TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

May 17, 1977

Prefatory Note

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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

May 17, 1977

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, May 17, 1977, beginning at 9:30 a.m.

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

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

Messrs. Black, Kimbrel, and Willes, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and Minneapolis, respectively

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

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

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

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

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CHAIRMAN BURNS. A motion to approve the minutes of the April 19 meeting will now be in order.

SPEAKER(?). So moved.

CHAIRMAN BURNS. Any objection to that? We pass now to Mr. Holmes's report on foreign currency operations.

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

CHAIRMAN BURNS. Thank you, Mr. Holmes. Are there any questions? I hear none. A motion to approve the transactions on foreign currencies would now be in order.

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN BURNS. Do you have any recommendations, Mr. Holmes?

MR. HOLMES. No, Mr. Chairman, except, as I mentioned earlier, there may be a possibility that we may want to make small drawings on the swaps. I think we have the authority to do that. I have no new recommendations to make.

CHAIRMAN BURNS. All right, then we will turn to Mr. Kichline now. May we have your report, Mr. Kichline.

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

CHAIRMAN BURNS. Thank you, Mr. Kichline. Now, we are ready for such views as members of the Committee may have on the state of the economy or such questions as they may wish. Mr. Mayo, please.

MR. MAYO. Just one supplementary comment, Mr. Chairman. We have checked out some of our heavy-goods industry people since the energy message occurred, and they have no changes contemplated in their capital spending. Part of this is just time, but to the extent that it's been discussed, and it has been discussed quite a bit in these companies, they see no effect at this point on capital plant and equipment spending.

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

MR. WINN. Mr. Chairman, the scenario that has just been presented, and also it's in various [staff] books--it seems to me highly probable. On the other hand, I am puzzled by the loan demand facet of the future. When you talk with insurance companies, their backlogs are going down, not up. And this doesn't look like robust demand. Second, some of the financing they are doing [arises from] the fact that some people feel that interest rates are a little low, and they are refinancing their position to take advantage of the interest rate, and that money is not going to [be] constructive for future expansion. The bank demand, as I see it, is in part the inventory buildup that is going on currently, and beyond that, we've got mortgages and installment credit, some agricultural demand, but not a heavy push toward expansion.

And the thing that troubles me is, are we seeing a little inventory cycle at the moment, occasioned by the bad winter weather of the first two months? And the plant and equipment expansion plans and that sort of thing seem to me heavily related to automobiles. If you take the utility component out of it, in this sense of the term, and with the feeling that businesses have developed ways of using existing plant and the machine tools they're putting in--[they are] providing fantastic increases in output for the capital investment. And are we really going to get the pickup in the investment sector that we need in terms of the continuation in output? I just raise a questions mark, particularly if you look at the lack of financing plans for this sort of expansion.

MR. JACKSON. Mr. Chairman, let me clarify the point you made. My recollection is that the staff memorandum we received indicated that the outstanding volume of commitments by life and insurance companies was going up. Did I forget--

MR. KICHLINE. I think the recent data that we have from the Life Insurance Association of America--and it's about three-fourths of the industry--indicated rising corporate commitments. The weak segment continues to be the commercial mortgages, but that, too, was just edging up a bit. I think one of the comments that we sorted out from our contacts with the insurance industry is that they are literally flooded with funds, and one of the problems, I think, is sorting out the extent to which they'd like to invest in high-yield acceptable instruments relative to the amount of money available, and I think they have more money than they see good commitments available. Perhaps it's that interpretation that they are placing upon the flow of funds.

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

MR. WILLES. Thank you, Mr. Chairman. Just one question. When our staff worked through the numbers for this month, they came out in general very close to where you came out. They did place less confidence in consumer spending and more confidence in business fixed investment. I just wondered, suppose that consumer spending was not as strong as you are assuming; would that really do much to your feel for the vigor of the expansion?

MR. KICHLINE. Well, I think the key area of business investment--that's the one that has fooled us for some time. And if we got into a situation where consumer spending slowed substantially, we could find that business investment plans were deferred, and I think that would pose a risk to our forecast.

I might note, though, that in terms of our consumer spending projection, we have looked at that very carefully because it is a place where our forecast differs from a number of outside forecasters, for example. And just to indicate what we have in the second quarter, we've assumed an increase in retail sales in May and June, 1/4 percent each month. That will get us on average something like a 10-1/2 percent [annual rate] increase in personal consumption expenditures this quarter, so we have already seen a massive burst of spending. And secondly, if we move into the third quarter, we have in our forecast a dropping off in consumption expenditures to about an 8-1/2 percent annual rate, so we have allowed, we think, for an appropriate lull in spending. It gets much worse than that, I think. It could well be feedback, at that time, in the business equipment area, which I think does pose a problem there.

MR. EASTBURN. How soon would you think that feedback would come?

MR. KICHLINE. Well, I think, perhaps by later this year. We have raised our forecast for this quarter in plant and equipment expenditures, and I think the third quarter looks very good, given the orders and shipments data. But as you get on into the fourth quarter and early next year, I think that's where you might find something happening.

MR. EASTBURN. What kinds of probability would you assign to that kind of scenario?

MR. KICHLINE. We talked about that--among the staff--and I think our assessment is rather low. But not minimal. I think there is a risk, of course, if consumer spending were to slow and the momentum that we have now in industrial production [were to be maintained],we could find inventory backing up a good deal. And concerns could arise similar to those that developed a year ago.

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

MR. BAUGHMAN. Mr. Chairman, we have no areas of significant difference with the staff's projection. It seems a good a characterization of prospects to me. And I guess it probably comes as no surprise that the President's energy program was received with a good deal of wailing and gnashing of teeth in the Southwest. But that notwithstanding, the onshore drilling activity is moving forward very well. There is literally no idle equipment around, but not enough demand pressure [to drive] up prices yet, at least. But probably the most encouraging element is that contracts are beginning to work down the idle capacity in offshore drilling rigs, where there has been, and still is, a substantial amount of idle capacity.

It seems to me that an area of possible concern are the indications of renewed speculation in real estate. I would be interested in anything John Balles might have to report on what I read about what's going on in California. It seems to me I see just mild indications of that sort of thing going on in some of the Southwest centers, both with respect to residential properties and with respect to farm and ranch lands. And it almost seems to have some of the flavor of people having concluded that money is going to continue to decline in value at a fairly rapid rate. They might just as well get into a margin situation in real estate so long as credit's available.

And thus far, I have seen no indication that the prospect of increases in the cost of fuel are having a locational effect with respect to the areas in which this speculative interest is beginning to appear. That's all I have to say.

CHAIRMAN BURNS. Thank you, Mr. Baughman. Would you--yes, Mr. Balles.

MR. BALLES. Since Ernie has brought up this housing boom situation in California, I suspect I should say a few words on it. It's obviously a very unhealthy development, and I would have to also say it's being somewhat encouraged by all the major banks in California getting into a second mortgage business. That used to be anathema in the banking business, but there is a great rise in real estate values in the residential field because of the population growth limitation on available land, or what have you, in California.

It's not untypical for the prices of houses in suburbs to have about doubled in the last four years. That suddenly gives people a lot bigger equity position, and the major banks in the state are now promoting a second deed of trust at a 12 percent interest rate--take a trip around the world or invest, send your kids to college, or do anything you like with the money. And I am afraid a lot of people are taking this equity out of their present homes and using it for speculation in other houses. We have seen instances in which this has been reported by several of our directors, where, before the builder even has the houses up, he's got all the sales completed, and the minute somebody buys it they can turn around and sell it within 10 minutes at a $10,000 or $20,000 profit.

There's something wrong with the pricing system. The builders themselves aren't setting a high enough price on it. But that sort of speculative bubble is bound to come to an end at some point. And when it does come to an end, there is going to be a lot of lending institutions left with some bad loans. Now, fortunately, some of our banks and some of the S&Ls have taken steps to try to head this off. The Home Loan Bank increased its lending rate by a full percentage point not long ago. Some banks are requiring that borrowers sign a statement that they will occupy the residence or the house that they are going to buy, or not sell, within two years. There have been a number of such statements.

But unfortunately, like shoveling sand against the tides, speculative profits are so large that a 1 point increase in interest rates or the requirement to sign a statement that you don't move out or intend to sell this property or intend to hold it for investment--people will sign those things lying through their teeth. So we don't know quite how to come to grips with it, but it's not a healthy development.

MR. MAYO. I might add, Mr. Chairman, that farmland values and sales prices in the Midwest are continuing up. We have 10 percent higher just in the first quarter of this year. We were expecting that this would level off. This is a 40 percent annual rate--sales are basically at a 40 percent higher price than they were this time a year ago.

CHAIRMAN BURNS. These are very disturbing comments. I am not too aware of the speculation and things going on in California. Which banks are involved in the second mortgages?

MR. BALLES. My recollection, right off the top of my head, Mr. Chairman, is that there is not a single major bank that isn't involved.

CHAIRMAN BURNS. Does our staff know anything about this?

MR. KICHLINE. We're familiar with the housing situation in Southern California, especially, but I'm not familiar with the second mortgage situation.

MR. JACKSON. This is nothing new, Mr. Chairman. This has been going on all throughout the country for the last 10 years or so. Really, consumer finance companies have offered this type of financing. Their experience has been excellent. The last nationwide figures I saw for one of them showed a net underwriting profit instead of a loss. In other words, they had no loss whatever. Many of the bank holding companies have entered into this type of activity through their consumer finance subsidiaries. Their experience thus far has been generally good. I would suspect that if you looked at the actual loan-to-value ratios, you would find that the first and second mortgage combined wouldn't exceed a prudent first mortgage whatever, and probably the combined debt service would not be materially more burdensome than that on a first mortgage at current rates.

MR. WALLICH. Well, I think--

MR. JACKSON. I need to be shown the figures to see that this is wild speculation on the banks' part because it's a practice that's been pretty well known throughout the country in the last 10 years.

CHAIRMAN BURNS. I think I would want to see the figures to see whether it is or isn't. I think we need to gather evidence, and I think our staff should look into this very promptly.

MR. WALLICH. This, I think, performs a function. People have substantial capital gains in their homes. All they get out of it so far, if they don't refinance, is higher taxes, so they actually think they're poorer when their wealth has increased. Their consumption could legitimately rise. So therefore, a question of how soundly this financing is handled--but basically, I think this is a logical and good development, where the financing system fills a gap which so far has not been filled properly--how to cash in on these capital gains that are quite invaluable.

CHAIRMAN BURNS. Why aren't these mortgages refinanced? Why a second mortgage at 12 percent instead of a first mortgage at 8-3/4 or 9?

MR. JACKSON. Because many times the existing first mortgage, which may be assumed or retained, is at such a low interest rate--4, 5, 6, or 7 percent--that the combined total cost of the two produces a lower cost to the customer than a refinance rate at current rates, which now have risen to the 9 to 9-1/4 rate, I understand, out there. Is that correct, John?

