthcoming, so the next alternative, I guess, is to accept almost exactly--or exactly--the specifications you suggested. I think that's about as good as we can accomplish at the moment.

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

MR. MACLAURY. Thank you, Mr. Chairman. I think I'm a little closer on the aggregates to Paul Volcker. As I recall, I'd take the 4-1/2 to 8-1/2 [for M1]. I think especially--I know this anticipates out next discussion on the long-run aggregates--but if we do move down the longer-term Ml, then it would be in my view a little inconsistent to be moving up in the short range, despite Chuck's point about shortfalls just seen with our short-term ranges for M1. So I'd like 4-1/2 to 8-1/2, and 8-1/2 to 12-1/2 for M2. I like your range [for the federal funds rate] of 4-1/2 to 5-1/4, but I would move within the first week to 4-7/8 as the midpoint.

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

MR. BLACK. Mr. Chairman, I would favor Mr. Volcker's second version, which I understand to be 4-1/2 to 8 percent on Ml, 8 to 12 on M2, and 4-1/2 to 5-1/4 on the federal funds rate. But I would take the second alternative you posed as our operating procedure and hold the funds rate around 5 percent unless the aggregates come in weaker than projected for the next couple of months. My guess is that the staff is right on this. Our own staff has made similar projections, and I believe they'll be coming in rather strong, and I would not start moving that federal funds rate down until I saw evidence to the contrary.

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

MR. BALLES. In the interest of brevity, Mr. Chairman, and because I am concerned about the uncertainties in the economy and the sluggishness that we're witnessing, and until that gets resolved, I would resolve our policy or any uncertainties somewhat on the side of a little greater ease. And I think Governor Partee has already given my speech. I would come out with that same set of specifications he was talking about, which was your numbers on Ml and M2. But I would associate myself with his views on 4-1/4 to 5-1/4 range on the federal funds rate, with the aim of nudging it down in the near future--try to give a little stimulus to the economy if only in a psychological and confidence sense.

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

MR. MORRIS. Mr. Chairman, I find myself in disagreement with Mr. Gramley's position. It seems to me that the basic problem of economic policy in the past decade is that we've had a fiscal-monetary policy mix which has been adverse to investment. I think to the extent that the recent weakness in the economy is a product at least in part of the shortfall in government spending, it's particularly appropriate that we have a response in monetary policy. And I think that Mr. Gramley's feeling that we will not get much of a response in the economy to lower interest rates and higher security values that a somewhat easier policy would create, I think it's something I don't share. So for all these reasons, I would support Mr. Partee's position, accepting your specifications for the aggregates but proposing a 4-1/4 to 5-1/4 funds range with instruction to the Manager to move to 4-3/4 and see how things develop from there.

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

MR. WALLICH. I share the view of those who argued like Governor Partee. I see a need for some kind of a push, however mild and slow it would be in working. I think we've been low on the aggregates over a long period of time. I think that's by and large the result of our emphasis on the funds rate. [If] we don't allow the funds rate to go down, then the aggregates will not expand, and I think that's what's happened and what seems to tell us that there isn't much expansionary force in the banking system. Well, the differences are very minor, but I'd go for 4-1/4 to 5-1/4 [for the federal funds rate], and the aggregates 5 to 9 and 9 to 13. And unless there's clear strength in the aggregates in the next week, I would move to the midpoint of that funds range, 4-3/4.

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

MR. LILLY. I have no quarrel with Ml and M2 of 5 to 9 and 9 to 13. I do feel that a little more ease is indicated than would come with a midpoint of 4-7/8, so I'd favor the 4-1/4 to 5-1/4.

CHAIRMAN BURNS. Thank you, Mr. Lilly. Who's next? Yes, Mr. Jackson.

MR. JACKSON. I'd agree to the two aggregates constraints. I would personally consider a kind of skewed federal funds rate of 4-1/2 to 5-1/4, but to go to the "midpoint" of 4-3/4. I wouldn't want to see it go under 4-1/2 or over 5-1/4, but I would like to see us go to 4-3/4 right away.

