TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

March 29, 1976

Prefatory Note

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

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

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

Staff Statements Appended to the Transcript

Mr. Kalchbrenner, Adviser

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FEDERAL OPEN MARKET COMMITTEE

MARCH 29, 1976

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

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

Mr. Eastburn, President of the Federal Reserve Bank of Philadelphia

Mr. Broida, Secretary
Mr. O'Connell, General Counsel
Mr. Axilrod, Economist (Domestic Finance)
Mr. Gramley, Economist (Domestic Business)

Mr. Holmes, Manager, System Open Market Account

Mr. Kalchbrenner, Adviser, Division of Research and Statistics, Board of Governors

Transcript of Federal Open Market Committee Meeting of
March 29, 1976

[Executive session]

CHAIRMAN BURNS. Gentlemen, we're ready. This will now be a meeting of the Federal Open Market Committee, and we're in executive session. I'm going to call on Tom O'Connell to advise us on the status of the lawsuit.

MR. O'CONNELL. Yes, Mr. Chairman. The Committee will recall that the lawsuit of Merrill versus the FOMC, pending in the District Court, had been subject to the court order announced from the bench, and [as of] the last [FOMC] meeting [the lawsuit] had not been the subject of a final written order entered in the District Court. Since the date of the oral opinion, that court order has been entered, and it quite accurately sustained the oral statement from the bench. With respect to the record--minutes of record--which is the subject of the first portion of the court's order, the Record of Policy Actions would be provided immediately [to the plaintiff] upon its completion by the Committee. As the Committee will recall, [that order] was made subject to a stay by the court so that the Committee could file an appeal.

That appeal was noted and filed on March 16. So, until further order of the appellate court or as otherwise ordered by the District Court, the requirement with respect to the Record of Policy Actions will not be in place, and, effectively, the 45-day lag is still the operating date for the Committee.

The second phase of the court's order, you'll recall, dealt with the Memorandum of Discussion. The second phase required that the Committee, through its staff, remove from the January and February 1975 memoranda reasonably segregable facts and that they be given in proper form to the plaintiff as promptly as that could be done. And should there remain from the two memoranda any portion of facts that the Committee claims could not be reasonably segregated, then that portion of the memoranda would be submitted in camera to the District Court for inspection by the court and a further judgment and order as necessary. That was required to be done by March 19. We got an extension of time by stipulation of counsel until the March 24, last Wednesday, and on that date, on behalf of the Committee, there were filed with the District Court the documents that you have in the package in front of you.

I haven't presumed for a moment that anyone has had a chance to look at these documents or that, having had the opportunity, you can fully appreciate what's in them. In front of you is a report to the court, prepared on behalf of the Committee, in which we advised the court of what we have done, accompanied by an affidavit executed by Mr. Broida in which he recites under oath the steps that had been taken. Attached to that affidavit are the January and February memoranda separated into two parts.

[The first part] exemplifies that which was given to the plaintiff and resembles, I must say, a blank pad of paper for the two months. The second part, the full Memorandum of Discussion, [contains] bracketed [material] to exhibit to the court that which was given to the plaintiff and,

[in] nonbracketed fashion, that which remains--as to which we asked the court's judgment in concurrence in what the Committee has done.

Now, in the affidavit, I direct your attention for future study and reference to the recitation by the Committee, to its counsel, of the areas of factual representation that were not made known to the plaintiff. That's found on page 2 of the affidavit. The statement is made that, while certain portions of the materials withheld from the plaintiff can arguably be considered factual in nature, they have not been given to the plaintiff because they fall into one of the following categories. Then, three categories are stated, the third of which we are referring to first; these are the materials that were covered by paragraphs 5, 6, 7, and 8 of the court's March 9 order. Those are merely the record with policy action types of materials as to which we have an appeal. Our position is that, having had that order stayed--so we are not required to disclose them within the 45-day lag--we did not intend to make such disclosure from the Memorandum of Discussion. For that reason, where similar types of materials were found in the memorandum, we withheld them.

In the first category are statements principally descriptive of procedure, which if disclosed would [reveal] the deliberative, consultative process of the Committee and its staff for exemplification purposes. [On page 6 of] the January Memorandum of Discussion, which was given to the court as a full memorandum, the first two full paragraphs exemplify that which we're speaking of. It reads, "Chairman Burns observed that the Committee had planned to discuss the first stage of the report of the Subcommittee on the Directive this afternoon." And then it proceeds through two paragraphs to recite procedures that either the Chairman has suggested would be taken or had planned to be taken, but it contains references to substantive thought and process which, in effect, lead to the deliberative process of the Committee. We elected to remove that from disclosure to the plaintiff [because] it would lead them to knowledge of the deliberative, consultative process of the Committee.

The February Memorandum of Discussion, page 18, will give you a suggestion of the type [of material] covered in the second category in the affidavit. Turning to the so-called B type of [material]--that is, information received in confidence from foreign central banks and information relating to negotiations with or among such banks, disclosure of which could irrevocably and totally damage relations with these banks and result in the cessation of the flow of essential information from them.

[There are] numerous instances [of this type of material] in the Memorandum of Discussion--references are made to reports from members of the Committee, comments from our Chairman with respect to conversations that are being held with representatives of foreign central banks. I won't take the Committee's time to indicate specific examples, there are several--a common market agreement with respect to serving of the intervention agreements, the rate for which they would be made, and so forth. This type of reference, although containing some factual material that arguably could be disclosed, would inferentially lead to the type of disclosure of discussion of highly confidential foreign central bank exchange [unintelligible] that we felt should not be disclosed. And for that reason, we have identified to the court, quite frankly, [what] we have withheld and the reasons for it.

The affidavit then closes with a request that, if the [judgment of the] court differs from that of the Committee and [the court] intends for any reason to issue a contrary adverse order for further disclosure, then we be so advised and be given the opportunity to note this on appeal--and thus we would seek an emergency stay of this order in the Court of Appeals.

Mr. Chairman, implicit in our affidavit is an opportunity to appear before the District Court and perhaps take suitable steps to comply with whatever further order the District Court has in mind. We have heard nothing from the court on its reading, if any, of this document. We have had a phone call from counsel for the plaintiff, who asked for somewhat of a verbal description and explanation of the three withholding categories that I have briefly discussed here. Counsel talked with plaintiff's counsel and gave examples of both A and B. He seemed satisfied, he didn't raise any further question, and we haven't heard any further comment. Mr. Chairman, I think that constitutes a report on this filing as the Committee now has it.

CHAIRMAN BURNS. Thank you, Mr. O'Connell. Are there any questions?

MR. COLDWELL. One question, Tom. Do you gather any sense or feeling from the judge as to the degree of push that is likely to be made towards release or attempted force of release of the Memorandum of Discussion item beyond the segregable facts?

MR. O'CONNELL. Mr. Chairman, Governor, we've had no conversation with the court or the court's clerk, so I'm unable to give you any reaction or impression from him. Our conversation with the plaintiff's counsel did not give us any feeling of total dissatisfaction or surprise on the part of the plaintiff's counsel that the portion given him was as sketchy as it was. One or two comments he made, as a matter [of] fact, suggested that he anticipated that it would be just about like this. As I say, the only questions he had were to exemplify the types of categories we had withheld. We did so, and subject to Art's further knowledge, I got no impression that he was umbraged or that he would push hard for further disclosure.

MR. BROIDA. I might add, Mr. Chairman, that the original request we received from this Mr. Merrill was for the full Memorandum of Discussion. And in the course of the pleadings, the request was narrowed to factual portions. I don't know why [it was] narrowed, but that was all that the judge was faced with in making this order. He requested factual portions.

CHAIRMAN BURNS. [Unintelligible] to conform to the Freedom of Information Act.

MR. BROIDA. Perhaps.

MR. O'CONNELL. That might well be the explanation of--may I hold the Committee's attention for one more moment, Mr. Chairman, to indicate what our possible time schedule may be. I noted that we had filed a notice of appeal. The D.C. Circuit Court calls for the filing of a record in the Court of Appeals 40 days after the notice of appeal. The notice having been filed on March 16, [the requirement] means that, by April 26, we as counsel for the Committee must designate to the Court of Appeals the portions of the District Court record that we wish the Court of Appeals to review on our appeal.

Forty days after that date, or, by my calculation, June 6, the Committee must file its brief [to the Court of Appeals] in support of its appellate points. From its submission on--as I've calculated--June 6, the plaintiff himself has 30 days, or until July 6 or July 7, to file an answering brief. Within [14 days after] that period of time, this Committee can file a rejoinder brief, so that, in total, all briefs being filed, the case [could be] ready for argument as early as July 21, or [it] could be later, subject to any extension of time or orders of the court. That's all I have, Mr. Chairman.

CHAIRMAN BURNS. Thank you. Any questions or comments?

MR. HOLLAND. Might I ask the Secretary a question, Mr. Chairman? In some of the segregable facts, such as one to the plaintiff, there are included factual statements. [For example,] the German Central Bank was intervening in modest amounts--it's certainly a factual statement. Did the Committee staff ascertain whether that was a fact still being held as confidential by the foreign central banks?

MR. BROIDA. We ascertained it not by consulting with the foreign central bank but by consulting with the staff [at] the New York [Federal Reserve] Bank. They gave us a judgment on each of these points.

MR. HOLLAND. As to whether or not it was already a matter of, I'll say, general knowledge, of public--

MR. BROIDA. The information was in the public domain.

MR. HOLLAND. That's all I wanted to know. And in each case it was.

MR. BROIDA. They sat down with the memorandum and read it all the way through and identified those passages that pertained [to] information not in the public domain.

MR. HOLLAND. Thank you. And none of that [unintelligible] so all that is stuff that the New York Bank staff regards as already in the public domain with respect to foreign central bank intervention.

MR. BROIDA. No, that's not--let me put it this way. There were a number of cases in which they felt that the public interest would not be served by making this information available, but we could not find any basis within the criteria that we had agreed upon for withholding it. And we talked it over and they agreed reluctantly, or less so, to our decision.

MR. O'CONNELL. I should say, too, that in those conversations, where severe reluctance was expressed on the part of the New York Bank staff, we did our best, and I think successfully in two instances that I can recall, to withhold under a valid claim. In all cases, Governor, I believe we satisfied to the fullest extent possible the concerns of the New York Bank staff about each of these items.

MR. HOLLAND. Well, did you leave [in the memorandum] any [information] that the New York staff did not think was in the public domain?

MR. BROIDA. This question gets rather subtle, Governor Holland. There was information here on our own operations which is in the public domain. The question was whether, by giving this information to the plaintiff, we had set a precedent such that, in the future, we might have to make equivalent information available before it came into the public domain.

MR. HOLLAND. Yes.

MR. BROIDA. It was primarily on this issue that they expressed some concern.

MR. HOLMES. There's more to that question, Governor, of future releases of information, which do not lag as much as these do, because we've had several--three monthly, six monthly--reports. But as far as these facts are concerned, in the case--

MR. COLDWELL. The plaintiff has made no comment publicly on the amount of material or any material of these proceedings?

MR. O'CONNELL. I know of none, I haven't heard any, Governor.

MR. COLDWELL. [Unintelligible]

MR. O'CONNELL. He may have, but it hasn't been brought to my attention.

CHAIRMAN BURNS. Any other questions?

MR. BALLES. Tom, maybe I've missed something, but have you had any feedback of the plaintiff's complaining or commenting on the material that was excised?

MR. O'CONNELL. No, I haven't President Balles, and certainly he did not appear to be either surprised or irritated in the conversation we had with him when he was directing the questions to us. I've heard of no complaint yet.

MR. BALLES. Thank you.

