TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

December 20-21, 1976

Prefatory Note

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

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

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

Staff Statements Appended to the Transcript

Mr. Sternlight, Deputy Manager for Domestic Operations

Content last modified 01/11/2011.

Meeting of Federal Open Market Committee

December 20-21, 1976

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Monday and Tuesday, December 20-21, 1976, beginning at 3:30 p.m. on Monday.

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

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

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

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, 1/ Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Axilrod, Economist (Domestic Finance)
Mr. Gramley, 2/ Economist (Domestic Business)
Messrs. Brandt, Davis, Kichline, Parthemos, Reynolds, and Zeisel, 2/ Associate Economists

1/ Attended Monday session only.
2/ Attended Tuesday session only.

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

Messrs. Coyne and Keir, Assistants to the Board of Governors
Messrs. Gemmill and Kalchbrenner, 3/ Advisers, Divisions of International Finance and Research and Statistics, respectively, Board of Governors
Mr. Paulus, 3/ Chief, Banking Section, Division of Research and Statistics, Board of Governors
Mr. Smith, 3/ Chief, Financial Markets Section, Division of International Finance, Board of Governors
Mr. Beck, 3/ Senior Economist, Division of Research and Statistics, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Messrs. Boehne, Doll, Eisenmenger, and Scheld, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Kansas City, Boston and Chicago, respectively
Messrs. Burns, Karnosky, and Keran, Vice Presidents, Federal Reserve Banks of Dallas, St. Louis, and San Francisco respectively
Mr. Hall, Assistant Vice President, Federal Reserve Bank of Cleveland
Mr. Duprey, Economic Adviser, Federal Reserve Bank of Minneapolis
Ms. Tschinkel, Adviser, Federal Reserve Bank of New York

3/ Attended part of Monday session only.

Transcript of Federal Open Market Committee Meeting of
December 20-21, 1976

CHAIRMAN BURNS. We will be discussing legislative, administrative details. In case I fall asleep, please do not join me. As I think all of you know, Mr. MacLaury will be leaving us. He'll still remain in this city, fortunately. We'll have the opportunity to see a good deal of him, but he will carry his loyalty and his love for the Federal Reserve with him, and he'll be joining the Brookings Institution. And we have a way of punishing people that do things like that. There will be a luncheon, and Mr. MacLaury will have to make a few remarks on that occasion. That luncheon is scheduled for 1:00 tomorrow.

The first item on the agenda is a report by Governor Partee's Subcommittee on the Domestic Policy Directive, and therefore Mr. Partee, we're ready for you and for other members of your subcommittee. I suggest you proceed your own way.

MR. PARTEE. Thank you, Mr. Chairman. This is a holdover from the last meeting of the Committee, and it represents, I would say, essentially a housekeeping proposal. Specifically, we have discussed in this Committee from time to time the question of the proper location of the long-range aggregates specifications and the short-run aggregates specifications. For a number of years, they have been in a supplementary piece for technical reasons that no longer apply. Therefore, my subcommittee--which consists of Governor Wallich, Mr. Morris, and Mr. Balles--met on one occasion in November and decided that there no longer was a reason why these specifications couldn't appear directly in the directive to the Manager, since, in effect, they form a very important part of the directive to the Manager. And the wording as we've shown in here accomplishes this purpose.

I might say that one can naturally worry over the specific wording of including these longer-range and shorter-range specs in the directive; and indeed, I have worried over them a little bit more since the report was issued. So I have a small proposal [for] a change as compared with the way it appears now [in our proposal]. But the concept is simple. It is that since the Committee in fact discusses in detail and votes on both the long-run and short-run specification ranges, and since in one way or another the Manager is expected to pattern his behavior on the basis of what is happening with respect to those ranges, we believe that it ought to be in the directive.

If everyone has a copy of the appendix to the report with them--that's the last three pages of the document--I would suggest to you what the small further word changes that I would propose are. First, on the first page of the appendix, item 1 deals with the longer-run ranges, in the next-to-last paragraph. I would suggest that this read: "In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster" and then add, "bank reserve and other financial conditions." The reason I would propose that is that the Committee has always been concerned with the rate in which bank reserves are being provided, and this suggestion would be consistent with the recommendation in the second subcommittee report that we'll be taking up next on the agenda. So that it will read: "to foster bank reserve and other financial conditions that will encourage continued"--that's the only change there.

Now, when we get to the operational paragraphs--it is the last paragraph of the directive--we have two kinds of formulations that we have customarily used. One is a monetary aggregates formulation and one is the money market formulation, and I propose a small change in both cases to somewhat loosen up the relationship between the performance of the aggregates and the federal funds rate targets that the Desk would have. I believe Mr. Axilrod tells me--although my recollection is rather dim--that my suggested change would conform more closely with what in fact we have done in the past.

First, the last line on page 2--and this is the monetary aggregates formulation--instead of saying, “will approach or move beyond the limits of the indicated ranges,” I would say, “will deviate significantly from the midpoints of the indicated ranges.” The reason for that is that there is sort of a staged response as we get further and further away from those midpoints. We use the word “significantly,” and that’s a term of art. The definition of “significantly” could vary, of course, from time to time, depending on thoughts as to ranges of indifference and things of that kind.

And on the money market formulation, the same linkage is covered at the very end, on page 4, and there, about six lines down, “if given approximately equal weight to M1 and M2, it appears that growth rates over the two-month period are deviating from these expected ranges,” instead I would say, “are approaching or moving beyond the limits of the indicated ranges.” Again, that makes it possible within the strict terms of the directive specifications for the Manager to begin to react, even in the money market directive, to deviation in the performance of the aggregates that has gotten us close to either the high end or the low end of the range. And I think that does conform with what we have done on quite numerous occasions over the last several years when we did have a money market directive.

So those are the changes I would propose. Now, Governor Wallich had some thoughts about the linkage in fact being perhaps a little too loose already, and I would like to call on him for any comments he would like to make. And Mr. Morris didn’t have a chance to look directly at the specific words we used in these proposals because he was out of the country, and I would like for him to comment. And then, finally, Mr. Balles, as the other committee member, should have a chance to comment, too. So Henry, do you want to present your position.

CHAIRMAN BURNS. Before we do these comments, I want to make sure that we all know, or at least that I know, where we’re going. I understand your report to mean simply that we codify, so to speak, what we have been doing. Is that the objective?

MR. PARTEE. Yes, but there are questions of nuance in the exact words you choose to do that.

CHAIRMAN BURNS. Yes.

MR. PARTEE. That’s all we’re going to--codify it, put it into the directive, and drop that--what do we call it?--spec sheet that we have at the end.

CHAIRMAN BURNS. What is your--

COLDWELL. Thus, it’s part--you register votes on the short range.

MR. PARTEE. Yes, but I think we do that now--

COLDWELL. Not individually, we don’t have to.

MR. PARTEE. On the specs?

COLDWELL. I believe we record votes on the specs, don’t we, Art?

CHAIRMAN BURNS. No, we record votes on the directive, which includes all of the specs.

MR. PARTEE. After having often voted on every aspect of the specifications and then we vote on the whole thing.

MR. COLDWELL. But we have not recorded the specs. Now will this require a vote recorded on the specs?

CHAIRMAN BURNS. No, I want to correct your statement, Mr. Partee. We don’t vote on individual items. What we do is to test the sentiment of the Committee. We vote only on the full set of specifications. We have one vote only.

MR. PARTEE. This, to answer--

MR. JACKSON. [Unintelligible].

MR. PARTEE. This would mean that you would vote [only] on the directive--to show a range directive, and the directive would include the specifications. Presumably we would have decided on what those specifications ought to be by something like the same process that we now use. And you also would vote on the long-range specifications when they are changed, that is, when they are considered just before the end. I recall we did that at the telephone conference call in November for the first time.

CHAIRMAN BURNS. Mr. Broida.

MR. BROIDA. As a matter of actual procedure, the Chairman, typically at the end of the meeting, will read the proposed directive language, and [he] then reads the specs, and then the roll is called. For record purposes, we have always followed the practice of indicating that the formal vote was on the directive, and it was understood that the directive would be interpreted in accordance with numerical specs.

But the specs were not treated as part of the vote because, had they been so treated, their publication would have been required by law, and for a long time the Committee was not disposed to publish them. There is no longer any reason for that procedure because the Committee is now publishing them in the Record of Policy Actions. And this is one reason for putting them in the directive, so that the vote will cover both the language of the directive and the specs.

MR. COLDWELL. We would not get you into the problems of publishing or releasing them?

MR. BROIDA. We would continue to publish the directive as we always have, but now the directive would include the numbers.

VICE CHAIRMAN VOLCKER. We now just publish in a narrative form.

MR. BROIDA. That’s right.

VICE CHAIRMAN VOLCKER. Which changes from meeting to meeting, depending upon--

CHAIRMAN BURNS. Except that we put out, after 30 days have elapsed, a narrative account of what happened at the meeting, we put down the specifications.

SPEAKER(?). [Unintelligible.]

CHAIRMAN BURNS. What’s that?

MR. STERNLIGHT. The policy record would not go out immediately after--

MR. PARTEE. It goes out as a package, doesn’t it, Art, after about 30 days?

CHAIRMAN BURNS. Mr. Jackson?

MR. JACKSON. Maybe I’d better ask counsel then. In the event we were required under the various lawsuits and hearings to publish the meetings, is there any particular strategy or merit in separating the specification from the directive? Or is that temporizing with the situation as recorded by--we proceed through that and require that both be linked?

MR. O’CONNELL. Mr. Chairman, Governor, I have to say that, depending on what the Committee’s sense of need and circumstance were for deferring the date--I’m speaking now of the short-run figures--if the Committee felt that, [in contrast to a] Court of Appeals decision mandating immediate publication of the policy record itself--say, immediate in two days--the Committee felt that a longer period of the holding of figures would be highly desirable, I would then be put through the task of finding within the law one of the exemptions that permit withholding. In the absence of such a finding, they would have to be published at the same time the court ordered the directive itself to be published.

MR. BROIDA. I might add, Mr. Chairman, that the District Court order that is now on appeal requires immediate publication, not only of the directive, but of the interpretations thereof.

MR. JACKSON. So we would be required to publish the English and the Arabic [numerals].

MR. O’CONNELL. That would be my judgment.

CHAIRMAN BURNS. Well, I must say you've raised a question in my mind, but I know nothing about the law. But implicit in Mr. Jackson's question, I think, is the suggestion that we do not deviate from the present practice unless there is a clearer reason than has yet been set forth. That's the way I interpreted Mr. Jackson's comment.

MR. JACKSON. My point is that by incorporating the two, it is possible that we could foreclose our options that might be available to us at a later date.

CHAIRMAN BURNS. I understand. Well, what do our attorneys--we better have a legal ruling on that before we take this fatal step.

MR. O'CONNELL. Mr. Chairman, any opinion I would give you--of course, premised on the stated assumption for the moment that a Court of Appeals will accept this, [but] a Court of Appeals may well affirm a lower court judgment that the policy record and the directive are subject to prompt and immediate disclosure. Now that's on appeal at the present time. If that is sustained [by] the Court of Appeals, and under the recommendation now made that the figures of which you speak are incorporated as part of the directive, they too would be required to be published promptly, unless at that time the Committee is able to determine through advice of counsel that an exemption or an exception exists. I don't know at this moment that I can put my finger on it.

CHAIRMAN BURNS. This is an altogether new thought for me--I went along completely with the suggestion, and I thought it was fine. Might it not be desirable, in view of the question that Mr. Jackson has raised, to defer acting on this recommendation until there has been a ruling by the court. No--I want Mr. O'Connell to comment.

MR. O'CONNELL. Mr. Chairman, in the light of the question now being raised, I'd consider that a most responsible thought and recommendation--that the action be deferred pending a reading of the court's decision on appeal.

CHAIRMAN BURNS. All right, now we turn to associate counsel, Mr. Broida.

MR. BROIDA. Mr. Chairman, I'll try to speak in my function as Secretariat and keeper of the record. This matter was discussed at one time, in fact several times in the past, as I recall--you and several other members of the Committee took the position that you would not want to split hairs. The court ordered the Committee to publish its directive; you would not want to attempt to defend a position that the numerical specification was not part of the instructions of the Desk, and therefore, you would prefer to go beyond the court order if it should be limited to the directive.

CHAIRMAN BURNS. Well, I might have said that. Your recollection is better than mine, but I have found in the past that second thoughts at times are a little better than initial thoughts. Why do we want to make a move right now? Mr. Kimbrel.

MR. KIMBREL. That was exactly the thrust of my question, Mr. Chairman. Is any urgency attached to making a decision this afternoon? Could we delay and await some further action before making this final decision?

MR. PARTEE. Could I summarize the facts here once more, Tom, because I understood that it didn't make any difference. The lower court has interpreted the directive as including the specification sheet, is that right?

MR. O'CONNELL. To my knowledge, that is not correct.

MR. PARTEE. That is not correct. You're just speaking of the moderate growth in the monetary aggregates, aren't you. No reference to publish. But why don't we publish it, for Pete's sake.

MR. O'CONNELL. But the court's decision does contemplate that all interpretations of that directive would be promptly made available. I believe that the figures themselves could be termed to be interpretations of that policy.

MR. COLDWELL. If we were to fight this court matter, Tom, would we be giving up anything by taking this action? Would we compromise your ability to resist this court order?

MR. O'CONNELL. I believe the answer to be no, Governor. I'm not aware of any impact, adverse or pro, that the action now contemplated would have on the appeal as it stands. The Committee should be aware that, should the Court of Appeals affirm the lower court, [then,] by this action that is now before the Committee, you are broadening perhaps the total package of materials that would have to be made promptly available.

MR. COLDWELL. Yes, but you're talking about this particular appeal, and I was thinking of something broader than that. If you got a different challenge to the record of the Committee, would [we] compromise your ability to resist that, by [our] having put the specifications into this record.

MR. O'CONNELL. If anything, Governor, I would judge a position might be made more strong. If these figures [are] in the directive, we can argue adverse impact [if] they were demanded and be required to be made available [in] whatever form [unintelligible] sought them. I think perhaps it would strengthen the Committee's position of defense against their publication.

CHAIRMAN BURNS. Gentlemen, we could debate this for a long period of time. A new question has been raised, and with possible difficulty [that] I, for one, didn't foresee. We don't have to take this action today. I would suggest that our counsel study this matter and we come back to it next month, [after] it's been looked into and examined from a legal and administrative viewpoint to the best ability of our counsel. Is that acceptable?

All right, I'm going to shift the order around a little. Let's move to item 3 on the agenda--the discussion of various foreign currency instruments. Governor Wallich, would you be good enough to take us through the various steps that we ought to go through.

MR. WALLICH. Mr. Chairman, we have three documents here, and concerning these there are four actions that the Subcommittee [on Foreign Currency Instruments] recommends be taken. Let me just specify the documents. One is the Authorization for Foreign Currency Operations, given to the Federal Reserve Bank of New York, which corresponds to a similar type of document for domestic open market operations. The second is the Foreign Currency Directive, which corresponds to the directive that we formulate every month within the domestic field. And a third document that has no counterpart in the domestic area, entitled Procedural Instructions, which serves to pull together internal relations between the Manager, the Foreign Currency Subcommittee [of the FOMC], and the Committee. And finally, in addition to these three documents that the subcommittee recommends approving, there is a fourth, entitled Special Authorization, which deals with some aspects of the main authorization.

CHAIRMAN BURNS. All right, now, there are four items to be taken up, and we'll take them up one by one, act on the first, and move to the second. And will you confine yourself now to the first title, Mr. Wallich, the Authorization for Foreign Currency Operations.

MR. WALLICH. This authorization was circulated to the members of the Committee along with the other documents, and I hope you had a chance to familiarize yourself with it. We've received a number of comments, which were very helpful, from within the [Federal Reserve] Board, and as a result, the subcommittee, consisting of Mr. MacLaury and myself--in the past, Dick Debs--have made some changes in the authorization and also and more specifically in the other two documents, so that these documents now embody all the recommendations--to the extent that they could be accommodated--that we received. The authorization--you will find it on attachment B to the document of December 14, and it is also in the document of November 12, as attachment A. You can work from either one.

The authorization is the broad framework within which the instructions [from] the Committee to the New York Bank Manager are given. It sets forth the currencies in which the Manager may operate, it sets forth the swaps that he may maintain, and the amounts of these swaps. It gives him the broad guidelines for how he is to operate in cooperation with the foreign central banks [unintelligible] coordination currency holding ought to be invested, daily reports to the foreign currency subcommittee, and a number of items of that kind.

In this authorization, we have no major changes. There's been some shifting of materials to the so-called procedural instructions, which are the third document, and furthermore, there is now a somewhat greater integration with the three [documents] than was evident when the draft was first circulated on November 8. By making a reference in the authorization to the procedural instructions, there is a legal difference among these documents. In this sense, we should have to publish the first two--the authorization and the directive--in the *Federal Register* at once and in the Record of Policy Actions after 30 days. We should speak to the procedural instructions, the way they are handled, when we get to that document. A different publication requirement is advised there.

CHAIRMAN BURNS. All right, we'll confine our discussion, then, to the document entitled Revised Authorization for Foreign Currency Operations. Are there any comments or questions? Yes, Mr. Kimbrel.

MR. KIMBREL. Mr. Chairman, I wonder if I could get just a little amplification of what is intended at the bottom of page 3, "suggest in handling these transaction and no attempt shall be made to establish rates that appear to be out of line with underlying market forces." I wonder if we could have just a little further indication of what--

CHAIRMAN BURNS. What was that? I don't find it.

MR. KIMBREL. The very last phrase at the bottom of page 3.

SPEAKER(?). The date of the document.

SPEAKER(?). What?

SPEAKER(?). The date of that document?

MR. KIMBREL. Revised Authorization.

MR. WALLICH. If you go to the beginning of the document, the first page, does it say September 14? What date does it give you there?

VICE CHAIRMAN VOLCKER. It gives you November 12.

MR. WALLICH. November 12. That is related but does not contain all the material that [unintelligible].

VICE CHAIRMAN VOLCKER. It looks to me like it's in the November 12, the sentence that he's referring to, and also the 14.

MR. WALLICH. I can tell you in general what the point is without referring to it. It was renewed--

CHAIRMAN BURNS. I'm told by Mr. Broida that the sentence which you're referring to has been taken out of the version that we now are supposed to be discussing. If that is correct, you can't have a problem.