MR. BALLES. That's right. The prime lending rate on [mortgages] for good property has gone up about a half point. But in response to your comment, Phil, I agree that there is nothing new in this in terms of the principle. But what is [new] in my opinion is the intensity of the speculation to get amateurs of all kinds buying these second and third houses, renting them out for awhile, and hoping to make a killing. And, you know, as long as values stay up, that's fine, but if the values collapse, [there's] going to be some people unable to service those second mortgages, in my opinion.

MR. PARTEE. Are these real estate loans, John? Do they classify them as real estate?

MR. BALLES. Yes.

MR. PARTEE. So they are primarily secured by the real estate.

MR. BALLES. The second deed of trust. And it's not just the banks, it's the S&Ls, too, that are doing it.

MR. ROOS. Mr. Chairman, I think a similar phenomenon is occurring, as Bob Mayo has said, in bank loans to farmers. These loans are frequently predicated on the value of the land, which has been speculatively bid up terribly and unrealistically high in Illinois and Missouri and places like that. And the farmer's ability to repay in many instances is limited by the income that he can earn off of working that land.

There is an imbalance developing due to the extent of credit the bank is willing to make and extend and the inability of the farmer to work his land in a manner to service that loan, which is really a larger loan than he normally would be entitled to because of the speculative increase in value of the land. If this bubble bursts, it could be terribly serious to the agricultural economy, as I understand.

MR. MAYO. Mr. Chairman, there are two aspects of this farm pricing question. Some of it is accounted for by speculators. A large part of it, however, is accounted for by dollar averaging by the existing farmers who have such a low price basis for their existing farms that they can get their neighbor's farm at a decent price--I should say, even at an inflated price. It still pays them to pick up that property and, in effect, dollar average it in, and they can still make money on that basis.

The part of it that worries me most, though, is those, like [those in] John's statement, who are amateurs in this business. And to the extent that they can persuade farm organizations and congressmen and so forth for greater price supports for aid to agriculture to, in effect, support the value of their farm later on--this is something that isn't too evident yet, but it may be--

MR. BAUGHMAN. It's not evident to the farmers yet.

MR. MAYO. Not as such.

MR. GUFFEY. Mr. Chairman, as an addendum to what Bob Mayo has said, I would also note that this increase in the farm values in our part of [the country] is the support for the bank loan to these farmers and ranchers--they have not sold their crops since '75 and '76--they're in business to put a new crop in. It is a support that permits additional lending to those units.

CHAIRMAN BURNS. Well, I continue to think that this is a disturbing development. When you can pick up a piece of real estate at one price today and sell it at a profit the next day or the next week, you've got a real estate boom that can't last. And the world has had a great deal of experience with that, and I've lived through more than one real estate cycle like that.

MR. LILLY. Well, I think, John, isn't this pretty well isolated down around San Diego, the intensity of this boom?

MR. BALLES. It's more pervasive in Southern California than in Northern California.

MR. LILLY. Even less than Southern California, as I remember your board meeting last week. They talked about how, really, around San Diego--

MR. BALLES. Actually, it's in Orange County [unintelligible], east of Los Angeles, but it's certainly not limited to that.

MR. PARTEE. Well, people offer more money every day for that property down there and [unintelligible]. It must give a sense of speculative opportunity--every day the paper has got a new higher price bid for that urban property.

MR. ROOS. But this is also happening in farm land, a very similar occurrence. It isn't just residential property, that type of speculation. I think the land that Mr. Mayo speaks of has been bid up unrealistically, and it has [been] in Missouri and some of these other areas [unintelligible].

MR. WINN. Mr. Chairman, there is another side of this that I think is sometimes overlooked. We pay attention to the behavior of the stock market, that is, what it does to people's attitudes and their spending plans and so forth. But when we take a look at the financial assets of the consumer, we forget the changes in market value that have taken place in this real estate area. And some of the debt-equity ratios really are quite a great deal better for the time being if you take market values than when you take costs on some of these things. And it affects the consumer's willingness to spend because of the fact that the values have gone way up and [they're used] to borrow again rather than to sell or something of that kind. So there is another side of this value change that I think is important, frankly.

MR. WALLICH. This [is] compensation for the very high rates of interest that people have to pay. Unless the property goes up, there is really no justification [for borrowing], but they are collecting for the interest by remortgaging the property.

MR. JACKSON. To what extent have we seen a growth in the use of margin accounts for personal consumption purposes versus securities purchases? Is there any indication of that--I know there are several plans afloat that would relate the two types of financing so that you could use a margin account for personal consumption purposes.

MR. KICHLINE. I'm not aware of any dollar magnitudes that are available on that. The aggregate use of margin credit has been increasing and is now at a new high level. It's about a billion dollars over what it was six months ago. But I'm not aware to what extent it's to purchase securities as opposed to withdrawing the funds from the account.

MR. MORRIS. I think there has been a good deal of that, Phil, simply because the brokers find that they can offer better rates than the banks, and I think another piece of evidence is that the performance of the stock market relative to the growth in margin credit is much weaker than you would otherwise anticipate.

MR. JACKSON. Well, that's my judgment. It's obvious the money is going someplace.

MR. MORRIS. Because otherwise you've got to assume [unintelligible]--somebody's moving out of the market and allowing the little guy to take it over, and that doesn't seem to fit the facts.

CHAIRMAN BURNS. Well, the last two years have been characterized, by and large, by remarkable [unintelligible] from excesses and speculation. This is the first significant sign that I have heard of and I'd like to see this watched very carefully. And I think that [in any] study that our staff may be undertaking, it would be very useful to comment on this phenomenon in the real estate market, urban and rural, that we have just been discussing, to comment on that in the Redbook. And who's responsible for the Redbook, Mr. Kichline?

MR. KICHLINE. The System Research Advisory Committee.

CHAIRMAN BURNS. Will you make sure that whoever is responsible gets on top of it promptly, and next month we will get reports through the Redbook on this alleged phenomenon.

MR. KICHLINE. All right.

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

MR. BLACK. Mr. Chairman, I find myself in close agreement with Mr. Kichline's assessment of the business outlook, in particular for the outlook in plant and equipment expenditures. I was puzzled about one thing, Jim, on [page] II-15 in the Greenbook, where you have the Commerce Department series on contracts and orders for plant and equipment.

MR. KICHLINE. Yes.

MR. BLACK. The last couple of lines there show weakness of the last two months, February and March--and I'm just wondering if there were special factors in the private nonbuilding area for utilities and pipelines, or something of that sort, that would account for that weakness there. All the other indicators would be sort of strong in the direction you have indicated.

MR. KICHLINE. I truthfully don't know--this is a highly volatile series, as you know. I think that is part of it; the weather effect may have been another. We have also heard at McGraw-Hill that the bulge in March reflected some contracts that were just reaching fruition about the same time, and it may be sort of a lumping problem over the February-March period. But I am not aware of anything. Jerry, maybe you are?

MR. ZEISEL. No.

MR. BLACK. What I'm really trying to get at is whether the nonbuilding part of it--

MR. PARTEE. It almost has to be, if you read that footnote. That's the only thing that isn't shown separately.

MR. BLACK. But I was wondering whether it was just an aberration or whether that could be a weakness that might overwhelm the strength received.

CHAIRMAN BURNS. When I read that table, I was disturbed by exactly the same point. Then I consulted the table on page 12, which seemed to contain a reassuring answer--that is, you find that, according to the latest McGraw-Hill survey, expenditures--plant and equipment expenditures [for] electric utilities are scheduled, if these figures can be trusted, to go up by 21 percent, and for gas utilities by 34 percent, and you find a sharp increase in the estimates prepared in February for those occurring two months later. So it looks like an aberration.

MR. BLACK. Well, that's what I felt. It was because everything seemed to indicate that it might be, but I just wanted to go ahead and take the information on it anyway.

MR. KICHLINE. I'm sorry we don't--

MR. BLACK. Well, I think Chairman Burns has confirmed my feelings about it, by pointing these things out, that's certainly not [unintelligible].

MR. PARTEE. Well, it's also, if you look at the last column there, the year-over-year is much less, possibly, than the other component. The other component would have to be remarkably weak.

CHAIRMAN BURNS. I think this is something that should be looked into. There are margins of uncertainty throughout.

MR. KICHLINE. Fine.

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

MR. PARTEE. Well, I want to return to this question of a possible pattern developing throughout the year. I certainly agree that all of the figures currently look very strong. One can't really find anything--except for the concern about the rate of inflation--to be very disturbed about with the performance of the economy in the last couple of months.

But it is also true, as a number [of us] have pointed out, that the configuration could be something like that of last year. As I recall, retail sales rose strongly in the first few months last year to a March or April point--I would say a decline, although I think there were a couple of months of decline, and then [it] leveled out for the next six months. And it wasn't very long at all before that had a marked effect on inventory attitudes, in particular. And the question is, is there enough strength elsewhere in the economy to offset the possibility of that occurring again, and you have it in a modest degree, in the sense that you're bringing up the saving rate gradually over the next couple of quarters, so your increases in consumer spending are less than they have been running.

But it isn't a leveling off, by any means, that you have. And in that connection, I notice that the March inventory numbers, I think it was March, really were pretty large. Thirty billion or 31 billion in the supplement, and that made me wonder about the first quarter GNP numbers. So far, I guess, we've just had the Commerce preliminary, and there'll be a final or semifinal here in a few days. It could be that that inventory number is already higher than we think it is. Jerry, do you have a view on that?

MR. ZEISEL. Well, yes, there was a very large increase, particularly in retail trading inventories in March.

MR. PARTEE. Yes, but the total is $33 billion; that's quite a large number.

MR. ZEISEL. The $33 billion for total business--manufacturing and trade, the average for the first quarter is about $30 billion. Given the very rapid increase in wholesale prices, our IVA is jumping and now is somewhere in the low 20s, so that it's possible that the inventory figure, as you suggest, may be stronger in the first quarter. I wouldn't expect it to be a great deal stronger. It is a little hard to make out that retail trade inventory figure for March because it comes in the face of very strong growth in sales and perhaps, quite frankly, [is] a bit surprising.

In terms of the point about consumption, Governor, Jim earlier cited the increases that we are projecting for personal consumption expenditures in current dollar terms. I think the story as we can foresee it is even clearer if you look at it in real terms. For the second half of 1977, we're forecasting about 3-1/4 percent real rates of growth for personal consumption expenditures. And that's really quite modest. In terms of the possibilities of a weakening, of course, they are there. And there's a very real concern about that, but we have had fairly substantial gains in income recently; wages and salaries have been rising at 1-1/2 percent per month for the last several months, and that gives a strong basis for continuing growth in consumer outlets. And our judgment is that even with the slowing down of personal consumption expenditures to something like a 3 to 3-1/2 percent rate, there's enough strength evident in the other sectors of the economy to keep the momentum moving at something close to 5-1/2 to 6 percent overall for GNP.