MR. PARTEE. So you're skewing the opposite way of last time.

MR. JACKSON. Yes, that's what I'd like to suggest. [Unintelligible.]

CHAIRMAN BURNS. Thank you, Mr. Jackson. Who would like to speak next? Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, I would simply say that I concur with Mr. Partee's recommendations, which use your numbers and slightly lower fed funds midpoint. It seems to me that the market situation is one which justifies additional pressure on that prime rate and possibly even on the savings and small CDs.

CHAIRMAN BURNS. All right, thank you, Mr. Baughman. Who is next? I'm going to have to start calling on individuals. Mr. Guffey, we haven't heard from you. Mr. Guffey and then Mr. Winn.

MR. GUFFEY. I don't think I have a great deal to add Mr. Chairman. I would hate to see the fed funds rate down at 4-3/4, although the specifications of 4-7/8 would be acceptable. I think we have some other tools of monetary policy that I'd like to see us use if we were perhaps not so close to November 2. The Desk is only one of three, I think, tools that we have and I prefer to see the reserve requirements and/or the discount rate used at this time to get some psychological [unintelligible] in our economy.

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

MR. WINN. I think I can live with the range that we specified here among the group. I think my preference would be for the 4-1/4 to 5-1/4 short-term range [for the federal funds rate]. I am more nervous about your long-term suggestion, however, Mr. Chairman.

CHAIRMAN BURNS. Well, we're going to come to that later. Mr. Roos.

MR. ROOS. I would prefer the 4-1/2 to 8-1/2 for Ml, 8-1/2 to 12-1/2 on M2, and 4-1/2 to 5-1/4 on the federal funds rate.

CHAIRMAN BURNS. Has everyone spoken? Oh yes, Mr. Gardner.

MR. GARDNER. Mr. Chairman, I see a significant consensus here. I think we're only arguing about various minor aspects. I think 5 to 9 [for M1], 9 to 13 [for M2], and 4-1/2 to 5-1/4 [for the federal funds rate] would be appropriate. You talk about 4-1/4 on the funds rate. I'd be a little suspicious of our economy if our funds rate should go down to 4-1/4. I like the 4-1/2 to 5-1/4 midpoint.

MR. PARTEE. What did you say about midpoint? I didn't hear it.

MR. GARDNER. Well, what I meant was 4-3/4 and 4-7/8 [as alternative midpoints]. I'm only commenting on extending the full percentage point range from 5-1/4 to 4-1/4 on the funds rate. I'm suggesting that we'd be doing some upswing if the funds rate were down at 4-1/4. We had a funds rate of 5, we had a funds rate of 5-1/2, 5-1/4 for quite a while--way down to 4-1/4 is a significant difference.

MR. PARTEE. That, of course, would mean that the aggregates would be at the minimum.

MR. GARDNER. Listen, we don't [know] all the shocks. I guess we don't think [there] are going to be [any], not in October anyway.

CHAIRMAN BURNS. Well, we don't know. Well, gentlemen, we have to agree on the language of the directive. I think the monetary aggregate directive using the innocuous language of alternative B would be proper, in view of today's discussion.

MR. COLDWELL. I came out differently on that, Mr. Chairman. I came out with a money market proposal using the words "seeks to ease bank reserve and money market conditions." I keep hearing around this table people wanting to lower the funds rate.

CHAIRMAN BURNS. Well, let's have a show of hands. Let's have a show of hands on the language of the directive. How many would prefer a monetary aggregate directive this time?

MR. BROIDA. Nine, Mr. Chairman.

CHAIRMAN BURNS. Well, I think there is a clear majority. As to the [short-term] specifications, the majority of the Committee favors a range of 5 to 9 for Ml; 9 to 13 for M2; and 4-1/2 to 5-1/4 for federal funds. In view of the discussion that we've had, and in view of the minority which would seek a lower federal funds, I think it would appropriate to take the midpoint--4-7/8--as the immediate target and to move symmetrically around that midpoint as we normally do.