MR. KIMBREL. That's right, very good. Question withdrawn.

MR. COLDWELL. I have a question, Mr. Chairman, on something that I should think does remain in the doctored document. Are we changing the System policy to invite swap drawings for 12 months instead of 3 months? If not, then this "fully liquidated" comment on top of page 2 is, "any such agreement shall be fully liquidated within 12 months after origination"--

CHAIRMAN BURNS. Well, I interpret that to mean that this is the outside limit. Because you can have renewals up to a year but not beyond a year. Is that correct, Mr. Wallich?

MR. WALLICH. That's how we practice it. It's always for 3 months. Sometimes with a short renewal for another 3 months, rarely for more, but it can be extended up to 12 months.

MR. COLDWELL. But in our present--is this consistent with that policy?

MR. WALLICH. As far as our lending operations are concerned, yes; as far as borrowing operations have been concerned, as you know, we sometimes exceeded that.

MR. COLDWELL. Well, I understand that we have exceeded the borrowing side, but I meant with regard to the policy of the Committee.

MR. WALLICH. Yes, that's correct.

MR. COLDWELL. The policy of the Committee does say 12 months.

MR. WALLICH. Does say 12 months.

MR. COLDWELL. On a renewal basis.

MR. WALLICH. There's no legal limit, but this is a policy.

MR. BROIDA. The procedure has been, and this language is unchanged from the present instrument, the procedure has been for the Committee to note, without objection, renewal up to a year. Beyond a year, the Manager has to get a formal authorization from the Committee, and we've always recorded formal votes in the minutes if the line's been outstanding more than a year.

MR. COLDWELL. My second question relates to the terminology at the bottom of page 3, in which you say the currency to be used for liquidation may be purchased or drawn on at the same exchange rate as that employed, whereas in the bottom sentence you're talking about at prevailing market rates. Is that a change or is that--

MR. WALLICH. That's where a sentence was removed, I think, specifying that no artificial exchange rate be set. What this here says is that the foreign central bank and the Federal Reserve reciprocally guarantee each other the exchange rate--that intervening exchange rate movements would not affect the value of the payments. Now in addition to--

MR. COLDWELL. [Unintelligible] purchases as the rate of the drawing. Now what [does] that mean to them?

MR. WALLICH. Apart from purchases from the foreign central bank, which are in effect reversals of the swap and repayment, if there are purchases in the market, such as when we're engaging--

MR. COLDWELL. Spot purchases--

MR. WALLICH. --such as we're engaging in with the Swiss, for instance, that we engaged in with the Belgians--those ought to be at a market rate and not at some other artificially set rate.

MR. COLDWELL. The other matter relating to procedure--I take it we're not discussing that now.

MR. WALLICH. Yes.

CHAIRMAN BURNS. Yes, Mr. Volcker.

VICE CHAIRMAN VOLCKER. I have one question of interpretation, Mr. Chairman. At the top of page 4, the first sentence in [point] 4: It says, "It shall be the practice to arrange with foreign central banks for the coordination." I don't question this desirable practice, and I hope that it's done in all but exceptional cases, but I can imagine there's an exceptional case where we want to do something that's not in coordination with a foreign country. They may not want to operate, and I interpret this to mean that [their unwillingness would not necessarily be accommodated].

CHAIRMAN BURNS. I think you're absolutely right. In fact, the item will come up tomorrow. The recent swap drawing on us by the British did not involve coordination with the Bank of England.

MR. JACKSON. Do you want to insert the word "normal"?

VICE CHAIRMAN VOLCKER. I would be happy, I think, if you put in "normal" or "usual practice." I think something like that would be--

CHAIRMAN BURNS. I think that would be wise and accurate. Any other question or comment.

MR. PARTEE. Does that require changing the next sentence then?

VICE CHAIRMAN VOLCKER. I don't think so.

CHAIRMAN BURNS. I don't see why.

MR. WALLICH. These operating arrangements refer, I think, to the cases where there is a coordination with a foreign central bank.

CHAIRMAN BURNS. Yes, any other questions. Well, if not, can we all agree to this first document on Authorization for Foreign Currency Operations? Any dissent? All right, it will be so recorded.

Let's turn to the next item of the four that we will consider. The second item, this is on the Foreign Currency Directive. Let me say one word about this. The Foreign Currency Directive is a very brief document, but every noun and every verb and every proposition has been accorded the most loving care over several months. As we examine this document, let us bear in mind the history of its preparation.

MR. COLDWELL. Even bearing it in mind, Mr. Chairman, I still have that one word which I would question slightly, which I questioned the other day with regard to an item. At the bottom of page 1, it says "in collaboration with the United States Treasury," semicolon. The [phrase] "collaboration with," rather than "consultation with."

MR. WALLICH. Well, this was language that was negotiated, and it bears on an important point--that the Treasury is an important factor in this area. It's not like the domestic area. And the word "consultation" seemed to reduce, or may seem to reduce, the role of the Treasury.

MR. COLDWELL. Well, if you can find the halfway house, you might be willing to buy it, Henry, but "collaboration" to me means a participation in this, almost guaranteeing that we do go into participation with the United States Treasury on each of our operations. I'm not sure I want to do this.

CHAIRMAN BURNS. Would you be willing to enter into a swap arrangement with a foreign central bank that the Treasury was opposed to?

MR. COLDWELL. Probably not.

CHAIRMAN BURNS. Well, that's the issue.

MR. COLDWELL. I'm not sure I want to be locked into the U.S. Treasury coming in on every one of those swap arrangements.

MR. WALLICH. These are not swap arrangements.

CHAIRMAN BURNS. Wait. This does not mean that the Treasury will be a partner of ours in entering into swap arrangements? It may mean that. More normally, it would mean that if we draw on a foreign central bank or if a foreign central bank draws upon us, this will be done with the full knowledge and assent of the U.S. Treasury.

MR. COLDWELL. This includes any action with regard to foreign currency operations, even if it were merely for stockpile purposes. Now I'm a little reluctant to go that far, Mr. Chairman.

CHAIRMAN BURNS. Well, I can understand that. But I, for one, have taken the position, and have so testified, that whereas our independence in the domestic area is complete, as far as foreign operations are concerned, foreign policy is, under our Constitution, a prerogative of the President. And if we engage in a foreign transaction, we therefore should do so only if we have the assent of the Treasury.

But in testifying, I've gone one point beyond that and indicated that if we ever disagreed--most of the time, you know, in practice, as far as my experience over several years goes, you're in a gray area, and you talk things out, and you reach an agreement with the Treasury. But I've testified to this effect, if it ever so happened that we disagreed with the Treasury in the foreign transaction and that disagreement could not be ironed out--we stood on our ground, the Treasury on its ground--then there would be only one proper thing to do, or two proper things to do. First, to accept the Treasury judgment that day. Second, to go to the Congress the next day and ask for a legal solution to a conflict that has arisen as far as the future is concerned. Now that's the position I've taken.

MR. COLDWELL. I would agree with you, it's worked very harmoniously to date. I'm looking [at] a change in the Treasury's lead group, and I'm not at all sure it's all that harmonious.

CHAIRMAN BURNS. Well, I can see that, but, now look, the Treasury is the President's representative in the foreign economic area. And for us to take an action that runs counter to the foreign policy of this government, to me it's a position that we could not maintain. Congress would never stand for it. I don't think we ought to put ourselves in the position of advancing a kind of independence that simply will not be supported. But this is something for the Committee to decide.

MR. COLDWELL. I haven't--let me make my position clear. I am not saying we do not talk to the Treasury. I'm merely arguing the word "collaboration" versus "consultation."

CHAIRMAN BURNS. Yes, but I think consultation is not the right term. But I think collaboration is the right term, in view of the practice that has existed, and I think in view of the Constitution of this country as I understand it. But let's hear from others. Mr. Bruce MacLaury.

MR. MACLAURY. One of the most difficult cases that I can think of is when the Federal Reserve with the Treasury's blessing has borrowed under a swap arrangement and then the Federal Reserve Bank, or Federal Reserve System itself, has an obligation outstanding to repay. And history has shown that there have been occasions like that when the Treasury has not been willing to provide reserve assets when that was a case in point, when that was relevant, and was urging us to simply roll over our indebtedness to foreign central banks when we were disinclined to do that. I think that's one of the more difficult areas to deal with.

And yet even looking at that, I guess I have to say that I don't think we have room for independence of action beyond what we have already asserted in buying currencies in the market. But much as I share Phil's wish that we could find a different word, I think this effectively characterizes the relationship.

MR. MAYO. Point of information--is the word "collaboration" in the present directive.

CHAIRMAN BURNS. Mr. Volcker has whispered a word which might possibly be more satisfactory: that's "cooperation" instead of "consultation." Henry, would "cooperation"--is rather close.

MR. WALLICH. We have "cooperate" in the next paragraph on foreign monetary authorities.

CHAIRMAN BURNS. We can cooperate with more than one. We are very cooperative.

MR. PARDEE. We even consult with the foreign monetary authorities.

CHAIRMAN BURNS. Let's not go in for elegant variations.

MR. WALLICH. Let me just say, this is one of the words that were quite heavily negotiated. So I would feel that we ought to at least inform them--you may not believe it--but two grown-up men meeting six times, holding 10 hours of discussion, mostly on the first sentence of this document. And, yes, [taking] this quite seriously.

MR. COLDWELL. We could wait a month--

CHAIRMAN BURNS. Oh no, oh no. You may go through this cycle once again. Let's not wait a month.

MR. PARTEE. Do you read the word "collaboration," Henry, as going both ways? That is, if the Treasury wants to do something, that we'd collaborate with them and join them, or do you read it only as our collaboration with the Treasury on actions that we wish to undertake.

CHAIRMAN BURNS. We are really debating a legal point when there is no problem in practice. The Treasury is not going to make a move without consulting us and working things out with us. We, to the best of my knowledge, have never made a move without consulting and working things out with the Treasury. We don't always agree on the first instant, but as we talk--this always being an area surrounded by uncertainty--you know, the thing is worked out. I don't see any problem arising.

MR. JACKSON. I can see value in imprecision because then we interpret collaboration to mean what we want it to. It could mean whatever on occasion we want it to mean then.

CHAIRMAN BURNS. Well the only difficulty is, "collaboration" is a more precise term than "consultation" suggested by Phil.

MR. JACKSON. It doesn't mean participate.

CHAIRMAN BURNS. Work together--yeah, that's what collaborate means--work together. Mr. Wallich, you were asked a question about an earlier--whether this term appears--

MR. WALLICH. Right now I can only give you the answer that it appeared in a different form in an earlier draft of this. Apparently not--I can't find it to be in the existing directive. That form was objected to, and as a result, this language was found which set the Secretary of the Treasury one stage higher, in the degree of consultation, than foreign monetary authorities, with whom we cooperate but not collaborate.

MR. GARDNER. The whole thrust of that paragraph, I think, is entirely appropriate. We must respect the treaty, the IMF articles which our government signed. We certainly cannot take a position against the foreign policy interests or the perceived foreign policy interests of the government of the United States, whatever independence we have domestically. Surely they have the same degree of independence internationally. I think we are courting, in all of our work, the prospect that at some future date these operations will become defined as treaties, resulting in a totally different form of handling, and I would much prefer the results of Henry's tedious negotiations because I think it's the right posture.

CHAIRMAN BURNS. Well, I certainly agree with that. I don't think anyone has fought harder than I have for the Federal Reserve's independence. But that does not extend to the foreign area. The foreign area--I don't think we could ever sustain that position. Though I have a great deal of sympathy with Mr. Coldwell's suggestion, I still think it is impractical, really, particularly in view of the tortured history that underlies this simple word.

MR. WALLICH. I think that the effort to go back to the word now and change it would certainly not escape attention.

CHAIRMAN BURNS. Well, we could do this. We could instruct Henry to go back--and advise him not to spend too much time on it--and persuade Mr. Yeo that "cooperation" would be just as good from Mr. Yeo's viewpoint but would make us here a little more happy--we would substitute "cooperation" for "collaboration." But in the event that he doesn't persuade Mr. Yeo, the word "collaboration" should, I think, be accepted by this Committee.

SPEAKER(?). So moved.

MR. WALLICH. I'd be glad to do that.

CHAIRMAN BURNS. Any objection. Any other question about this currency directive. Yes, Mr. Eastburn.

MR. EASTBURN. A matter of clarification in the first paragraph, the word "behavior." Is there special significance to that, Henry, as opposed to "action"?

MR. WALLICH. Yes, I think you should be aware that the philosophy that the Treasury seeks to impart in the international monetary system is one of clean floating. And so their view was that the only grounds for intervention were two: counter disorderly markets and, second, act when foreign monetary authorities have been violating a section of the proposed article 4 of the IMF, which prohibits manipulating exchange rates or trying to gain an unfair advantage.

Our argument was that markets aren't that perfect, that conditions might arise in which extreme values might be reached by the dollar and that it would then become desirable, to the very limited extent that it would be possible, to intervene in the market to correct that. It's very difficult to change the rate of the dollar in the scale of operations that seemed feasible for us. [After] very extensive discussion, it was agreed to accept this proposition but to incorporate it in these torturous terms where the word "actions" refers to the actions of foreign monetary authorities, and "behavior" refers to the behavior of the market.

CHAIRMAN BURNS. The word generally gives you all the elbow room that you may need or want.

MR. COLDWELL. What is the status of article 4?

MR. WALLICH. That it's being approved by legislative action by the membership. The U.S. has approved the legislation, and it's expected that it will go into force when the right number of countries has approved it. It's not yet--

CHAIRMAN BURNS. Any other questions?

MR. EASTBURN. Will there be any kind of a record as to what "actions" and "behavior" mean?

MR. WALLICH. Well there is a description in the subcommittee's report to the Committee on this.

MR. EASTBURN. Will that be always an underlying document?

MR. WALLICH. It is all the legislative history that sort of forms the [unintelligible] of a file in which this has been annotated over and over again. But no letters have been exchanged or other formal communications.

VICE CHAIRMAN VOLCKER. If I understand the negotiating history here, it's better not to have an explicit understanding of what the words mean.

MR. LILLY. Well, I think the words are reversed, but far be it from me, at this point--

MR. EASTBURN. I can understand the desire for flexibility here, but I wonder whether this does resolve the questions as to how much you are going to intervene in the market or how much you are not going to intervene.

CHAIRMAN BURNS. It certainly does not resolve that.

MR. WALLICH. No, this gives us the possibility--suppose that, through aggressive intervention or interest rate action or market events, the dollar should go much higher than it is now, and suppose this would affect us competitively. If we thought that this was due to action in the markets not reflecting underlying factors, we would be entitled to move into the market and try to correct that--I repeat, to the very limited extent that we could influence the rate.

MR. EASTBURN. Could I ask one other question now? The reason for removing that earlier section referring to sustaining artificial values of currency, or something like that. What is the consistency of removing that and leaving this so open ended here.

MR. WALLICH. Well, the reason for removing it in the other place was that it gave a policy directive in a place where we were simply writing a broad framework for authorization. So it belongs in here, that it is correct. What is in here is now the maximum I think that could be done under the prevailing circumstances. Intervention is certainly now a great deal more limited than in the days when we intervened to support the dollar, to safeguard the value of the dollar, to maintain an equilibrium rate, to supply liquidity, and various other things that we thought we were doing under a fixed-rate regime.

In this framework, here are floating rates--[there] is no implication that anyone knows the right rate, therefore there is nothing here to say that we are to establish or attain any particular rate. It's simply a statement of what can be done within a system of floating. There is a considerable advantage to the United States in having others float cleanly because one of the troubles with the old system was that the dollar got overvalued, but we couldn't correct it. Others pegged to the dollar. Today the dollar is free, but only so long as others do not interfere with that freedom in the market. Therefore we have an interest in urging others to float cleanly. If we want to do that, we ought to have a conduct that manifests the same intention on our part in a directive that, at any rate, doesn't say overtly that we might violate that principle.

CHAIRMAN BURNS. I think, in this last statement, you've gotten into a controversial zone, which is not necessary at this point. I would argue with your last statement--I don't know that I want clean floating everywhere at all times. But let's not debate that issue.

MR. WALLICH. I would add to this, Mr. Chairman, it's not my basic philosophy either, but it certainly is the philosophy under which the U.S. has been operating for the last year.

CHAIRMAN BURNS. Thank god, philosophy and practice sometimes, as in this instance, diverge. We're not going to be discussing history or philosophy, we're discussing a 300-word document hammered out with pain and love and extraordinary care. Any other comment on that?

VICE CHAIRMAN VOLCKER. To put it rather rudely, it seems to me, Mr. Chairman, that the object of this first sentence is not to constrain us in doing something that we are likely to want to do in our own mind, sometime in the future. It doesn't do that, as I understand, so therefore it's acceptable.

MR. PARTEE. But it generally by itself says a great deal.

CHAIRMAN BURNS. Well, I hear no objections to this. So, therefore, I assume that the Committee has approved the Foreign Currency Directive and that we are ready for their document on procedures. Mr. Wallich.

MR. WALLICH. The third document was modified by the December 17 memorandum by Mr. Broida, so that, if you're following it from the document of December 14, please bear that in mind. Let me just summarize what happens here. In the old authorization, where much of this comes from, there was a variety of activities and transactions that were authorized which had various historical origins. And there was no clear limitation on what the Manager could do by himself, what the subcommittee could do, and what could be done only with the Committee.

Here we have tried to, first, pull together all types of operations and define them as the overall open position, which means the total risk exposure on which we could suffer loss. That covers all currencies. Then we have the open position in a single currency, and finally we have gross transactions, which are simply the operations over a given period of time. The overall exposure that we've [specified] in the authorization is limited: here, the Manager is limited to $100 million a day in changing the overall position, and $300 [million] since the regular meeting. He is further limited to $100 [million] a day anyway on gross transactions regardless of how that affects the overall open position. And beyond that, he has to clear with the subcommittee. He also has to clear any swap drawing proposal by a foreign bank with the subcommittee.