SPEAKER(?). Mr. Chairman, do I understand that we are appealing the 45-day lag?

CHAIRMAN BURNS. That's correct.

MR. BROIDA. That's correct.

SPEAKER(?). And that is the only thing that's being appealed as of now?

MR. O'CONNELL. [Yes--] at this point in time and subject to some word from the District Court as to the court's satisfaction [or] not with what we've done with the Memorandum of Discussion. If an adverse order follows which is more stringent than is now entered, we have every intention to advise the Committee in pursuing an appropriate appeal.

SPEAKER(?). Thank you.

MR. COLDWELL. Are we left in a position where we could appeal the entire thing on even segregable facts?

MR. O'CONNELL. My earlier statement, Governor, at the last meeting, was that we felt we were in [a] poor position to directly appeal a court order on the issue of segregable facts because that's a direct part of the law. On a court mandate for specific portions of the memorandum, [which would differ from] our judgment as to what is a fact and what is not, I believed we can appeal, and we intend to do so.

CHAIRMAN BURNS. Very well. I want to make a comment on the Memorandum of Discussion. Let me recall what took place at the latest meeting of the Committee. Governor Coldwell presented a report on behalf of his committee dealing with the future of the Memorandum of Discussion. We had a lengthy go-around, and the sentiment of the Committee clearly was that, with certain kinds of modifications, [the] recommendations of their committee be adopted. At the end of the meeting, I suggested that, while I was in whole sympathy with that decision, each of us [might] do a little more thinking about the future of the Memorandum of Discussion and we [would] take a formal vote at the next meeting of the Committee.

The reason I suggested that was that it's an important matter, and in view of the status of the work in our Secretary's office, nothing would be changed there, and the delay would have no consequences as far as the Secretary is concerned. And each of us could spend a little more time weighing that tentative decision.

Well, I have weighed that tentative decision because I've [had some] additional experience. In carrying through the exercise ordered by the court, and including now the expurgated [edition] of our memoranda for January and February, members of our senior staff spent a great deal of time on it, a very heavy investment of effort, and I spent 2-1/2 hours, approximately, going over their decisions. [I] disagreed with a number of them, didn't impose anything on the staff, but after a full discussion, we arrived at a consensus.

We all recognize that the determination of what is a fact or what is not a fact is a subject that is surrounded by great difficulty. But no two individuals going through that exercise with a lengthy document before them will arrive at the same decisions. Now I differed with our staff on one point--they included factual statements about procedures as facts--and convinced them. I argued that what the court was interested in was facts concerning the economy rather than facts concerning our procedures, and that argument prevailed with our staff.

But, looking at the expurgated document, I became aware of certain difficulties that I had not thought of previously. First of all, here's a document, and the amount of factual material [unintelligible] and I can see that [the] document is not going to stay with the plaintiff--it'll be on Capitol Hill before very long, and I can [imagine] derogatory statements that might be made on Capitol Hill. "This is what that Committee [does]. They sit around, and they talk, and what they know and the number of facts that they consider is very scanty. It's a talking Committee." And that would cause some mischief.

Next, I became aware of a fact that individual statements, you see, can so easily lead this or that member of the Congress to ask for documentation, which obviously must exist, and additional reports. Now, I recognize that the recommendation of the Coldwell committee would reduce that burden and reduce that difficulty, and that was the purpose of that committee's recommendation. I don't think these difficulties are going to be eliminated. I see myself, unfortunately, having to devote a good deal of time after the Committee staff has done its work--they'll come to me with questions because there's always a gray zone and it's pretty large.

I see also the very real possibility that after all of that is done, there will be individual statements that will be picked up by members of the Congress, or members of the press, or both, that will cause us additional work and, what is worse, embarrassment. And therefore, I want to ponder this matter further.

But two weeks from today, which is when I think the next regular FOMC meeting is scheduled--

MR. BROIDA. Three weeks.

CHAIRMAN BURNS. Three weeks from today, the chances are that I will be recommending to the Committee that we do away with the Memorandum of Discussion and that we expand the Record of Policy Actions, so that the public will be informed rather promptly, not only of our decisions, but of the reasons for our decisions and of any shadings of views within the Committee. Now, it means a break with tradition, but so does the sanitized version that the Coldwell committee had recommended.

We live in a new world, and I think we had better adjust to it. I have not reached a firm decision on that--it's a painful decision for me, but that is the way in which my thinking is going. I mention it now to you because we'll have to reach a decision. I say "have to"--we don't, but we should reach a formal decision at the next meeting one way or another. That's all I have to say.

MR. MAYO. Will there be any more information about the status of the Government in the Sunshine [bill] by that time?

CHAIRMAN BURNS. Well, we may have a little more information. That isn't going well in the legislation. Our efforts to defeat it are not prospering. We still have a chance, but it doesn't look very good to me. Do you have any more detailed knowledge?

MR. O'CONNELL. [Unintelligible] if I may, Mr. Chairman, I brought to the attention of the Board [of Governors] at its last meeting the [unintelligible] of the Judiciary Committee, in a two-day session last week, to enquire into possible conflicts of the existing Sunshine legislative proposal with the Administrative Procedure Act, the Freedom of Information Act, and the Privacy Act provisions. The Deputy Attorney General has called to the Committee's attention several areas in which he felt the proposed legislation, if enacted in its present form, would conflict with existing provisions of law and with these other statutes. He has offered amendatory language in several instances, the exact impact of which we don't know at this moment, but it could somewhat improve the position of the agencies. But the Chairman, I think, is quite correct that substantive provisions of the law as now proposed, generally requiring open meetings, stand pretty well in place and they won't be impacted by these other amendatory proposals.

CHAIRMAN BURNS. Well, we may have a change on the House floor. If we do, I have excellent reasons for thinking that we could get constructive assistance from the Senate conference.

MR. COLDWELL. May I inquire, Mr. Chairman, about the relevance of the Government in the Sunshine question to the Memorandum of Discussion?

CHAIRMAN BURNS. Well, I think that that is a complicated legal question involving the FOMC, which Tom is still in the process of studying. Is that correct Tom?

MR. O'CONNELL. It is, sir. Does the Chairman wish me to comment at all? I don't intend to--

CHAIRMAN BURNS. Depends on Mr. Coldwell, whether he wants to hear the complications. I don't. He well may, and therefore he's entitled to.

MR. COLDWELL. Just a "splash windshield" opinion, Mr. O'Connell. What do you think that we would have to yield in our Memorandum of Discussion if we had at this time the Government in the Sunshine law?

MR. O'CONNELL. Governor, my "backseat" opinion is that it would depend on the full applicability to this Committee of the Government in the Sunshine law as finally enacted. If it should be judged fully applicable to this Committee, and thus [require] an open meeting, then I think the issue now of what form a Memorandum of Discussion [unintelligible] [would take would be] academic because [unintelligible] you would then have to determine what portions of that Committee meeting could be closed. If closed, and all discussion having been transcribed, what portions could be deleted? And then we're back in the same game we're now playing with the Memorandum of Discussion. It is involved, Mr. Chairman, that's my point.

CHAIRMAN BURNS. Any other questions? Mr. Broida has an announcement to make.

MR. BROIDA. We've left a little form on top of your packages for you to indicate whether you would like these materials mailed to you at your [Reserve] Bank or whether you don't want them and would like us to destroy them. If you check the appropriate box, sign your name and leave them at your place, we'll pick them up. If you want to carry them with you, leave it unsigned.

MR. COLDWELL. If I could, Mr. Chairman, I'd like us to return to this question of the Memorandum of Discussion for just a moment. I think it will be well for members of the Committee with [unintelligible] think about the problems of deleting the Memorandum of Discussion entirely, or maintaining it in an abbreviated or edited form. It would seem to me that the problems which have to be addressed in making this decision center on two or three points. First, how much trouble is it going to be to delete segregable facts? Second, how much staff time and member debate would have to go into a discussion of an enlarged Record of Policy Actions? And third, is the Committee overreacting to a potential mischief which might be down the road, and should it move in anticipation of that mischief or wait until the mischief shows up?

CHAIRMAN BURNS. Well, the one question that I think Mr. Broida would be able to answer is--now you send the Record of Policy Actions around to members of the Committee, do you not?

MR. BROIDA. Yes sir.

CHAIRMAN BURNS. And do you find many criticisms made by members of the Committee?

MR. BROIDA. Very, very few, Mr. Chairman. I'd say perhaps [from] eight of the 12, or maybe one or occasionally two comments, but most of the time we get no comment from the [unintelligible].

CHAIRMAN BURNS. Well, I would draw the inference that if the present [Record of Policy Actions] were double their lengths, there would be more comments but it would not be a huge burden on the Secretariat. Is that a fair inference?

MR. BROIDA. I believe so.

MR. COLDWELL. Well, I would challenge that only to the extent that if we're attempting to double the size of the Record of Policy Actions to obtain the flavor of each member's position, it is going to [unintelligible] discussion.

CHAIRMAN BURNS. That isn't what I had in mind. Governor Wallich argued the case for the kind of document that I have in mind. I don't think that this Record of Policy Actions should identify individuals.

MR. COLDWELL. I don't mean identify.

CHAIRMAN BURNS. I don't think my name or the flavor of each individual's thinking should be represented. Here is [unintelligible], let's say we do it by symbols. Here is A's thinking, here is B's thinking. Now let us say a member of the Committee felt that the Record of Policy Actions as prepared by the staff did not convey the majority's thinking or did not convey a divergent sentiment that he had expressed clearly to the Committee. He would suggest a sentence or a paragraph, and I would expect the Secretary to adopt it. Do you have any opinion, Mr. Wallich?

MR. WALLICH. Well, I'm wondering what would happen, for instance, with minority points of view. If one member of the Committee were to hold a view totally different from others, this presumably would have to be stated. It would also be stated that there was little support for it, something that conveys the balance of the meeting.

MR. BROIDA. If a member dissented, that, of course, would be recorded, and his reason for dissenting would be noted.

CHAIRMAN BURNS. Well, now, wait. His reason for dissenting would be noted if he elected to [explain his dissent]. [But] isn't that a privilege of a member? He [could instead] just vote.

MR. BROIDA. All the law requires is that the vote, pro and con, be shown. The tradition has been that there's an explanation for dissents, [but] that would be at the member's option, obviously.

CHAIRMAN BURNS. That's right.

MR. WALLICH. Well, I was thinking of a description of the arguments presented at the meeting, not the dissent as such. Suppose one person believes the economy is contracting and then [is] led to believe it's expanding. He may not even dissent substantively--

CHAIRMAN BURNS. But I think the sentiment would be indicated. If I were the Secretary I would indicate that virtually all members of the Committee agreed that the economy is continuing to expand; and to cover that individual or two [who disagreed], well, I'll tell you, the Secretary has great skills in that regard. And he has able assistance, and all of the cumulative knowledge of the Secretary's [office] is now in Mr. Broida's brain, and he would serve us well in that capacity. We'd have more questions with the longer statement, there's no doubt about that, but I doubt it would be a great burden in view of the experience that we've had. Gentlemen, we'll break now and reconvene at approximately two o'clock.

[End of executive session]

[Lunch recess]

CHAIRMAN BURNS. Gentlemen, we are ready to discuss the study that has been conducted by the Subcommittee on the Directive, on which Mr. Holland serves as chairman. I am going to call on Mr. Holland to indicate to the Committee where, in his judgment, we ought to come out at the end. Now, we may or may not want to follow [the recommendation of] Mr. Holland's [subcommittee], but if we know the thrust of [his] subcommittee's recommendation, then we can follow the discussion in a more informed way. So, Mr. Holland, tell us where you think we ought to come out today.