So I would suggest that we vote on the following: monetary aggregates directive as described by the language of alternative B**,** the growth of Ml within the range of 5 to 9, the growth rate for M2 of 9 to 13, a federal funds range of 4-1/2 to 5-1/4 with a move towards 4-7/8 within a week or 10 days. How would you like that worded Mr. Sternlight? Within a week?

MR. STERNLIGHT. Within about a week.

CHAIRMAN BURNS. Within about a week, all right. Let's put it that way, within about a week.

MR. BLACK. This is regardless of the behavior of the aggregates, Mr. Chairman?

CHAIRMAN BURNS. Yes, within about a week you're not going to have much information. I think that is the meaning, that regardless of the behavior of the aggregates, you move toward 4-7/8 and then you move up or down depending on incoming evidence on the aggregates. And the move being restricted to 3/8 of 1 percent in each direction. Well, any questions? If not, would you be good enough to call the roll.

MR. BROIDA.

Chairman Burns	Yes
Vice Chairman Volcker	Yes
President Balles	Yes
President Black	Yes
Governor Coldwell	Yes
Governor Gardner	Yes
Governor Jackson	Yes
President Kimbrel	Yes
Governor Lilly	Yes

Governor Partee	Yes
Governor Wallich	Yes
President Winn	Yes

It's unanimous.

CHAIRMAN BURNS. [For] the longer-range targets--and recognizing that our discussion is preliminary and the final decision will be made on November 8--in expressing our views we can [unintelligible] preliminary discussion and we actually should ask ourselves the question, if we were to announce longer-range targets two or three days from now, where would we want to set them. That's the best we can do in discussing the long-range targets in a preliminary way and depending on incoming data and second thoughts, which may be better than original thoughts. We may want to depart from tentative decisions we have made today. All right, Mr. Eastburn, let's start with you, please.

MR. EASTBURN. Mr. Chairman, we prepared a memorandum which we distributed to the members of the Committee, making some suggestions about--

CHAIRMAN BURNS. May I just interrupt to say that--please feel free to proceed in your own way. But I don't think we can take up your suggestion today. I think the proper way to take up your very interesting suggestion would be to have the staff analyze it, and let's try to do that rather promptly and have the staff comment and evaluate your suggestion then.

MR. EASTBURN. Yes, I was going to suggest that very thing. I might just say one thing with respect to that memorandum. That it obviously owes a great debt both to Governor Wallich and Bill Poole, who advanced these kind of suggestions before and I think I should make sure that that is understood.

With respect to that memorandum, the thrust of it is that, for current decisions as far as long-run targets are concerned, to hold policy where it is, where we mean to make no change, would require an increase in the specified percentage growth rate. That is, we have had a shortfall, and if we intend to hold policy where we meant it to be, then we would have to have some increase in specified percentages.

CHAIRMAN BURNS. But is that a correct statement? He says what he meant--well, now, wait, this is the correct statement for Ml, now there have been changes in the behavior of income velocity, we have learned something about that. There's been substitution of time and savings deposits, demand deposits, there's been other changes in financial technology that we didn't allow for right at the [unintelligible], knowing that these changes have occurred. Is there a correction that needs to be made up?

MR. EASTBURN. Well, I think that would bear studying to see what the magnitude of that should amount to. My guess is that, over this time period that we examine, we've had more drift than would be accounted for by those kinds of factors.

CHAIRMAN BURNS. Well, I don't know. You see, this staff study that Mr. Axilrod referred to gave you some specific numbers, and it arrives at the conclusion that if the financial technology had been constant, Ml growth would have been almost 2 percentage points higher in the past year than it turned out to be. Now, so we have had some study devoted to that subject, and you know perfectly well how wrong the economics profession has been in estimating the demand for money over the past year, year and a half, or a bit longer than that.