MR. PARTEE. But you do have every line moving up strongly. Except net exports, which moved up slightly; but everything else is moving up strongly in order to give you this 5-1/2 percent for GNP.

MR. ZEISEL. We have business fixed investment certainly moving up strongly. I must say, our assumption about inventories remains approximately what it has been in recent months, to wit, a rather conservative rate of growth. The inventory-sales ratios continue edging off all through 1977, and we just turned them around as we move into 1978. That I consider conservative, given the projection of business fixed investment we have in there. There's generally a buildup of durable goods inventories that is associated with that, and so I think that's a conservative picture. We do have considerable strength in residential construction for the next couple of quarters, but I think that's pretty well in the bag with the kind of increase we've already had in housing starts. So we [have what] I think in those two sectors are reasonable views on what is likely to happen.

Certainly, I think the key to this is really business fixed investment, as Mr. Kichline said earlier; if we don't get the kind of growth that we are now anticipating, then the economy could well falter later in the year. But we have had some fairly good news there. The orders figures have held up well. McGraw-Hill survey figures have come in quite strong, the backlog of orders has begun to build for nondefense capital equipment, so there seems to be a basis for assuming continued growth.

CHAIRMAN BURNS. All right, we will hear from Mr. Wallich now, please.

MR. WALLICH. I wanted to address myself to the same subject as Chuck and look a little farther ahead, if possible. This recovery is now entering its third year, so it's beginning to be an old one, and while there are no clear imbalances--

CHAIRMAN BURNS. An old one with new life.

MR. WALLICH. --a new one, maybe with new life; we certainly wish it a long and happy life. But what I seem to see in the projections is some kind of a rolling readjustment, with some things losing strength and other things therefore necessarily being relied on to gain strength if the expansion is to continue. So if housing were weak--you've still got it very strong, but you've got good reasons why it should come down: flows of funds, interest rates. Consumption has carried this expansion for a long time, autos have been very important in it--we could easily, with the savings rate rising, have some slowing there. And government, while scheduled to be strong the next couple of quarters, also into 1978 tapers off.

And what we have is businesses fixed investment hopefully coming along and the very strong inventory numbers in the middle of 1978. Those are the two big elements of the strength. Both are not assured. It's conceivable that one could have a cycle without an investment surge, and it is conceivable that that cycle can peter out without ever reaching a credit climax. At any rate, I think what one has to accept is that the elements that are carrying the thing forward are changing guard. And what's carried it so far will probably be relieved , in the next quarter or two, by some of these new forces, if things work out right.

MR. PARTEE. But there could well be a pause there; you mentioned new cars. I recall 1955 as a year in which new car sales were extremely strong for a while, and when they fell off, why there wasn't really anything. Well, the economy continued all right, but there was a pause in the sense that there wasn't anything to take their place.

MR. WALLICH. In those days I think your report, Mr. Chairman, called it a rolling readjustment, and [it] went from one sector of strength to another sector of strength, and so there was hope the business cycle had been overcome.

CHAIRMAN BURNS. As I remember that period, you had a decline in automobile production, and that was accompanied by a decline in homebuilding, and those economists who look upon those two industries as dominating the economy were crying, "We must have a depression, it's coming immediately." Eventually they were right, but we had a considerable period of expansion with these two factors of the economy moving down and other factors compensating for that decline.

MR. WALLICH. Right, there was a real sequence, first housing in '54, then cars in '55, and plant and equipment thereafter, so it was really going from one support to another. It's just a question of whether these things will always show up in time.

MR. COLDWELL. Jim, what's your balance between industrial production and inventory gain? You've had about a 2-1/2 to 3 percent increase in industrial production, first quarter, and I noticed looking down here that, taking off from the third quarter of 1977, our industrial production growth--7.8, 8.8, 9.0, 10.1--a steady rise throughout this. Is this balanced between industrial production and inventory?

MR. KICHLINE. I think the gains in industrial production--I don't have the numbers right handy--were stronger through the first quarter on average. I think it is closer to 5 percent. And given the strong surge in sales, the inventory numbers that we have, and what we would anticipate for the second quarter, much of the production is going into final consumption. It is not showing up in inventories.

Most recently, in looking at the industrial production index, there has been a pickup, however, in nondurable goods supplies, materials and supplies, and so if you look back in terms of stable processing, we're getting a buildup there, which will feed through. And I think that's where the inventories are now concentrated; it's in its early production process. And I would not view the current numbers as being out of balance. Jerry, would you have a comment?

MR. ZEISEL. No, I think, Governor, that you were making a valid point in the sense that there is a somewhat closer relationship between the growth in industrial production and real final sales than between industrial production and, let's say, the commodity portions of GNP at the moment, because of the relatively sluggish growth in inventories. We expect that industrial production will be rising relatively more rapidly in GNP later on as we start building inventories. The relationship is really quite close over the last couple of quarters, but by late this year, we expect growth rates of industrial production in the 8 to 9 percent range as inventories are built.

CHAIRMAN BURNS. I wonder if it's inventories. I wonder if inventories are the reconciling factor or the expenditures on services.

MR. ZEISEL. Well, I--aren't they really basically the same?

CHAIRMAN BURNS. You and I are not on the same track. Go on, just elucidate your thought.

MR. ZEISEL. The balance of gross national product has been heavily toward services, in part because of the lack of investment in inventories. If there were more rapid rates of growth of inventories, that sector of the economy would be growing somewhat more strongly, and so the balance between services and goods would be somewhat more normal than it's been recently.

MR. COLDWELL. You lost me a little bit on that last comment.

MR. PARTEE. Inventory to services--

MR. COLDWELL. Well, I understand that. Coming back to the inventory question, though, I'm just a little bit puzzled. Jerry, if you take an early inventory buildup in nondurables at the manufactures level, which I believe is what Jim said, do we have enough track record to call that a forecasting development to [an] enlarged total inventory, and does the balance between your industrial production, with that track record, give you pause for thought? An inventory cycle question.

MR. KICHLINE. I think it depends very heavily on one's expectation for sales and--

MR. COLDWELL. But you said yours was going down.

MR. KICHLINE. That's right, but the inventory growth that we have projected is really quite moderate relative to sales, so we still have in our projection, in each of the four quarters this year, a decline in the inventory-sales ratio.

MR. COLDWELL. That's exactly my point. That's where I think I get off the track--I think that the inventory-sales ratio either should level off or go up. If sales weaken and you continue your industrial production--

MR. KICHLINE. Well, the arithmetic, I think, is correct, so what one has to focus on is the two parts of that ratio. Either you get a faster increase in production--a buildup in inventories--or alternatively, sales don't keep pace and production adjustments come along with a lag and you get this buildup in the ratio because sales tend to falter while production is still roaring along. We don't have that in our forecast; it's one of those things that obviously could happen, and it did, indeed, happen last year.

VICE CHAIRMAN VOLCKER. You do have a rapid increase in the inventory-sales ratio in early 1978?

MR. KICHLINE. Right. It's in the first quarter, I think; it begins to turn around, and in the second quarter of 1978, we have it bouncing up.

CHAIRMAN BURNS. Well, Mr. Eastburn.

MR. EASTBURN. I'd like to come back again for a minute to this question of a possible lull or rolling readjustment. We've been talking about this, too, and I think the probabilities that I would assign would agree with the ones that you have. At the same time, I've been concerned about the possibilities for further price increases. And I'm just wondering whether some kind of a rolling process, as long as it doesn't adversely affect the capital goods area, might not be just what we need, in terms of the price pressures we might be experiencing later on this year. Would you think that if those probabilities were to materialize and we were to have something like the situation that we had a year ago, that this would have a material effect on the price changes?

MR. KICHLINE. If we had something like we had a year ago, I think we'd be talking about significantly less real growth in total. And I must say, personally, I'm getting a bit discouraged with the behavior of markets in terms of pricing behavior relative to the strength of markets. I think increasingly, the staff is convinced that transactions prices in many areas are differing from list prices, and that's in part confusing the situation, in that many industries are attempting to push through price increases at every opportunity. And more recently, we have had reports that, with the pickup in demand in certain areas, there's been a very rapid increase in prices, but at the same time, it has not been affected in terms of the actual transactions prices.

And so it's not at all clear to me--the impact of this so-called rolling readjustment on actual transaction prices. I think that it could well be that you begin to get, in some areas like capital goods, some price increases that we haven't seen yet because there hasn't been a good deal of strength. In other areas, it may well be that list prices don't change very much, so that the indexes as they measure prices perhaps are giving us a poor reading.

It certainly can't hurt; it runs in the direction of lessening price pressures. I think this is particularly important in the housing area, which is the one place where we have heard reports of potential supply problems with wallboard, insulation, that sort of thing. So with a slowdown in housing for example, I think it [unintelligible] the price problem--

MR. PARTEE. But your overall industrial utilization figures are not so high until you get into next year, I think by the middle of '78. That's a pretty high number.

MR. KICHLINE. They get in to the 85, 86 percent range.

MR. PARTEE. A lot of inventory accumulation, and then an 86 percent capacity utilization rate. But for the time being, you don't have that overall utilization pressure. And what Dave said occurred, you have to remember--the effect would be a higher unemployment rate. In other words, if there were slower real growth. And the question is, What would be a congressional response to the higher unemployment rate?

MR. EASTBURN. Well, the irony of it would be, Chuck--and this was the thrust of my question--that you might suffer a higher unemployment rate and still gain no ground on the price front.

MR. PARTEE. You might, yes.

CHAIRMAN BURNS. You sound like a very discouraging lot. We seem to be looking for trouble. Speculating about possible sources of trouble. Why don't we look for possible sources of price stability, possible sources of encouraging, balanced economic growth? Mr. Kimbrel, perhaps you'll supply that function.

MR. KIMBREL. Well, Mr. Chairman, indeed, in our area, we are hearing an awful lot of very happy news. Everything is relative, though, I guess. But I was concerned at our breakfast meeting last Friday and in some of our sessions very recently with businessmen that, for the first time, we've been observing purchases anticipating high prices or anticipating the possibilities of some slow deliveries. I wonder if you are observing this in other areas.

MR. KICHLINE. Jerry, would you--Jerry has been watching this particular situation.

MR. ZEISEL. There hasn't been too much; there have been some reports in that direction. We don't have very great quantitative information, but you have the reports of purchasing agents, which seem to be fairly concrete, and there has been some tendency in that direction, but nobody is complaining very greatly yet, as far as I can tell.

MR. PARTEE. From deliverywise?

MR. ZEISEL. Deliverywise.

MR. KIMBREL. You would not assign a great dimension of current purchases against borrowing from the future.

MR. ZEISEL. On the part of consumers or on the part of businessmen?

MR. KIMBREL. Well, businessmen.

MR. ZEISEL. It's a little hard to evaluate since we have no real concrete information. But it would seem to me that, given the generally available capacity and no significant indications of shortages in the immediate future, I wouldn't think that there would be too much stockpiling except as you suggested, some possibility of anticipating further price increases.