Then, when operations go beyond that size, the subcommittee or the Manager clears, with the Committee as a whole, [those] transactions that would affect the overall open position in excess of $500 million, and [they] would have to clear with the full Committee any swap exceeding $200 million. The meaning of that is that this is a limit on what the subcommittee can authorize the Manager to do, and the subcommittee can authorize changes in overall open positions up to $500 million and foreign swaps up to 200 million, or 15 percent of the size of the total swap. The $200 million is smaller than the full size of any swap, so the subcommittee never authorizes a full amount [for] any swap. Under the 15 percent, the subcommittee could go up to, for the largest--$3 billion swaps--up to $450 million.

MR. COLDWELL. If you would forgive me, Henry, the way you described that paragraph 2 isn't the way I read paragraph 2. The way I read paragraph 2 was that it does clear with the Committee but it has a parenthetical "(or with the subcommittee)," which would give the subcommittee, and ultimately the Chairman, if he believes the time is not available, also the A and B authority.

MR. WALLICH. That is true. If some emergency should arise in which clearance with the full Committee is not feasible in the time available, then this would be done. I think this is not an unreasonable power because the contingencies could be large, if you read Charlie Coombs's book. On one occasion, the Manager had to act on a sizable scale on his own because he could not reach anybody. Ordinarily this is, I think, not likely to happen.

MR. PARTEE. May I ask, Mr. Chairman--Henry, there is no room, as I read it, between C of 1 and B of 2--that is to say, the subcommittee doesn't have any separate area of authority. Is that right?

MR. WALLICH. No, the subcommittee does everything with the Manager in the way of clearing a swap from zero to 200.

MR. PARTEE. Everything. I see, I see.

MR. COLDWELL. There is no Manager's discretion.

MR. WALLICH. No Manager's discretion.

MR. PARTEE. Then it shoots to the Committee. I see, thank you.

CHAIRMAN BURNS. Yes, Mr. Baughman?

MR. BAUGHMAN. Mr. Chairman, I assume the Manager had substantial input in this process. I, of course, wasn't privy to that, and just reading the document, it seems that it ties the Manager very securely. And I would feel better to hear the Manager say that the operational procedures described here will not unnecessarily or unduly interfere with effective operations. The other point--

CHAIRMAN BURNS. Let's take this point first.

MR. PARDEE. Alan Holmes and I have gone over this document with great care from the beginning. In effect, this describes an even more flexible approach than we are currently following. So we are quite comfortable with the overall limits that are placed here. I'm happy to be securely secured in line because I don't want to have too much rope to hang myself. There is enough risk in the operations that we have, so that we want to consult frequently and in detail on the kind of operations we have.

We will make every effort, and have made every effort, to consult in advance, and even in the case that Henry Wallich mentioned, just recently, where Charlie Coombs had to go into market, he was in the process of making phone calls [at] 15-minute and half-hour [intervals], and secured what clearance he needed. So this is a fair document. It describes what we have been doing up to this time. We are very comfortable with it, and we will be operating on an even more narrowly restricted basis in consultation with the Chairman and the subcommittee and the full Committee.

MR. BAUGHMAN. The other point--it seems to me the language is just kind of upside down [regarding] the sequence of consultation. It [should read], it seems to me, that the Manager in all circumstances must consult the Chairman; the Chairman then must decide whether to go to the subcommittee and or to the full Committee. As I say, the words turn that around, and as it's written, I don't really see that it's working.

MR. WALLICH. The way we think it reads, I think, is exactly the way it's intended to work. Let me go over it. Under 1, the Manager shall clear with the subcommittee; however, if [clearing with] the subcommittee isn't feasible, then with the Chairman--any transaction that would change the overall open position by $100 million in one day and any gross transaction exceeding $100 million. So he's free to engage in either kind of transaction. Gross transactions up to $100 [million] or a transaction that changes the overall open position by $100 [million] without the benefit of clearance. Scott Pardee has just said that, as a practical matter, he doesn't do that; he consults for amounts that are much smaller. But within this $100 million, he has a degree of freedom, so long as it doesn't involve the activation of a swap or so long as it doesn't involve nonroutine transactions. This you find at the end of the piece that is paragraph 3.

MR. BALLES. Let me take a stab at this. I think I know what Ernie is talking about, because under paragraph 1, point C, it says "any swap drawing proposed by a foreign bank not exceeding." For a while, I thought that that "not" was an error, that it shouldn't have been in there. That particular word "not" doesn't come into the full meaning until you get to paragraph 2, which says, on bigger transactions, the Manager has got to go up to the Committee or with certain alternative arrangements. In other words it might make more sense, if this is what Ernie was saying, I will suggest consideration of it--simply reverse paragraphs 1 and 2.

MR. WALLICH. Well, we've reversed this a number of times, and the word "not" is there very deliberately. One could perhaps phrase it positively, that the Manager shall clear with the subcommittee [under item] (c), every swap drawing up to $200 [million]. And then later, the larger ones will be cleared with the full Committee, according to (b). But I think this is perfectly clear in what it says.

MR. BAUGHMAN. Actually, my point was a bit different, but I don't want to belabor it. It says the Manager shall clear with the subcommittee, but then it continues, if the Chairman believes that it is not feasible, then he clears with the Chairman. Well, [unintelligible] Manager clear the subcommittee. Now someone else decides whether that is feasible. And the same thing in 2. The Manager clears with the Committee, but if that's not feasible, the subcommittee will decide that it's not feasible. And so the Manager is told to do something with one group, but someone else decides whether he can or not.

MR. WALLICH. I regard that as useful because that relieves the Manager of the responsibility of deciding whether or not it is possible to clear, and he shouldn't be in a position to make that decision, it seems to me.

MR. BAUGHMAN. Well, it seems to me that the instruction to the Manager is inappropriate: [It should read that] the Manager shall consult the Chairman, the Chairman then, if time is available, arranges the further consultation. I think that--

MR. MACCLAURY. I don't think that captures it because if the intent is that the subcommittee be consulted and not just that the Chairman be consulted, there has to be a fail-safe kind of an out if that can't take place. And I think the instruction is designed to give that thrust to the intent.

MR. BAUGHMAN. Well, all I am suggesting is that that thrust should be given to the Chairman rather than to the Manager. The Chairman calls the meetings, it seem to me. He winds up making that decision. But as I say--

MR. WALLICH. The Chairman does make that decision.

MR. COLDWELL. I have a more substantive problem with 2 than I do with 1--I think 1 is perfectly clear; I really had no problem with it. It requires a subcommittee or the Chairman's action, which I think is appropriate. When you get to number 2, however, if I read this correctly, ultimately the Chairman could commit the entire Committee to the full swap arrangement if he chose to do so.

MR. WALLICH. Well, that is possible in the case when consultation with the full Committee isn't feasible in the time available or even with the subcommittee. These are, however, fallback positions.

CHAIRMAN BURNS. That has never arisen.

MR. COLDWELL. I know it hasn't, Mr. Chairman. I'm wondering, though, if that's a desirable position for this Committee to be in.

CHAIRMAN BURNS. I think the Committee has to be in a position to act, and it may have to act on the basis of an emergency where you have just a few minutes to act.

MR. COLDWELL. Few minutes to involve a $3 billion swap arrangement agreement?

CHAIRMAN BURNS. Yes, yes, it could happen. Yes it could. [Unintelligible] to act on the British loan the other day. And it was possible to reach three members of the subcommittee before a decision could be reached. And it might have been impossible to reach any member of the subcommittee.

MR. COLDWELL. It might not be desirable to do it.

CHAIRMAN BURNS. Well, if you know all the circumstances of this particular instance, I don't think you have any doubt, and in all this, one has to have confidence in someone. Ideally the Committee could pass on all these transactions, but, you know, I have worked on a good many of these problems. There's one thing now, another thing an hour later, still another an hour later or a day later. And they're just constant negotiations; they go on. When you have time, and when you don't have time, well you've got to make a very quick decision.

Now, fortunately from my viewpoint, on this recent British swap drawing, I got hold of Henry, Henry got hold of Mr. Gardner, he tried to get hold of Mr. Volcker, but he didn't succeed. A condition could arise where you couldn't reach these men. And therefore we ought to have the provision to deal with the problem should it arise. As to probability, well no problem such as this has arisen in the seven years I have been here. It could arise tomorrow.

MR. PARTEE. It seems to me that the Chairman is accountable and the subcommittee is accountable under this procedure. If the procedure turns out to be offensive to the Committee, it'll be changed. As you say, in seven years there hasn't been an example.

VICE CHAIRMAN VOLCKER. Also, I suppose there's an element of protection here, going to the authorization, in that word "collaboration" we talked about--little chance of the Chairman doing anything absolutely on his own.

CHAIRMAN BURNS. This particular swap was not only done in collaboration with the Treasury, in the sense that we talked matters out, but the total swap was for $500 [million]; the Treasury took half of it, and we took the other half.

MR. GARDNER. I've had a short experience in this activity. [In] seven or eight months, all of the major events that have occurred have been problem events. I support the collaboration, I support the eventual narrowing in an emergency to the Chairman, who I also believe is accountable, and I think that adds accountability to the Chairman's role and the subcommittee's role. But it is also true that the Desk needs support, and it can be most extraordinarily difficult. Now, we've had some talk that a problem has never arisen, gentlemen, but we did have a touchy situation when the Chairman and Henry were both in Manila, and Paul was in Europe, and the Desk wanted some help. Scott, you remember that. So I am fully in favor of the step delegation.

MR. JACKSON. Do you want to go beyond this to say, in the absence of the Chairman, senior members of the Committee?

MR. GARDNER. No, I don't think we need to. Because the sense and thrust to this is written clearly. One of the problems is security. You just can't pick up the phone and talk to Manila, and to Bonn--or perhaps you could to Bonn, Paul, or wherever you were--and come up with an unmonitored conversation without going through some extraordinary arrangements. The last time you were in Manila, they assured me that if they could get you to Clark Air Base, I could use a scrambler phone. Well, that's about 100 some miles from Manila.

I think we have a good procedural memorandum, one which we have not had before, and I'll call your attention only to the last sentence: " . . . any transactions that are not of a routine character." So even within the discretion of the Desk, and it could be transactions under $100 million in any one day--I'm delighted with Scott's statement, I think that's appropriate as well--we can have transactions of less than $100 million that are not of a routine character.

CHAIRMAN BURNS. Any further discussions? Yes, Mr. Mayo.

MR. MAYO. I wanted to raise this at some point, Mr. Chairman. [My point] doesn’t deal with the specifics here, but I think it should be raised, and that is the absence of a preamble of some sort as to what the philosophy of the swap line is. The absence of such a preamble kind of bothers me. I have no solution to this. I throw it on the table only as a problem. We used to talk about creating liquidity with the fixed exchange rate; those references have appropriately disappeared. But I’m just wondering if we are at some point along here in need of some defenses as to why we are in the swap business. I don’t see it. I miss it.

MR. WALLICH. I may draw your attention to the directive, the previous document we dealt with. The first paragraph does state the purpose, not so much of swaps but of foreign currency operations in general. And our operations are dependent on having a swap so that we can obtain currency, and in some cases the operations on the other side are dependent on their having a swap so they can obtain dollars. And the purpose, therefore, of the operation of the swaps is here generally directed at [countering] disorderly market conditions provided, etc., and this proviso clause implies there may be other motivations, mainly market failure and manipulation on the part of others.

MR. MAYO. Yes, I see this, Henry, and I think it is appropriate, and I can’t define too well what’s bothering me, but I’m looking for something more philosophical.

CHAIRMAN BURNS. I can see what’s bothering you. What you would like, I think, is to see this paragraph you elaborated upon so that it would have more meaning for you and for the rest of us.

MR. MAYO. That’s right.

CHAIRMAN BURNS. I think that’s a perfectly valid comment, but I don’t really see how we can do it in this context in view of the history of the Foreign Currency Directive, but I think it’s a very proper question to put to Mr. Wallich and to me and to our staff, and a brief document response to your question, I think, should be worked out.

MR. MAYO. That’s why I brought it up at the tail end of my discussion, Mr. Chairman. I don’t think it has direct relevance to the specific documents we are looking at today, but I think it does have direct relevance to our policy as a System.

MR. BALLES. May I ask a question, Mr. Chairman, whether it would be appropriate to put in this sort of additional explanatory preamble in document number one, Bob, [rather than in] the revised authorization for the foreign currency operation. This is the document that deals at some length with the parameters of such operations without ever mentioning what the purpose is. I don’t see that there would be any harm to a well-chosen paragraph in here of what the purpose of it is. I would agree with Bob. I would feel happier, too, if that sort of rationale were in document number one, provided that it doesn’t clutter up or cause any problems by being there.

MR. MAYO. Well, John, my only problem with that is, again, a question of tactic, strategy, and timing, as to whether it would be unfair to ask Henry and his associates to open up--first of all, we would have to develop a statement here ourselves that we would agree to, it seems to me, and second, Henry would then have to enter into a further discussion with Treasury on it. And I'm wondering if it would be inappropriate, timewise and strategically, to introduce it right now. But I think it should be there somewhere along the line.

CHAIRMAN BURNS. Well, if I understand the spirit in which you make your comment, you would like to understand better why we are engaged in this business at all. And to answer that question, we ought to go back to history. How we got into this activity, and why we are still in it, what we are seeking to accomplish, and also whether or not we ought to continue in this action. This wouldn't be a paper that we need even show to the Treasury, [but] that we ought to discuss among ourselves and not look for precision in wording but to clarify the basic ideas. I think to set aside an hour for that in the not-too-distant future would be salutary.

MR. BLACK. Mr. Chairman, I believe--

CHAIRMAN BURNS. That is what you are getting at, am I correct? Let's do that.

MR. BLACK. I believe that's pretty well spelled out in the Memorandum of Discussion at the time we entered into this and in subsequent memoranda, so we could distill it from that, in large part.

CHAIRMAN BURNS. Any other comment or question? Can we assume that this procedural document is acceptable to the Committee?

MR. COLDWELL. It's not to me, Mr. Chairman, but since I seem to be the only one bothered by this line--

CHAIRMAN BURNS. Would you want to be recorded as dissenting?

MR. COLDWELL. I would, on the parenthetical phrase of page 2.

CHAIRMAN BURNS. All right, that would be so recorded in the minutes.

MR. WALLICH. That is in page 2. All of the subcommittee, etc.

MR. COLDWELL. That's right.

CHAIRMAN BURNS. And in connection with your dissent, it might be helpful, you know, for any use [to which] others may put the minutes, if you would indicate your alternative. We don't want to take time to do that now. All right now, we have the fourth and final item. And this item is recorded in attachment B, written out on six lines, which means it's worth just 60 seconds, 10 seconds per line. Let's see if can't finish this in a minute.

MR. WALLICH. The purpose of this is to lift the ceiling--the authorization said that, long-run, [it is] $1 billion. Since we've got a Swiss swap outstanding close to $1.1 billion, we need to make an exception for that. That's the purpose of this special authorization.

CHAIRMAN BURNS. Motion made. It has even been seconded. No discussion--therefore, universal assent. We're finished, gentlemen. Now, I described this meeting at the outset. We [had] a third item on the agenda, and then we [would] return to Mr. Partee, who will present a report of his Subcommittee on the Directive [regarding nonborrowed reserves].

MR. EASTBURN. Mr. Chairman, could I ask a question first? I think most of us got this document very late last week, and some of our staff's have been doing some work on this. Am I right in assuming that we are not reaching any decisions on this today?

CHAIRMAN BURNS. Well, I think that we ought to reach a decision. However, if members of the Committee would prefer to delay consideration of this item, and I take it that is your wish, then we ought to do so.

MR. EASTBURN. I have no problem with discussing it, but I think that in view of the short time period and the lack of ability to circulate studies that various people have been doing, it might be wise to do that.

CHAIRMAN BURNS. You see any difficulty, Mr. Partee, in delaying this?

MR. PARTEE. No, I think it does require some time to talk about it, and I don't know when else the agenda of the Committee is going to permit the time.

MR. JACKSON. Would it be possible to take action and encourage those people who later have reached different conclusions to present their conclusions at a later meeting?

CHAIRMAN BURNS. Who has difficulty in taking up this argument today in addition to Mr. Eastburn. Well, in view of that, I think we better go ahead, and you have ample opportunity to register any further thoughts. Mr. Partee, would you proceed, please?

MR. PARTEE. Well, Mr. Chairman, this is a report by the [Sub]committee on [the Directive regarding] nonborrowed reserves and the experiment that has been conducted by the staffs at the Desk and then also at the Board over recent months--six or eight or nine months it's been going on. The question is whether it would be better, or whether it would be more precise, or whether our purposes would be accomplished by operating more on providing a certain quantity of nonborrowed reserves and less on the funds rate and on the other current considerations that affect the operations of the Desk.

This goes back a long way. The subcommittee has been in existence, I believe, for several years, and the nonborrowed proposals which were a part of the report to the Committee some considerable while ago were a principal [rationale] for this kind of an investigation. We are transmitting staff documentation to the Committee, and we have a transmittal note to the staff, of course.

Naturally, in deciding what the experiment has shown and what our recommendations would be, we relied on the staff work that has gone into the conduct of the experiment. The papers attached are by a Board group, Mr. Paulus, Mr. Beck; and New York Fed views, Mr.

Sternlight, Miss Tschenkel principally. I could call on each of those authors, but I think in the interest of time, what I'll do instead is ask Steve Axilrod to summarize the results of the experiment as it was presented to the Committee and as resolved. So why don't I start with Steve Axilrod to briefly summarize the results of the experiment.

CHAIRMAN BURNS. Gentlemen, coffee is available in the corner of the room, so please feel free to refresh yourselves as you see fit.

MR. AXILROD. We thought that, following the Committee's decisions after the report of the Subcommittee on the Directive, we ought to divide the experiment two ways. One would be to run in the Bluebook a nonborrowed reserves target covering the intermediate period that we believe was consistent with each of the alternatives presented to the FOMC; and then [second], after the FOMC made its decision as to what aggregates it wanted, to adopt its range of tolerance in the intermeeting [period] to adjust that nonborrowed reserve target to be consistent with those aggregates.

That adjustment, therefore, involved an estimate of the multiplier relationship between nonborrowed reserves and the midpoint [of] the M1 and M2 growth ranges that the Committee adopted. That was the part of the experiment that was undertaken by the Board's staff and was described in the memo by Messrs. Paulus and Beck. This nonborrowed reserve target was then taken by the Trading Desk as a shadow operating guide for itself in the intermeeting period. In addition, it took as its shadow operating guides the other limitations or specifications in the original report of the Subcommittee on the Directive--that is, the federal funds rate should move no more than 25 basis points in a weekly period and that very little attention should be paid to the possible shifts in the multiplier. Essentially, you are on a nonborrowed target with this kind of federal funds rate constraint.