MR. HOLLAND. Mr. Chairman, I have been mulling over that question ever since the Committee had that preliminary discussion at its last meeting, and [I have been] trying to benefit from the comments that had been made to me by members of the Committee as to their questions, their aspirations, their understanding, and their own preferences. Taking all that into account, along with the actual contents of the report of my subcommittee, I believe I'd recommend that this Committee end today's discussion [by voting to take] three concrete actions.

[First,] beginning with the preparation for the next meeting of the FOMC, that we replace RPD [reserves available to support private nonbank deposits] with nonborrowed reserves wherever RPD appears in the materials prepared for the FOMC--that is, in the specification sheet, the Bluebook, the Manager's report, and the Record of Policy Actions. I believe RPD is non-operational, and I believe we are at a stage where we can fairly replace it with nonborrowed reserves. And [we could] say, if we need to, in a brief public announcement, that the operating reserve measure we want the Manager [of the System Open Market Account] to take account of henceforth is nonborrowed reserves, not RPD. That leaves for later--

CHAIRMAN BURNS. I don't know what that means, exactly. The Manager has not paid the slightest attention to RPD for many months, I suspect. Is that correct?

MR. HOLLAND. I suspect that is correct.

MR. HOLMES. No member of the Committee has mentioned that, sir, for many months.

MR. HOLLAND. In saying this, I am deliberately leaving our subcommittee's separable second decision to whenever the Committee feels comfortable [with it]. [That is] to begin putting more weight on the operating reserve measure, in this case nonborrowed reserves, letting the [federal] funds rate work as a constraint, as outlined by the subcommittee. I believe that is a second and separable decision that this Committee can reach when it feels comfortable with it. If it feels comfortable with it today, grand, but my impression is that you can benefit from a little more thinking and, indeed, experience.

To come as close as one can to get experience with that, my second recommendation would be that the Committee tell its staff that, in all the materials it prepares for the FOMC, it should supply the information that would enable the FOMC to actually use nonborrowed reserves and the related analytical techniques, as recommended by our subcommittee. That is, in the Bluebook, in the Greenbook, in the Manager's reports and the Record of Policy Actions drafts, there would be information provided concerning nonborrowed reserves and its relation to the monetary aggregates and in relation to the fundamental economic variables.

I'd extend that even to the Manager's weekly and monthly reports, where he would [explain how he would] have operated if nonborrowed reserves had indeed been his primary target since the last meeting and what he thinks might have happened to money market conditions had he followed that. That is as close to a hands-on experiment as this Committee can get. And for a number of months now, he has been including in the reports [from] the Desk a paragraph that tries to do this. It may or may not have caught your attention, but this [recommendation] would urge him to include even a little more amplified description of that and would urge each member of the Committee to give that serious attention so that, as you come to each meeting of the Committee, you can decide whether you are prepared to put more emphasis on [nonborrowed] reserves as an operating target.

Third, I'd suggest that you encourage the staff to continue exploring some of these newer techniques for judging the interaction of monetary magnitudes, interest rates, and economic variables and [ask the staff] to report to you occasionally on their findings. This whole body of research--which academics have rather idealistically labeled optimal control theory--is, as has often been said at this table, not yet a workable scheme of things, but I believe it can provide insights in the months and years ahead that would be useful to this Committee.

Finally, I hope you will tell my subcommittee to just keep working away to finish the rest of its assignment. We are a good bit through but not entirely through, so that's in effect a four-part recommendation.

CHAIRMAN BURNS. We can take care of that last recommendation at once--we bless your efforts up this point and want you to continue.

MR. HOLLAND. Good--so the other three recommendations--

CHAIRMAN BURNS. We can take care of the third, too--let the staff continue [its investigations].

Now, the first recommendation, what does it really mean? We have paid no attention to RPD, and you are recommending a ceremonial burial and the announcement that a new regime is being instituted. Wouldn't it be wiser to separate these two? We don't need a ceremonial burial--we can just drop RPD, which has been so much excess baggage, and then announce nonborrowed reserves after experimentation for several weeks or, preferably, several months.

MR. HOLLAND. I thought about that. The reason I didn't recommend it is that I think the Committee would be badly served if its only announced operating target was a federal funds rate--that it is a matter of prudence--

CHAIRMAN BURNS. That is not our operating target--we use the federal funds rate with a view to reaching certain [targets for the] monetary aggregates.

MR. HOLLAND. I stand on what I said--I think it is, in practice, our only operating target, and we need to have a structure that has a reserve measure in it that is workable and that the Committee can work towards.

CHAIRMAN BURNS. Well, the Committee will have to debate that, but as I understand you, you are not really recommending that we adopt the nonborrowed reserves as [part of our] operating procedure immediately and use it at the Desk [but rather that we should] let the Desk carry through some simulations, some experiments, and advise us.

MR. HOLLAND. I am trying to come as close to that as I can without the Committee doing it--so that the Committee can have the benefit of as close to an online experiment as possible without committing itself until it feels comfortable doing so.

CHAIRMAN BURNS. Well, I think you have made it pretty clear where we want to go, and we'll debate that later on. And now we'll turn to a member of the staff, Mr. Kalchbrenner, who will advise us on what the studies by our staff indicate concerning the relationship between the federal funds rate and various measures of bank reserves on the one hand and monetary aggregates on the other, and what that relationship seems to be.

MR. KALCHBRENNER. Thank you, sir.

CHAIRMAN BURNS. To guide me, how much time do you think you will need?

MR. KALCHBRENNER. About 10 minutes, sir.

CHAIRMAN BURNS. Well, you can have 15.

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

CHAIRMAN BURNS. Thank you very much--how good are any of these predictors?

MR. KALCHBRENNER. They all have quite substantial errors on the order of $1.1 billion to $1.8 billion in M1. None of them is terribly accurate in precisely a monthly context. For comparison purposes, we have indicated in the appendix, in table 3, the month-by-month errors for these various equations both for a one-month period and for a two-month average. In the Stage I report, it is obvious, looking at the information that we have before us, that none of these techniques promises very precise predictions of M1 or M2 in a one-month period.

CHAIRMAN BURNS. Now, I'm accustomed to thinking of our monetary aggregates in terms of growth rates rather than in terms of dollars. An error of $3 billion--would that be equal to a 12 percent error, approximately?

MR. KALCHBRENNER. Yes sir.

CHAIRMAN BURNS. And therefore an error of $1 billion would be equal to a growth rate error of plus or minus 4 percent?

MR. KALCHBRENNER. Yes sir.

CHAIRMAN BURNS. And therefore--looking at nonborrowed reserves in table 3--in seven months the error is about $1 billion, and therefore the error is larger than 4 percent. In other words, you are shooting at 4 percent [and] you might get 8 percent--

MR. KALCHBRENNER. Plus or minus 4 percent, yes sir. In the absolute errors, [the error for] nonborrowed reserves is close to 6 percent.

CHAIRMAN BURNS. Let's say the error was merely $1 billion and you are shooting at 4 percent, and you may get, what, between 0 and 8 [percent] in what percentage of the cases?

MR. KALCHBRENNER. Two-thirds of the time.

CHAIRMAN BURNS. Two-thirds of the time. Well, what good is any of this? Now you take one, two, three, four, and five months of 12, the error is over $2 billion. And therefore if you are shooting at 6 percent, that would be within the range of minus 2 and 14 two-thirds of the time. You might as well throw it all away. Well, that's life. I mean, why kid ourselves about the [unintelligible] of the predictive value when the predictive value is negligible. Am I wrong?

MR. KALCHBRENNER. No sir, the standard errors of the [unintelligible] measures on all these equations are as large [as] on judgmental projections that we have looked at over time. They are, as you point out, substantial.

MR. AXILROD. Mr. Chairman, I think two other points might be added. One is that it is true that predictive [error] values are very large on almost any result you choose in a very short run. We only went as far as two months here, which lowers the predictive errors in most cases. If you went a length of three, four, five months, your predictive errors would smooth out even more. I mean they would get smaller, that's one point.

CHAIRMAN BURNS. What would that mean in terms of the Committee's operation? If you go beyond one month? We meet once every three months, we reach a--

MR. AXILROD. No, it would mean, for example, to use an extreme case--if next month you increase nonborrowed reserves $100 million in the expectation that money will grow 5 percent, and [instead] it grew 10 percent, then the following month you increase it $100 million because you still think it will grow 5 percent and it grew 2 percent, then I think it would average out over a long period. If you were persistent in this nonborrowed reserve relationship, that's what it would mean.

The second point I wish to make is that these are relationships based on an econometric fit, as Mr. Kalchbrenner mentioned, and do not make any allowance for any efforts the staff would make judgmentally to allow for the special factors.

CHAIRMAN BURNS. What makes you think that your judgmental efforts produce an improvement?

MR. AXILROD. That, I judge, is why Governor Holland was asking to do this experimentally.

CHAIRMAN BURNS. I'm not saying they wouldn't--

MR. AXILROD. I was avoiding that--

CHAIRMAN BURNS. I know, but you are implying that an improvement will result.

MR. AXILROD. I believe, for example, that all through the year we underestimated the decline in CDs, but we [didn't underestimate] them as badly as these equations are underestimating them. So, judgmentally, we would have been closer because we would have had to take account of our experience.

CHAIRMAN BURNS. I want to turn to another question--I suspect the bias in this effort and I'm going to call the shots as I see them. On page 62 of, I guess, the second stage--

MR. HOLLAND. If it's that many pages, it's probably the staff supporting document.

CHAIRMAN BURNS. It's the staff supporting document, and here is how it goes: "Given current incomplete evidence, it appears the federal funds rate should be rejected tentatively on the grounds that, first, the relationship between the federal funds rate and the monetary aggregates is not closer than the relationship between nonborrowed reserves or the nonborrowed source base and the monetary aggregates." Well, a purely objective statement would be, if there's nothing to choose between them, why reject a federal funds rate?

MR. HOLLAND. The results are weak--

CHAIRMAN BURNS. Well, you know I want to put this right on the table--there is a monetarist bias, I think, in these documents. Now that's all right if, first, there is evidence to support it--and even if there is no evidence to support it, if that is the Committee's inclination. But I would be inclined to argue that, just as the quantity of money has its repercussions on the behavior of the economy, so do interest rates, and if we choose to ignore or minimize the importance of interest rates, let's do that deliberately and not because we have a preference for the money supply. And I see, as I say, a definite bias, and I can read many statements in the staff report that indicate bias to me. Now, your answer might well be that that's the trend of thinking in much of the economics profession, which I think is true. Well, interest rates have also played a significant role in the thinking of the economics profession.

MR. PARTEE. This is in determining M1. The question is, can we do better with the federal funds rate or with some kind of reserve [aggregate]? I think the answer was that there is not much difference.

CHAIRMAN BURNS. No, I think the critical question is, do you put all of your emphasis on the growth of the monetary aggregates or do you put emphasis on that and also on the behavior of interest rates?

MR. PARTEE. I was speaking to that quote you read and also to these tests, which are predicting the ability to determine M1.

CHAIRMAN BURNS. That's right.

VICE CHAIRMAN VOLCKER. What's in this monthly model? Is that the federal funds rate?

MR. PARTEE. That has some federal funds rate--

MR. AXILROD. It simply relates the commercial paper rate and personal income to the demand for money, and the federal funds rate determines the commercial paper rate. Those lags affected--

VICE CHAIRMAN VOLCKER. I also have a couple of other questions--it surprises me, if I read this right--the nonborrowed reserves one--it gets very little better when you take a two-month average compared to some of the others. Why is that?

MR. AXILROD. This was a bad year.