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

VICE CHAIRMAN VOLCKER. I don't know whether I want to add a great note of cheer around the table, Mr. Chairman. I came in feeling somewhat the way Mr. Winn started us off with, maybe a little more reason for uneasiness about the pattern over time. I think our basic forecast is a little stronger in the short run and a little weaker as time passes. There seems to be something--I don't necessarily have a better projection to offer--but something inherently improbable about the inventories proceeding quite so smoothly as the staff has it here, with steady increases through the next four quarters. I would think that might come a little sooner in terms of big increases and take some of the strength out of the latter quarters. As I listen to this conversation, this kind of uneasiness gets reinforced, and I do have a feeling that maybe it's going too far. I don't necessarily anticipate quite as smooth an advance as has been presented by the staff this morning. I'm not sure--

CHAIRMAN BURNS. Let me just say a word about the staff. Chances are that members of the staff have thought of many of the uncertainties that have been mentioned around the table, but they don't know how to translate that into numbers over time, so they have a smooth--

VICE CHAIRMAN VOLCKER. That's right, that always happens in forecasting, and I sympathize.

CHAIRMAN BURNS. If I may say--add another word--I have the feeling that this is true of much of mankind--it's certainly true of this Committee today--we do a constant amount of worrying. We don't have real problems to worry about, but we'll still worry, and we will create problems.

VICE CHAIRMAN VOLCKER. I agree with all that, but I still have a little more worry. Not quite as much as the general tone that's emerged. Yes, I think for the first time, maybe, in this expansion you can begin pointing to some things that could develop in an unsustainable way over time. But maybe the most serious thing in the background is, I don't like the way prices, and particularly costs on the compensation side, are developing. They are not developing as smoothly or as optimistically as I thought some months ago. And I do share the comment that Mr. Kichline made in that respect just now, that my earlier optimism on that score is being somewhat eroded. I don't think it is a good thing, in a vague way, looking out [to] the expansion a year from now. But also, it has interesting implications for how you handle this in terms of policy. This is a main source of concern.

CHAIRMAN BURNS. Perhaps the only word that I can add to this discussion is that, we are having, I think, a very normal expansion. That's all that I see, with all the uncertainties--prices accelerating, and there will continue to be surprises--but I see nothing abnormal about the expansion so far.

The one disturbing thing that I've heard was what Mr. Balles developed, the facts that he presented, and then Mr. Mayo, Mr. Roos, about farm real estate values. That's something that doesn't develop on a significant scale in every business cycle expansion. And when it does, yes, it will go for a while, but it carries the seeds of trouble, and therefore, we will have to watch that carefully. Who else would like to speak now on the state of the economy?

MR. PARTEE. May I ask, that first-quarter compensation increase had some--was more--and perhaps you were referring to that, Paul, about the faster compensation rates. But that had some special factors in it, didn't it?

VICE CHAIRMAN VOLCKER. Well, the first quarter was certainly more, but if you just look at the projections beyond the first quarter, it is also more than it was last year, although not as much as the first quarter.

MR. PARTEE. Are we seeing a speed-up in the size of contract settlements or nonunion wages? Are they accelerating? Is there anything detectible as yet in the figures on that?

MR. ZEISEL. It's a mixed picture. I hate to use that phrase, but it is. You mentioned the contract settlements in the first quarter. They were not out of line with what we had been having through 1976. But there has been a distinct speed-up in average hourly earnings, and we think that this is a function in part of the composition of recent employment growth being oriented toward high-wage industries, which happens to jack the figures up. But also, there are hints that earnings may be rising a little more rapidly than we thought, and we have built in a slightly larger projection of compensation for 1977 this time than last. It's about 3/10 more.

VICE CHAIRMAN VOLCKER. It discourages me about this a little bit more. One more comment on this point, purely a qualitative reaction. The more time passes, businesses seem to take it more and more for granted that you give a 9 to 10 percent [compensation] increase, and we don't even raise much question about it. It's the normal, expected way the economy works these days. It seems to be part of the mentality. I don't know how you get out of this syndrome.

MR. GARDNER. Just a question, Jerry. What does the staff think about the proposal to increase Social Security withholding applied solely to the employer?

MR. ZEISEL. It's going to be expensive. Obviously that goes directly into labor costs. The proposals, which carry through over a number of years and eventually involve no ceiling on employer contributions, run into a fair amount of money. We have some rough estimates of the amount. Most of that is far off, several years from now. The adjustments that we've already had are fairly significant; let's see--

MR. PARTEE. It must be at least 1 percent of payroll.

MR. ZEISEL. It runs above 1 percent of payroll, Governor. I think, if I remember correctly, the adjustments run 1, 1-1/2, and 2 percent of payroll over three succeeding years.

CHAIRMAN BURNS. Well, I hate to join the questioners and doubters, but I have to at this point. Not so long ago the Administration made a proposal to its Congress, namely that business firms be granted a tax credit in the amount of 4 percent of their payments on account of the Social Security tax, and this measure was described as an employment stimulating measure. This was a minuscule reduction of taxes for business firms, and that minuscule reduction was designed to increase employment. And now we have a massive increase in taxes on employers proposed by the Administration, and not a word is said about the effect that that may have on employment.

MR. PARTEE. Oh, no, no, on the contrary. The Secretary was asked about that, and he said that it would have no effects on employment. And then he was asked about the effects on prices, and he said it would have no effects on prices. And the reason is the business would absorb costs.

CHAIRMAN BURNS. That hardly improves the thinking process that is going on in this area.

MR. KICHLINE. Mr. Chairman, we have an explicit estimate of the Administration proposal. Governor Gardner, [for] the first quarter of 1979, which is when it will become effective, our estimate is that it will add 1-1/2 percentage points annual rate to total compensation, 2 percentage points in the first quarter of 1980, and 2-1/2 percentage points in the first quarter of 1981.

CHAIRMAN BURNS. You know, if I were a businessman today, I think I would be bewildered. Here you have something called an energy policy, and this energy policy contains the most massive tax bill ever presented to Congress. With taxes running up, money being taken out of one set of pocketbooks in the amount of perhaps $70 billion per year by 1985, and the money going elsewhere--it isn't at all clear into which pocketbooks that money would go. And also the Social Security tax and the rebate one day and down the next day.

I think I'd be a little confused, and as a businessman, I think what I want--and Dave, I'm looking at you to refute or confirm what I'm saying--I think I could live with a tax gain within broad limits, aggressive, encouraging, mild--but I need stability. I'm not getting much stability in the area or I'm thinking about the tax area and I think I would find that very disturbing if I were a practicing businessman. Am I making sense?

MR. LILLY. Well, if you will remember when you were talking about a speech you were giving on this subject, I suggested you say that, until we have an energy policy, there's more uncertainty than ever. And the minute that all of the proposals have gone to Congress, we have had some kind of a policy--I guess you'd call it a no-policy policy--on energy. Now we have a series of proposals for a policy which is adding even more to the confusion, and until the Congress works through the package, the uncertainty is going to be higher, and that's why I thought it was appropriate that you suggest to the Congress that they hustle the thing along.

There is a great deal of uncertainty right now. However, people are also feeling very good. I'm a little surprised to find this group feeling as somewhat depressed as it is. All of the directors meetings that I've been to around the country have been uniformly bullish. I went down to the Business Council meeting last Friday, and other than this squabble with [special adviser to the President on energy, James] Schlesinger, they were very bullish. I'm concerned that there may be too much bullishness in the air, and I'm concerned about some lag effects in what's happening in the interest rate structure.

CHAIRMAN BURNS. All right, thank you. Mr. Guffey, you will now speak.

MR. GUFFEY. I can only observe--the philosophy of these meetings seems to be, if things are going well at the present, the meeting gets longer because of the [unintelligible]. And I would suggest, as Chuck has mentioned earlier, we have had rain in the Midwest--spring has arrived, the sap is rising. There is an increased demand in the recreational areas of Wyoming and in Colorado for condominiums, which is something we have not seen over the last two or three years.

And another sort of interesting thing that's heard--the announcement of the energy package or proposed legislation has apparently not deterred those looking for gas and oil drilling operations, because the loan demand at the banks has continued to increase, even in view of the supposed uncertainty. Now, whether or not this was something that was in the pipeline before and is just now being taken down, or whether these people are just overlooking the uncertainties that hinge on the policy is not clear. But it is going forward; the drilling is accelerating in our part of the country really nicely. Things look good in the western part of the Midwest.

CHAIRMAN BURNS. Gentlemen, I think this is a very good time to stop our discussion on the state of the economy. Mr. Sternlight, would you like to report on operations of the Desk?

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

CHAIRMAN BURNS. We'll continue our deliberations and go along with Mr. Axilrod's statement. Mr. Axilrod.

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

CHAIRMAN BURNS. Thank you, Mr. Axilrod. We are ready now to discuss the reports by Mr. Sternlight and by Mr. Axilrod. Mr. Coldwell?

MR. COLDWELL. Mr. Axilrod, in forecasting the aggregates over the remainder of May and early June, my recollection is that you are looking at about 4 to 5 for May and 1 to 2 for June. Does your cutback reflect the idea that April is now explained at least partly in a seasonal, or is this a stock and flow concept--there's enough in the hands of the consumer to do what he wants to do over the next month?

MR. AXILROD. It's the latter, principally, Governor Coldwell. There's enough in the hands of the consumer now, or in the public, generally financed in the second quarter transactions. Our second quarter growth rate, as I mentioned, is still a relatively high 9-1/4 percent. So we have not assumed that, say, a half or even two-thirds of that April growth was money that was going to be offset by negative numbers. We believe, or I believe in any event, a large part of that reflected the strengthening of the economy and will be reflected in the higher growth rate in the second quarter, and increased velocity.

MR. COLDWELL. Well, I may be missing something in the rationale here, but see if you can help me. If this is a position in which sufficient [funds have] been created now to handle the second quarter's expenditures, and we still get further enlargement of the recovery and growth in the economy, presumably creating additional funds--yet I believe I heard you say that you are going to have a further slowing of the time and savings deposits. Now what am I missing, if the time [and savings deposits are] going slower and the demand [for them] is going slower.

MR. AXILROD. We're not expecting--I was trying to explain the behavior of time and savings deposits recently. In April, there were both special factors as well as, I believe, shifts to demand deposits for spending purposes as well as direct use [of the original demand deposits] for spending purposes. We're actually projecting some pickup in the rate of growth of time and savings deposits, but not at a rate as fast as occurred in the first quarter. A slower rate of growth, but a pickup from the pace of April-May.

MR. COLDWELL. [Does] your forecast for these various alternatives range no higher than 8 percent for M2 and go as low as 2-3/4 per cent, depending on the alternative selected?

MR. AXILROD. That's right.

MR. COLDWELL. Now, that to me sounds like you're still slowing this time and savings [deposit] package.