MR. EASTBURN. Well, I should think that when the time comes to analyze the proposal, that that should be an important thing. My offhand feeling is that at least our announcement would suggest that we're some 6 billion below the fixed-based target, and I would suggest that that would be greater than would be allowed for in this philosophy. The point I want to make, however, is that so far as the immediate determination of long-term targets is concerned, I would come out different from your specification. Rather than lowering the specifications for Ml, I would raise them. I would have 5 to 7-1/2 percent, midway between alternative A and alternative B: 5 to 7-1/2 percent for Ml; 9 to 11 for M2; and 11 to 13 for M3.

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

MR. COLDWELL. Mr. Chairman, I'm not with you on the long term, like I was in the short-term. I'm afraid the long-term targets you suggested are a bit low for me. I'm not ready to take another notch off of this, partly because I have some of Dave's feelings that we have not met what we set out to do. I have sought somewhat more stimulative policy a little bit around this table for months, but I think you really have not lived up to the level we set in front of ourselves as they've actually come in. That's partly the problem with forecasting and other things characteristic of these Ms.

I think that [unintelligible] for the long range I would be willing to keep the bottom figure of 4-1/2 [for M1], but I would raise the top figure from 7 to 7-1/2 or even 8, partly because I think we're reaching a point where we just cannot do a forecasting job on these figures, and we're coming in so differently month-to-month and even quarter-to-quarter, and yet we always seem to be at the bottom end of this package. The M2 range of 7-1/2 to 9-1/2, I'd actually prefer a 10 to 12; and on the M3, instead of the 9 to 11 we now have, well, it actually would be acceptable to me, but I really prefer a 9 to 12.

CHAIRMAN BURNS. Just a factual point, the way figures have come out relative to our projection--or plan, if you like--at Ml we've been toward the lower end; M3, we've been toward the upper end; M2, we've been close to the midpoint, and therefore, taking the three Ms together, I say we have been surprisingly close.

MR. COLDWELL. Except that everybody looks at Ml instead of the other two.

CHAIRMAN BURNS. Well, we've learned better, and now we look at Ml and M2 at least, giving them approximately equal weight, as we had occasion to remind ourselves at this meeting. Who would like to speak next? Mr. Partee and then Mr. MacLaury.

MR. PARTEE. Mr. Chairman, I think that my preference as of today, if we were to announce this as you specified, in a matter of a few days, would be to hold just exactly the same Ml range we now have, 4-1/2 to 7. And I do believe that gives us room, which we may well need, to have a period of more rapid expansion in M1.

My concern is with M2 and M3, because, you recall, we cut the upper end of those ranges the last time on the technical grounds that it wasn't reasonable, that the relationship didn't seem to be reasonable. Now I think in an atmosphere where interest rates may be lower than we previously have thought, we may run into difficulty with these on the top end. And so I think I would be inclined--I wouldn't like to make much of a change there, but I think I would be inclined to go back on the M2 and M3 to the ranges that we had specified prior to last time, that is, to undo what had been done before and on the same grounds that it was explained before, where we said, "Well, technically, we think that the relationship is not quite right." But now we can say, "Well, technically, in view of the way the markets have developed, we think that it was right before, and so we will return to those previous levels." Now, Steve, am I right in thinking we have reduced--was it a 1/2 point on one of them and 1 point on the other?

MR. AXILROD. A 1/2 point on M2 and 1 point off the top of M3 last time.

MR. PARTEE. And so what we would do [if we] go back, it will be 8 to 10 and 10 to 12?

MR. AXILROD. It was 7-1/2 to 10 and 9 to 12.

MR. PARTEE. 7-1/2 to 10 and--

MR. AXILROD. The time before last.

MR. PARTEE. All right, I think that as of today that should be my thinking about it. On the question of making further progress and ridding the economy of the monetary base for inflation, I just think that this is a desirable longer-run objective, but I just don't think that, with the kinds of business news and employment news we've had, this is the time to make another step.