VICE CHAIRMAN VOLCKER. It seems to be a particularly worse year for that one than for some of the others. And I assume, subject to correction, that this is operating in effect without any federal funds constraint in here at all. At least you get worse if you do review some [unintelligible] equations, not worse but you would expect to do worse in this practice as soon as you put any other--

MR. KALCHBRENNER. At least that would be the amount of reserves that were targeted and were not achieved because of the constraints--

MR. HOLLAND. No, Jack, don't you want to answer that question the other way around? This 1975 was a year in which the Desk probably placed more weight on the federal funds rate than it would under the proposed technique, and therefore you did more to allow reserves to move around, because of your federal funds constraint, than would be implied by the Committee [directive], and that if the Manager were targeting on one of these measures, probably interest rates would bounce more, but these relationships would be tighter. Have I said that correctly?

MR. KALCHBRENNER. It is not altogether true that that would be the case in the sense that if the Manager was using the federal funds rate as the target, the reserves responding were subject to the demand for money in the bank. That's why the results you get--

MR. WALLICH. I think you have two separable problems--one is that the data over the period on the review were constrained because of the effort not to let the federal funds rate get outside its range; that is Governor Holland's point. The other point is that, if you had a [non]borrowed reserves target, interest rates would in effect be more variable and you wouldn't be as constrained in pursuing the nonborrowed reserves target as you are now.

MR. KALCHBRENNER. Yes, but I thought the question was in terms of if there were a constraint?

VICE CHAIRMAN VOLCKER. The question is, on these equations, it's necessary to assume you hit the [non]borrowed reserves target. If you were using them as a target, you might not hit the target, which would make the error greater.

MR. AXILROD. Probably wouldn't hit the target if you had them as a target. And given the margin of error, I wouldn't know—

CHAIRMAN BURNS. Tell me, your estimating equations covered what period?

MR. KALCHBRENNER. The estimating equations covered the period from 1969 through 1974.

CHAIRMAN BURNS. And is that a long enough period to give you stable results? Especially in view of the intercorrelation of successive figures--serial correlation?

MR. KALCHBRENNER. With monthly data we thought that was enough.

CHAIRMAN BURNS. You did.

MR. KALCHBRENNER. Yes.

MR. AXILROD. Also, Mr. Chairman, before that period, you begin to get interference from the change to lagged reserve requirements. There's a noticeable institutional change in 1968.

MR. EASTBURN. Could I raise a point [about] that? Steve, we've done some fairly simple kinds of relationships covering some of those earlier periods, and there is apparently a favorable performance in relationship [before] lagged reserves are put into effective force.

CHAIRMAN BURNS. Would you just be good enough to repeat that?

MR. EASTBURN. Yes, a better relationship between nonborrowed reserves [and money] before the [institution of] lagged reserves than after. This raises, I think, a significant policy question, that if we institute a policy whereby the Desk operates on the basis of nonborrowed reserves, with lagged reserves accounting, we may not get very reliable results. It raises a question as to whether we should ask the subcommittee to proceed with its phase III on the lagged reserve question before we start to operate on the basis of nonborrowed reserves.

CHAIRMAN BURNS. Well, now, on the matter of lagged reserves, the Board's staff has been working on that, and I for one have the feeling that we ought to make some change there no matter what we do as a Committee. And your studies of that are pretty far along, Steve?

MR. AXILROD. Yes, they are, Mr. Chairman, and within a matter of three weeks or so, well after the next FOMC [meeting], we are going to come before the Board [of Governors] with a proposition. Because of that, we ran some of the same tests that President Eastburn is mentioning, and because of the proximity of [this] meeting, accelerated them, and they did show within the sample period the same results. That is, comparing running these results with contemporaneous accounting as against a two-week lag; with a two-week lag your results got worse on the order of 25-30 percent, [unintelligible] percentage annual rates of growth--errors in percentage annual rates of growth.

However--I must mention this and just to further confuse things in a way and I'm sorry to do it--but if you then go outside the sample period but still before lag, and outside the sample period but still within the contemporaneous period, and outside the sample but still lag, then the results fall apart again and it's not so clear. That is, outside the sample period, the contemporaneous accounting did no better than the two-week-lag accounting, and I have not been able to explain that result. Within the sample period--what you would expect, the contemporaneous accounting did much better.

CHAIRMAN BURNS. Well, now, your sample period is a much longer period than the period outside, isn't it?

MR. AXILROD. That's correct. The period outside the sample period was in each case one year, and the sample in one case was run six years, and in the other case seven. But in each case there's one year outside the sample period. And that's been our experience. These things just break down outside the sample period.

CHAIRMAN BURNS. Well, now, wait--that seems to mean that you have a generalization with very little predictive value.

MR. AXILROD. With very little consistent predictive value, that's right.

CHAIRMAN BURNS. Mr. Partee.

MR. PARTEE. If I may ask a question? Jack, turning to table 2, now what we're talking about--the first proposal of the subcommittee--is that you substitute nonborrowed reserves for RPD as an operating specification. Table 2, and I'm taking it to mean absolute error--as an example, if one compares nonborrowed reserves to the third line with RPD--

CHAIRMAN BURNS. You're on table 2?

MR. PARTEE. Table 2.

CHAIRMAN BURNS. What year are you on?

MR. PARTEE. Well, I'm looking through the whole series, because the comment was made that nonborrowed reserves were very bad and RPD was very bad in 1975, but as I look at this year-by-year, comparing nonborrowed reserves with RPD, I don't see that nonborrowed reserves were at any time appreciably better than RPD as a predictor over this five-year run. Am I reading that correctly?

MR. KALCHBRENNER. Yes sir, you are. That is correct.

SPEAKER(?). But the Committee did not decide to move away from RPDs because of a finding that its predictive relationship was inferior. Our basic reason is that this is a magnitude that the Manager cannot control in a short-time, sort of [unintelligible]--

MR. PARTEE. Well, I guess my question though is that--

CHAIRMAN BURNS. Why try to control something which has little predictive power?

MR. PARTEE. That's exactly my question. That is, wouldn't we be--my question frankly is--wouldn't we be as embarrassed with nonborrowed reserves missing it by a very wide margin as we have been by RPD missing it by a very wide margin? Is there that much to choose between one and the other if one assumes that we're not going to hit it--that is, that we're going to have the same kind of difference since we're mainly interested in the monetary aggregates rather than these [unintelligible] as we used to call RPD? Would we be that much better off with it than we were with RPD?

MR. AXILROD. If I might answer Governor Partee. If you had the same federal funds rate constraint, in my opinion, you'll miss nonborrowed reserves in exactly the same way that RPD has missed; there will be very little difference. That is, they'll be outside the range with exactly the same frequency.

MR. COLDWELL. Will you improve your predictabilities against M1?

MR. AXILROD. Well, you're asking me over a two-month period. On the basis of these results I would say no, but certainly, over a longer period, I don't believe the Committee operates this way. But if the Committee operated over a longer period on a nonborrowed target, I believe it would [perform] better than a federal funds rate. I believe that I would be able to improve on these results judgmentally, but I cannot tell you how much without making that effort. But I do believe that, judgmentally, I could improve considerably on the results Mr. Kalchbrenner has presented.

CHAIRMAN BURNS. Well, let's put the judgmental factor aside. When you say operating over a longer period, could you make that more concrete for me? What do you mean precisely by the phrase "operating over a longer period?"

MR. AXILROD. Well, I meant in my own mind something quite mechanical, Mr. Chairman. I meant that, if the Committee said it wants to increase M1--just put it in an extreme way, 6 percent over a six-month period--I believe that we could set a nonborrowed reserves path which has a better chance of attaining that than if we said this federal--

CHAIRMAN BURNS. Yes, but I want to understand that. The Committee makes that decision today--does the Committee then go home for six months?

MR. AXILROD. Well, that's why I said it's not a practical point.

CHAIRMAN BURNS. Then I don't know what you're talking about. We are--

MR. AXILROD. It could reconvene and reassess and continue on.

MR. PARTEE. Do you mean that, with no federal funds rate constraint, you could hit it better with nonborrowed reserves?

MR. AXILROD. If you are asking me as a technician, "Tell me how to get 6 percent, six months from now"--

CHAIRMAN BURNS. Wait a minute, 6 percent in what?

MR. AXILROD. M1 growth.

CHAIRMAN BURNS. M1.

MR. AXILROD. I believe that I could do it better by telling you what nonborrowed reserves to hit than what federal funds rates to hit. And the only reason I believe that is because I would not have to predict GNP; GNP would not be as strong an element in that factor. However, I might add, again, since I have great confidence in Mr. Gramley's predictions of GNP, it might in practice mean that I could do it very well with the federal funds rate.

MR. PARTEE. This is just doing it once every six months, Steve, is that right? You're not talking about coming back month after month and adjusting your federal funds rate?

MR. AXILROD. Well, I think by extension you would.

MR. COLDWELL. What about the prediction capabilities on M1 itself? We're attempting to make judgments about M1 and seem to be missing quite often. Now, are you going to be able to predict with nonborrowed reserves with any greater certainty?

CHAIRMAN BURNS. Well, that's what he's suggesting.

MR. COLDWELL. But he keeps coming back to federal funds as opposed to the other prediction.

MR. AXILROD. Well, I think that question, Governor Coldwell, is a question of, if I put down a nonborrowed [reserves] number, and it may be right or wrong, whether that number is obtainable. That is a question you may want to address to Mr. Holmes. I should think, within--

CHAIRMAN BURNS. Wait now, what is obtainable? The nonborrowed reserve figure?

MR. AXILROD. Yes, I thought that's what Governor Coldwell was asking.

MR. COLDWELL. I was asking if you could forecast in the coming months a nonborrowed reserve figure any better than you've been able to forecast for the M1 figure, if you had one.

MR. AXILROD. Because I can put down a nonborrowed reserve number, and I'm believing nonborrowed reserves is controllable. Whether it is in fact controllable within the margin that the subcommittee addressed, I think is an empirical question. I myself would say that, over a month, you'd need broader ranges than the plus or minus $50 million. But I do believe it is controllable within some reasonable range, and over a six-month period there would be offsets. I mean you'd miss this way and miss that way.

MR. COLDWELL. I believe the subcommittee report says that the market factors are at least equal to our input into this nonborrowed figure. If that's the case, then over a month's period, the least we have is wide [unintelligible].

MR. AXILROD. That's why I keep talking about the long run, Governor Coldwell.

MR. COLDWELL. I hear you.

MR. HOLLAND. If I may Mr. Chairman, I think there are a couple of perspectives in regard to this discussion. One is that no short-run or immediate operating target that we have been able to conceive and test has anything other than wide ranges of error. [We have] an inability to hit M1 with any short-run target or indeed in its relationship with the fundamental economic objectives of employment and prices. They all have major variances, major errors associated with them. We're dealing with a set of very imperfect relationships as tested statistically. We each have our own judgmental impressions of how those go and how those change. Those, too, I think most of us would say, have turned out in our own experiences to be pretty loose.

So we're dealing with an imperfect mechanism with a lot of slippages. I think that such work as the subcommittee has done has suggested that if we stick to one of these things month after month, the errors gradually start to offset each other and you tend to settle down a bit over the longer run. And that's something of what underlies Steve's comment that over a span of months, he thinks he could come reasonably close to it.

CHAIRMAN BURNS. I still am not grasping the point. I understand Steve's comment if, let us say, with regard to nonborrowed reserves the Committee makes the decision as to where we're going to be for the next 6 months, and in the meantime did nothing else. We don't meet, or we meet and talk about all kinds of things but don't change that target figure, then I understand Steve. But if we're going to make adjustments month by month, then I no longer understand Steve, and I want to understand.

MR. AXILROD. Mr. Chairman, if I might take a try at one other way, and again putting it in a slightly extreme phase. Suppose--

CHAIRMAN BURNS. You're going to have monthly adjustments.