MR. AXILROD. Well, we're getting a very low growth rate in May because of the pattern. We had a jump up in the beginning of April, it's been very stable through the first week in May, and then we're beginning to pick up the rate of growth in May. But that gives us a very low growth rate in May as compared with April, and then you get a rather more normal growth rate appearing in June. And so when you average the two months together, you do come out with a low growth rate for June, as a rather more normal growth rate for the time and savings deposits on the order of around 10 percent, whereas May is an abnormally low growth rate, on the order of around 5. We are projecting a pickup.

MR. COLDWELL. I won't take any more of the Committee's time Mr. Chairman. I don't quite understand the figures with what I've heard when you look at the forecast of the June rate on M2 at 6 percent. But on the second sheet, page 6, on the alternatives [unintelligible].

MR. AXILROD. Well, you see, that goes with a 1 percent M1, and so your time deposits would be on the order of 10 percent for another month.

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

MR. PARTEE. I had two questions. First, Mr. Sternlight, as you stated in your review, the adjustment in the market [to] the changes in observed Federal Reserve policy was remarkably, extraordinarily smooth. Would you say, Peter, that it's completed? That is, would you say, since it was so smooth, is it still partial? Or, say that the federal funds rate stayed in the 5.25 to 5.30 range, where it's been trading--do you think the market adjustment was not--

MR. STERNLIGHT. I think the adjustment to that 5.25 to 5.30 or--

MR. PARTEE. --or 5.35--

MR. STERNLIGHT. --area, or something like, has been completed.

MR. PARTEE. And that involved an increase in bills from about 4.40 to about 5 percent?

MR. STERNLIGHT. Thereabout, 4.50 to 5 percent.

MR. PARTEE. --4.50 to 5 percent. Which brings me to my question to Mr. Axilrod. Now this last 50 basis points in bills was really not a segment of the [interest] rate range competitive with thrift institutions and time and savings deposits. If you have another--and I guess this is sort of like Phil's question--if you had another 50 basis point increase, it would be a much more sensitive increase wouldn't it, from the standpoint of limiting growth in time and savings deposit forms? I think you made that comment in the Bluebook, but you didn't dwell on it in here, in your oral comment.

MR. AXILROD. Well, that's essentially why, under alternative C, which assumes another 50 basis point increase in the funds rate and approximately that in the bill rate, that we have a somewhat more substantial slowing in M2 than we would ordinarily have in comparing two alternatives. And our thought was that you would force out a considerable amount of the hot money, in effect, that had been put in savings deposits as the rate gets significantly above the ceiling rates of 5 and 5-1/4 percent. And a large part of that money would flow into Treasury securities. Some of it might flow into large nonnegotiable CDs that would have no effect on M2, but some of it would also fall into Treasury securities, so we would expect a more substantial one-time reaction in time deposits.

MR. PARTEE. And that could be even more so, I suppose, Steve, because we have a larger proportion in time and savings deposit form now that are really sizable sums. I happen to divide our categories in savings and time deposits between the consumer type and business or institutional type, and the consumer type has held up very well through April. The cumulative increase in consumer-type savings and small certificates is at a 10.6 percent annual rate through April. Whereas the other, the residual, that includes large nonnegotiable CDs and things like that, has dropped off from a 20-25 percent rate earlier to a cumulative of only 9 by April.

MR. AXILROD. I might add, Governor Partee, if we are right and you don't get an offset in some other components of time deposits, this effect I think would be temporary, and you would return later to a higher growth rate even at the higher level of interest rates because you would have just removed--

MR. PARTEE. You have a stock adjustment.

MR. AXILROD. --you would have removed a stock of hot money; that's what we are assuming. So therefore, that's why we suggested a 3/4 point drop in the alternative C range for M2 relative to alternative B, to accommodate that stock adjustment without having to make a policy move.

MR. PARTEE. And what that's associated with is another increase in the complex of market rates of about 50 basis points.

MR. AXILROD. In effect, to moving the Treasury bill rates, obviously, well above the passbook ceiling rate. On an investment yield basis, it's above the commercial bank ceiling rate right now, of course.

MR. PARTEE. Thank you.

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

MR. BLACK. I'd like to ask Mr. Sternlight--Peter, a couple of things impress me about the behavior of the financial markets since our last meeting. One is that most rates, and long rates, of course, in practice have moved up less than the federal funds rate. The other is, you've had some little strength in the stock market in the face of an increase in the prime rate. And I'm wondering here, and this is a very hard question to answer, do you read into this any feeling on the part of the market that inflationary expectations have diminished at least temporarily, [any] feeling of relief that we have provided evidence that we are moving to stem inflation?

MR. STERNLIGHT. I think that some market participants would take some comfort in observing that the System has moved to counteract that burst of growth in the aggregates. I don't know if I'd want to go further than that, as to saying that inflationary expectations are significantly diminished, because the markets were also getting evidence through this period of continuing price increases.

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

MR. EASTBURN. Steve, you mentioned that you've revised your interest rate forecast upward. One of the things that we have been doing regularly once a month is to look at the interest rate patterns to see what this tells us about expectations and forecasts for interest rates on the part of the market. And, with the exception of one month, the market pattern has consistently forecast lower interest rates than the Bluebook has expected. Do you have any feeling about what that means? The only thing that occurred to us was that the market may believe that we're going to be more liberal with the aggregates than in fact we think we are going to be.

MR. AXILROD. Or the market may have a weaker economic forecast, more obviously. We do check our forecasts against what's in the futures market, and what's implicit in the yield structure--both. And at the time we were making the forecast, the three-month bill rate in the futures market, by the first quarter of '78, was being forecast at 6-3/4 percent; by the second quarter, around 7. And implicit in the yield structure, it was being forecast around 6-1/4 percent. So you are about 1/2 to 1 point, roughly, below what we would expect a three-month bill rate to be at that time. But I have no way of knowing whether it's a weaker economic forecast, or a higher money growth forecast, or just sheer hunch. I just literally couldn't quantify that.

MR. EASTBURN. Have you ever gone back to check the accuracy of these two methods of--

MR. AXILROD. No, I haven't, but I'd say it was a good thing to do. I think we will.

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

MR. JACKSON. Steve, in view of your flow of funds projections and the general scenario painted in the Bluebook, what do you see the yield curve doing during this next six to nine months? Is it going to get significantly flatter, or are long-term rates going to react upward, where you continue to have a significant disparate view between short and long term? Or what's the general scenario you are expecting to pull out of all of this?

MR. AXILROD. I believe that if short rates go up over the next several months, roughly the order of magnitude that we projected or a little less or a little more, that you'll have not very large effects on long-term rates on average. Any time that the short rate begins to move up, we'll have an expectational effect, or just an adjustment effect, then it might ease off a little. So I think the yield curve will follow something like the normal cyclical pattern, that it will tend to flatten. And of course, in saying that, I'm making an assumption that any tightening that develops will be of a kind that restrains inflation and not merely an increase in rates that is reflecting an inflation that is, as it were, pulling the rates up. If you're in that situation, then I think that long-term rates would move up rather sharply.

MR. JACKSON. Does that tie in with the flow of funds projections that we've got?

MR. KICHLINE. Yes, they're consistent. We have a fairly easy corporate bond market. We've got a lot of institutional money around, and some drop-off in corporate bond market borrowing. Our explicit forecast of a corporate bond rate is, by the end of this year, to the 8-1/2 percent area, which is only up about 1/4 point, so you do have a substantial flattening in the yield curve as you go through the year.

MR. AXILROD. I would like to point out, Governor Jackson, because I think it's a very critical point, that if you think back to '74, while the yield curve flattened, there was a sharp tightening in the money market partly because of how sharp the rate of inflation became, and so you did get a very sharp rise in long-term rates at the same time. And I'm assuming that the restraint on the aggregates, if that develops, would be sufficient to keep the rate of inflation from accelerating significantly.

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

MR. BALLES. Just a comment on the Board staff forecast, Steve, of M1 and M2. My staff's been keeping book on the accuracy of these things and found out something rather interesting, I think. In the first place, we always filter out the noise in the week-to-week series, as you know, by using these 13-week moving averages, and we incorporate your forecast numbers into our moving average. But for the first quarter of this year, it was quite significant, we thought, that the accuracy of the M2 forecast that you have was considerably better than that for M1. Specifically, for the first quarter, the average error in the forecast of [the] M1 average is at about 1/4 percent [relative] to the actual level of the aggregates, but for M2, only 7/100 percent. Now, so far, we haven't gone back earlier than the first quarter of this year; perhaps you have. I wonder if you would comment on any impressions you might have on the accuracy of these forecast numbers which, at least at the moment, seem to indicate that a better job is doable on M2 and not M1.

MR. AXILROD. No, I don't have any good feeling of the last year. And I think that we will go back and assess both our interest rate forecast in line with President Eastburn's suggestion and our M1 and M2 forecast. As you know, we reassess these things periodically and have normally found that there is somewhat less error in the M2 forecast because you do have some offsetting shifts between demand and time deposits that help you, and it's a larger number, in a sense. If our error is, as you have noted, 1/4 percent on M1, it's got to be the lowest in history.

MR. BALLES. That's on a moving average.

MR. AXILROD. That's why we would have--

MR. PARTEE. And it didn't include April.

CHAIRMAN BURNS. Any other question or comment? Well, if not we still need to act on the activities carried out at the Domestic Desk. Is there a motion to approve the transactions of the Desk.

SPEAKER(?). So moved.

CHAIRMAN BURNS. The motion has been made and, I take it, approved. We're ready now to turn to monetary policy and our domestic policy directive. I think in some ways our task today is an easy one, and in other ways it's somewhat puzzling. I think our decision last month was certainly in the right direction, and I think it's been carried out well at the Desk. And we're in a stronger position than we were a month ago.

But when I look at the several alternatives for M1 on page 5 of the Bluebook, I'm a little puzzled. Take for example, the figures under alternative B. Well, now, suppose that the rate of growth for the May-June interval of M1 was as low as 1 percent. Then, to be consistent with that, as indicated in this tabular construction, the federal funds rate would need to be 4-3/4 percent. I think it would be a great mistake to move down from the present level--which is, I think, a little closer to 5-3/8 than it is to 5-1/4--back to 4-3/4, if we had 1 percent [growth of M1]. I'd say the same if we had a figure of zero. I'd say the same if we had a figure of minus 1 or minus 2. At some point, I would stop saying this, but you see what I'm getting at. We ought to be willing to tolerate an extremely low rate of growth over this two-month interval without having the federal funds rate decline at all appreciably.

Now, that leads me to feel that the lower limit of the federal funds rate ought to be 5 percent, or preferably 5-1/4 percent. And that we might have a narrow range for the federal funds rate, say 5-1/4 to 5-3/4 percent--the Desk staying at the present level, and then moving to one direction or another within that narrow range, depending on how the rate of growth of the monetary aggregates develops.