CHAIRMAN BURNS. You say that in full recognition of the fact that, under my suggested range, we could still ease over a total of 12 months considerably.

MR. PARTEE. I say it for two reasons: one is, I'm afraid that the targets, what we think of--Ml and the range of M1--that the commentary would be that we've tightened another notch. And I don't think that's a good commentary to have about us. The second reason is at this stage and in the economic situation--

CHAIRMAN BURNS. Well, the commentary would be directed toward two sets of specifications. The short-term specification, [which] will have eased, and the long-term, which may be interpreted as having tightened but which need not be a tightening at all, for two reasons. First, we haven't used the upper part of the range, and there's ample room to move from the present 5 as a low figure up to 6-1/2; and second, we are not slaves to the figures that we put down. I'm not arguing, I simply wanted to clarify the--

MR. PARTEE. My problem is, we would not be expressing the short-range targets that we have adopted now because that still would be secret at the time you make the presentation.

CHAIRMAN BURNS. Well, that's a good question.

MR. PARTEE. And therefore it will be the long-term [specification] that'll be the news.

CHAIRMAN BURNS. Well, that's a good question, whether they should remain secret under the circumstances. Well, let's not debate that now. I think that I have not thought about that. You see, remember this, in the past, when we had to testify in the beginning of the year before the Joint Economic Committee--instead of allowing the lag of 90 days, we permitted the lag to fall below two months, even. In recognition of the fact that we had to testify before the congressional committee, we've deviated from that road.

MR. PARTEE. It's a little different though, because you'll be testifying at a time when the current specification is still the operating policy of the Committee.

CHAIRMAN BURNS. Yes, yes that's true, but on the other hand, yeah that's true and that would argue against specifying the short-term ranges. However, the market rate for federal funds will be known, and what happens before the--

MR. PARTEE. It might not be lower, Mr. Chairman.

CHAIRMAN BURNS. I realize that. I realize that. But the market rate will be known, and it may well be lower because we're giving it a head start in that direction and moving rather promptly to 4-7/8. I see your point, and I am glad you made the point because it will help me to think through a question that I hadn't thought about before.

MR. PARTEE. And my substantive point still was that I think we may need to use much of that Ml range [unintelligible] the period that is open to us, and therefore I don't like to see us reduce our headroom. And my final point is that we did have modest shortfalls in the last quarter, and then to be reducing the target range on the new base following a little shortfall would certainly bring comment, and I think it will seem [that it is] a little more tightening that really is intended. That's my feeling as of this--

CHAIRMAN BURNS. That's very understandable. Mr. Volcker. Oh, I'm sorry, Mr. MacLaury and then Mr. Volcker.

MR. MACLAURY. Thank you, Mr. Chairman. I guess I'm with Chuck so far as Ml is concerned. I have been a partisan, as you know, of this knocking down on the Ml in particular, but I think that as things seem today, this would be interpreted as an inappropriate time to do that, and I would concur in that judgment as things stand today. So I would stick with the 4-1/2 to 7 [for M1], mainly for the public interpretation aspects of it. On the other Ms, I think I again follow Chuck's idea of going back to a new 7-1/2 to 10 and 9 to 12 as consistent with the seemingly different relationship between the Ml and M2 figures.

CHAIRMAN BURNS. Thank you, Mr. MacLaury. Mr. Volcker please.

VICE CHAIRMAN VOLCKER. I've just been listening around the table this afternoon, Mr. Chairman, and I do think there's a little Ml myopia. When I look at all these things, you didn't go quite far enough according to the different ways of drawing these things. Going backward, it does seem to me going on the high side of M2 and very much on the high side in M3 in terms of longer-term targets; we are on the low side of M1.

When I look at the economics of these different things, M2 over a considerable period doesn't make much sense to me. I could never see the distinction between the savings deposits at commercial banks and savings deposits elsewhere. It's very convenient to use in the short run. Those proxies should move together anyway, but looking over a longer period, the M3 numbers, which are more meaningful to me alongside the Ml ones, are really pretty high, and it concerns me.