MR. AXILROD. Yes.

CHAIRMAN BURNS. Okay.

MR. AXILROD. Suppose the Committee does have a long-run target of a 6 percent increase in M1, and then it meets and says [that in the next] two-month period--a normal two-month period--it [still] wishes M1 to grow at 6 percent, and the staff provides a nonborrowed reserve number which we believe will attain that. It turns out that M1 grows at 9 percent. The Committee meets again and says "I still want M1 [to grow at 6 percent]." If the staff tells the Committee that, based on past experience, it thinks that [the previous change in M1 was] within the range of error, then there is no reason [for the Committee] to change its attitude toward the increase in nonborrowed reserves. You're not going to get another 9 percent [increase in M1]. Indeed, you might get a 6, you might even get a 3. And therefore, the staff says, if you want to stay on the 6 percent path, then increase nonborrowed reserves by the same amount that you increased it at your previous meeting. Then it will probably turn out that you'll get 3 percent in M1 the next time. You begin averaging--it will average out.

CHAIRMAN BURNS. What's the evidence for that statement, and for your saying "probably."

MR. AXILROD. The evidence for that statement--it's not here, and we'll ask Mr. Kalchbrenner if I'm right or wrong--is that, if you averaged out over a period of more than the one or two months we had here, if you averaged out over a period of four or six months, I believe the error would be a lot less than the 0.9.

CHAIRMAN BURNS. How much less?

MR. AXILROD. Well, that I don't know.

MR. KALCHBRENNER. I don't know what the current number is, we haven't had time to compute that, but we could certainly do it.

VICE CHAIRMAN VOLCKER. That's still true on all these models. Is it going to be more true of the nonborrowed reserves model than either of the first two you have listed, which look a lot better than the [unintelligible].

MR. AXILROD. In my mind, President Volcker, the only way I would be able to work it down into my own mind is a matter of choice. But in the first models, what you have entering strongly is that some proxy in relation--

CHAIRMAN BURNS. Wait a while, in the first two models?

MR. AXILROD. The monthly and the Shadrack Skinner. What enters into those two models are either personal income or business sales. So they depend essentially on the GNP projection as per an important interval. And if the GNP projection is wrong, they will be wrong.

CHAIRMAN BURNS. How do you use the GNP projection? Is it the absolute figure or the increment?

MR. KALCHBRENNER. Let me check the exact form of the equations that were used. I can tell you that, sir.

CHAIRMAN BURNS. Do you see the reason for my question?

MR. KALCHBRENNER. In the Shadrack Skinner equations, it's the change in business sales related to a change in M1.

CHAIRMAN BURNS. What about the monthly model?

MR. KALCHBRENNER. That is also the increment.

CHAIRMAN BURNS. The increment, all right.

MR. AXILROD. So in the nonborrowed reserves equation, the unpredicted element--I mean the element that we can't control--that enters is interest rates generally. I mean, given nonborrowed reserves. To use a technical term, the elasticity involved, the interest rate--in a nonborrowed reserve [equation], the interest rate variable has less power, so to speak, in influencing the result, than the GNP variable has in the other two equations. So if you believe you're going to make big errors in projecting GNP, you're better off with your reserve equations, and if you believe you're not, then you can work very well on your money market conditions, and I would not quarrel with that result.

VICE CHAIRMAN VOLCKER. These models put in the actual GNP figures.

MR. AXILROD. That is correct. They are based on actual GNP. We have not tested them with the GNP as we thought we knew it then, which would be a reasonable test to run.

SPEAKER(?). It sure would.

MR. COLDWELL. Your element of controllability, Steve, that you mentioned before with regard to prediction of nonborrowed reserves versus money supply, is [higher than] controllability in federal funds. Right?

MR. AXILROD. Well, I don't think we have any problem in controlling the federal funds rate. We have some problems in market reactions when we move it and none in controllability.

MR. COLDWELL. I agree, but you also--what, you've taken a fast look at is the question of federal funds as this proxy target as opposed to nonborrowed [reserves], and I guess you just tentatively, anyway, said that's not so good.

MR. AXILROD. In terms of controllability, I don't think there's any question that the federal funds rate is controllable. The question of controllability entered in [as], of the reserve measures, which is the most controllable? And the most controllable in my mind is the nonborrowed base. And the second most controllable is the nonborrowed reserves.

CHAIRMAN BURNS. Wait now. The nonborrowed base. What is the nonborrowed base--[nonborrowed reserves] plus currency?

MR. AXILROD. That's right. That means you don't have to predict currency. But it might be viewed [as producing] somewhat more money market distortion, and you have big movements in currency relative to the politics.

SPEAKER(?). As you know, accounting costs.

MR. HOLLAND. I think there's another consideration at some stage in our discussion, and before we're under the Government in the Sunshine [law], so, Art, I'm not in the minutes at this point here. [I] thought this could be said [just] across the table. You'll recognize there's a place or two in our subcommittee report where we said that some of the desired results in terms of aggregates could probably be gotten using either a reserve operating target or a federal funds operating target. Theoretically we could get the kind of results to which the Committee aspired with either one of those two alternative operating mechanisms. One of the main reasons we opted for nonborrowed reserves instead of federal funds as a short-range target was a reason that can only be called a matter of political science and not economics. Secondly, when it comes to describing the ultimate target--

CHAIRMAN BURNS. What are the reasons?

MR. HOLLAND. Well, I was going to come to that in a minute. And I was going to say there is also [an option] in terms of whether or not we specify our long-run objectives [in terms of] income and employment, and price increases. The reasons why this report opts not to do those are reasons rooted as much or more in political science as in economics. The reason on the short-run side, the political science reasons for not naming the federal funds rate as our exclusive operating target are two, fundamentally, I think.

One is, we felt the System would occasionally be [beset], if it so overtly accepted the responsibility for hitting an interest rate--for setting an interest rate, if you will, and for setting the federal funds rate that is recognized as a key in the whole interest rate framework. An interest rate setting is a kind of lightning rod in terms of some of the public discussion about monetary policy, and its problems and its consequences, and we would simply increase the chances for involving this Committee and the Federal Reserve [unintelligible] if we had an interest rate operating target. That's one of the reasons we thought it was wise to keep a reserve target in place for use by the Committee in order not to be so closely associated with a particular interest rate target.

CHAIRMAN BURNS. Now, let me just stop you there [unintelligible]. How would you characterize our practice over the past few years?

MR. HOLLAND. Well, I think there's been kind of an evolution over the past few years. But I would say that, in the last year or two, we have basically been moving the funds rate around in the interest of trying to generate monetary aggregate results we were satisfied with, subject to a constraint on the amount of interest rate change we'd make in any short-run period. What we published doesn't say that quite that clearly, but I could say in practice that's what we've been moving toward. And I think it would be desirable to keep a reserve target--a short-run reserve target--in the picture in order to stay away from naming a short-run interest rate target so overtly as the System's objective.

CHAIRMAN BURNS. You don't mean that the federal funds range would be done away with?

MR. HOLLAND. No, no. There would be a federal funds range under the subcommittee's proposal, and it's a range that starts out being plus or minus 1 percent but within which the funds rate might move. We suggested a quarter percent a week--that's not much different than the pace of change we've had at times in the past. So we weren't going to cut it out differently, although we did contemplate that experience might lead us to widen that federal funds range a little bit. We also contemplated that there might be times when the Committee would be concerned with the money market and it wouldn't want that range to be that way, and we felt that the controlled procedure we specify allows for that too. But we thought in general that it would be wiser--safer, if you will--for the Committee to have something besides an interest rate as a short-range operating target. And, indeed, I think the Committee itself has often times reflected that same kind of attitude.

CHAIRMAN BURNS. Suppose the Committee went along with your thinking on the role of nonborrowed reserves, and we set certain targets for nonborrowed reserves. Now could we also have a federal funds rate constraint with the range of movement of the federal fund rate being limited, let us say, to 3/4 of 1 percent, or 1 percent?

MR. HOLLAND. Definitely.

MR. PARTEE. Then you'd miss the nonborrowed reserve [target].

CHAIRMAN BURNS. Well, now, how would that differ from the present procedure, which is what we've done in the last few months, pretty much?

MR. HOLLAND. It wouldn't differ very much, I mean, except we would be missing nonborrowed reserves instead of RPD. The Committee would have, however, I think added [unintelligible] hand to you.

CHAIRMAN BURNS. What I'm having a little difficulty with is, RPD is dead--it's been dead for some time. Now to say that we're substituting nonborrowed reserves for something that is dead, that troubles me. That either means that nonborrowed reserves will be stillborn--and you can't possibly mean that--therefore, you mean something is going to be introduced which will have life and significance in contrast to RPD, which now has none. It's not that we're substituting one thing for another. RPD is dead.

MR. HOLLAND. Well, now it's a little worse than that, Mr. Chairman. RPD is non-operational, but it is very existent in our records, in our policy statements.

CHAIRMAN BURNS. That's true, but that's just excess baggage that we're carrying and should have abandoned long ago; we haven't done so, and maybe there were good reasons. But it is dead, and therefore, you're not substituting nonborrowed reserves for something that exists. You're introducing something new.

MR. HOLLAND. Well, I think you're thinking in terms of operational results, Mr. Chairman, and I'm trying to think of two things: one, operational significance, and second, sort of public significance. RPD is still playing a public role. It provides a complement to the funds rate so we don't appear to be aiming exclusively at the funds rate.

CHAIRMAN BURNS. RPD is unfortunately misleading the public, because we're publishing that among our targets, and we pay absolutely no attention to it. Is that an exaggeration, Al?

MR. HOLMES. No, I think that's true.

MR. HOLLAND. That's true. Now what the subcommittee is recommending is that the Committee work toward the time when it can tell its Manager, pay some attention to nonborrowed reserves. So the subcommittee clearly wants that to happen and the only question about how soon it tells him to start paying attention to it is a question of the Committee's own learning period.

MR. WALLICH. We had several--

CHAIRMAN BURNS. Now, in terms of the goals towards which you're striving, would this make sense, Bob, to drop RPD? Just drop it henceforth, now, and not as yet adopt nonborrowed reserves. Wait a few months, have some further study or indicate we're thinking of it, but haven't yet arrived at it. Would that make sense from your viewpoint?

MR. HOLLAND. Operationally--I think we might be a little slower to get to the time when we actually do it--we said something like that to the Manager last summer. We said to the staff, we'll keep track of nonborrowed reserves and see how it goes--and I believe the Committee's members really had not done that, that we need to do a little more. Press the Committee a little more to raise its attention to nonborrowed reserves so it gets comfortable enough with the magnitude and what it does so it can make a decision on it. That's answer number one.

Number two, in the public arena, I think that it would be unfortunate if the Committee dropped a reference--any reference--to a short-term reserve target, so that the only short-term operating target we were then publishing was a federal funds target. That makes us an interest rate [targeter].

CHAIRMAN BURNS. Well, but how can the Committee publish a nonborrowed reserve target if the Committee hasn't yet decided that that is a desirable thing to do? Or how much attention to devote to it?

MR. HOLLAND. I believe it could publish a nonborrowed reserves figure and----to the extent that the Committee directs the Manager to give weight to an operating reserve measure in its day-to-day operations--say to the public that this is the operating reserves measure that we are going to tell him to pay attention to.

CHAIRMAN BURNS. Well, but if the Committee continues to operate as it has been doing for some time, paying no attention to RPD and as yet not being thoroughly convinced about nonborrowed reserves as a target--and your recommendation is that we're not quite ready for it, we ought to have further study and experimentation--then why should we put down such a target?