Now as for the rate of growth of the monetary aggregates, I think I would prefer the figures under alternative C more than the figures under alternative B. Actually, the figures that I would suggest that the Committee consider are as follows: zero to 4 percent for M1, 3 to 7 percent for M2, and perhaps 5-1/4 to 5-3/4 percent for the federal funds rate. There may well be inconsistencies that we would need to consider, either through a special telegram from the

Chairman or through a telephone conference. Well, let's hear from members of the Committee. Mr. Coldwell, please.

MR. COLDWELL. Mr. Chairman, you started taking my speech away. I was going to suggest a 5 to 5-3/4 with a 5-1/4 to 5-3/8 midpoint, and 5-3/8 happens to be the midpoint of 5 to 5-3/4. And I was with you until you started talking about the aggregates. At that point, I dropped off the list because I'm a little bit hesitant about some of the forecast on this. I'd take the M1 forecast of 1 to 5. I'd prefer M2 of 4 to 8 because I suspect that we are going to get some reactions in this picture ahead. I, too, am not willing to give up what we've already had, but I don't believe I want to say that if the thing comes in at below zero, I'd be unwilling to lower the funds rate target. We need to be flexible on both sides. We reacted to a very high April. You get a very low June, then I think we ought to have some reaction to that. But that kind of a construct sounds perhaps equally unbalanced to yours, where you took the alternative C and I took in effect, alternative A, to some extent, although I didn't go that far.

CHAIRMAN BURNS. For purposes of clarification, I made some introductory comments first and then suggested some numerical specifications. Taking my numerical specifications, you see--zero to 4 for M1, for example--if a negative figure for M1 developed, and assuming that there was no counterindication arising from M2, then an inconsistency would emerge that would call for special action by the Committee. All right, let's hear from Mr. Willes first now, please.

MR. WILLES. Thank you, Mr. Chairman. Last month--which, of course, was my first meeting--the Committee was very cautious in approaching policy. And I suspect that was, as you indicated, very prudent in light of the uncertainties that the Committee faced. But I, for one at least, feel much less cautious today than I was inclined to feel last month. Most of the uncertainty relating to the energy program seems to be uncertainty as to what would get passed rather than how much of an impact it would really have on business spending. None of the businessmen in our District really are changing their plans or have any inclination to change their plans. The underlying economy is strong and seems to be getting stronger each time we look at the numbers, which raises again the threat of increased inflation. The international situation would seem to call for a very careful management of the expansion in the economy. And I was interested in Paul Volcker's comment about how do you change people's willingness to grant large wage increases, and there has been a feeling that there's nothing you can do about that.

But I guess I'm not persuaded. In Philadelphia, they've just had a very serious transit strike. A statement made by city government at one point was, we're just not going to give you any more money. They went out on strike for a long time and finally settled for no more money. And then the next group that came in to settle after that, settled at precisely the same rate.

CHAIRMAN BURNS. Well, that must have been [a matter] of financial stringency--we don't have more money to give you. Now, to the extent that business firms are in the same position, they can hold out also against large wage demands, but you need a little adversity to produce that result.

MR. WILLES. I think that's exactly right. And that's my point. I think if businessmen think that every time there is a little adversity, whether it's an increase in the Social Security tax or something else, and we are going to bail them out with monetary policy, they've got no inclination to stand up. But I get the impression from many that I've talked with that they think we are serious about combating inflation, and they think that's very good. They're looking for that kind of support and strength in the actions that they are taking.

Well, given that, I would have a preference for taking a fairly significant step toward moderation in the rates of growth in the aggregates. And even though I'm currently trying to negotiate for a mortgage, and this is probably not in my self-interest, I would not be at all averse to seeing interest rates increase. I think the numbers that you have come up with in terms of the aggregates are certainly fine. It would not disturb me if we had negative growth in M1. I guess the only concern I would have is whether--well, I don't really understand, I guess, the way the Desk works. The range 5-1/4 to 5-3/4, I wouldn't be at all concerned to see it go up to 5-3/4, but I get the impression that you only use the upper portion of that range if the aggregates are growing more rapidly than these numbers would suggest and so on.

CHAIRMAN BURNS. No, if--let's take, just for purposes of illustration, a range of growth of M1 of zero to 4. And let's ignore the fact, for purposes of this illustration, that the Desk gives equal weight to M1 and M2. Then, as 4 was approached, the Desk would be moving the federal funds rate toward the upper limit of 5-3/4.

MR. WILLES. I see, okay.

MR. PARTEE. Or vice versa if it's toward zero.

MR. WILLES. All right, that's a little different than my understanding, and that helps. I guess, if anything, I'd be inclined to go 5-1/4 to 6 just so the Desk did feel willing to move fairly aggressively on [the] interest rate. The only other comment I would make is that, in addition to these steps in terms of open market policy, I would think that, fairly quickly, we might want to consider an increase in the discount rate, and I know our own board of directors is becoming increasing inclined to move in that direction.

CHAIRMAN BURNS. All right, Mr. Willes. Mr. Eastburn now, please.

MR. EASTBURN. Well, I would agree essentially with the staff's projections on the economy, with the possibility that we will be seeing a slowdown in the latter part of this year. And as I indicated earlier, that might not be too undesirable. So I approach this session with two main points of view. One is that we should be seeing adjustment toward our longer-range targets for the aggregates, and that requires a small increase for this two-month period. Second, that unless unusual developments occur, the funds rate should not decline. So I like your specifications, Mr. Chairman. I think that I would be reluctant to see a significant negative figure for the two-month period because, if May comes in at 5 percent, as now forecast, that would imply a significant decline for June. And I'm not sure that I'd like to see a very large decline--

CHAIRMAN BURNS. Well, you say it would imply a significant decline for June. If May, I think our staff in that event would be revising the figure for June. Isn't that correct?

MR. AXILROD. Yes, if May were coming in weaker, we would of course, begin writing down June right around that time, so that both months could in effect be quite weak. Something like that. There could be a large negative in May, even a small plus for June; you can't tell quite how the pattern would come.

MR. EASTBURN. Well, all I'm saying, unless I don't understand what you're saying, you have a zero or a significant negative figure for the two-month period--I think [that] is a little risky, and this leads me a little bit to alternative B.

CHAIRMAN BURNS. I expressed a personal attitude, and that personal attitude was not translated into a numerical specification that I suggested to the Committee.

MR. EASTBURN. So I think the important thing is to have the funds rate reasonably stable and be prepared to move it up, if necessary.

CHAIRMAN BURNS. All right, thank you, Mr. Eastburn. Mr. Partee now, please.

MR. PARTEE. Well, two things restrain me from moving with anything like as much alacrity toward monetary tightness as Mark Willes suggests. The first is that in addition to an inflation objective, we also have the objective of maintaining reasonable growth in the economy, and the growth rates that are being projected by the staff are not unreasonably high. This quarter, and I agree that it will be a high quarter, is perhaps a little on the high side. But after that, even with every considerable strength, as I mentioned before, in each line of the projection, why we're talking about a growth rate of around 6 percent or perhaps a shade below, which we need unless we are to accept this unemployment rate as a permanent thing. And I think it's too high, of course, to accept as a permanent thing.

So I would argue that the economic situation, which calls for some trade-off between inflation and growth in the objectives, ought to restrain [us] from being too restrictive, Mark, until you clearly see a period of excessive growth developing. The second thing, though, that restrains me a little bit is we have done this twice before. We did it in the spring of '75, and in fact the aggregates then came in quite weakly, and we eased off. And we did it a year ago.

CHAIRMAN BURNS. What harm did we do?

MR. PARTEE. And the aggregates eased off. But I would rather not go a long way in that direction until I felt fairly certain this time that the trend was really with us. And I think it probably is, but then I thought it probably was a year ago, and so I don't know that I'm much of a forecaster.

CHAIRMAN BURNS. Do you think we did much harm, significant harm, in '75 or '76? You know, we reversed rather quickly.

MR. PARTEE. No, I don't think we did, because we did reverse, but I think it's something I would prefer not to do if I didn't--

CHAIRMAN BURNS. Oh, in other words, you prefer not to make a mistake.

MR. PARTEE. But in any event, you know, we only have one high month--now, it's an awfully high month.

CHAIRMAN BURNS. Sure is.

MR. PARTEE. But on the other hand, there could well be a negative, which isn't really projected in the May-June period, because if one is to use that as a sort of a stock adjustment in money supply, it may have been overdone. And it may not turn downward. So I think we ought to be a little cautious for another month or two about going gung-ho toward increased tightness. The Chairman's suggestion of zero to 4 for the M1 range I think is appropriate. According to my figures, if the midpoints of the staff's alternative B projection were realized, the December-to-June increase in the narrow money supply would be 6-1/2, which is right at the very top of our range. And cutting that just a little bit would make me a bit more comfortable, so I think zero to 4, which I think may well be where we'll be in May and June, is reasonable.

On M2, I think I would go Governor Coldwell's way and say, well, M2 hasn't been all that strong, and therefore we can afford to accept without real concern, say, a 4 to 8, which would mean that the December-to-June growth would be at the midpoint of our range or even a little below, if we fell in that range. So that in case there is a snapback in time deposits, and I think it's possible, I wouldn't want to see us tighten if it were in that modest range of 4 to 8 percent.

And on the funds rate, I would, as I suggested earlier, argue that the next half [percentage point] is more important than the last half percent[age point] movement in the rate, and so I think we ought to be fairly cautious. But a 5 to 5-3/4 strikes me as being a good range, with a 1/4 to a 3/8 midpoint range, which, as I understand it, is about where we are--we're probably a little above a quarter, so we're probably not quite at 3/8. And so a 1/4 to 3/8 is about a characterization of current condition.

But unless we continue to get unusual growth in the aggregates, which we may, I don't feel I'd want to make a really major move in our posture, and so it's only in that case, which would call for a special wire, that I would want to see [us] go above 5-3/4 in this next--I guess it's a five-week interval before the next meeting, is that right? It is a five-week interval, so we have a little longer time to make. But it may call for a wire, but I would want to stop and consider before we went above 5-3/4.

CHAIRMAN BURNS. Well, I would certainly join you in considering pretty carefully. Mr. Jackson, please, now.

MR. JACKSON. I would share a lot of the judgments that have been expressed about the concern for an unusual rate of growth, but I also am concerned about the uncertainty of the reaction that might flow from that. I wouldn't want to hesitate to restrain that rate of growth if it's quite clear that, in the period ahead, this growth has some underlying fundamentals to it. But at the same time, I think it would be a mistake to try to react to it too severely when it could be seasonals and everything else that would distort the course of policy. I would prefer that we do so with a slightly different technique. Of course, the one alternative would be to use the money market approach, but I think that's a mistake under the circumstances, with the underlying economic conditions developing the way they are.

I think perhaps a better way, in my judgment, would be to intentionally broaden the ranges. More specifically, zero to 5 [for M1], 3 to 8 [for M2], which would give us the flexibility of recognizing that we may have some reaction within a range. But at the same time, it would give us the capacity--without having to have any special meeting or anything of that sort if the aggregates were clearly way below any expectation or the strength continued--to react and go ahead and move to it with a 5 to 5-3/4 percent federal funds range and the same midpoints of 5-1/4 to 5-3/8 we talked about. But it strikes me that this may be an easier operating method of approaching the same goal that's been expressed by all of us.