I think we have both a technical and economic problem here, as has been advised, with the [broader] Ms coming out higher relative to the Ml figure than people have expected, and that should be corrected if we have a chance to correct it because it will probably persist at the current level of interest rates. When I put that together with the economic problem, it seems to me that all these specifications have lots of room for increasing any of the aggregates as much as I'd like to see them increased over the next year, almost regardless of business activity. If business really slacked off, these numbers, as they are, imply a very easy money market situation--extremely; you would probably have trouble making these figures.

MR. PARTEE. Except in M2 and M3. That would be very strong.

VICE CHAIRMAN VOLCKER. Well, the Ml, that's right, the discrepancy will increase even more.

CHAIRMAN BURNS. You'd have enormous difficulty if you had a business recession reaching anything like the figure we have for M1.

VICE CHAIRMAN VOLCKER. So taking all these things into consideration and considering the long-range objective of moving them down--and they do still seem high to me in a secular way--given all the technical arguments you've made about Ml, to which I'd add the compensating balance thing, I very much like the idea of moving down the M1 figure. I had actually thought of moving down the lower end of the range rather the upper, so that nobody would raise questions about it if pressures did go the other way. We'd be committed to continue for a while, but I'd take either one and be perfectly happy with what you suggested.

Reluctantly, but in recognition of the technical problem, I could conceive, if we went down in M1 slightly, going up on the others equally slightly and getting some balance the same way, if someone attached great importance, as obviously some do, to the announcement effects. I think that is of some importance, but since it runs a little contrary to what I would like to do in substance, I guess I would swallow the announcement effect. And I think we can get by with it safely enough without moving the M2 and M3 up, even though I think it could be justified technically, in moving the M1 down a little on the basis you suggested. I would hate to see a general movement upward in these things, but it seems to me precisely in the opposite direction you want to go, and we're already too high in the long-range perspective.

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

MR. MAYO. Well, I personally prefer, Mr. Chairman, sticking where we are, 4-1/2 to 7 [for M1] with a rise in M2 to either 8 to 10 or 8-1/2 to 10-1/2, which is the prescription in alternative B. I didn't consult with the doctor who prescribed alternative B, but it seems to me that this does have some announcement effect that is very slightly toward easing, and the only rationale, or the major rationale, for taking your prescription in preference to this--for Ml at 4-1/2 to 7--would be if you indeed did combine it with a rise of 8-1/2 to 10-1/2, and I think you could cover the possible, indeed, perhaps likely, misinterpretation that we were squeezing too early here on the long-term ranges by doing that. But I still have a preference for the way alternative B is stated by the staff.

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

MR. WALLICH. Well, I would go with the 4-1/2 to 6-1/2 on M1. I think the logic of gradually cutting each time is quite hard to resist because one begins to wobble when it becomes a controversial action. Whereas if one does something of this cutting kind, no matter in which of the aggregates and whether the upper or lower edge of the band, one follows a continuing principal that makes sense. Eventually we've got to come down to lower rates of money growth and never will unless we move in that direction.

The real significance, I think, of today's action in any event is what we do on the two-month targets. On the longer targets, they have significance, but we're not really trapped into those, we can change them. Besides, base drift, although I've been concerned about it, is something that I wouldn't readily give up because it's a great safeguard and may stand in some good stead some day. I don't feel too concerned about the longer-run aggregates, and I'd go with the same specification for M2 and M3 that we have at the present time.

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

MR. KIMBREL. Mr. Chairman, like Governor Wallich, I too am in total agreement with the long-term policy of gradually reducing our longer-range targets, particularly in recognition of our reduced inflation. I therefore would like very much to see us inch down to the 4-1/2 to 6-1/2 [range for M1,] particularly since we have not really been using that range, as you've pointed out. In fact, continued low interest rates do make the savings and time deposits attractive, and maybe it would be technically fair--and as was suggested earlier, maybe it would have some announcement effect--if we rightfully eased [M2] back to 8 to 10. I have no trouble with what you pointed out, but if I had a particular preference, I guess I would prefer to have 4-1/2 to 6-1/2 [for M1] and 8 to 10 on M2.