MR. HOLLAND. I think what we need a little more of is the Committee getting used to nonborrowed reserves.

CHAIRMAN BURNS. Well, all right, then why not wait until we are used to it, sufficiently used to it, and then adopt it as the target?

MR. HOLLAND. Because I think that over the last six months we've demonstrated that [nonborrowed reserves] has to [be] pushed harder on the [thinking of] Committee members than it has to date for them to acquire that kind of feeling and comfort with it and that kind of awareness of some of its strengths and some of its weakness.

CHAIRMAN BURNS. But now I'm thinking of our public posture. I think we owe it to ourselves and to the public to drop RPD, since we're paying no attention to it. But is it really proper for us? Might it not be premature to indicate that we have a nonborrowed reserve target when we've reached no such decision, and are not likely to do so today, and when that isn't even your recommendation?

MR. HOLLAND. If I have misread the willingness of the Committee to pledge allegiance to nonborrowed reserves, I retreat, but I don't think I have, and I believe the Committee will move in that direction better if it, in effect, puts it in place. And I believe that if it doesn't put it in place now, it is going to be more awkward for us, distinctly more awkward for us, to do so as time goes on.

CHAIRMAN BURNS. Well, I can see the Committee putting out a release saying we're dropping RPD, we have not found it useful, and we are considering substituting for it nonborrowed reserves and some further studies are under way. Now that, I think, would be completely in harmony with your suggestion and yet not involve a commitment by the Committee or an indication to the general public that we're doing something that we as yet have not decided to do.

MR. COLDWELL. Why do anything, Mr. Chairman? Why not just commit ourselves to looking at this question four months from now, or three months from now, and say, "All right, at that time we will substitute it."

CHAIRMAN BURNS. But I feel somewhat uncomfortable, and I think probably all of us do, in continuing to publish the RPD figures, which are sheer ritual, ritual that doesn't even have emotional value.

MR. COLDWELL. I agree they are not useful. My question is, does another three months of publication hurt you at a time when you could make the substitution three months from now?

MR. EASTBURN. May I ask Alan to clarify something he said before? Is RPD positively misleading the [unintelligible] market?

MR. HOLMES. I don't think many people in the market are paying much attention to RPD.

MR. EASTBURN. So, as far as--

MR. HOLMES. Now, maybe in some academic circles they are, but I would say not very much.

MR. EASTBURN. I see.

MR. HOLMES. Mr. Chairman, could I point out, too, that in our [unintelligible] directive the Committee regularly calls attention to reserve availability without specifying RPD, and I see no particular harm, Governor Holland, in dropping RPDs but saying that we're continuing to pay attention to various measures of reserve availability without opting for a particular one at this point.

CHAIRMAN BURNS. Well, that's another possibility.

MR. HOLLAND. But that's kind of calling nothing something, I think, Alan. I think the Committee--

MR. HOLMES. RPD certainly is nothing [unintelligible].

MR. HOLLAND. No, I mean there wouldn't be anything at all in the Committee's specifications in that sense. But suggesting a reserve aggregate that the Committee was tracking and following along--it seems to me that is of underlying help, underlying value to the Committee.

CHAIRMAN BURNS. Yes, but Bob you have not recommended that this be done as yet. You recommended further study.

MR. HOLLAND. No, no, Mr. Chairman I said [unintelligible] and have it up, so as soon as the Committee is ready to pledge allegiance to it, its results are there. And in the meantime, the Committee can follow how Alan's reports say he would have used it, and they can see what the staff would serve up.

CHAIRMAN BURNS. Well, you know, if Alan comes and tells us week by week or month by month what he would have done, I think it's going to be very confusing, really. I would rather think that we request Alan to take some specified number of months, it might be as short as three--six probably would be better--and ask him to simulate Desk operations during that period on the assumption of a nonborrowed reserve target and how that target might be set for him by the staff, you see, and how we would have fared and what the difference would have been. And in addition, to simulate over this period what Desk operations would have been like and what the results with regard to the monetary aggregates would have been if nonborrowed reserves had received a certain specified weight along with M1 and M2 in the Desk's operations. Could you do that, Alan?

MR. HOLMES. Mr. Chairman, we've done a great deal of that work going back through last June up through the end of March. All of this, of course, suffers from one big defect, and that is, if you're not operating on a nonborrowed reserve target, as soon as you get away from the base [period] you know your numbers become less and less meaningful. I think maybe we can report on the first two [unintelligible] after a Committee meeting. That would be more significant. We've done all this other work, and I must say it's not very good.

CHAIRMAN BURNS. You say it's not very good.

MR. HOLMES. No, but it does suffer from a fundamental defect, which is that we're not operating on a nonborrowed reserve target and so therefore we may be [seeing] results that are peculiar in terms of nonborrowed reserves.

MR. BLACK. You also have more constraint on your federal funds than you would have under this scheme.

MR. HOLMES. Presumably, although that still can't be decided, this is the presumption that the Subcommittee on the Directive made.

MR. HOLLAND. I see no distinction, Mr. Chairman--or, if you're drawing a distinction, I miss it--between what I was suggesting that Alan do in terms of keeping track of how he would operate and what the results might be, and what you're implying when you say simulate. I think the intellectual operation comes to the same thing.

CHAIRMAN BURNS. Ah, well, without belaboring the difference, you would have him report at every meeting, and I'd have him report after a period of months. But in view of what Alan said, your suggestion is better than mine. That's the way I interpreted Alan's comments.

VICE CHAIRMAN VOLCKER. Even that strikes me as being very difficult. You're more than a few days away and you're engaged in some operation, and the situation is different.

MR. HOLLAND. The reason is--what we're struggling with--is trying to find ways to make this Committee feel as sure as it's likely to be able to feel in a highly uncertain world of what's going to happen before it makes that decision to change the emphasis that it has now come to place on federal funds and shift it instead in the direction of a short-term aggregate reserve target.

VICE CHAIRMAN VOLCKER. What troubles me, Bob, is that I start out philosophically thinking this is a good idea, but the more you learn when you look at these numbers, the less it seems to be borne out statistically, and the more you wonder whether it's just a question of getting the Committee used to it. This really doesn't look very good in substance.

MR. HOLLAND. Neither does short-term interest--neither does the funds rate as a guide.

VICE CHAIRMAN VOLCKER. Looks better than nonborrowed reserves--that's all you can say.

MR. HOLLAND. No, I don't think that would be true if you ran through all the evidence.

MR. JACKSON. I'd like to ask a question, Mr. Chairman. Maybe our problem is our concept of measures of these monetary aggregates. Perhaps we should move toward John Balles's suggestion of a longer-term measure instead of a shorter-term measure and then measure the operational aspects against that concept of M1 rather than the shorter-term concept of M1. Then we could in fact produce the type of relationships where something makes some sense. And we all have to admit that as long as you stick with the short-term concept of M1, nothing is going to make any sense.

MR. BALLES. Exactly.

MR. JACKSON. And that only when we go to a longer-term concept will any of this begin to make any sense, and maybe our definition of what we're looking for ought to change rather than the way we look for it.

CHAIRMAN BURNS. Well, I think that's a fair question.

MR. WALLICH. Mr. Chairman, I think we have two ways of looking at the funds rate here. As I understood our subcommittee's work, the reason we're tending to move away from it is that the funds rate may be a very good predictor of M1, but it is a good instrument [only] if you're willing to move it around vigorously to get the M1 or other aggregates that we want.

We treat the funds rate in two senses: in one sense as an instrument and in the other as an objective in itself as a proxy for other interest rates and something therefore that we don't want to move as vigorously as we may have to in order to get the [behavior of] aggregates [that we want]. In the past, this has often caused trouble. And as it causes the aggregates to run away or to lag, the funds rate has proved to be a poor lever even though it's an effective lever if it's used [aggressively].

That's where we were going and I thought we were going probably to a less accurate nonborrowed reserves instrument. Now if we could prevail on ourselves to treat the funds rate as we would treat nonborrowed reserves, namely, purely as an instrument and not at all as an objective, then I think it would be the superior thing. But we're not able to do that for pretty convincing reasons.

MR. BALLES. I'd like to pick up on the point that Governor Jackson just made, because it also perhaps expresses in a sharper way what Steve Axilrod was trying to tell us a little while ago--these tests of the predictive ability of nonborrowed reserves for M1 on a one-month basis or a two-month basis obviously leave a lot to be desired because the margin of error is very large.

But what we do know, because this has been pretty thoroughly tested, is that there is some minimum span of months, probably between three and four, that you need on money supply data so that these random errors on the monthly seasonally adjusted value begin to cancel out. And if we were to look at our aggregates target as being some version of this smooth series, a moving average of some number of months, three or four, then I think that the kinds of errors that Jack's paper came up with in 1975 would appear far smaller and far more [acceptable], and perhaps we ought to run through that exercise. Jack, would that be feasible to do?

MR. KALCHBRENNER. Yes sir, we can do that.

MR. BALLES. I'm fairly confident that we'd get numbers that would look far better than the ones you came up with in a one- and two-month test.

MR. HOLLAND. I don't think there's any question, John, that that's the way the results would come out. There is a lot of noise in the month-to-month bounces that smooth out a bit over some span of time. Whatever operating instrument you're talking about has a lot more short-run noise than long-run persisting influence. Henry is harking at something that I meant to be subsuming under my comments about political science reasons for talking about a reserve target as well as a federal funds rate target. I believe myself, from sitting and watching this Committee in years past, that when the federal funds rate was its predominant operating target, you could pick critical points when that has led the Committee to be too slow and too late in making its major cyclical adjustments in monetary policy.

CHAIRMAN BURNS. Is that necessarily true?

MR. HOLLAND. No, that's an expression of judgment. Because it's not the kind of thing you can empirically test, or run against an equation. That's another way of saying the same kind of thing Henry's trying to say. And it is one of the things that led me and, I believe, other members of the subcommittee to urge that a reserve operating instrument be available to the Committee as well as a funds rate--because of that pattern back over time.

CHAIRMAN BURNS. Well, I wonder how much difference it really makes. Now suppose you have a reserve target, and to achieve that reserve target you find that interest rates keep on shooting up at a rate which members of the Committee will find disturbing because of prospective economic effects, and I'll say nothing about your political science. What's the use of kidding ourselves--not all of us, I know, but some of us do regard interest rates as playing a significant role in the economic process.

MR. MORRIS. I think the virtue of the system, Mr. Chairman, in that context is that the Committee would be clearly alerted to the fact that if it holds down the funds rate over a period of several months, it is highly probable that it will get a pattern of monetary growth which is excessive and will exceed its longer-run targeted numbers. I think that, in the sense that the Committee has this brought forcibly to its mind at every meeting, I think we'll face up more realistically to this choice we've got ahead of us.

MR. WALLICH. I don't see focusing on the aggregates as in any way denying that money works through interest rates. I think that is precisely how it does work. But our question is, should we achieve interest rates directly by setting the federal funds rate and making a judgment as to what's the right interest rate, which is hard to do in times of inflation, or should we go with the aggregates and trust that they will produce the right interest rate because, under inflation conditions, that's a safer guide? We don't know what interest rates we want, but we think that a reasonable rate of money growth will produce an appropriate interest rate. That's how I view our procedures.

CHAIRMAN BURNS. Well, that's one way of looking at it, and another way of looking at the world is to judge what reasonable movements of interest rates are from the viewpoint of our more basic economic objectives.

MR. WALLICH. Well, in the funds rate there are notches where one becomes concerned, say, when it [unintelligible] approaches disintermediation level, but other than that, it's really very difficult to say now what is a rate that contributes to stable growth.