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

MR. BLACK. Our work with the aggregates tends to pretty well confirm the staff's guess as to where these would come out for the second quarter, around 9 percent on M1, which is well above our long-run target rates. But at the same time, as Governor Partee has pointed out, we ought to be careful to note that, historically, the second quarter in the last couple of years has been rather strong, and the third quarter has been somewhat weak. And I think we ought to take that into consideration in reaching our decision today. And I think it's also worth noting that, while M1 has accelerated pretty sharply in the current quarter, M2 is moving less rapidly and may move even less rapidly than that in the future.

And in view of all of this and our having moved the fed funds rate up by over 50 [basis points] fairly quickly , I would be inclined to stay about where we are at present. And I would buy your specifications, Mr. Chairman, and the monetary aggregates directive. But I think we ought to be quite prepared to use the latitude in the federal funds range if the aggregates in fact do tend to come in higher than we are estimating. I think the economy is quite strong. I would not be surprised to see more strength than some of my colleagues think will be there.

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

MR. MORRIS. Mr. Chairman, could I clarify your proposal? Do I understand you properly that you keep the funds rate at around 5-1/4 and only move it up if we were hitting the higher part of the ranges?

CHAIRMAN BURNS. No, I would use the federal funds rate range in the normal fashion, and the federal funds rate now is closer to 5-3/8 than it is to 5-1/4--that's my understanding. And I would leave it where it is for a week or so, and then depending on how our estimates of the monetary aggregates come in, move within the indicated range. But the [center point of the] indicated range that I suggested is asymmetrical.

MR. MORRIS. Well, I think that my feeling, Mr. Chairman, is that we ought to make a bigger move right now. I think the economy is very strong. I think the lull that Mr. Partee and Mr. Eastburn speak of is certainly a possibility, but I don't see in the indicators any evidence that it's probable. We are faced with this April bulge in the money supply, which means that even if the staff's projections are correct for May and June, that we are going to come out with a very high M1 number. And in order to meet the midpoint of our longer-term ranges, this would mean M1 growth at 4 percent and M2 at 6.8 for the subsequent three quarters, and that, gentlemen, if our forecast is correct, is going to be very difficult to do.

It seems to me that we need to take out some insurance today against the May and June aggregates coming in higher. And therefore, I would propose a funds range of 5 to 6 percent, with the Manager instructed to move to 5-1/2 next week. Now, unlike Mr. Partee, I don't view the spring of 1975 experience as a mistake. It seems to me that that's sort of the model that we ought to be thinking of in this kind of context. Because it seems to me that the move we made for the spring of 1975--because it was reversed rapidly as the evidence came in showing that we didn't have a permanent increase in the demand for money--we didn't harm the economy. But if we had been right, and there was a big increase in the demand for money, we would have been in a much better posture to meet it, and--

CHAIRMAN BURNS. I would go even further to say that the fact that we moved that early in 1975 gave reassurance to the business and financial community.

MR. MORRIS. Well, it seems to me that, again, it is a matter of taking out insurance [in case the] second quarter bulge turns out to be bigger than we are now projecting. But I think we ought to make another move, and I'm just talking about a modest initial move next week, to 5-1/2 [and] give the Manager authority to move as high as 6 if the numbers come in on the high side. It is not often, Mr. Chairman, [that] I'm on your right.

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

MR. BALLES. Mr. Chairman, I find a great deal of merit in your proposal, both for the reasons that you cited in your comments and because of the considerations in the longer term, as you set forth in your recent testimony on monetary policy. But looking upon other things, the fact [is] that, if anything, we have probably been a little too stimulative in the past. As you all know, we've had some quite significant increases in the aggregates in 1976. M1 over 6 percent, and M2 almost an 11 percent annual rate, and I can't believe the full effect of that has yet pulled through the economy. Aside from the real estate speculation in California and possibly elsewhere, I was not one of the worriers today about the general economy. I consider it to be quite strong for the balance of the year. And I think my principal concern is that the longevity of this expansion may in fact be threatened by the strong inflationary tones we saw in the first quarter of this year, only a part of which I think is temporary.

I find it interesting to look back to, say, the January Greenbook and see the increases in the staff's forecasts for real GNP and inflation that have occurred since that time despite the withdrawal of the fiscal stimulus by the Administration. And, if I can get in a plug for some recent research work we've been doing, I think this upward revision might have been anticipated if we had paid more attention to what's been going on in M2. That is to say, this recent paper I have circulated to all of you suggests that M2 is presently, and has been since early 1975, a better predictor of income growth and of future price developments than has M1. And we don't see any signs of M2 growth slowing significantly. The first half of 1977 looks to us like it's going to increase at about a 10-1/2 percent annual rate.

As far as the M1 figure is concerned, I think we need to keep reminding ourselves of the work that Messrs. Axilrod and Paulus have done in their memorandum of last November suggesting, in effect, that M1 growth was really understated by all these financial market innovations by about 2 percent and perhaps another 1-1/4 percent this year. It suggested that the true growth of M1, if it had not been subject to these changes, would have been more like a 7-1/2 percent [rate].

In short, I'm of the opinion that we have been overly generous. I concur with you on that point in our past policy. So that net-net, I believe it would be a mistake to let the federal funds decline right now, and if anything, [we] can move it up in a cautious manner rather than let it go down, with a view to keeping the aggregates under control, keeping them within our ranges, and giving allowance to the fact that there are long lags, as you know, between the aggregates and the effect on prices. And I think there was quite a bit of stimulus in 1976 and so far in 1977.

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

MR. WINN. Mr. Chairman, I'd like to associate myself with the description provided by Chuck in what we should be doing. The demand for credit, particularly for the large commercial and industrial borrower, is the thing that gives me pause at the moment. I guess if we hadn't had our blip in the money supply, we'd have been closer to a cut in the prime than the increase that occurred. And the uncertainty with respect to future demand gives me pause about the outlook. And in terms of the way we've had to revise our numbers, looking back, the blip may not be quite the blip that we think it is. Yet, at the moment, I would tend to say, steady as you go. If the numbers come in again adversely, I'd be prepared to move upward, but until we have a little more confidence, I'd be inclined to hold as Chuck suggested.

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

MR. KIMBREL. Mr. Chairman, it isn't often that our view in the deep South coincides so much with New England, but this morning I'm very close to Mr. Morris. We've done a little more than our usual checking on attitudes and relationships with businessmen in the last couple of weeks. And we find them ebullient. We find the expectation [for] the economy strong and likely to continue, including the New Orleans area for investment and retail trade. Our Florida friends are almost completely overlooking the weather-induced difficulty [with the] citrus [crop]--[they] almost think that it was an act of providence [because of] our overproduction.

MR. PARTEE. It keeps the price up.

MR. KIMBREL. Right, right. The vegetable people have already come along with a crop to regain [unintelligible]. Flowers and houseplant people are full speed ahead, so they are very happy. Tourist [offices] admitted that the studies they are making with relation to gasoline are not very scientific, but they are [saying] that [it] would take a dollar a gallon to very much [reduce] tourist activity in Florida.

Well, moving [from] that to the possibility that the minimum wage is going to be raised, I have come [to] the very strong feeling that business leaders are confidently expecting that the system is going to lean against inflationary pressures that are building. Frankly, I think we should, and I concur on that view and that we should continue to do so gradually. If I had any difference of view with the numbers you've specified, I would take 5-1/4 to 6 percent on the federal funds rate and use it. We've stuck for some months and then gradually moved since our last meeting, so I think the market really is about ready to accept this restraint. I'd accept the other numbers you've assigned under an aggregates objective.

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

MR. WALLICH. I am one of those who worried about the economy, but more because I didn't understand what was going on than because I had a negative forecast. Now I am impressed by the very peculiar behavior of the aggregates. I think this may be a time where one might contemplate a money market directive. I think that no matter what happens to the aggregates in the immediate future, the second quarter and even the first half will look like a period of very high monetary expansion, and I would like to hold that down while at the same time not relying too much [on] what one can guess [about] which way the aggregates are going to move from here.

So I would go with Philip Jackson and widen the aggregates range. My preference there would be to allow even a negative number in M1, negative 1 to 4; and on M2, 2 to 7. Now the funds rate--I am impressed by the fact that, according not only to our own forecast but even to Otto Eckstein, we have got to go up 150 basis points or so by the end of the year. We have taken one bite right now, but there are three more bites [of] that size ahead. I think we cannot--

CHAIRMAN BURNS. That is, ahead according to Otto Eckstein.

MR. WALLICH. Well, that's a hint according to Otto Eckstein; then more may be ahead according to--

MR. PARTEE. Is that 150 from here, Henry?

MR. WALLICH. From here to 6-3/4 or 7. But we've three more bites of the size that we have taken just now. Each time will take a great effort of will on our part to steel ourselves for that. And given that the aggregates behavior right now has been helping us and justifies the appearance of a further move, I'd go to a 5-1/4 to 6 on the funds rate and move slowly, not immediately, to the midpoint of that range. And as I say, I'd be open to a money market directive on that if there is some spirit for that from the Committee.

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

MR. GARDNER. Gentlemen, I have been listening to a great deal of wisdom. I guess we all know who we are today. I think originally, until I heard the Chairman's suggestion, [unintelligible] I asked myself, in view of the buoyancy of the economic indicators, what would we be doing if we hadn't had a 19 percent growth in M1 in April? I suspect we wouldn't be quite as aggressive in raising rates as some of our colleagues are proposing. So if we look at the alternates involving quite constraining M1 and M2 ranges and, on the other hand, a fairly narrow and modest proposal on the funds rate, I think this has some advantage. If we can achieve what the staff forecasts and [eliminate] the very dramatic bulge in M1 in April through passage of time, we'll have present market rates already up and [a] willingness to go up half a bite, Henry, in our range for the federal funds proposal.

It seems to me that incorporated in this reduction in the aggregates ranges and retaining or narrowing the federal funds range, we have a compromise that makes a good deal of sense to me because there [were] a great number of queries expressed about the future of the economy. We've put a lot of attention on automobiles. The auto business falls apart in the middle of the year, as we all know. It may fall apart further this year because of the incipient energy program that might change the mix significantly. I'm quite happy with this alternate suggestion, although I haven't heard it before because I think it's a balanced suggestion.

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

MR. LILLY. Well, I'm glad to be almost at the last because, as the meeting started out, I had kind of a sense of dismay about whether I was going to be able to voice my theory. But then Frank spoke up, and now I have somebody to speak against. Thank you, Frank. We have moved 70 to 80 basis points since last January, depending on how you figure it. It's 72 to 84 basis points, and I think that's a rather significant movement, particularly when it takes us right back to where we were [in] June a year ago. And my feeling is that we ought to look for some lag effects and make sure that we haven't moved too rapidly before we go any further.