The report by Ms. Tschenkel and Mr. Sternlight discusses their results. We've summarized these in the paper. In essence it turned out that in four of the six intermeeting periods, within the limitations imposed by the experiment, you could get within $50 million of the target level, the shadow targeted level, four of the six times, and in practice it turned out you were within $50 million of that targeted level one of the six times. So in that sense, even with a limited federal funds rate movement, it seemed to turn out that you could hit the nonborrowed reserves target, probably more than you could, for example, [hit] an RPD [reserves available to support private nonbank deposits] target at that time.

But then it turned out that, on the basis of the results of the Board's experiment, you would not have been very much better off in terms of short-run money supply targets even if you hit the nonborrowed reserve targets. Except in the very critical, perhaps April-May period, hitting the nonborrowed reserve targets would have gotten you closer to the M1 and M2 targets at considerable interest rate costs. In most other periods, it would have made very little difference.

Our multiplier relationship between nonborrowed reserves and the money supply is so slippery and so difficult to forecast that it simply meant that we could not say with any reasonable certainty what the relationship was in the very short run. Thus, it turned out that if you had hit that nonborrowed reserve perfectly in all six of the periods examined, M1 would have been closer to expectations only one-fifth of the time and further away three-fifths of the time. Now, indeed, these are small differences, so "away" and "closer" are really within a range of almost indifference [and] not exactly as you would have expected. M2 on the other hand, would have been closer three-fifths of the time and away one-fifth [of the time], and again, small differences but no significant improvement.

The conclusion the staff drew was that the nonborrowed reserve experiment indicated that you could not come any closer to hitting the M1 target in the short run with nonborrowed reserves than you could with operating on a federal funds rate. This was no surprise. But because this was completely consistent with the econometric results that we had beforehand, what we seemed to demonstrate was that close and careful attention to the relationship on a day-by-day monthly basis couldn't improve the econometric results, which built in an historical multiplier which isn't shifted about continuously.

In closing, I would just like to add one caveat, which is noted in the report of the subcommittee. The experiment is very limited, of course, because we couldn't have a dynamic situation, that is, you had a result and a one-month period. If you had hit the nonborrowed reserve target, and [then] the funds rate, say, [went] up, the aggregates would have been slightly different than you would otherwise have had. And then, in the next month's period--if we were playing this game--we'd have had a different Bluebook, and we'd have presented different alternatives to the Committee, and then we'd have had to guess what the Committee was going to conclude, and so on. And that is on the [unintelligible] of it, as you can see. Fairly impossible to do.

So, essentially this is an experiment which says that in each four-week period you can't do much better than you did with the federal funds rate but says very little about what would have happened over a sustained six-month period if you stuck rigorously to a fixed rate of growth in a nonborrowed reserve target. I think, Governor Partee, that concludes my summary of the staff results. Other members of the staff are here for any detailed questions that people may wish to ask.

MR. BALLES. Chuck, I wonder if I could add something at this point to what Steve has already said. It is true, I can't object to anything in the way of the summary of the experiment's results [and], something that Steve has already alluded to, that we should have expected [them]. And I would simply like to lay on the table my thoughts, that had the experiment been constructed somewhat differently, we might well have gotten different results. That is to say, we have known for a long time that the month-to-month variation in the Ms is quite erratic. They are riddled with random fluctuations that tend to be self- reversing.

This has been a point that I have been emphasizing for well over a year now. If we had, instead--and this is supported by some staff work--been trying to keep, say, a three-month moving average of money of the various Ms at some level, I think we would have found considerably less erratic behavior or unpredictability in the multiplier as compared with trying to do it on a month-to-month basis. So I think that point is worth noting simply because it underscores the fact that any instrument--whether it's the fed funds rate, or nonborrowed reserves, or any other measure of reserves for that matter--is never going to give a short-run, month-to-month control over the level of the aggregates or the rates of growth. [That is] because [unintelligible] built in very strong tendencies for the month-to-month changes to be quite erratic in the Ms, [although] they do average out over a somewhat longer span--three or six months. Mr. Kalchbrenner did some good work demonstrating that in one of the staff papers.

MR. PARTEE. Well, I think it's true, John, that the longer the average chosen, the better chance of success in getting something within that range. Of course, the Committee has been operating on a two-month specification with the aggregates, so that is why the experiment was specified in that way. I don't know how they could have done it on a longer- range average--a three-month average or four-month average--in the absence of knowing what the Committee had chosen as its target for that period.

MR. BALLES. I completely agree with that, Chuck. I am not criticizing the experiment for how it was constructed; it was the only reasonable way of doing it. My only point is, somewhere down the road, and I hope in further assignment to the subcommittee, we will be asked to look at what the outcome might be on a simulated basis were we to move to, say, a three- or even four-month horizon in our Bluebook rather than our present two-month horizon. It does contain within it a lot of statistical noise.

MR. PARTEE. Well, I think we should ask, Mr. Chairman, whether there are any staff comments. Mr. Axilrod has attempted to summarize what the staff paper shows, and I think the staff--Mr. Paulus, Mr. Sternlight--ought to have a chance to correct anything that he said that they consider inaccurate. Is there anything, John?

CHAIRMAN BURNS. Inaccurate or incomplete--any comments, Mr. Paulus?

MR. PAULUS. I think President Balles is absolutely right, that there are severe limitations imposed on the analysis by the type of experiment that we undertook. Without designing a different kind of experiment, I think it's very difficult to say with any certainty what the cumulative effect of hitting the nonborrowed reserves target would be on control of the monetary aggregates. But I have no disagreements with anything that he said.

SPEAKER(?). Mr. Chairman, I think I should add, if we did circulate the paper that was circulated to the Committee about last June or July by Mr. Kalchbrenner, [it would] demonstrate that over a six-month period, nonborrowed reserve targets would permit you to hit the aggregates reasonably well. However, that paper also demonstrated that a federal funds target would have about the same results. We couldn't differentiate between the two in any significant way on the basis of the data presented there.

CHAIRMAN BURNS. All right, thank you. Mr. Sternlight, do you have any comments?

MR. STERNLIGHT. I didn't have anything to add.

MR. PARTEE. Well, now, from that summary, Mr. Chairman, the subcommittee reached three operational recommendations that it wishes to present to the Committee. The first is the conclusion, which follows from the summary, that there isn't anything much to be gained in adopting nonborrowed reserves as a target for the Desk so long as we continue to have a two-month short-run horizon, the kind the Committee has used before. Indeed, sometimes it appears that it could be counterproductive, as for example in the last two months, when it was consistently indicating--when the Manager would consistently have them operate against a nonborrowed reserves [target] that was running above the target, and would have done that, I presume, by raising the interest rates and raising them substantially.

The fact of the matter is that neither nonborrowed reserves nor the funds rate are going to be terribly helpful in achieving short-range target objectives in terms of the monetary aggregates. But the difference is that, in my view at least, whereas the nonborrowed reserves operational vehicle will result in considerable interest rate fluctuations--sometimes rather extended movements in rates over the four-week period--the use of the funds rate avoids that short-run instability in the great [unintelligible].

Now that gets me through the second recommendation. We have always, in this Committee--in the 10 years or so that I have been involved--felt that reserves were a very important ingredient in this System's operation. There has always been an effort to find some reserve measure that we can point to and use in the Committee's work. There used to be some very considerable--in the first report, I think, Frank, it was total reserves. In the second report--

MR. MORRIS. Total reserves, and then into RPDs.

MR. PARTEE. --into RPD. That was in the second report, as I recall. But in any event, RPD was attempted, and now in the third subcommittee, recommended nonborrowed reserves, and now the experiment is not shown to be terribly successful in the short run. In view, however, of the fact that [unintelligible] the Federal Reserve basically does provide reserves [to the] banking system on which it can base the expansion in its long-term investments on one hand and in its deposit base on the other, we do believe that expansion should still be directed toward reserves over a longer-range period, say, six months. And that, in the Bluebook, the staff ought to specify what it expects to be the growth in reserves that would be associated with the targets in the monetary aggregates and that it also chart the course of the original reserves against that expectation. So that it would be a longer-term emphasis on the provision of bank reserves at an adequate and not excessive rate rather than a short-term attention given to that factor. That's our second recommendation.

Our third is that, since the short-range experimental attempt has not shown great success, that the Committee ought to now tell the staff to discontinue the short-range experiment, which is continued in the Bluebook which we have for consideration tomorrow, and, indeed, that the subcommittee should now look at other problems rather than the short range control question having to do with nonborrowed or any other aggregates reserve measures.

There were some qualifications to these recommendations. There is a considerable interest in reserves as a target, and there is considerable [disquiet] in the subcommittee with excessive attention to narrow funds rate ranges and narrow control of the interest rate structure. So I think I will ask the other members of the subcommittee who feel this way to speak. Governor Wallich has a supplemental comment attached to the report which seems to me to show a considerable underlined desire for some reserve measure for controlling the growth in the aggregates, and I would like him to speak first. Henry.

MR. WALLICH. Well, I think that we ought to realize that this is an extremely important matter which can play a very great role in the success of monetary policy. It has been the experience of the System from Bank to Bank that by focusing on interest rates and the funds rate, but more broadly on interest rates, it has believed [itself] to be doing one thing when actually the force of the aggregates are not adequately observed [and] cause the Committee to be doing something else.

Typically, the central bank that pursues interest rate policies always looks good cyclically. In the recession, interest rates go down, and so it seems that the central bank has done the right thing. In an expansion, interest rates go up, so the central banks seem to have done the right thing. That's fine. If you look at the money supply behavior during these periods, the money supply may well have been behaving procyclicly instead of anticyclicly. That is to say, during a recession, even though interest rates went down, money supply may have slowed or even shrunk; and during expansion, even though interest rates seem to be exerting a braking role, actually they were not rising enough to exert an effective brake, and the money supply was expanding more than normally.

Now that is why essentially I think there is something to be said for an aggregates target as against interest rate [targets] in general, and the narrower range for [the path of] nonborrowed reserves and targets as against the funds targets. It is certainly true that nonborrowed reserves has a high cost. It makes the funds rate tend to roam, and we all know that this unsettling [of the markets] has been damaging in many ways. At the same time, the more we try to avoid these unsettlements at these costs, the more we tie the whole rate structure to the funds rate because the market knows of our reluctance to move the funds rate unless it is necessary. And so when it does see the funds rate move, it anticipates a change in policy and moves with it. And so gradually it becomes harder to move the funds rate, the cost becomes greater, and the danger that we are moving inadequately and allowing the aggregates to move too far one way or the other becomes more real.

I am not arguing here to adopt a nonborrowed reserves target. I do think that [would be] too unsettling, even though after a period of time that unsettlement would wear off as the funds rate became somewhat uncoupled from the rest of the rate structure. What I am arguing for is more willingness to move the funds rate in order to avoid the danger of having the aggregates get away from us, because if we do that deliberately, I think we can forestall that danger. That means, however, moving not toward a narrower funds rate [range], as we seem to have been doing lately, but toward a wider funds rate [range], more frequent reversals of funds rate movements if necessary--accustoming the market to [expect] that such things may happen and that this need not dominate the movement of the whole rate structure. That way we may be keeping our hands on interest rates [and] at the same time making sure that the aggregates can't get away from us.

MR. PARTEE. President Balles had a supplementary comment to the report also. John, I don't think you amplified everything you wanted to say in your earlier comments.

MR. BALLES. Well, thank you, Chuck. In my supplementary comments, about a half a page, I first associated myself with the supplementary comments that Governor Wallich had made because I thought he put the case very well. I would simply like to stress that, at least as I personally view it, I would think that this Committee would want to strike a reasonable balance between short-term term interest rate stability on one hand and keeping the aggregates within the specified 12-month growth ranges that we consider so carefully once each quarter. As I look at the recent experience, I can't avoid a conclusion that the pendulum may have swung too far toward short-term interest rate stability at the cost of significant undershoots to overshoots for extended periods in how the aggregates behave with respect to the 12-month ranges that we have decided upon.

With regard to the first of those two points, that is, the tendency toward perhaps a narrower funds rate fluctuation in recent years, the statistical evidence as I read it does seem to support that--there has been less variation more or less progressively as we've gone from '73 to '76. With regard to what I mean by significant undershoots or overshoots in our longer-term targets, probably the most significant sustained undershoot was in the fourth quarter of 1975, just to refresh your recollection, followed by the first quarter of 1976; in those two quarters, M1 grew 2.3 percent versus our 5 to 7-1/2 percent range. The next quarter, it grew by 2.7 percent [versus] our 4-1/2 to 7-1/2 percent range. That was a six-month period, which I don't think is insignificant. [We were] not only below the midpoint, we were significantly below the lower end of our target range. And as I look back on that period, that was one in which the federal funds rate was declining, [but] not by very much--about 100 basis points in the first quarter and about 50 basis points in the second quarter. And I suspect that if we had let that rate come down a little faster, we might not have gotten the six-month undershoot in M1, which probably occurred at a time that was not very fortunate in terms of the business cycle; that is, we were still at a fairly early stage of the recovery pace.

So, I am not arguing for constant stability and rates of monetary growth. That's the last thing I want because I am a strong believer in flexible policy. I do think that, since we get such careful attention to the ranges of monetary growth 12 months ahead, and since those ranges themselves are rather wide, rather generous, something does appear to be wrong when we, over, say, a six-month period [are] well below even the lower end of that range. I would like to see a little more attention given to keeping at least within those ranges that we have specified for ourselves and at the cost of perhaps somewhat wider movements, not only day-to-day but from one level to another, in the federal funds rate.

I'm simply asking that the pendulum, as I would put it, swing closer back toward the center of that dual objective of preventing destabilizing interest rate fluctuations on one hand and preventing destabilizing overshoots or undershoots in long-run growth ranges on the other. I think that completes my comments, Chuck--excuse me, may I add one more thing?

In view of that consideration, I was not terribly happy with the recommendation that we not have a nonborrowed reserves target in our short-term operating specifications. But I accepted that with a proviso that the Committee would pay serious attention to the second recommendation which the subcommittee made. That second recommendation was that, in the Bluebook, the staff include estimates of growth rates for the various reserve measures over the ensuing six months [that are] expected to be consistent with the movement of the aggregates, etc., and that there be an analysis in the Bluebook which evaluates the recent behavior of reserves in relation to such expectations.

In short, that we keep a very careful eye on the volume of reserves, preferably as measured by nonborrowed reserves, so that we don't allow ourselves, as I think we probably have in the past, to get too concerned with freezing our funds rate in position at the [cost] of letting the aggregates [move] considerably outside of the ranges that we have specified. Thank you.

MR. PARTEE Well, I think President Morris agreed with the recommendation as it is written, but, Frank, do you have any additional comments you would like to make?

MR. MORRIS. I would like to say that my agreeing with the recommendations represents a reversal of a position I took as a member of the Maisel and Holland predecessor subcommittees. My thinking has been changed for two reasons. I think my previous thinking was stated very eloquently in Governor Wallich's supplementary statement. But I think two things have changed my thinking.

First, I think that experience has demonstrated that we can control the money supply over periods of six months to a year with the present operating procedure, provided that the Committee is willing to move interest rates sufficiently to do it. I think the great case in point was the first half of '74, when we succeeded in hitting our aggregates objectives in a very difficult situation. We did so by unprecedented movements in short-term money rates. I think the last half of '74 we backslid a bit into our former ways--we expressed an unwillingness in the last part of the year to move rates sufficiently on the downside to get the kind of monetary growth rate that we were seeking. So I think point A is that we can do the job with the present operating procedure.

Second, I think that despite the limitations in the experiment, it does show that, during a one-month period--and for an operating instrument, that is the relevant period--the multiplier relationship between reserves and monetary aggregates is extremely unstable. And it has not been demonstrated that a reserves operating target would be superior to a federal funds rate operating target.

One other point I wanted to add to the first point, on the success we had in the first half of '74 in terms of hitting our objectives: I think it also shows that we do not need day-to-day stability in the funds rate to produce an environment for control of the money supply if we are willing to move in significant increments.

I think there is one final point. There is an implication in Henry's statement to the effect that a reserves operating target would somehow desensitize the market to Federal Reserve open market operations, and therefore the Federal Reserve would somehow be freer to move interest rates because of this desensitizing. I don't think that's realistic. I think that we have to recognize that to any investment institution or underwriting institution, the reading of the Federal Reserve's intentions is of prime importance. And no matter what operating instrument we use, as long as we have a rational system and adhere to a rational system, the market is going to figure out how to read that system.

If we shifted to a nonborrowed reserves operating system, the first thing that would happen is that every single investment house, underwriting firm, in the United States would immediately gear up to forecast nonborrowed reserves. And it would take a little while, but pretty soon they would be doing about as good a job as we do. Because they could afford to invest in the talent necessary. In the five years between the time I left the Treasury and joined the Federal Reserve, I was with an investment counseling house. I would spend a couple of hours every week analyzing the Fed and reporting to our investment committee. At that time we were operating on free reserves. And it didn't take long to get into the swing of things and to interpret those numbers coming out. I don't think I misjudged a move in Federal Reserve policy once in five years.

Now I think the other thing is, in addition to everybody's forecasting nonborrowed reserves, which would be difficult and would [involve] a lag, as long as you have a narrow funds constraint, the market will still be observing the range in which the Manager is operating--let's say the range is 4 to 4-3/4, just to throw out an idea for tomorrow--and the market observes that the Manager will continue to intervene at those two points, even though the rate may fluctuate day-to-day. As soon as the Manager is not intervening at 4 to 4-3/4, you will get the same flow of information on the ticker tape.

So I think that the idea that we can, by changing our present system, somehow get away from the extreme sensitivity in the market to monetary policy, and to remove whatever inhibitions that gives us, is just not realistic. I think the form of market sensitivity will change [but in] substance will still be there. I don't think that our concern about market reaction would diminish one bit.

It seems to me that, as I say--I'm a repentant sinner--I think clearly we can do the job with the present system. And the way we can really is by a willingness to move rates. There is no other system that would permit us to do the job if we are not willing to move rates. I don't care what your operating target is, as long as you have a narrow funds constraint, you're not going to control the money supply. So it seems to me that we ought to be diverting our attention to more [unintelligible].