MR. MORRIS. And I think to follow up on the point that Mr. Axilrod made, I think that to the extent that we choose a rate without careful consideration as to the probable monetary growth that is to be associated with it, we're very likely to run off course in those instances when our economic forecast is wrong. To the extent that we're focused on reserves as our operating target, I think we're less vulnerable to making mistakes when the forecast is wrong than we are when we are pursuing the federal funds rate target.

MR. HOLLAND. No.

MR. WALLICH. I also tend to think that changes in rates are significant, and they probably are. The immediate effect of going from one Treasury bill rate to another, particularly from one long-term rate to another, is pretty major. And for that reason we may delay the necessary adjustment that would come about automatically if we stuck to some rate of growth of the aggregates.

CHAIRMAN BURNS. Well, this assumes that we know, or have a way of knowing, what rate of growth of the aggregates will produce optimum results for the real economy--

MR. WALLICH. Well, I think we--

CHAIRMAN BURNS. --and your argument seems to imply that we know that as far as monetary aggregates are concerned, but do not know that as far as interest rates are concerned. I can grant the second part of the argument without also granting the first.

MR. WALLICH. Well, my argument is that it's a little easier via the aggregates and only at a time of inflation, when you really don't know what the real interest rate is, With the aggregates, you know at least that you're not way out of the ballpark--7 percent cannot produce enormous inflation or it cannot produce stability.

CHAIRMAN BURNS. You know, each one of us has his own impression both of what economic proof is, or may be, and also of Federal Reserve policy. I think that, as a practical matter, we have been aware of two channels of influence on the real economy through monetary policy. First, through the monetary aggregates, and second, through interest rates, and we paid attention to both. I think that the Committee--over the years, we've made our mistakes, but we haven't done too badly. Sometimes the emphasis is shifted in one direction and sometimes in the other direction. I think that by paying attention to both we are probably utilizing what economic knowledge exists more wisely than if we put all our bets on one rather than the other.

Now in fairness to your subcommittee, the subcommittee that you served on with Mr. Holland, you're not ignoring interest rates, you have an interest rate constraint. But you would allow the federal funds rate to move within a wider range than we typically have--for example, during the past year. And second, in response to a question of mine, Mr. Holland has indicated that the narrow range we have had during the past year and many months for the federal funds rate is entirely consistent with the recommendations of this subcommittee. I think you said that Bob.

MR. HOLLAND. Would the mechanism put in place by the Committee--

CHAIRMAN BURNS. Oh yes, not with the--the mechanism.

MR. HOLLAND. The FOMC could occasionally vote to narrow its range, it could vote its federal funds rate ranges and it could widen them.

CHAIRMAN BURNS. No, I realize that your subcommittee would favor a wider range, but as far as the mechanism is concerned and the accent that you think is proper for nonborrowed reserves, all that could be respected and we still could operate either occasionally or invariably, if we so chose, with a narrow federal funds rate range.

MR. HOLLAND. Yes, we'd be having a number of meetings to deal with the inconsistencies in the specifications, undoubtedly, but the Committee could do that.

I'm conditioned very much on this recommendation by two underlying things. One, time and again, this Committee is going to have to reach mental compromises on how it feels about what's happening in the aggregates and how it feels about what's happening to interest rates and attach a relative weight in terms of those two effects on the real economy. We've done it in the past and we're going to have to do it in the future. It seems to me to be as clear as can be that that's going to happen, and we need to be using a mechanism that the Committee can work with as sometimes [the Committee] accentuates one and sometimes the other. I believe this mechanism we're suggesting to the Committee lends itself better to that than the mechanism we have now.

Second, when the Committee is making mistakes, I believe the mechanism our subcommittee is suggesting will work a little better than the mechanism we have now or the mechanism we've had in the past. If the Committee always has everything figured out, then it doesn't make any difference which variable you start with because you'll have the linkages figured out, and you'll get the right results. The real critical--

CHAIRMAN BURNS. Not that, we'll get the right results because we're lucky.

MR. HOLLAND. Well, luck has saved us more than once, and I hope she does again. One of the critical points of distinction [between mechanisms] comes when the Committee is wrong and the real economy is doing something and the financial system is doing something different from what this Committee has foreseen, what it wants, and what its staff projections suggest ought to happen. When you have that kind of error developing, I believe the kind of technique the subcommittee is putting forward to the Committee will surface that error for the Committee's attention a little sooner and a little more closely than the mechanism we're using now.

CHAIRMAN BURNS. You know, from the viewpoint of public relations, one could make an argument in favor of your recommendation along the following lines: We have no way, really, of controlling M1 or M2--the linkage between reserves and these monetary aggregates is loose, and the multiplier, if you want to call it that, keeps on shifting and it's unpredictable. What we can control is reserves, and more specifically, nonborrowed reserves. We set certain targets for ourselves that we believe are reasonable on the average, and that is something that we can do and we are doing. And we're obtaining the targets that we have set, and don't ask us to do that which we can't do.

Now there may be a certain advantage in that in our public relations, but that goes very much further than anything you've recommended, you see, because you still want M1 or M2 or M3, and it becomes only a question of how you can best get there. What I've just said goes far afield from that: nonborrowed reserves, the quantity we can control--we do no more, and don't ask us to do any more; we're not magicians.

MR. COLDWELL. Mr. Chairman, nonborrowed reserves has a lot of attractions for me if we use it as a substitute for attention to M1 in a short time frame. But if we're merely adding the nonborrowed reserves as another element for inconsistency purposes, I have a lot of trouble with that.

CHAIRMAN BURNS. What's the trouble?

MR. COLDWELL. Well, we just add another item that the Desk is going to have fight between M1 and M2, the federal funds rate, and now nonborrowed reserves.

CHAIRMAN BURNS. Plenty of intellectual talent that in--

MR. COLDWELL. I understand that, but I'm a little resistant to the idea of giving them more elements of inconsistency to work with in a short-range period. Over a longer range, if we use nonborrowed reserves in a monthly context and look at the Ms in a quarterly context, I can see this as being a valuable addition.

MR. BALLES. Mr. Chairman, may I respond to Governor Coldwell. One thing that may have been neglected here is the subcommittee's recommendation that the Manager refrain, we really mean that, we [unintelligible] kind of look through [non]borrowed reserves to the aggregates. It would be the [responsibility] of the staff to make these linkages between the [non]borrowed reserve range and the aggregates range the Committee decided it wanted. And in this fashion we could at least pinpoint where the problems were.

[If] the Desk [was unable] to get the [non]borrowed reserve range because of the federal funds constraint, then the Committee would have full [unintelligible] fairly sharp path in the decision to make in the context of the national markets and what our instincts tell us is good for the economy and so forth.

On the other hand, if the Desk did hit the [non]borrowed reserve target within the federal funds constraint, but we weren't getting the end results that we wanted on the aggregates over some span of, say, three or four months, then the staff would have to reexamine its equations in relationship to what level of [non]borrowed reserves would achieve the aggregates [target] over some span of months. And I think that's one real advantage of this proposal over the system that we have now. We can't quite tell whether it's a federal funds constraint, or the multiplier, or what it is that's causing us to miss our target.

MR. COLDWELL. Is this workable?

MR. HOLMES. Well, Governor Coldwell, let me make that simply a very concrete observation. And I want Peter to make sure that I say this correctly. As of last Friday, we had M1 and M2 right in the middle of the Committee's two-month target. And if we had had a nonborrowed reserves target, and if we had constructed a [reserves] path correctly--I had many problems in making sure that we've constructed a proper path--we would have been called upon to tighten the money market, let the funds rate go up. Now is that really what the Committee wants? What I thought the Committee was really interested in is the aggregates, admitting that we can't judge where we really are.

CHAIRMAN BURNS. Why would you have had to tighten, Alan?

MR. HOLMES. Because we would have been well outside our nonborrowed reserves path as best we know how to draw it.

CHAIRMAN BURNS. I see, you're sure of that?

MR. HOLMES. Do I have it right?

MR. STERNLIGHT. Not sharply higher, but moderately higher, it--

MR. AXILROD. Well, there's room for dispute in all this. I think you are going to get projections differences between the Desk and the Board's staff in all of this, as you do now. And looking back at that period, it looked like we didn't change the federal funds rate. Your average nonborrowed reserves would have been $100 million higher over the five-week period than the target level we constructed. On the subcommittee's guideline, plus or minus $50 million, that hadn't been widened, [so] the Desk would have the choice of tightening up a little bit now or waiting awhile in order to see if maybe, with a little luck, our required reserves would drop later. So, while, [on a] literal reading early in the period we might want to tighten up a tick, it would also [be an] option to wait another week or so. And by [that] time [if] you were still $100 million off on your projections, then you might not have very much option left if the range were still plus or minus $50 million.

MR. WALLICH. Is there a possibility that if you waited a little while it might turn out that the aggregates would in fact begin to move in the direction in which the overshoot error in the nonborrowed reserves suggested that they would go?

MR. AXILROD. That's the question of judgment, but the aggregates projection was actually below the midpoints of the ranges.

VICE CHAIRMAN VOLKER. But literally, if I understand the subcommittee's recommendation properly, Alan shouldn't even have been looking at M1 or M2. All he knows is that [non]borrowed reserves is above the targets so he should have been acting.

MR. JACKSON. I have [unintelligible] knows that your projections for M1 may just happen to accidentally hit the midpoint, which will lead you to future error.

VICE CHAIRMAN VOLCKER. Well, what is the theory of the subcommittee? [Unintelligible], forget about M1 and operate on [unintelligible].

CHAIRMAN BURNS. Well, now, that may be the theory of the subcommittee. I asked Mr. Holland to advise us where he would like to [come] out. He made no such recommendations.

VICE CHAIRMAN VOLCKER. This is the ultimate, the--

CHAIRMAN BURNS. I don’t want to debate ultimates because I don’t know whether we will even go to the first step. The Board [of Governors] still has a meeting, and we’ll have a difficult meeting. We’ll have to bring this FOMC meeting to a conclusion very soon and I’d like to come out with some decisions. Now let me, under 4a, make this suggestion and see if it’s at all agreeable to the members of the Committee. Let’s accord RPD a decent burial, and a decent burial would be to publish an article in the *Federal Reserve Bulletin* reviewing our experience with RPD, and why we consider it a failure, and then review some of the studies that we’ve been making of other reserves measures and indicate that there are other reserve measures that are more attractive, perhaps particularly nonborrowed reserves, and stop at that point as far as A is concerned. I give you that as a target to shoot at, to accept or to reject. Does that suggestion make reasonably good sense to the Committee?

MR. JACKSON. How much time?

CHAIRMAN BURNS. Well how long would it take to prepare such an article, Steve?

MR. AXILROD. I think it would take at a minimum two months or more. I think it would have to be very carefully worded. I believe you would have to face the problem, Mr. Chairman, of why we missed the RPD targets. And I think to a great extent it would be because the evidence would show that the Committee chose to adhere to the federal funds rate constraint rather than the RPD target.

CHAIRMAN BURNS. I don’t think so, call the shots as you see them and as the facts are.

MR. AXILROD. What the evidence will show--

CHAIRMAN BURNS. That isn’t necessarily a criticism of the Committee--in fact, that may be evidence of the Committee’s practical wisdom. But you’ll have to write it up in an objective spirit and not suggest that the Committee failed because of its federal funds rate constraint, and be neutral as between that and between or suggesting that it acted wisely. Mr. Gramley.

MR. GRAMLEY. Mr. Chairman, suppose one took a very cold, hard, objective look at the RPD experiment and said there never was one. The Committee was fooling itself from the beginning, that any significant realistic experiment would have required much larger variations in the federal funds rate than the Committee was ever willing to tolerate--

CHAIRMAN BURNS. Well, all right, this is what--

GRAMLEY. --which I take it is a view that most academic critics have taken. This is very difficult to write up in print.