And I, therefore, think this: I don't find that there's a great deal of difference between any of what I've heard, and I would associate myself with Chuck's position just because of a little more flexibility. And that's zero to 4 [for M1], 5 to 8 [for M2], and the 5 to 5-3/4 [for the federal funds rate] with the midpoint--one of those wonderful things that this Committee decides a midpoint is--another range, 5-1/4 to 5-3/8.

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

MR. MAYO. Mr. Chairman, as a preamble to my remarks, I should report an observation coming out of my recent brief vacation in Greece. I decided that, despite my confidence in the staff projections and in the ability of this Committee to do a good job, I'd like to consult the independent sorts of wisdom, so I spoke with the Oracle at Delphi about monetary policy. The Oracle is strangely silent about M1 and M2. The Oracle gave me the impression that these things had to be viewed in longer[-run] terms, and one shouldn't be too concerned with things that are happening right at the moment.

The Oracle in effect then suggested that I look around me and make my own observations. I observed that Greece at this time of the year was very green. It was raining when I was there. I interpreted this as the Oracle telling me that we did have, indeed, at least plenty of liquidity in the country and maybe too much. I also observed around me the ruins of half a dozen treasures of the city states of Greece. I noticed that the treasury of Athens still had its walls intact, but the roof had fallen in. I took this to mean that we, too, should be concerned about the affairs of the Treasury.

To get back from Greek mythology--the Oracle was often wrong on substance--I find your prescription quite appropriate today, Mr. Chairman. I wouldn't object to going to the zero to 5 on M1, or the 3 to 8 on M2. I feel that, indeed, looking at this in a little longer perspective, we've had this increase in M1. I suspect that this may be a place for a pause in our movement upward, which I think may proceed over a period of time here. But I would prefer going along with the 5 to 5-3/4 percent range in the money market directive. I think the 5-3/8 is a suitable midpoint at this time. I have as a side issue a little concern that if we start paying more attention to M2--I'm not disputing Mr. Balles's analysis, I think it is a very good one--[but] we may find that we are giving ourselves too much stimulation in terms of over-reliance on a target of M2;

[it] may mislead us with regard to M1, to which the market, for better or for worse, still pays most attention.

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

VICE CHAIRMAN VOLCKER. I'm afraid New York is not to be confused with Athens, although I sometimes think the roof is falling in. Everything that I could have said has already been said in one way or another. Let me just say in terms of the business situation, where I think that a fair number of uncertainties could develop later this year and into next year--but that's always the case--I do think there's a lot of buoyancy now, and as I add up the business and inflationary situation, we may be better off to meet these uncertainties later in the year by moving a bit now. And I think it would be reassuring psychologically and otherwise.

I think the aggregates have certainly been rising too rapidly. This April figure puts the frosting on the cake in a big way, but they were rising somewhat too rapidly before. And when I look at this pattern projecting ahead, with all the uncertainties that it has, it brings the aggregates down within the targets, but it does it with a lot of interest rate increases later in the year that I'm not sure I would like to see, given the uncertainties that exist. We've also gotten by with an adjustment so far with very little disturbance in the market. And I think I'd like to press that luck a little further. This may be a better time to do it, with the market in good technical shape, than some subsequent time.

So in terms of the actual specifications, I had the same numbers in mind that you cited about an hour ago, that if the range was widened at all, and I sometimes think it's useful to widen the range. I must say I would lower it. I'd put negative 1 to 4 [for M1], as Henry Wallich suggested, and 2 to 7 [on M2], if I was going to move in any direction. It wouldn't disturb me at all to see zero or a slight minus figure in this particular period against the background that we have. I would be content with zero to 4, 3 to 7.

I also think the federal funds range of 5-1/4 to 5-3/4 is a good one. I'd want to stop and pause before going above 5-3/4. But given the way I feel about the aggregates, I'm not very eager to see the funds rate being reduced if we were plus 1 or 2 percent on M1 or equivalent figures on M2, so that [a midpoint anywhere from] 5-1/4 to 5-1/2 strikes me quite nicely. I suppose I would be a little cautious after what we have just done and like to consider the midpoint something like 5-3/8 or 1/2, implying a pretty modest move at the moment. But anything from 5-1/4 to 5-1/2, whether we consider it fully symmetrically or a bit biased at least in not moving too rapidly to 5-1/2, is fine with me.

CHAIRMAN BURNS. Thank you, Mr. Volcker.

MR. BAUGHMAN. Mr. Chairman, as mentioned earlier, it seems to me I see indications of a spreading speculative inclination in the economy, and while competitive efforts of extenders of credit to put out funds probably don't guarantee speculation--

CHAIRMAN BURNS. I am having a little difficulty hearing you, Mr. Baughman.

MR. BAUGHMAN. It seems to me that the competitive efforts of lenders to put out funds don't guarantee speculation, but they do nevertheless provide an environment in which it can be continued and spread. And so it seems to me that we're at a point where we should be pretty sure we don't add further to liquidity in the economy and [therefore we should] possibly tighten up just a little. It's in that context that your specification has great appeal to me. It seems to me that it just does the job about right--starting with the present market rate on fed funds and with the intention not to move below that, and if we see the substantial growth rate in either M1 or M2 move up from that level. And it seems to me that's appropriate.

I would make one other kind of gratuitous observation, and that is, with the proposed well-head tax on petroleum products, that it would be appropriate to start [feeding] into the conversation at the Washington level, if possible, that those funds, if collected, not be collected [to] be fed back into the economy into the hands of petroleum users but rather be funds used either for the purpose of reducing the federal deficit or for being available for some kind of reduction in tax rates. And the experience with respect to the $50 rebate just might have set the stage for some such operation being effective also.

CHAIRMAN BURNS. Thank you, Mr. Baughman. Mr. Guffey, we haven't heard from you yet.

MR. GUFFEY. Mr. Chairman, waiting until or near the end to speak should be of some help, but it is not to me this morning because I had an underlying philosophy or feeling to want to take a bite against inflation. But I'm also troubled by the fact that we have received a rather substantial surprise in April. And there is not a great deal of uncertainty toward May or June. And as a result, I'm attracted to a proposal essentially made by Governor Partee, that is the aggregates, zero to 4 [for M1], 4 to 8 for M2, but I would also adopt your proposal for the funds rate, with some restraint on the Desk to move from the current level until we get fairly near the upper bounds of those ranges. And as the result, I think it would be appropriate to adopt the money market conditions directive, with that type of restriction.

CHAIRMAN BURNS. Thank you, Mr. Guffey. And we will hear from you, Mr. Roos.

MR. ROOS. Thank you, Mr. Chairman. We feel a greater concern of danger at the upside than we do at the downside. I personally don't share the concern that has been expressed this morning that there could be a slight slackening in the rate of in the recovery. I think if the recovery continues to move ahead at its present rate over a prolonged period of time, we'd have a greater problem than if there were a moderate slackening of that.

Specifically, I would subscribe to the Chairman's ranges for M1 and M2. Philosophically and for other reasons, I resist a narrowing of the funds range, and I would prefer to see 5-1/4 to 6 percent. We don't have to use the 6 percent, but it's there. We have a--probably isn't too relevant--but we have a large cemetery in St. Louis, Mr. Chairman, which I passed on the way to the airport, which advertises its plots by saying it is better to have and not need than to need and not have, and if there is a need to go to 6 percent, maybe it's better [that it] be there.

CHAIRMAN BURNS. I'd like to pick up where you left off and say a word about cemeteries. I think cemeteries should be used more extensively than they are. They could serve a novel purpose, namely to bury economic forecasts. Now where we were about three months ago or so, and the Administration came forward with a fiscal package, the Administration made its forecast for the economy. Well, since then, the President has withdrawn his recommendation for a rebate, and federal expenditures are $10 billion lower than had been estimated, and the economy is now just about where the estimators thought it might be at the end of the year.

Now all this proves that we've put so much emphasis on changes in fiscal and monetary policies, and we tend still to ignore the great momentum that our private economy is capable of carrying through on its own. And I think this has a bearing on today's discussion. I still have to review the sentiments and the views expressed by members of the Committee, but as I listened to members of the Committee, I thought we were all saying pretty much the same thing. But I guess there were differences. The differences were all over the lot. But the differences were within an extremely narrow range and a range that is of no significance at all relative to the errors that we keep on making and that we don't know how to improve upon. And now, if you will just forgive me, I want to study these minutiae and give my best report on it.

MR. JACKSON. Mr. Chairman, while you are studying that, may I ask Mr. Kimbrel a question? In discussing the Florida freeze, you mentioned that you thought it might have been an act of providence. We are aware that certain of your townspeople are now running the United States government, but I didn't know they had taken over the weather.

MR. KIMBREL. I hope they do a better job of that than they do some other things.

MR. PARTEE. Is there anybody left in Atlanta?

MR. KIMBREL. Really got our share of--

MR. COLDWELL. They certainly loaded the airplanes to Atlanta from Washington every Friday night.

CHAIRMAN BURNS. Gentlemen, I could take a great deal of your time and my time summarizing these figures, and, if you will permit me, I will not do that but simply make a suggestion to the Committee that I think comes close to summarizing the central tendency of the Committee's thinking. I would suggest we vote on the following: A monetary aggregates directive on an M1 range of zero to 4, on an M2 range of 3-1/2 to 7-1/2, on a federal funds rate range of 5-1/4 to 5-3/4 with the midpoint of 5-3/8, a figure that is to be approached within the next few days--the Desk is very close to it.

That is my suggestion to the Committee. I think it expresses the tendency of the narrow ranges within the Committee's thinking during this 3-1/2 hour meeting. Are there any questions or comments?

SPEAKER(?). Could we take a vote on money market versus aggregates?

CHAIRMAN BURNS. Yes, let's do that. Let's have a show of hands on monetary. Those that prefer a monetary aggregates directive, raise their hands, please.

MR. BROIDA. Seven.

MR. JACKSON. Estimating errors really are getting tough around here.

CHAIRMAN BURNS. Do you mean to say we can't even count hands?

MR. JACKSON. I didn't say that.

CHAIRMAN BURNS. Good. Any other questions or comments? If not, will the Secretary be good enough to call the roll.

MR. BROIDA.

Chairman Burns	Yes
Vice Chairman Volcker	Yes
Governor Coldwell	Yes
Governor Gardner	Yes
President Guffey	Yes
Governor Jackson	Yes
Governor Lilly	Yes
President Mayo	Yes
President Morris	Yes
Governor Partee	Yes
President Roos	Yes
Governor Wallich	Yes

It's unanimous.

CHAIRMAN BURNS. Anything else we have to do today?

MR. BROIDA. Set the date for the next meeting.

CHAIRMAN BURNS. Well, I think the date is set. We will go to lunch punctually, and we will have three members of the staff with us. We are going to discuss the legislation with regard to NOW accounts and paying interest on reserve requirements. I hope all of you can come, because this is a matter of great importance to the System.

END OF MEETING