MR. PARTEE. That completes our report.

CHAIRMAN BURNS. Our Subcommittee on the Directive has carried through an experiment, and, on the basis conducted, it has not yielded positive results. That's not too surprising. The members of the subcommittee have not reached unanimity, and that's not too surprising considering the difficulty of the subject.

You know, we use terms such as "control the money supply," and that is becoming an increasingly ambiguous statement. We live in a world in which financial technology has been exploding and which former relations between narrowly defined money and the dollar value of the nation's output no longer seem to hold, and we'll continue to live in such a world. And I think that monetary policy has to be judged increasingly by the results that we get rather than on whether we are hitting a certain target figure that we have set for ourselves.

I'd say that monetary policy by and large has performed admirably during the past, year and half, or two. The economy has continued to expand, though at a rate that many of us have found less than satisfactory during recent months. In particular, we've had a very substantial decline of interest rates and therefore have been able to demonstrate that normal experience during a business cycle expansion is not something that need apply to the present or the future. With interest rates behaving as they have, one could hardly argue that the economy has been starved for money. We continue to look at M1, the magnitude that I believe is progressively losing all significance. I think that M2 and M3 are indicating far more accurately what is happening to the state of liquidity.

In any event, these are very complex questions, and the fact that members of our subcommittee have not reached complete unanimity should not surprise us. Now the subcommittee has recommended further work, and--except for one item, namely, exploration of the possible changes in concepts of money--I think the several tasks that the subcommittee has defined are worth pursuing. We have to be critical. We have to continue the process of self-examination in which we've been engaged.

Now, exploration of possible changes in the concepts of money--our staff has been working on that, and we've had a special outside committee that worked on that subject for over two years or longer. That study is now being carefully evaluated by our staff, and recommendations on redefinition of money are in process. Let's see what our staff comes up with and not make this assignment to any subcommittee of this Committee.

But the other four subjects, I think, fully deserve exploration. One question in my mind is whether this burden ought to be placed on the present subcommittee or on a new subcommittee. I reviewed the history recently and have found that three such subcommittees have been at work. The present Subcommittee on the Directive was established in July 1973. There have been one or two changes in the composition of the subcommittee. Perhaps the members of this subcommittee, who worked so hard and for so long, ought to be relieved, and a new group ought to get into the act. The important thing, I believe, is that the subjects recommended by Mr. Partee's subcommittee for further study ought to be actively pursued with periodic reports to this Committee because many of us feel uneasy about our procedures, perhaps most of us do. We'd like to improve on them. We don't quite know as yet how to do it.

Now, I have stated the point to which we have gotten, and if there is no objection on the part of the Committee, I will give some thought to the appointment of another subcommittee to go to work on these four questions and perhaps others. And extend thanks to Mr. Partee and his group for doing what they've done. You haven't reached the ideal path, but you've helped to clarify your own thinking and the thinking of the rest of us. And we'll make more than one negative experiment before we're through, I'm sure. There should be a better way than the one we're pursuing.

But we haven't done too badly in my judgment. By paying attention both to interest rates and to monetary aggregates, I think we're not only capturing the thinking of most members of this Committee, but I think we are also attending as reasonably, responsibly--perhaps as well as we can at the present time--to the basic task of the Federal Reserve System. And if we move either exclusively to monetary aggregate targets and ignore interest rates, or the other way around, I think we would soon work ourselves into all kinds of difficulties and perhaps create difficulties in the economy that would not be easy to correct. And by keeping the balance between these two sets of objectives, by and large, I think we've done reasonably well, and served the economy reasonably well. That's my opinion.

MR. LILLY. Could I ask if the new subcommittee that will be taking up where these gentlemen left off will take into consideration what would be the best operation of this Committee if it's required that we release--two days or 24 hours after we make a decision--our objective for the next 30 days? Making a prediction, in other words, that that's the next thing facing us--it may well be that this whole procedure, which seems satisfactory now, will not be satisfactory in that kind of time [sequence].

MR. JACKSON. Would it even be possible for them to address the issue of how often the Committee should meet?

CHAIRMAN BURNS. How…?

MR. JACKSON. How often the Committee should meet.

CHAIRMAN BURNS. Well, I think that that is a question that is best left to the Committee as a whole or perhaps another subcommittee. I think that monthly meetings are by and large satisfactory. The main difficulty with monthly meetings that I see is that, since we get here once a month, and since some of us travel a considerable distance, there is a natural human impulse to do something, even when common sense might indicate that doing nothing for the time being might be the wiser course.

However, reviewing the economy once a month--and bearing in mind that we need not really take an action every meeting, that now and then it's best to stand still, catch your breath and see the economy adjust to what we've already done--may be the wiser course. That's the only question I have about monthly meetings. I, for one, would still vote for monthly meetings. What is the sentiment of the group? We used to meet quarterly.

MR. JACKSON. I'm not trying to challenge the idea of when to meet, I'm just thinking it should be objectively viewed in light of the policy action.

CHAIRMAN BURNS. Well, I think that is a very fair question. We used to meet at quarterly intervals, that was well before my day.

MR. JACKSON. I'm not advocating a change, I just think that if they're going to study the issue of policy action, the change in the rate of policy actions is sometimes as important as the action being taken.

CHAIRMAN BURNS. Mr. Black.

MR. BLACK. Mr. Chairman, in this excellent review which was described, I wonder if we couldn't accomplish some of the aspects intended for phase three. You commented that the new subcommittee would look at [alternative] practices. It may well be that you'll run into some changes there in relationships to aggregates and minimize fluctuations in the federal funds rate at the same time. There's always some [unintelligible].

CHAIRMAN BURNS. Well, that's worth thinking through seriously. Yes, Mr. Winn, please.

MR. WINN. Mr. Chairman, I'd like to suggest that maybe we take another look at some of the implications of our narrowing the funds rate range, particularly what our policy [has] meant for institutional behavior, savings flows, the profitability at certain institutions. I'd hate for us to be caught by surprise.

MR. PARTEE. That's sort of an analytic background of [unintelligible] as I understand it. This is how excessive dependence on the market the funds rate--that is, if you're really defining excessive, I've got to say, what would you mean by excessive terms.

CHAIRMAN BURNS. Yes, that's the second of the studies recommended by your subcommittee.

MR. PARTEE. Or at least it's closely related.

CHAIRMAN BURNS. Any other? Yes--

MR. EASTBURN. I think related to this is the cost of interest rate fluctuations. This is something that we've been doing some work on and I think it's--

CHAIRMAN BURNS. That would be very interesting, to see the results of your study. Is it pretty well along?

MR. EASTBURN. Yes.

CHAIRMAN BURNS. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, I'm not sure I heard you correctly, but if I did, you opened the question as to the frequency of meetings.

CHAIRMAN BURNS. Yes.

MR. BAUGHMAN. I have thought about it a good bit, and I have to admit I've come to the conclusion that, during much of the time, a very thorough meeting about once a quarter would probably serve the needs fairly well. I think there are times--when the economy is in fact changing or giving indications of imminent change, either in direction or pace--when that would be too far apart.

CHAIRMAN BURNS. Well, let's just have a show of hands. Mr. Baughman has expressed a sentiment. We're not voting for anything. But how many of you see some rough good sense in Mr. Baughman's comment. Any of you? Well, we all like to travel once a month--all but you, Mr. Baughman.

MR. BALLES. Mr. Chairman, I wonder if I could bring the discussion back for a moment to the report of the subcommittee. I want to emphasize that I did not dissent. Henry, as far as I know, did not dissent. There were no dissents. There were two, actually three, recommendations. Governor Wallich and I had some additional qualifications to our votes, as it were, in terms of points of emphasis that we thought ought to be given greater attention in the future. I think it would be unfortunate if the Committee as a whole concluded we have a split report because we didn't. And I think it would be unfortunate if the Committee as a whole didn't address itself to our recommendations. Perhaps not today in view of what President Eastburn has said, but perhaps at the next meeting.

There were two quite specific recommendations there: that the nonborrowed reserves not be included in the short-run operating specs; and number two, that the Bluebook include certain vital information about the past with respect to behavior of reserves vis-à-vis the monetary aggregates. I would not like to see the Committee walk away and not pay any attention to these two recommendations. Does that make sense, Governor Partee? You are the chairman [of the subcommittee].

MR. PARTEE. Yes, I would like to second what President Balles said. There weren't dissents--just qualifications, and those two recommendations, I think, do require some kind of disposition by the Committee some time or other.

CHAIRMAN BURNS. I would assume that those two recommendations would be entirely congenial to the entire Committee. Am I wrong on that? I would doubt whether there would be any difference of opinion within this Committee on those two recommendations. Yes, Mr. Eastburn.

MR. EASTBURN. Could I ask a question, Mr. Chairman, to Governor Henry Wallich and John Balles. Do you see any possibilities of adoption of the subcommittee recommendations that it'd make [it] more difficult to move in the direction that Henry presented in this comments? Do you see these [as] quite independent? Do you see the adoption of the report's recommendations as being independent of your--

MR. WALLICH. Well, the recommendations with respect to the future treatment of the nonborrowed reserve number, I think could [be consistent with] what I had in mind, namely, consent can be reached that we should be more flexible on the funds rate. I think one could even argue about the cyclical timing at which one might move in that direction, but, generally, what I had in mind is something that we would be aware [of], not something that goes into effect as of a certain date.

MR. EASTBURN. And you don't see adoption of these recommendations hindering the direction that you want to move in.

MR. WALLICH. No.

MR. BALLES. I don't either, Dave. And I think I've already expressed myself to the effect that I hope that whatever subcommittee addresses the questions that are left on the table would look at one very key proposal, and that is to lengthen somewhat the so-called short-term horizon over which we now attempt to maintain some ranges of growth in the aggregates. [That proposal would be] based on all the experience which shows that, if you go to, say, a three-month or maybe a four-month moving average of your money targets, you're going to be a lot better able to hit those than if you try to hit them month by month, because there's such a lot of random variation.

But I don't see anything in the adoption of these recommendations that would preclude that sort of additional work. And particularly recommendation 2, that the Bluebook now contain additional information, projecting for six months ahead the levels of various reserve measures, and especially nonborrowed reserves, that would be consistent with our longer-term monetary growth ranges.

CHAIRMAN BURNS. Well, if I understood Governor Wallich's comments and your comment, John, you want simply that the federal funds rate range should not be excessively narrow.

MR. BALLES. That's correct.

CHAIRMAN BURNS. Or to put it differently, it should be fairly wide.

MR. BALLES. If I may interrupt, President Morris also joined in that in his remarks.

CHAIRMAN BURNS. Yes he did. And Governor Partee did not necessarily--

MR. PARTEE. Well, I did. I think there's a time horizon here. I don't know that I agree that this short-term operating range [should] be longer. I think you have to be prepared to move it over time, which is what every other--

CHAIRMAN BURNS. This is a question that members of this Committee have debated time and again; we [have] disagreed on [it] from time to time; and we've had wide ranges and we've had very narrow ranges. We voted unanimously for wider ranges; we voted unanimously, or almost that, for narrow ranges. And philosophically, I don't think the Committee as a Committee has reached a conclusion. I don't think we ought to rush a conclusion.

MR. MORRIS. Mr. Chairman, in line with Governor Lilly's comment on what we'd do if we have to publish the specifications immediately, I think one thing, clearly, we'd have to do is to publish a very wide funds range. I think any narrow funds range would produce a very immediate market reaction. If the funds range were so wide that it could encompass a tremendous array of moves, I think we would desensitize--it seems to me this is one thing we'll have to do.

MR. BAUGHMAN. Since we don't use the range we now publish, what reason is there to think we'd get any mileage out of publishing a wider one?

CHAIRMAN BURNS. Well, I'm not sure that's the answer. The answer would be to--

MR. PARTEE. [Unintelligible].

CHAIRMAN BURNS. --the answer would be to stop publishing any federal funds rate range that's [unintelligible]. And with the Desk being instructed to rely on the behavior of reserves, on the behavior of the federal funds rate, and to seek to the best of its ability to approximate these ranges. I don't know, I don't know what we're going to do in--

MR. JACKSON. I think the proposal by Governor Partee would accommodate that kind of problem because it discusses action from a midpoint rather than action within a range.

MR. PARTEE. [Unintelligible].

CHAIRMAN BURNS. Well, I think in view of the legal problems that we've recently had, we may face a problem such as this before too long, and doing a little thinking in advance as to how we might react to that is probably wise.

MR. LILLY. [Unintelligible].

CHAIRMAN BURNS. Gentlemen, it's 6:00 and the normal time for adjournment. We're two to three minutes beyond 6:00. Well you're . . . great, eager to continue this meeting--

MR. BALLES. Mr. Chairman, I wonder if I could propose one final time, the question I asked you several moments ago and so that the rest of the Committee members will know what to expect. Is it your intention that there will be some further discussion and perhaps a vote on these subcommittee recommendations at the next meeting of the Committee? I say "next" with the sense that some members apparently didn't receive the report in time to really digest it thoroughly for today's meeting. I just happen to be uptight about unresolved loose ends. I want to express my feelings--

CHAIRMAN BURNS. I thought that the two recommendations of the Committee were adopted without taking a formal vote.

MR. BALLES. Oh, I see. I'm sorry, I didn't catch that. All right. Very good. Thank you.

MR. PARTEE. Yes, I think that's right.

December 21, 1976

[Secretary's note: The raw transcript for the December 21 session begins at this point. The session began with Committee approval of the Minutes of Actions of the meeting of the FOMC held on November 16, 1976, and the Manager reported on, and the Committee approved, System open market transactions in foreign currencies during the period November 16-December 20, 1976.]

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

CHAIRMAN BURNS. Thank you very much, Mr. Gramley. I think we're ready now for general discussion on the condition of the economy and the outlook. I think, as is our custom, it would be most useful if members of the Committee would emphasize points of disagreement as well as points of agreement, elaborating on the first but not on the second. Who would like to be first. Mr. Black, please.

MR. BLACK. Lyle, in view of the inventory situation--such things as we picked up in the Redbook and also the last couple reports of the National Association of Purchasing Managers' upward revision in real final purchases--I was a little bit puzzled that you don't show a little more strength in inventories a little earlier than you do. I was just wondering--if we do get particularly good Christmas sales, if we have this sharp upturn in housing that we expect should strengthen durable goods sales--how you would rate the chances that you might conceivably have underestimated that upward rebound in inventories.

MR. GRAMLEY. President Black, I think that is a possibility. We have been impressed, however, by the fact that this inventory problem has been a very difficult one for businesses since last spring. We think they are going to be very, very cautious about adding to their inventories until they see rather certain signs that consumer spending is picking up. An extremely strong Christmas, stronger than we have allowed for, a continuation of stronger consumer spending in the first quarter, [those] certainly could do it. I think we would have to wait and see those results, however, before we became more optimistic on our inventory projections.

MR. BLACK. Could I ask one question about housing. I was a little puzzled, Lyle, by your figures on housing starts, particularly from this fourth quarter. If I figure right on this, this is a pretty sharp drop in December.

MR. GRAMLEY. It implies some drop in December, yes.

MR. BLACK. Sixteen percent or so, and I was curious--

MR. GRAMLEY. I have not made that calculation for the December figure. It does imply a drop. We had been expecting--

MR. BLACK. Below what permits have actually been running.

MR. GRAMLEY. Oh no, they wouldn't drop below the [permit] level.

MR. BLACK. Well, I've got it figured at 1.432 million [annual] rate for December, which is below the permit level, which surprised me.

MR. GRAMLEY. I'd have to check that calculation, President Black; I'm not certain.

MR. BLACK. I just guess I would expect a little more strength than that in housing, though I may well be wrong.

MR. GRAMLEY. We think our projection of housing generally, looking into 1977, is reasonably optimistic. It does imply a movement of single-family housing starts to levels that are near the highs of the 1950s. It doesn't exceed the highs, but--

MR. BLACK. I am not much different than that. It's really mainly the fourth quarter that surprised me, and I didn't know whether there was something special in the December situation that I didn't know about, or what.

CHAIRMAN BURNS. All right, thank you, Mr. Black; and Mr. Eastburn, may we hear from you now.

MR. EASTBURN. Two points, Lyle. First on your changes from [your projections] last time. I wonder why there isn't more effect on unemployment, with the increase that you have in real GNP from the last time. Second, did you do anything with alternative kinds of fiscal action, a rebate or anything of that kind?

MR. GRAMLEY. In response to your first question, the reason that you don't see more effect on the unemployment rate is because we looked over our projections of labor force growth and decided that our projections were simply much too conservative, that we needed to project a larger increase in the labor force, and we did so quite independently of the additional fiscal stimulus. The fiscal stimulus package adds, roughly speaking, 1 percent to the level of real GNP by the end of the year and reduces unemployment by about 1/2 percent, so there is a significant effect there.

We didn't try alternative packages. My feeling would be that a rebate program of the same dollar size would have significantly less impact on economic activity because it would lead to a significantly larger increase in the saving rate. We do put the saving rate up--it rises from an estimated 6 percent in this quarter to 6.3 in the fourth. And it would surely go considerably higher than that if the rebate technique were used.

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

MR. MAYO. An observation and then a question. We have found in our probing among our directors and other business contacts that the time has come to again say that the subjective feelings of the executives and economists that we've been talking too are a little ahead of the statistics. In other words, the statistics are still weakening in some areas, stabilizing in others, but are really not optimistic yet. And yet we detect a little more cautious optimism than a month or certainly two months ago with regard to what you might call the flavor of the business outlook.

The question, I guess, has been largely answered already, but I'll ask Lyle anyway for a little elaboration. My question was how much of your improvement from last time is due to fiscal stimulus, and how much is the economy coming up on its own. If I read you correctly, the improvement, say, by the fourth quarter, from 4.9 percent real GNP growth to 6.4--you attribute two-thirds of that to fiscal stimulus and one-third to the economy without the fiscal stimulus. Am I jumping to a conclusion, or is that about right?

MR. GRAMLEY. Those are about the right dimensions, President Mayo. We would have weakened very slightly our projection from a month ago without adding any fiscal stimulus.

MR. MAYO. Oh, you would have.