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

MR. MORRIS. Well, Mr. Chairman, I think that what I would do this session is to present the same numbers you presented the last time, all the way. I think given the softness in the economy, I would be concerned about scaling back in any of the numbers at this time, even though I think that, quite clearly, as a long-term proposition, that's what we have to do. I think the timing, however, might be unfortunate. And while I sympathize with Mr. Partee's technical reasons for raising M2 and M3, and I think as a technical matter there's a lot that could be said for it, by the same token I wouldn't want to be raising the limits in this environment either. I think you may or may not be able to persuade the Committee that you are doing it for technical reasons, but I think the press would not report the technical explanations but simply the upgrading. So I think the safest thing, the best thing would be, for one time, present no changes.

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

MR. JACKSON. Mr. Chairman, I would not want to see us lower the upper end of M1 today. I think if you listen to our staff's projections for the next year, over which this time framework is proposed--while admittedly an overall reduction in the growth of that aspect of our monetary policy is appropriate, I don't know that it's appropriate considering the economic projection.

I would disagree with the likely consequences of the relationship between that type of M1 growth and the M2, M3 growth. I would suspect that, here again, in this trading off between the breakpoint of the arbitrary price mechanism that we call Regulation Q, as the short-run operating aspects have traded one side or the other to that, it has produced distortions in the rates of growth in M2 and M3. And in the longer-term context, the experience that we have seems closer to our longer-run targets [unintelligible] the more likely consequence of the two.

There's another reason why I would hesitate to increase them, and that is, to the extent that M2 and M3 are becoming transactional as we discussed, it strikes me that increasing those ranges by whatever mechanistic means would be a mistake and certainly out of character with our attitude about M1.

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

MR. BALLES. Mr. Chairman, there has been one aspect of switching to a third-quarter base that I don't think has been fully brought out yet, and perhaps the staff could do the homework on this and let us know in this forthcoming conference call in early November. My impression--I don't have the figures, even tentative figures, in front of me--is that moving to a third-quarter base will in effect mean an upward drift in the base of M2 and a downward drift in the base of M1. Is that approximately correct? Steve?

MR. AXILROD. Yeah, we tried to explain it, yeah they go in different directions, and we've tried to explain the effects in the footnote on page 6 in the Bluebook. And that's very elliptical and possibly unclear, but the new alternative C in the long run gets you the same M2 and M3 as if you had continued the existing growth rates, and for Ml if you go to another alternative, between alternatives A and B.

MR. BALLES. Thank you, Steve. That confirms the general impression I had, Mr. Chairman, even though we don't have the exact numbers worked out yet. For that reason, along with the further reason that we had some inconsistency, I believe, between our target ranges on Ml versus M2 and M3. As for an example, M2 has grown about 4-1/2 percent faster than Ml ever since March 1975, and if you take the New York Bank projections, that's going to continue right on through March '77. But the differential in the targeted growth midpoints has averaged only 3 percent, and now it's only 2-3/4 percent in the current setup. And I think we've got an inconsistent set of ranges here.

Well, this is the long way around this thing--the downward drift in Ml base and the upward drift in M2 base that we will get by moving to a third-quarter base from a second-quarter base. And I think we can solve that problem by adopting Frank Morris's proposal, which I now associate myself with. Leave the whole thing unchanged.

I'm very concerned about the announcement effect. The thing that got the headline last time when you announced a lowered upper limit for both M2 and M3 was that the Fed is tightening. What really counts is what we do within the range and not so much the range itself, but we'd have a big difficulty in overcoming an impression among the public that we're tightening if we lower the upper end of these ranges because of this uncertainty in the economy that I have earlier discussed. I would come out in favor of leaving the ranges unchanged this time around.