CHAIRMAN BURNS. All right. Now let me ask you this question. Can we bury RPD without an explanation?

MR. GRAMLEY. I would be inclined to suggest a minimal kind of explanation. I think the explanation that you're suggesting would be too revealing if it were written in up in a fairly honest, candid fashion.

CHAIRMAN BURNS. Well, I…I honestly have a very good conscience about all of this, and I think that is true of the whole Committee.

MR. PARTEE. The problem I have with it, Mr. Chairman, is that once you admit that the RPD wasn't hit because of federal funds rate constraints--well-intentioned, proper policy as it was--then you would have to conclude that no other reserve aggregate would be any better than RPD. That is, I don't know how you keep from saying [unintelligible] about reserves.

MR. MORRIS. I think you can make the argument, Chuck, that the difference lies in the ability of the Manager to control--

MR. PARTEE. Not with a federal funds rate constraint, he has no better ability to control it.

CHAIRMAN BURNS. Gentlemen, I want to move along. Drop that suggestion about an article in the *Federal Reserve Bulletin* and let me suggest that we just drop [RPD] and not say anything about it. I'm going to the other extreme now. First is a full scientific explanation in a scientific journal; the second is a very quiet death, we say nothing about it, we drop it.

MR. PARTEE. Maybe a paragraph in the Record of Policy Actions.

MR. BROIDA. That's what I was going to suggest, Mr. Chairman. We mentioned it in the Record of Policy Actions this time; we could simply omit it and indicate that the Committee had decided to stop setting two-month ranges for RPD and be more eclectic with respect to reserve measures.

CHAIRMAN BURNS. All right, does that suggestion meet with the--let's have a show of hands from the members of--

MR. COLDWELL. May I make a comment first.

CHAIRMAN BURNS. Yes, please.

MR. COLDWELL. A question, I guess. Why do you want to bury it today rather than wait till we have a substitute? What does the difference of another few months carrying on a nonexistent or a noneffective [unintelligible] after you've done it for a year?

MR. JACKSON. Let me speak to this, Mr. Chairman, because I raised this point several months ago. It makes me extraordinarily uncomfortable to tell the public that we are watching some measures or a relationship when in fact it's a lie, and I just hate to see us do it. I'd rather see us do the wrong thing and tell the public the truth than perhaps to do the right thing and lie about it.

MR. COLDWELL. Well then what you have to say is--

CHAIRMAN BURNS. What you've said I think is entirely accurate, but it's not a lie we've had. You know, we're traditionalists--

MR. JACKSON. Excuse me, that perhaps was an overstatement, we don't say things so directly [unintelligible] we say things more subtly.

MR. WALLICH. Federal Reserve [unintelligible] everything.

CHAIRMAN BURNS. No, I don't think there's been any lying. It's been just a failure, you know we're just a tradition-bound group, and it's been a failure to recognize that, and I think it's negligence on our part rather than anything else. But I'm quarreling with you on your language, not on your thought. There I have to be with you. Well, let's face it, let's have a show of hands, do we drop now, say at the next meeting, with such a paragraph in the Record of Policy Actions, or do we wait a few months as Mr. Coldwell suggested. The first suggestion is A, the second is B. Let's have a show of hands of those who favor A.

SPEAKER(?). This is drop now, Mr. Chairman?

CHAIRMAN BURNS. Just those who are voting yes, members of the Committee.

MR. BROIDA. Seven, Mr. Chairman.

CHAIRMAN BURNS. Well, I think the majority of the Committee would favor that. Next we have the [unintelligible], what do we say, if anything, about nonborrowed reserves at this time? Now, let me make a suggestion on that. [We could] indicate in the Record of Policy Actions that we are experimenting with various other measures of reserves and as yet have not reached a conclusion as to which is the optimal measure. Would that be acceptable?

MR. EASTBURN. Mr. Chairman, would that be in the same context, the same paragraph related to the--

CHAIRMAN BURNS. Same paragraph, or a sentence or two in the immediately following paragraph.

MR. EASTBURN. Would the public interpret that as if they were in that close relationship, that you were actually substituting when indeed we have not so agreed?

CHAIRMAN BURNS. Well, we can word it so as to avoid that kind of confusion, that kind of interpretation.

MR. EASTBURN. Okay.

MR. WALLICH. Mr. Chairman, we really have experimented a lot with reserve measures, and I think among reserve measures there is some preference for nonborrowed reserves. We could at least hint that that's what we're thinking about.

CHAIRMAN BURNS. Well, let's first take the narrower sentence or paragraph as I suggested it, and then we'll add your thought. How many would favor doing that in the Record of Policy Actions, indicating that we have been studying and are continuing to study other measures of reserves for possible use in our operations at the Desk? Simply a sentence along those lines.

MR. BROIDA. Nine, Mr. Chairman.

CHAIRMAN BURNS. All right. Now, next, let's consider Governor Wallich's suggestion, which is to add a further phrase to the effect that nonborrowed reserves appears to be perhaps the best of these measures but not say that it is or that we're adopting it. How many would favor such an additional sentence?

MR. BROIDA. Four.

CHAIRMAN BURNS. Well, then, we don't do that at the present time. And we can do that, you know, at the next meeting or--now under B in the 4A in our agenda, emphasis on reserves as compared with monetary aggregates.

Now let me ask this, Mr. Holland, whether it would serve and be entirely in harmony with the recommendations of your subcommittee if we now agreed that at each meeting of the Committee, the Manager would indicate how we might have fared if he had relied on nonborrowed reserves completely or in part. And we do that for several months when he gives his report on operations at the Desk--that at the end of that report he takes a minute or two to indicate what might have happened if he had paid more attention to nonborrowed reserves.

MR. HOLMES. Actually we have been doing that for many months in the report--

CHAIRMAN BURNS. But you have not been reporting--

MR. HOLMES. --but not at the Committee meetings.

CHAIRMAN BURNS. You've not been reporting to the Committee. Now is that in harmony with your suggestion? Your second suggestion?

MR. HOLMES. Oh, yes.

MR. AXILROD. Mr. Chairman, do you also want us to include an appendix in the Bluebook giving the nonborrowed reserve measures that might be consistent with the alternative--

CHAIRMAN BURNS. That certainly was Governor Holland's suggestion, the suggestion of his subcommittee, and I think that would give us all something to study before we come to the meeting.

MR. AXILROD. --plus their relations to other reserve measures--plan to include their relation to total reserves and the base?

CHAIRMAN BURNS. Well, as to the scope of that appendix, at this stage we ought to leave that to the staff without putting fences around them. Is that acceptable to the Committee? Let's have a show of hands.

MR. BROIDA. Eleven, Mr. Chairman.

CHAIRMAN BURNS. All right. Now as to the federal funds rate constraint, I would suggest to the Committee that we do nothing about that at this time until we learn more about this--let our thinking mature as to the federal funds rate constraint--and operate as we have been operating. By that I don't mean that we do what we did the last time, but that each time we reach our best judgment as to what the federal funds rate range ought to be, and that we not try at this meeting to decide they ought to be wider or narrower. We'll leave that question open. Is that suggestion acceptable to the Committee?

MR. BROIDA. Looks unanimous, Mr. Chairman.

MR. WINN. Mr. Chairman, on that score how much do we really know about the impact of small changes in rates on economic activity and how much of this [unintelligible]?

CHAIRMAN BURNS. Well, the worst part of it is that we have a lot of private methodology, individual methodology.

MR. PARTEE. The small changes are cumulative.

MR. HOLLAND. The subcommittee has been unable to produce objective empirical evidence on that, Willis. That's one to which we hope to turn. At the moment, we're operating under conviction, personal conviction, that too much short-term bounce in interest rates hurts.

CHAIRMAN BURNS. Well, gentlemen, I don't know how Mr. Holland feels about this meeting or [how] the other members of this Committee [feel] but I think we've made some real progress. How do you feel, Mr. Holland?

MR. HOLLAND. Well, I regret your removing RPD and not putting nonborrowed reserves in its place. I think the Committee is going to suffer from that vacancy because I think it's hard enough for the Committee to move ahead as it is without taking that. And I'm afraid you'll produce a little public reaction to the fact that we are now not using reserves in any way as an operating instrument.

CHAIRMAN BURNS. Well, I thought that we all had the impression that the public pretty much knows that we've been paying no attention to it.

MR. HOLLAND. I think it's only [with regard to] the market participants that you can use the verb "know."

CHAIRMAN BURNS. Well, what about the economists that pay attention to money, do they think that we are using it effectively? Henry, do you have an opinion on that?

MR. WALLICH. Well, I think we will get a criticism from the monetarists for dropping it, whether they think that it's useful or not.

CHAIRMAN BURNS. Look, we've got criticism from the monetarists no matter what we do. It's their destiny to criticize, it's their place in life.

MR. BROIDA. Mr. Chairman, as I understood the earlier agreement, it was that the Record of Policy Actions would say that the Committee was considering a variety of reserve measures and experimenting and was to decide which was the best.

CHAIRMAN BURNS. Well, I think you ought to say the staff has been studying that intensively, and you might even list, that is, indicate the range that the staff is considering. I think, Bob, your concern is over the possibility that we may forget about nonborrowed reserves. That's the way I interpreted your comment.

MR. HOLLAND. No, I think the Committee would pay a little more attention if it is bumped again, that's true. But my larger concern is that how we may appear to outside groups.

CHAIRMAN BURNS. Well, outside people are ready to leap in, they know all the answers and we're not that smart. Now, I do think that because Alan has now assumed a definite obligation to the Committee--the report on nonborrowed reserves; what difference specific attention to that would have made; operations of the Desk; and assuming that obligation at every meeting henceforth--the Committee is not going to forget about nonborrowed reserves.

MR. HOLLAND. No, I think that's true. I think we could also ask the staff to do a quick review of what Alan has said in that fashion in the last eight or 10 months or so that he's been sticking a word or two in his report. And you can get a chance to see how his observations accumulated over a number of months, which might be helpful.

CHAIRMAN BURNS. Well, unless a member of the Committee wants to raise any other question, I think we're ready to adjourn.

VICE CHAIRMAN VOLCKER. The staff will inform us about at least one and I hope two things--how these equations look extended over a longer time period and how the present model would look if you were operating on forecast of GNP instead of [unintelligible].

SPEAKER(?). Right, we've noted that in--

CHAIRMAN BURNS. Well, then, I think that Mr. Balles's suggestion about the somewhat longer time span of a few months ought to be explored pretty thoroughly, and that ought to come before the Committee before too long.

MR. AXILROD. I had a tabulation prepared on certain noted measures. I was not able to work this four-month to the average, as yet. I could expand that and make that available at a later point.

MR. BALLES. Then we'll be getting an analysis of lagged reserves. Is that coming out too?

CHAIRMAN BURNS. Well, as Steve indicated earlier, this will come before the Board before the month is over.

MR. AXILROD. Before four weeks is up.

CHAIRMAN BURNS. Three or four weeks from now, I think more so.

VICE CHAIRMAN VOLCKER. Mr. Chairman, this is a parting shot here--maybe this will make you feel a little better about the report. Certainly [speaking] for myself, and I think on behalf of the other members of the subcommittee, I can give you categorical assurance that there is not a monetarist in the group.

CHAIRMAN BURNS. Well, that fills me with deep regret. I'd like to see a monetarist in the group. It's hard to live in this world... But I think that we owe a debt of gratitude to Mr. Holland, and to his colleagues--Governor Wallich, Mr. Morris, Mr. Balles--who worked with him and also to our staff, who have worked very diligently, very imaginatively on this problem for a good many months now. Well, thank you.

END OF MEETING