MR. GRAMLEY. Largely based on the grounds that, first, we anticipated and built into our last projection the sort of improvement in final sales and reduction in the rate of inventory accumulation which we think we're seeing in the fourth quarter. What impressed us particularly about the outlook was the weakening of the near-term anticipation for business capital spending in the first half of the year. We also thought we saw some reasons for thinking that housing looks stronger over the course of 1977 than we had built into our last projection. So we would have ended up with a little bit less growth in 1977 without the fiscal stimulus.

MR. MAYO. Well, now, I am puzzled, because I thought you agreed with me when I said about two-thirds was fiscal stimulus. Now aren't you saying that all of it is really fiscal stimulus? From 4.9 to 6.4?

MR. GRAMLEY. We had the year improving last time. It improves much more now. The principal part of that is due to fiscal stimulus, but we would have had the economy coming out of the slump and beginning to improve in 1977 in any event.

MR. MAYO. Well, what I was looking at is your page I-7 on the staff projections, and the fourth quarter of '77, 4.9 for a month ago and 6.4 for the current projections. And I gather from what you're saying, that since we did have an improvement built in a month ago, that really the additional improvement here is fiscal stimulus.

MR. GRAMLEY. Most of it is. I'm thinking not just in terms of the particular growth rates for the first quarter and fourth quarter as I am thinking also of what the level of real GNP in the fourth quarter would have looked like. You get a somewhat different pattern with fiscal stimulus than without. And it's hard to say what exactly we would have come up with had we made a judgmental projection without the stimulus. But roughly speaking, we added a little more than 1 percent to real GNP, very slightly more, because of fiscal stimulus. And we would have had a real GNP level two- to three-tenths, perhaps, below that without the fiscal stimulus.

MR. MAYO. Thank you.

CHAIRMAN BURNS. You know, the question of fiscal stimulus is being appraised rather differently today than it was ten years, five years, even two years ago. The preponderant opinion still runs in a Keynesian direction. There are voices of dissent. Let me read one. And I'll identify the author after I read the statement.

> We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candor that that option no longer exists, and insofar as it ever did exist, it worked by injecting inflation into the economy, and each time that happened, the average level of unemployment has risen. Higher inflation followed by higher unemployment, that is the history of the last 20 years.

This statement was made on September 28, 1976, by Mr. Callaghan, the prime minister of Great Britain. We'll go on now to Mr. Kimbrel, please.

MR. KIMBREL. Mr. Chairman--well, I guess the fiscal stimulus you've been toying with is at the level of $15 billion.

MR. GRAMLEY. That is correct--$15 billion annual rate.

MR. KIMBREL. You suggested that the lower OPEC prices produced a slightly higher GNP next year because of the lower rate. Have you toyed with any alternatives with less than $15 billion, [as] some of the new Administration people seem to say that they are going to wait until somewhat later and observe. And the chances this might not be the figure, it might be lower than that--have you toyed with any of that?

MR. GRAMLEY. We have not done anything formally with that. No, my feeling would be that, roughly speaking, if you cut the fiscal stimulus by a third, you would be inclined to cut the impact on real GNP by roughly a proportionate amount. So that, instead of getting 1 percentage point increase in real GNP in terms of level by the fourth quarter, you'd get maybe 7/10. We have not formally tried to assess what the effect of a lower OPEC price increase would be. We have looked at some model runs, but it is a very complex problem, and much is going to depend upon the reaction of prices of competing energy items like coal and natural gas. You have to work it all the way through, figure out how the control program is going to respond, and we just don't know yet how much impact that is likely to have.

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

MR. MORRIS. Mr. Chairman, I picked up a little piece of intelligence last week that I think perhaps you might like to comment on. I talked to Joe Barr shortly after he had attended the annual Christmas party of the House Ways and Means Committee, and he told me that he found that the reaction of the members of the committee on this issue of a tax cut to be quite surprising. First, he said that there is going to be a great reluctance on the part of the committee to approve any tax cut. Second, he thought that the committee was exhibiting, this goes for Ullman and a lot of other people on the committee, a great disenchantment with the use of tax measures as a stabilizing device. So this suggests, if this intelligence is correct, that perhaps the tax cut might ultimately come through if the President pushes it, but that it might take a while longer getting through Congress.

CHAIRMAN BURNS. Well, I can confirm what you learned from Mr. Barr. Mr. Ullman is definitely opposed, as of today, to a tax cut. The same is true of the ranking Republican on the Committee, Mr. Conable. In the Senate, Mr. Humphrey is definitely opposed, [unintelligible], but I have not heard Mr. Senator Long's views on this subject. But I'll tell you, let me just take another word--I think this will take longer than is commonly supposed, I think you are right on that. My guess, however, is that, unless economic news improves dramatically in the near future, we will get tax legislation from Congress.

If I read the political scene correctly, there is a widespread demand for fiscal stimulation; some want an increase in spending, and I think the members of the House Ways and Means Committee would be inclined in that direction, including Mr. Ullman. Some want a tax reduction of some kind, and this is being urged by liberals, it's being urged by conservatives, it is being urged by labor leaders, it's being urged by businessmen.

My own guess is that unless we get a very sizable improvement in news concerning the economy, that the Congress will pass a bill of the usual type. It will contain an increase in spending of some $3 billion to $5 billion. It will contain a tax rebate--and a rebate even means sending out Treasury checks to people who never paid income tax--and it will include a permanent tax cut, the aggregate amounting to perhaps $20 billion. If I were making a bet as of today, that would be my bet. And I must say it worries me--the near unanimity of opinion that so-called fiscal stimulation is needed, I find [it] very worrisome. So I can confirm very largely the report that you got from Mr. Barr. I can agree with your judgment; it will take longer for the Congress to act than many people are assuming. I perhaps differ a little on the judgment as to what the Congress will finally do.

MR. MORRIS. I was going to say, he also added [that] he was a little bit surprised [at] the vigor of the determination of the House leadership in the last year or so, O'Neill and the others, to maintain the independence of the Congress from the presidency. Politically they argue that almost all the members of the House were elected by bigger majorities than the President in their districts, and they don't feel beholden to the President. Here is another aspect, I think, which might produce a greater delay in response [by] Congress than might otherwise be the case.

MR. BLACK. Mr. Chairman, what is your guess as to how the tax cut will be divided between individuals and business?

CHAIRMAN BURNS. Well, pure guess of course--my guess would be that 80 percent of the dollar aggregate would go to individuals and perhaps 20 percent to corporations.

MR. GRAMLEY. Mr. Chairman, may I report to the Committee--I have just received the CPI numbers, and they indicate that there was another moderate increase in consumer prices for November. The size of the increase was 3/10 [percentage point], the same as October.

CHAIRMAN BURNS. Largely--

MR. GRAMLEY. Food was down. A little. The commodities less food, however, went up 4/10, as they did a month ago.

CHAIRMAN BURNS. What Lyle is saying is absolutely right, but you know we have to keep in mind, Lyle, what percentage of the price figures, in terms of weighting, enter into the consumer price index in the month for which the index is recorded.

MR. GRAMLEY. My recollection is about two-thirds.

CHAIRMAN BURNS. No, I don't think you're right. I think it is less than half.

MR. GRAMLEY. I may be thinking of the major cities.

CHAIRMAN BURNS. In any case, the figure for the month, it is a figure reported for the month, but it doesn't apply to the month. It applies partially to that month and partially to the month before and the month before that. And they have a reform program under way, and by spending a substantial sum of money, they will reduce the backward reference. But even so, it will be something like a three-month figure but with heavier weighting in any given month.

MR. MORRIS. Sir, in that connection, is anything being done to try to get the wholesale price index on a transactions basis rather than list price basis?

CHAIRMAN BURNS. Well, I don't know, that is, you may recall a study we made at the National Bureau [of Economic Research]--George Stigler--something that I've been interested in for very many years--I got that study [published]. We urged the Bureau of Labor Statistics

[BLS] authorities to work on the problem, substituting transactions prices for list prices. When I looked at the matter last, some time ago, very little progress in that direction had been made. Do you know, Lyle?

MR. GRAMLEY. I think you're right, Mr. Chairman. There is under way in the BLS a major improvement project for the wholesale price index. I believe the emphasis there, however, is in getting better-quality statistics and better industry detail. In the process, they may have improved the extent to which they get transactions prices instead of list prices. But that is a very elusive objective.

CHAIRMAN BURNS. It's very difficult, very costly, to get that kind of information. Mr. Baughman, please.

MR. BAUGHMAN. Mr. Chairman, kind of picking up on Bob Mayo's comment, I'd be interested in Mr. Gramley's reaction to the observation that if the current forecast proves to be somewhat off the mark, that the odds might be greater that it would be low rather than high. We're sensing a little bit of the same sort of thing that Bob has referred to. I might report that, at a recent small meeting of business economists in our area that we sponsored, there was quite--I'd almost call it a note of enthusiasm amongst these business economists flowing from their observation that long-term interest rates had declined more than they had expected and that this was generating quite a change in attitude on the part of their principals. They thought that they were viewing the outlook a good deal more optimistically to a considerable extent because of that development.

So I would just toss in one other bit of information which seemed to me to provide an index of where we are. Commercial rents in relation to current construction may have a bearing on prospects there. One of our directors, who is a rather sizable real estate developer and works over a large geographic area, reported that he has three sizable commercial office buildings coming up--Minneapolis, Cincinnati, Houston. In the Houston market, they were able to make it a feasible project at current rentals. But in the Minneapolis and Cincinnati markets, which he judged to be more typical of the country, the only reason the projects were viable was because the major tenant was willing, in the interest of getting the job done, to commit himself to pay $2.00 a square foot more than the going market, or more than they can expect to [get for] space [from] other occupants. It would seem that his experience suggests that, in most markets, either construction costs have got to come down something on the order of $2.00 a [square] foot or rentals have got to rise something on the order of $2.00 a [square] foot before we can expect any sizable amount of increase in activity in commercial construction.

MR. PARTEE. Are you talking about 20 percent?

MR. BAUGHMAN. I would think about 15 or 20 percent--20 might be a little bit on the strong side. With respect to--

CHAIRMAN BURNS. We have an enormous amount of overbuilding of office structures, and to me it's a bit surprising that there is a partial comeback in office building construction. So the lag that he is reporting is not a surprise.

MR. BAUGHMAN. He also reported that, as he shops for opportunities, he finds that banks are holding large inventories of real estate and, from his point of view, at prices well above what in his judgment the market is. I don't know whether Lyle [unintelligible] presume that he has given us a forecast for which he thinks the odds are 50-50 above and below.

MR. GRAMLEY. No, that is not necessarily the case. I think in the past six months I have expressed several times the feeling that the probabilities were greater that our projections would be too high than that they would be too low. Today, I don't have any strong feelings in one direction or another. I think we could be too high on some grounds, too low on others. I think our projection is reasonably optimistic on housing, reasonably optimistic on consumer spending; we have a fairly low saving rate. I think in view of the [Department of] Commerce survey on business fixed investment, you have to call our projection in that area reasonably optimistic. I think it is probably conservative in the inventory area, may also be conservative in state and local expenditures.

We have the state and local budgets excluding the operational budget moving into surplus--to the tune of about $6 billion by the end of the period. This is largely because we have increased grants. But it may be that there will be more state and local spending coming along than we've allowed for. Of course the big thing is how much confidence improves as the economy picks up, that's the big unknown. Confidence has been swinging an awful lot, and if we're wrong on any grounds, I suppose that would be it.

MR. PARTEE. Given your fiscal program, it shifts to about $15 billion deficit. I have lost track of what that's based on, whether it's still a 4 percent unemployment rate--it would be a higher real full employment deficit, and, of course, the Chairman added a $5 billion fiscal package. But just taking your figure, 15, it occurs at the beginning of the second quarter of next year, at a time when residential construction is still moving up rather substantially. And that represents a change in projection as compared with a number of months ago, when we saw it leveling out, but it's still moving up rather substantially. Plant and equipment is doing pretty well, rising 5-1/2 to 6 billion a quarter. It strikes me that that's an awful lot of demand for funds. Have you done a flow of funds projection to see whether there are interest rate pressures that would seem to come from this kind of scenario?

MR. GRAMLEY. I think Steve may want to comment on that. He's probably closer to that area.

MR. PARTEE. I think it's basically a nonfinancial question. At least it's not a monetary policy question.

MR. AXILROD. One interesting point that has come out of the flow of funds, we do have interest rates going up about that time, Governor Partee.

MR. PARTEE. Based on the flow of funds?

MR. AXILROD. No, based in part on our assessment of money demands but in part on the fact that the additional demands in credit would be coming after the tax reduction and the greater deficits implied. But there is an offset in that, given the plant and equipment spending and inventories that we have, we actually have been forecasting in 1977 a tax decrease [generating] less net external demand for funds by business corporations in 1977 and 1976 by a small amount. And that would provide some [offset], so that unless you really have a substantial recovery in plant and equipment or substantially more inventory investment, or unless our profits forecasts are way off, the interest rate pressures associated with this kind of tax decrease may be somewhat more modest than you might think, in an off-hand way, because we still don't have large external demands by nonfinancial corporations.

MR. PARTEE. There is a very large mortgage demand.

MR. AXILROD. Yes.

MR. PARTEE. I had the impression that when the full employment picture had gone sharply into deficit, on a full employment basis, that generally you've had considerable pressure.

MR. AXILROD. I don't think, by any manner or means, that we are going to get through next year without any interest rate pressures as we did this year. But what I wanted to point out was, we still don't have built-in the significant pressures from the corporate sector, in terms of net external needs for funds, that we had in '73 [and] particularly in '74.

MR. PARTEE. So that you don't have enough tightness to choke off housing or any of the other sectors within the year 1977.

MR. GRAMLEY. The level of housing starts does level out; the level of short-term interest rates does move up enough so that inflows to the mortgage lenders begin to slow in the latter half of the year. So that, by the first half of 1978, some downward movement in housing starts would be beginning.

MR. WINN. Steve, on that one point, to what extent do we get tripped up a little bit with the aggregate figures, where the large corporations have really gotten lower financing demands? The smaller corporations are really pretty shabby with their balance sheets, so really, you may get fooled a little bit here.

MR. AXILROD. That's right, but in credit market terms we really are looking mainly at the aggregates numbers, and these numbers may be an understatement, but they indicate to me surprisingly little pressure from the corporate sector.

CHAIRMAN BURNS. You know, perhaps at this point it might be useful, without arguing the case one way or another as far as interest rates are concerned, to put some fiscal facts before you. First, in fiscal 1976, the year that ended in June, the federal budget deficit was $65.6 billion. Now, there were off-budget outlays of $8.0 billion, and if you add those in, you will have a deficit of $73.6 billion. Government-sponsored agencies had a deficit of $5.4 billion, and if you add that in, you have a figure of $79.0 billion.

Now let me turn, on a corresponding basis, to fiscal '77, that is, the year ending not in June but on September 30, 1977. The budget estimated by the Congressional Budget Office was $50.6 billion. And more recently, Alice Rivlin, in congressional testimony, indicated that this figure is based on revenue that was overestimated by $5 billion to $10 billion. If you take the midpoint [of that range]--$7.5 billion--you have an estimated budget deficit for fiscal ’77 of $58.1 billion.

Now, if you take estimates that I got yesterday from Mr. Wendel of our staff on the off-budget outlays, they come to $10 billion; that raised the figure to $68.1 billion. And if you add the deficit of government-sponsored corporations, which comes to $9.2 billion, you get a comprehensive figure of $77.3 billion, which is very close to the figure of $79.0 billion for fiscal ’76, and this is before any new fiscal measures, the sort that are now being discussed around the country and in the Congress.

MR. PARTEE. Did you add $7-1/2 billion to the deficit on the basis of Rivlin’s testimony or did you deduct it?

CHAIRMAN BURNS. No, I added it.

MR. PARTEE. I imagine she meant it would be smaller.

CHAIRMAN BURNS. The revenue [was] underestimated. I was simply quoting and without comment, so if you take the unified budget figures at $65.5 billion for fiscal ’76, and if you take Alice Rivlin’s figures, its $55.6 to 60.6 billion, and I took the midpoint of $58.1 billion.

MR. JACKSON. That’s a shortfall in revenues of about 2 percent generally?

CHAIRMAN BURNS. Shortfall in revenue--total revenue is around $350 billion, well it’s 1-1/2 to 3 percent. Well, these are interesting figures. But we will move on. Mr. Balles, please.

MR. BALLES. I was wondering, Mr. Chairman, how much you know about President-elect Carter’s hopes, possibly goals, in terms of getting both the unemployment rate down, I think, to 6-1/2 percent in the coming year and getting real growth of the economy to 6 percent, if I recall the figures correctly. Do you happen to know whether those are just hopes as opposed to goals? And further, has our staff addressed itself to what sort of package of monetary and fiscal measures might be necessary to get that sort of extraordinary result?

CHAIRMAN BURNS. Well, I don’t how Mr. Carter himself would answer it. Mr. Lance has addressed the issue in some public pronouncements, and he has indicated that, in his judgment, it will be difficult to reach these target figures. And therefore I would interpret Mr. Lance to mean that these are hopes, these are goals, but practically speaking they are not quite likely to be attained.

How Mr. Carter would describe the figure, or these figures, I don’t know. As for our staff, Lyle will comment on that, and I hope that you would broaden your question to think not only of fiscal measures or monetary measures, but I think more importantly, structural measures. Measures that could reduce unemployment and increase the rate of growth of real output without releasing new waves of inflation.

MR. BALLES. Exactly. I would be glad to broaden that question. I know you stated the whole case on that very well in your November testimony. The real thrust of my question is how much pressure we are likely to see coming out of the new Administration and the new Congress to achieve these--I don't know whether to characterize them as hopes, targets, or goals--of the Carter Administration for a 6-1/2 percent unemployment rate and 6 percent real growth. That's what I'm mainly concerned about--how much pressure [is] there likely to be?

CHAIRMAN BURNS. Well, the impression I have is that the President-elect himself is being very cautious, and [I am] venturing an interpretation that these are hopes--and he will present programs working in that direction--but that he has not determined that these are goals to be achieved whatever the cost may be. That's my present interpretation; I don't know if I'm correct on that. But Mr. Carter is, I think, proceeding very cautiously, and this, I believe, is widely recognized and has proved reassuring to the country.