CHAIRMAN BURNS. Thank you, Mr. Balles. Mr. MacLaury you have another observation on any of these things?

MR. MACLAURY. If I may very briefly. Having sat around this table for many years, I can't remember many occasions in which anybody has changed his mind as a result of the discussion. But I would like to avow that at the moment and say that, listening to the discussion, I have changed my mind, and I think that technicalities are pushing us in the direction of reducing the range of Ml in comparison with the other Ms. Likewise the technicalities according to the preliminary impression you gave us today is telling us that Ml now means something more if it is adjusted for the shifting to [the nontransaction component of] M2 than the basic numbers imply. Therefore I'd like to, I think this is consistent, accept your proposal for 4-1/2 to 6-1/2 but offset the psychological effects of announcing a downward revision there by a 1/2 point increase in the other two Ms.

CHAIRMAN BURNS. Thank you, Mr. MacLaury.

VICE CHAIRMAN VOLCKER. Can I interject another time and make an assertion, and the staff can tell me I'm wrong--or somebody else. My memory is that previous changes in the long-range targets have been so small that that there's almost no announcement effect. I don't recall the market recoiling in horror or praise in any of these announcements.

CHAIRMAN BURNS. All right, Mr. Black, we haven't heard from you.

MR. BLACK. Mr. Chairman, I would come out where Messrs. Morris and Balles come out and leave the ranges unchanged from what they were last time. I could live with a knocking off a 1/2 percentage point of Ml, but I believe it would be preferable not to do that at this particular time, although I would hope it would not get up to 7 percent at the same time.

CHAIRMAN BURNS. Thank you, Mr. Black. Mr. Gardner.

MR. GARDNER. I agree with Henry on Ml. And your proposal, I think that'd be the proper approach--I'm not so sure about the 8-1/2 to 10-1/2 and 10 to 12 for M2 and M3. We've been reminded of significantly [unintelligible] higher end of those, and last time [unintelligible] seems to be a little uncertain. But I think the philosophy is a change, and the recognition of the technical factors in offsetting perhaps or similarly explaining what we're doing on Ml leads me, finally, after listening to this very active discussion, to go along with the proposal.

CHAIRMAN BURNS. Thank you, Mr. Gardner. Mr.--I don't have anyone left. Mr. Lilly.

MR. LILLY. I would join the forces to say make no changes because I am so concerned about the announcement effect.

CHAIRMAN BURNS. Thank you, Mr. Lilly. Mr. Guffey, Mr. Roos, would you like to comment?

MR. ROOS. Mr. Chairman, I prefer staying where we are.

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

MR. GUFFEY. [Unintelligible] philosophy, I like the idea of taking a cut in several quarters, but I think I would prefer to stay where we are [now]. Ninety days from now, we can make hopefully a cut in one or the other of the ranges.

CHAIRMAN BURNS. The Committee is evenly divided on Ml as between 4-1/2 to 6-1/2 and staying where we are at 4-1/2 to 7. As for M2, there is a majority for 7-1/2 to 9-1/2, which is where we are now. As for M3, there is a majority in favor of 9 to 11, which is where we are now.

Well, gentlemen, I don't think we need to go beyond this. Let's keep in mind the results of this preliminary discussion. For M2 and M3, a clear majority of the Committee will prefer to stay where we are. And on Ml, an equal number prefer 4-1/2 to 7, and [thus] staying where we are, [as] prefer to go down a 1/2 point on the upper limit. I don't think I want to argue the point now.

We will have another go at it 23 days from now, and I expect to be in a position to [present altered long-run specifications to] this Committee if necessary. But as of today I'm entirely satisfied with the expressions of opinion we have had. And I would be eternally grateful to that member of this Committee who would be bold enough to suggest that we adjourn. Thank you very much. What I said, 23 days, was wrong, it was 20 days.

END OF MEETING