MR. GRAMLEY. Well, I would just like to add, we have not tried to do any simulations, and for good reason, I think, to see how big a fiscal package you would need, or something of that sort, to get to a 6 percent growth rate on average for the four quarters and the 6-1/2 percent unemployment rate by the end of the year. If our outlook on economic activity is correct, you would be talking about very, very large amounts of fiscal stimulus--so large as to be alarming to the business community and to the public generally. Much larger than what we have talked about as an assumption underlying our projection. Now, if our assumption about confidence in spending plans are quite wrong, and things are building up much faster now than we realize, then of course it might take no more than what we have assumed.

CHAIRMAN BURNS. I wonder [if] there isn't a possible inconsistency--your initial comment, if the amounts needed fiscally are so large as to scare the business community, will you get the kind of expansion that the arithmetical exercise is designed to achieve?

MR. GRAMLEY. I think that's a real question, Mr. Chairman. And I would answer by saying you might, but it certainly wouldn't be of any duration.

MR. PARTEE. You said the four quarters--6 percent at the four quarters. That's the way you interpret the goal?

MR. GRAMLEY. Well, I don't think you could possibly get down to--

MR. PARTEE. Year over year, the average person would think of it as, and you would have 4.7 percent for the projection, which is less than 5-1/2 percent for the four quarters.

CHAIRMAN BURNS. No, you're looking--

MR. PARTEE. Am I looking at the wrong thing? '77, page I-7, and the fourth quarter, it's 5-1/2 percent, so you take it from fourth [quarter] '76 period.

MR. GRAMLEY. That would be quite an addition.

CHAIRMAN BURNS. Lyle, didn't I hear a member of the staff recite larger figures yesterday?

MR. GRAMLEY. Mr. Peret yesterday was adding into our Greenbook projections some personal judgmental assessment of what the effect of a 5 percent OPEC oil price rise would be.

CHAIRMAN BURNS. Well, these have not been reviewed by the staff.

MR. GRAMLEY. No, and--

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

MR. WALLICH. Lyle, your projections suggest at the very tail end--last quarter of 1977--a rather alarming acceleration in the rate of growth, going above 6 percent, which would be in the third year of recovery. Also, as Mr. Partee has pointed out, there are strengths in quite a lot of other areas--private investment would be surging to 20 percent, this all in nominal terms, and [unintelligible] constant prices should not accelerate. So one gets the picture here of [unintelligible] accelerating factors late in 1977 [unintelligible], which does seem to be rather ominous. Anyway, when you can, peer beyond this as possibly a temporary thing that you can look into [regarding] '78.

MR. GRAMLEY. We have not made any formal projections into 1978. But let me start first by saying that I would [not] consider a 6 to 6-1/2 percent real growth rate, even at this stage of the cycle, alarming. When unemployment is still above 7 percent, when capacity utilization in manufacturing is still projected to be below 85 percent, I think we could have a growth rate of that magnitude for three or four quarters with no problem. I do think that this projection implies a good year for 1978. But I would think that there would be elements in the outlook for 1977 which would be inclined to weaken in 1978--housing would be one, along the lines that Governor Partee was indicating. In 1977, we are projecting a significant further expansion of housing; I would think housing probably would be turning down in '78. The outlook for the thrust of inventory investment would also be less in 1978, I would imagine, than we have projected for '77.

And then, if our assumptions about the tax package are taken literally, what they mean is a reduction in withholding rates beginning in the second quarter to achieve a $10 billion annual rate of reduction in tax liability for calendar 1977. And that would imply some slight increase in withholding rates to the beginning of '78. So all of those things would mean, I think, an economy which would not get to still higher growth rates but possibly to somewhat lower growth rates in 1978.

CHAIRMAN BURNS. You know, we go through our arithmetical exercises--[they] are highly appropriate, they are a check on our thinking, and they are very helpful. Yet I can't help but feel, [in] that pronouncement that the President-elect made recently on stand-by price and wage controls, on his reluctance ever to impose mandatory controls except in a national emergency, my own guess is, I have no way of proving it, that [it] will contribute more for real GNP than the kind of so-called fiscal stimuli that we are debating.

MR. BALLES. The other thing that may help is--I consider the most helpful single sign is Ralph Nader's objections to the Cabinet appointments. They must be good. That's off the record.

CHAIRMAN BURNS. Mr. Coldwell, please.

MR. COLDWELL. Just a couple of questions, Lyle. Have you made a forecast of the labor force growth in '77.

MR. GRAMLEY. Labor force increase? Yes, we have projected an increase, fourth quarter to fourth quarter, of 1.9 million.

MR. COLDWELL. 1.9. Is '76 coming out 2.6?

MR. GRAMLEY. Oh, it's much higher than that, for the last four quarters.

CHAIRMAN BURNS. From November to November, it's practically 3 million, as I recall.

MR. GRAMLEY. As I remember, our fourth-quarter increase is around a 2.7 million rate.

CHAIRMAN BURNS. Well, that would be less; November to November was around 3 million, I think.

MR. COLDWELL. My second question--a decline showing the--

CHAIRMAN BURNS. Well, before you leave that, you know, this is a very troublesome question. We may be in the midst of a social revolution, and if so, with very large additions to the labor force--with women becoming more and more interested in jobs, they are being accepted in increasing numbers, they see their neighbors doing it, and inflation itself is a definite spur to such activity. So if this trend we have this year continues, we are going to have high unemployment.

MR. BAUGHMAN. There is, along with it, an indication of leveling off or even decline in registration of students in the professional schools.

CHAIRMAN BURNS. With labor force participation increasing on the part of teens.

MR. BAUGHMAN. All I suggest is that we may hold lesser numbers of the labor force in educational institutions, that they will be in the labor force.

CHAIRMAN BURNS. Well, there's been some increase in labor force participation in the younger age group; not nearly as dramatic as in the case of women.

MR. COLDWELL. It was exactly my point, looking at the projected decline in the unemployment rate, I was wondering, if you have a 1.9 million increase, it means you're projecting an employment increase even higher than the labor force increase.

MR. GRAMLEY. That's right.

MR. COLDWELL. How much of that do you expect to be government jobs?

MR. GRAMLEY. The public service employment program we put in would end up adding about 200,000, reducing the unemployed by about 200,000, so that a couple of tenths of the declining unemployment rate is due to that factor. The rest is due to the improvement in economic activity. If the economy grows at between 5 and 6 percent, as we projected, it's going to have a significant effect on labor demand. It's going to be a year in which, unless we have another extraordinary expansion of the labor force, we should make some progress in reducing [the unemployment rate].

MR. COLDWELL. 1.9 million is still high historically.

MR. GRAMLEY. It's quite a high rate of increase by historical standards, but it is certainly well below the extraordinary increases we have had in the past year.

MR. JACKSON. It's in the range of expectations for the next 10 years or so.

MR. GRAMLEY. I think it's reasonable, but it's like our interest rate projections. Though it's reasonable, experience has proved that we are rather bad forecasters in this area.

CHAIRMAN BURNS. Lyle, just as an arithmetical exercise, if the labor force were to increase by 3 million in calendar 1977, then your unemployment figure of 7.2 percent for the fourth quarter would be well above 8 percent.

MR. GRAMLEY. It would be 8-1/4 percent, yes, that's correct.

CHAIRMAN BURNS. 8.3 percent or a little higher.

MR. COLDWELL. We've made progress slowly.

CHAIRMAN BURNS. Of course, if this is the kind of world we are going to be living in, then, I think, in the first place, we will have to follow Geoffrey Moore and begin emphasizing the employment ratio more and pay a little less attention to the unemployment rate. And then we need wide-scale readjustments in industry because you take many of the women who want part-time jobs, and industry in time will adapt. And some highly specific measures of government designed to deal with the sectoral problems of unemployment may be far more effective than broad monetary and fiscal stimuli. So we might be entering--I say entering, we may [already] be in that kind of world now. I wonder, is this phenomenon occurring in other countries? Does anybody know? Mr. Reynolds.

MR. REYNOLDS. The increased participation of women in the labor force? Not to the same extent, but I think there is a tendency that way both in England and Germany. I don't suppose so in Italy.

CHAIRMAN BURNS. Well, but you see, this [unintelligible] might be able by survey techniques and determine [to] what extent inflation is the driving force; it obviously is not the only force.

MR. PARDEE. Taxes. The Europeans find it's taxes. As incomes rise and time structures stay the same, the bite out of income becomes greater, then you have the wife more inclined to go out to work.

CHAIRMAN BURNS. Well, in other words, we can generalize, as a pressure on income--whether coming from inflation or taxes--it's the desire to maintain or improve the standard of living of the family. Mr. Coldwell, do you have any questions? All right, Mr. Partee, please.

MR. PARTEE. Well, we've gotten off on the projection. There has been very little comment about the economic situation, so just for the record, I want to say that I subscribe to what Lyle said today about the improved tone. I think there has been a very marked improvement in the tone of the business statistics in the last month. The staff has been predicting it for some time, but one still feels better to have in hand an increase in industrial production that exceeds the Ford and Deere comeback, and the sharp rise in personal income, and the improvement and upward revision in retail sales, and the beginning of this inventory adjustment that is so critical to the future development as we go into 1977. I think, and others have commented, too, the situation has rather materially strengthened in the past four, five, six weeks.

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

MR. WINN. I really can't quarrel with the projections, but the unanimity feeling is the thing that bothers me. And I ask myself, is this cyclical pattern one that you would expect if you take the scenario at this stage of the cycle, or more typical of that starting out of the trough?

CHAIRMAN BURNS. Well, as I remember our studies at the National Bureau--my memory goes back some distance--we found that in something like three out of four instances, the economy in the course of a business cycle expansion would experience a pause or a retardation and then a reacceleration.

MR. WINN. But does the reacceleration come from the same forces as you get from the start?

CHAIRMAN BURNS. I cannot really answer that on the basis of any recollection of our work; my recollection is not that good. But analytically, on the basis of general knowledge, I think the answer must be different because the initial impulse is very strong from the side of inventories. And the later reacceleration, yes, you may get an impulse from the side of inventory as well, but it will be far less strong. And I think the main influence has to come from business capital expenditures. That is--

MR. WINN. The second comment on that is, in the wide swings in the attitude of the automobile industry, enthusiasm, pessimism, back to enthusiasm. I am afraid [unintelligible] that might mean. They're enthusiastic now, but there was quite a fall a while back. The third comment I would make is the obsolescence of statistics, I think rather dramatically shown in our supplement on savings rates paid by institutions. We've really had some major changes in the past weeks on the part of major institutions cutting back on rates on savings. I think [that] brings the [Regulation] Q situation to the fore.

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

MR. LILLY. Well, I wish I knew more about what is happening this week in the retail sales area; maybe it is just the time to be jolly. I must say that I am beginning to become a little more bullish than I was, and I really expect a quickening of capital expenditures in the near future in spite of the surveys that you have, and I think it is because of the long-term rates and the emergence of Carter's image as something less than a wild-eyed spender. I think there is a confidence factor building up, and I would only hope that we would allow the rates to drift downward as much as possible without threatening the aggregates.

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

MR. MACLAURY. Well, Governor Partee called upon those of us who [unintelligible] nevertheless to speak up, and I do so only to respond to that call. I find myself very much in sympathy with the Greenbook forecast at this point, and I think maybe what should be worried about [is] our consensus, but I am part of that consensus.

CHAIRMAN BURNS. Thank you, Mr. MacLaury. Would anyone else like to--yes, Mr. Guffey.

MR. GUFFEY. Just make a couple of comments with respect to the midsection of the country, and it has to do generally with the optimistic retail sales, Christmas sales, in the metropolitan area but [also with] a corresponding sort of decrease or depressed sales in rural areas, which stems from a great pessimism as a result of drought conditions. As a matter of fact, that's complicated in some measure by the fact that interest rates in the rural banks have started to move up, and are now at roughly 9-1/2 percent.

CHAIRMAN BURNS. They started to move up? That's a new fact. Has that come to our attention? Lyle.

MR. GRAMLEY. I am sorry, my mind wandered; I didn't hear the comment.

CHAIRMAN BURNS. Mr. Guffey has indicated that in the rural areas in his region, interest rates have begun to move up.

MR. GRAMLEY. That was, I believe, in the Redbook, was it not?

MR. GUFFEY. I am not sure that it was, Lyle. The information that we have, however, is that, as a result of the agricultural producers holding over most of their '76 wheat, and as a result of the increased cost of carrying cattle inventories, the rural banks are heavily loaned out and are trying to cut off that, to the extent they can, by raising their interest rates. It moved up within the last two to three weeks, the information we have, about a half percent to about the 9-1/2 percent level.

MR. PARTEE. Roger, is that for a good-grade farm loan?

MR. GUFFEY. Yes, those are high-quality credit risks. So there is a sort of contra trend in the rural areas. It has not apparently affected the metropolitan correspondent banks as yet.

There is another rather depressing fact--

CHAIRMAN BURNS. Are these rural banks--I'm not aware that they're coming to the Federal Reserve for assistance.

MR. GUFFEY. They are not. We do have some seasonal borrowings, Mr. Chairman. But there is not a substantial increase in our District. I think they're in a position where the cost of production and cost of carrying inventories and borrowing is beginning to worry the bankers to the extent that they're trying to make the free-market system work by raising the price of carrying those inventories.

Another, I think, sort of depressing factor in our area is the drought condition, and immediately that is the lack of snow. The ski industry in the Rocky Mountain areas through our District--principally Wyoming, Colorado, New Mexico--equals the summer tourist rate in that area. Unless snow comes on rather quickly, the spending that normally takes place starting in the Thanksgiving weekend is not going to take place. We are liable to have a combination of factors to depress the midsection [of the country] rather drastically.

MR. PARTEE. How could snow have any implications for the drought--

MR. GUFFEY. Indeed it does--

MR. PARTEE. You usually build up a lot more in those zones--

MR. GUFFEY. Yes, it does, although the snow throughout the plateau area [provides] the subsoil moisture that is necessary for next crop season. Except for the southern portion of our region, and I am talking about southern Oklahoma--it gets depressingly worse as you go north, into Bruce's area. It's deficient to the extent that there may be no crops actually put into the ground next spring unless there is a substantial amount of snow cover during the winter and then a real good spring.

MR. BALLES. I would have to say, Mr. Chairman, that everything Mr. Guffey has said about drought conditions and lack of snow--not only does it affect the ski resorts but also it affects our supply of water and reservoirs for next season--it is equally as bad on the West Coast as it is in his part of the country.

MR. MAYO. Also, the ground is frozen now, and the subsoil problem isn't going to get corrected until we have thaws, and the moisture now that is there in the form of snow helps the soil from blowing away to the extent that it isn't frozen. But there is still a serious problem around our area; the subsoil moisture has basically been used up.

MR. LILLY. It's still early in the winter, though; there is time for it to snow.

MR. MAYO. Well, again, it depends how the snowcover corresponds with the ability--if the ground's frozen, that snow isn't going to do much good--it will just gradually evaporate. The snow has to be there later on in the season. You're right, it is too early to make firm judgments on the crop fate, but it has got a lot of people worried.

CHAIRMAN BURNS. But it is not too early to make judgments about the vacations [business].

MR. GUFFEY. Half of that season has already passed. There is still the big season, that is, Thanksgiving and Christmas. Christmastime is the big season in that area.

MR. MORRIS. We have the same problem in New England, and 25 percent of the total ski-area revenue comes in the Christmas-New Year's week. If they lose that, that's gone forever.

CHAIRMAN BURNS. Rather unusual, isn't it? We've had extremely cold weather but very little snow. Isn't that unusual?

MR. LILLY. I want to point out to you, though, as an old admirer of snow, the main snow fall is in February and March, large snowfall--

MR. MORRIS. But then it is too late [for] the ski industry.

MR. LILLY. Unusual circumstances in New England. There may be some implications for monetary policy in what they did out in Colorado--called in the Indians to do a dance.

SPEAKER(?). Our Indians are busy with lawsuits against the State of Maine.

CHAIRMAN BURNS. The hour for coffee has arrived.

[Coffee break]

[Secretaries note: The raw transcript for this session begins at this point.]

MR. STERNLIGHT. [Statement--see Appendix.] Well, the profitability has been good this past year, although uneven over the past five.

CHAIRMAN BURNS. Thank you very much, Mr. Sternlight. Are there any questions? Yes, Mr. Eastburn.

MR. EASTBURN. Peter, I would take it that a cut in the discount rate would be hoped for but not expected. Is that correct?

MR. STERNLIGHT. I think that's a fair assessment. I don't think there's any imminent expectation of a further discount rate action.

MR. BAUGHMAN. May I ask a question? What do you observe in the market that suggests that a change in the discount rate did promote the downward movement in the federal funds rate?

CHAIRMAN BURNS. It's difficult to hear you, Mr. Baughman.

MR. BAUGHMAN. I was just asking for a bit of elaboration on the observation that the change in discount rate played a role in the downward move on the federal funds rate.

MR. STERNLIGHT. Well, you're referring to my comment that the last cut, the one announced on November 19, that came in the midst of our gradually reducing the funds rate from 5 to 4-3/4, and [unintelligible] seeking to gradually reduce that rate. The market tries to read interpretations into each action that the Desk takes or fails to take in any given day. It isn't always all that clear over a short period just what the Desk's intentions are. But I think [if there was] any doubt in their mind [that] there was some move under way, it tended to be resolved when it was accompanied by a discount rate reduction.

MR. BAUGHMAN. Well, I guess I was really wondering [unintelligible] essentially conversation, comments?

MR. STERNLIGHT. Yes, we would pick up the comments from dealers in talking with them and probing into reasons that they saw for the market moving as it has.

MR. BAUGHMAN. Thank you.

MR. PARTEE. You said, Peter, that the reduction in short-term rates was a little more than a cut in the funds rate, it's really quite a lot in the reduction of a funds rate. The market oversold in your view? Is there a tendency to back up after a 60 point--was it 60 in bills?

MR. STERNLIGHT. About 60 basis points in bills, and maybe a little more than that on some issues. I think there has been an element of anticipation of some further decline in the funds rate, at any rate, to probably about the 4-1/2 percent level. And certainly that got up--you got a further boost with the reserve requirement change.

MR. PARDEE. Governor Partee, it was early in the period when the drop in rates was a lot more than the drop in the funds rate. Most recently, the funds rate has, in my view in any event, caught up a little bit, but not entirely, with the drop in the market. The three-month bill rate started out below the 5 percent funds rate, of course, where the funds rate was at the time of the Committee meeting, and has dropped not too differently from the funds rate. And most recently, for example, the commercial paper rate has come up a little bit, so the bill rate again has dropped more. So I think there's a little bit of anticipation in the [unintelligible] funds rate decline, but not a large anticipation. I don't think we're very far out of line, we're just somewhat out of line with the [unintelligible].

CHAIRMAN BURNS. You had some decline during the month in some interest rates--short-term interest rates--of as much as 70 basis points.

MR. PARDEE. I think so.

CHAIRMAN BURNS. Yes, CDs--six-month CDs and one-year CDs. Yes, Mr. Black, you had a question, I think, or a comment.

MR. BLACK. Even before the Federal Reserve requirements were [unintelligible], insignificant number of market participants in the same deal with rates [unintelligible].

MR. STERNLIGHT. Yes, I think that release from the period from the first few days of December on, there was a kind of backing and filling, and a number of participants did think they were getting to about the low point. And perhaps they reached it.

MR. BLACK. How do you think the markets would react to leaving policy unchanged at this meeting? I mean, [unintelligible].

MR. STERNLIGHT. I would think that there could be some modest backup in rates if the funds rate were just to proceed unchanged from this point on. Not a very great backup, but a mild one.

MR. PARTEE. 4-5/8 you say is [expected].

MR. STERNLIGHT. Yes.

CHAIRMAN BURNS. Yes, John.

MR. BALLES. I wonder if I might ask two questions, Mr. Chairman, of Mr. Sternlight. First, what his view is of how the market would now look upon or receive a further cut in the discount rate by, say, another quarter of a point? Since my second question is totally unrelated, maybe you'd like to direct yourself to that one first.

MR. STERNLIGHT. Well, I don't think there's any great expectation of it. I don't think it would come as a great surprise, either. And it would depend on how it was presented to the market. If it was presented as something that was just catching up with market rate declines that have already occurred, I think that after some very initial reaction in the market, there might not be much lasting reaction at all, and they'd begin to look at whether this was going to be accompanied by any further push down in the funds rate. And if it were not, then I think that there would be negligible net effect after a week or two.

MR. BALLES. Oh, I'm interested in that--my own view of it happens to be that the market would look on this as merely catch-up. My second question, I'm not sure that this would be appropriate at this early date, but if it is appropriate, I'd be interested in the comment. How the mechanics will be handled of this release of reserves with the latest cut in reserve requirements, which, I might add, I was glad to see for a little bit of good it will do on the [Federal Reserve System] membership problem. But there will be, what, $550 million released, as I recall the figures, Peter?

MR. STERNLIGHT. That's right. That will come at a time when we still have some projected reserve need, and I think it can be folded very readily into our week-to-week operations that are largely countering operating factors of some size.

MR.BALLES. So you don't see that as having any particular impact on the funds rate, short-term--pushing it down even further.

MR. STERNLIGHT. No, I wouldn't expect that to happen.

MR. PARTEE. Just to follow up on that. In the normal course, you would just provide $550 million less.

MR. STERNLIGHT. That's right. Yes.

CHAIRMAN BURNS. Any other questions Very well, thank you for your report, Mr. Sternlight. Now a motion to confirm the transactions of the Desk will be proper. Motion has been made and seconded. No objection is heard. Let us now turn to Mr. Axilrod, who, as always, will be very brief.

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

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

MR. COLDWELL. Mr. Chairman, I don't play these numbers games too often, but I'm curious [about] citing comparisons against decades or five years. You also compared the rate of growth of M1 and the other aggregates against periods in recovery?

MR. AXILROD. I wasn't doing that for this purpose.

MR. COLDWELL. I know you hadn't. You didn't here. I was curious whether you had measured against other recovery periods. How does this M1 or M2 growth stack up against periods of recovery prior.

MR. AXILROD. Well, in 1971 and '72--I don't know how you want to characterize that period--but growth in M2 was 11.4 percent in both those years. In 1976, it's 11.3. So it's the same as in those two years, which of course preceded the inflationary period of '73-'74. In 1967, growth in M2 was 10 percent. In--

MR. COLDWELL. What about M1 in that period?

MR. AXILROD. In M1 in 1967, growth was 6.6 percent. The numbers I happen to have here are December to December. And in 1976, from December to December, it would be about-- depending on [this] December--somewhere on the order of 5-1/2 percent, which, in comparing it with 1967, I would adjust on a comparable basis to over 6-1/2--to 6-3/4 percent because [of money] substitutes--

MR. COLDWELL. It's not the same.

MR. AXILROD. Yes.

CHAIRMAN BURNS. Yes, Mr. Morris.

MR. MORRIS. Steve, we have been for a number of months instructing the Manager to give equal to weight to M1 and M2, that's [unintelligible] to policy, given the diverse behavior of these two series in the last six months. Should we, in your judgment, continue to give the same instruction to the Manager, or should we alter it?

MR. AXILROD. Well, President Morris, may I answer it this way. It would be my feeling that if M2 and M3 fell short within the range suggested, for example, in alternative B, I would think that the Committee might not wish to give that very strongly in terms of the money market. That is, if it fell short, I wouldn't think that would be a strong reason for easing the money market. It would not be a strong reason under current conditions, as [it would be] if M1 fell significantly short.

On the other hand, if M2 and M3 were very strong in their ranges, [then]--because of the experience with them and how rapid it is--I would tend to give that weight, if you wish to tighten the money market. So I think they still have 50-50 weight, but I tend to interpret them differently when they're high than when they're low.

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

MR. JACKSON. Steve, have we had any unique events take place in the December figures that you've had, like currency going to Mexico, a bank that's [unintelligible] reserve accounting, anything like that that we create uniquely?

MR. AXILROD. Well, I do not.

MR. JACKSON. [Unintelligible].

MR. AXILROD. I don't know of any.

CHAIRMAN BURNS. This December? At this present month?

MR. JACKSON. Yes, for the December figures.

MR. AXILROD. I don't know yet of any unique events, but you did mention an error in bank reserve accounting. I do happen to know the there was an error in reserve accounting that, if it's not offset by other compensating adjustment--which may often happen--will tend to increase the weekly numbers for the week just past. But that's the only special factor that I know of.

MR. JACKSON. You don't think that's significant, though.

MR. AXILROD. No.

MR. JACKSON. In the growth rates that have been projected.

MR. AXILROD. No, I don’t know of any fundamental factors that are going to--for some reason or other, December often is difficult for us to project. Maybe it has to do with year-end window dressing. It’s hard to gauge to what extent banks are going to engage in [it] or not, but I’m not absolutely certain it’s a lot more difficult than any other month. It’s a little hard.

CHAIRMAN BURNS. All right, Mr. Partee.

MR. PARTEE. I’d like to follow up on President Morris’s question. I found myself being drawn instinctively and more and more to M2 and M3 as relevant considerations. But most relevant considerations, in trying to chart over the longer range, are based, of course, on monetary policy. The difficulty I have with that is that I don’t think we’re nearly as well fixed on what is an appropriate M2 or M3 growth rate range. We haven’t spent nearly the amount of time concentrating [on them as] we have on M1.

For example, you mentioned the last decade. Well, a decade ago you didn’t have any certificates in M2 and M3 to speak of. You certainly didn’t have any four-year or six-year certificates, which has an effect on the way you ought to look at the figures, I think. I just don’t have a decent map in my mind of what we ought to be looking for in M2 and M3 growth rates. I would hope [I] would be prepared to put relatively more weight on this if I had that kind of a background, but I don’t have any at this point. I hope, when we look at the long-range targets again, that we will spend a little effort on trying to set M2 and M3 targets, [unintelligible] in association with the economy, and that kind of thing.

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

VICE CHAIRMAN VOLCKER. Well, I’ll make a brief comment just following up Governor Partee before I get around to my question. I recognize from instinct that goes toward the broader aggregates, but I really wonder, in line with Mr. Axilrod’s earlier comment, whether they’re broad enough when you get a situation where you may be moving out of the market liquid assets, in or out of those particular institutional numbers.

The question I had--Mr. Axilrod touched upon [it] at the end of his previous comment, but I’m not sure what I [unintelligible]. My impression was that both December and January were probably the two most erratic months by some fairly clear margin. And you, I guess, suggested that they are erratic, or at least that it wasn’t all that clear and pronounced [unintelligible].

MR. AXILROD. Well, I have [a] casual impression that we have troubles, but I have that impression.

MR. PARTEE. I have a different impression that we have troubles.

VICE CHAIRMAN VOLCKER. Well, that’s more my memory that it’s far more trouble than even [unintelligible].

MR. AXILROD. I have a difficulty disassociating those troubles with the troubles I seem to experience every month. And I would really like the Board to be able to go back [to] some array of projections and results. But it is true that in past years, December and January have shown exceptionally low growth rates, [with] surrounding months of high growth rates. And we have not been quite clear as to which month is going to be low and which month is going to be high. We have inverted November's and December's and January's and February's. So there is something odd in the seasonals, apparently around that time, that makes it very difficult for us.

CHAIRMAN BURNS. Any other questions? Yes, Mr. Wallich.

MR. WALLICH. Once more on the question of M1 and M2, if I may--why we can't choose from looking at the data. I'd like to get Steve's view on that, whether that has some numeric [calibration]. Whereas M1 is marginally understated at the present, the growth of M2 is very substantially overstated. I say this in terms of a normal relationship, 2 or 3 percentage points difference. At the present time, the difference, 4-1/4 to 6-1/8, we're now 2 percentage points understated [for] M1. Then ask ourselves, what, on the basis of M1, equals 4 at the present? What would M2 be? We get a very substantially lower figure than the 10 to 12 that we've got now. And I attribute that, of course, to the same denominator that everybody else is mentioning.

MR. AXILROD. Well, I think that if you look back over the past decade or even beyond, M2 and M3 on average are running higher relative to M1, [by an amount greater] than you would get by looking at the past relationships. And I believe you're quite right, this is being intensified by the fact that banks are lagging so much [in] lowering the rates on time and savings deposits relative to market rates.

But in addition, I think as Governor Partee was mentioning, we have instruments in M2 and M3 that are, to my mind, like bonds or notes--they're four-year, six-year instruments. And I don't know to what the extent the public thinks of them in that way. I talk to bankers who say they believe the public thinks of them in that way. I talk to [other] bankers who say they believe the public thinks of them as rather liquid instruments, and I don't know whether the public yet is aware fully of what would happen to their yield--which would drop, as you know, below the passbook rate--if they try to get that money out early; sharply below if [the withdrawal] is well ahead of maturity [and] sharply below their expected rate.

So I believe that we'd have to do an analysis, taking those things out, to begin to be very certain that we're dealing with the same kind of instruments that we were dealing with in the past, because the composition has changed. And I'm not sure how the results would end up if we did that.

CHAIRMAN BURNS. All right, any other question? Well, if not, we're ready for a discussion of what our domestic policy directive to the New York Bank Desk might best be for the coming month. I might say just a few words, and my own view on different Committee targets [unintelligible] or seek another and wiser target perhaps.

It seems to me that alternative B is probably, details aside, as good a decision as we can make today. I say this, first, because the economic outlook has improved. We've had a very substantial decline of interest rates in recent weeks. The prospect is that new fiscal stimuli will be voted by the Congress and an enormous budget deficit is in the making--in fact, larger even than we had in fiscal 1976. Inflation is still with us. The recent report, the one that Lyle referred to on consumer prices, is somewhat encouraging. On the other hand, the report that we've had on industrial prices and the wholesale market for the past five or six months--the increase has been averaging around 10 percent. The dollar has weakened recently in foreign exchange markets. The System has acted in an easing direction to lower the discount rate, the reserve requirements.

We certainly don't want to convey the feeling to the general public that we are worried or anxious about the economic situation. I think the time has come for a pause. And that, I think, is essentially what alternative B conveys. I think this is the time to look around, to stand still, stop pushing interest rates down; we guide it a little in one direction or another depending on how the monetary aggregates come in. And [then we will] come back next month with more evidence before us, a refreshed outlook, and decide to move one way or another. That's my judgment as to what we might best do today.

I'm going to call on Mr. MacLaury for a very special reason--

MR. MACLAURY. In some ways I wish, at this last opportunity, to say something wise, insightful, or controversial, but I could think of [nothing] wise, insightful, or controversial to say. As the members around this table know, when I have felt that we were going astray, I have not hesitated to say so. But at this time I very much share the Chairman's summary of where the economy is at [and] where we are at with respect to our part in seeing that the economy evolves. I would share therefore the general thrust of alternative B at this time.

My sense is one of relief that the economic indicators are now pointing in the direction that I felt instinctively, or by the seat of the pants, they should have been pointing earlier. I don't know that I have revised upward my feeling of where the economy is heading, but I certainly have somewhat more confidence now that that relative optimism was justified. I think that the case for some of the fiscal stimulus, which is not our prerogative, after all, is as the Chairman described it--pervasive if not correct. I guess I would say that I think it is correct as well without trying to get into the specifics of how that stimulus ought to be structured. I was struck by the Chairman's question, I guess it was last month, as to whether there is a lack of liquidity, or what more could be accomplished by trying to put more liquidity into the economy, and I found myself unable to give a positive response that there would be much to be gained. In fact, I felt, to the contrary, that there might be something to be lost.

On structural matters, taking advantage of the opportunity the Chairman has provided me, I would like to urge once again, more in the spirit of yesterday afternoon's conversation, that we expand the funds range a bit when an opportunity exists, and not be afraid to move it. I have certainly been among those who have viewed the greater emphasis on the monetary aggregates as useful but perhaps in a different way than the monetarists do. Not because I think there is great stability between any particular aggregate and the economy. I think the experience of the past year or year and a half has amply demonstrated that that stability does not exist. And I share the Chairman's view that the technological, structural changes that are taking place make it particularly perilous to link ourselves to an aggregate or a set of aggregates in any sort of a slavish way.

Rather, it has seemed to me [that from] a rather political point of view, dealing with the Congress, the public in general, that the aggregates, in an admittedly oversimplified way, distracted some overattention to interest rates and our impact upon interest rates; that we could explain to the public what we were doing by reference to the aggregates in a way that seemed to make at least structural sense. And that, therefore, when the time came for raising interest rates we could adhere to and speak in terms of the aggregates.

Likewise, I think around this table my feeling has been that if we can avoid being caught in our own rhetoric by overemphasis on the aggregates, [they give] us a reason for moving interest rates up or down more rapidly in the face of changing economic circumstances than we were inclined to in the past when we were not focusing on the aggregates the way we have been in the recent few years. In that last sense, I will align myself with Henry Wallich's comments of last evening, that my hope will be that there will be a willingness to allow interest rates--short-term interest rates--to move, move rather more rapidly if the economic circumstances seem to call for it at the moment. I think that's not the case now, and, as I say, in the short-run I share fully the Chairman's view of the outlook and our part in it. Thank you, Mr. Chairman.

CHAIRMAN BURNS. Well, now and then, as Chairman, I do something right. I'm going to give you the opportunity to have the last word as well today, so that if you want to go ahead and store up some remarks, please go ahead and do so.

VICE CHAIRMAN VOLCKER. Mr. MacLaury said he wasn't going to be very controversial, and I don't think he has been controversial, but I'd like to think he's been wise and insightful, because he's seconded your motion and I sum up my position by saying that I third it. Very much along the lines of what's already been said, I also interpret the recent bit of business news as tending to confirm expectations that the pause is a pause and not the beginning of [a recession]. I don't think it suggests that the economy has great exuberance; there is certainly an awful lot of unemployment. On balance, I think we could use some stimulus, but I would prefer to see that come in a mild fiscal package. I think there is some danger [that] it won't be so mild as you suggested earlier, Mr. Chairman.

I think the real trick is getting some stimulus here without upsetting the inflation area--the expectation of the inflation area. And if we think fiscal stimulus is appropriate, or whether it is appropriate or not, we are likely to get it. I think it is important that monetary policy not appear to be overdoing it. I think we can take a lot of satisfaction in what has been accomplished, particularly in breaking the resistance in the long-term rate area and beginning to break the resistance in the institutional rates, which, as commented on earlier, could be helpful to the investment outlook and the general climate of opinion.

I worry a little bit about the aggregates cross-[cutting] in various directions. I find myself worrying about M2 and M3 being persistently so high. I'm a little comforted by the data Mr. Axilrod gave us on M2; it doesn't fully reflect that it tends to [unintelligible]. I think the main thing is getting some measure of stimulus here without upsetting the inflationary target. I am also very conscious of the exchange rate thing at present that you mentioned, Mr. Chairman. I think that could be upsetting because the market's into its very high range, as far as [unintelligible]; [upsetting] not just because of balance of trade reasons, but upsetting [in] the psychological situation it would pose, if it [went] much further. And I don't see much hope that we are going to get any significant easing on the other side of the Atlantic to help us out there.

So I do come out in essentially a standstill posture, which I also interpret as [alternative] B. Just to spotlight that the projections may be particularly uncertain--and I agree that they are always uncertain--I just report that New York's projections are significantly lower than the Board's projections on both M1 and M2, a couple of percentage points. That creates the possibility that, with [alternative] B and the 4-5/8 percent midpoint, if you push lower and track the aggregates fairly closely, I could visualize moving to 4-1/2 percent in these circumstances in the B context. I'd be awfully reluctant to see it go below that, and I'd be reluctant to see it go much above the present 4-5/8. I would see use of this range as being increasingly viscous as we depart from the midpoint by very much. But with that qualification, I do think that B looks right.

MR. COLDWELL. Mr. Chairman, I guess I'm kind of in a halfway house here. I'd like to have my cake and eat it too, [which] means I'd like to have kind of a blend of some of these targets in front of us here. I'd like to broaden that rate range a little bit and yet keep squaring on the aggregates. I think a small additional decline in the rate would not be damaging and would validate that very small reserve requirement change we made.

I'm still concerned over the unemployment forecast and the prospects for heavy fiscal stimulus. I think a minor monetary stimulus could reinforce this incipient reemergence of a faster recovery. I believe there is a small move that we could make for a further rate decline that could be helpful to this recovery, so I would prefer an M1 target of 3 to7 percent; M2, 9 to 13; and the federal funds rate of 4 to 5 percent, which would put the midpoint at 4-1/2. I would not want to see it below the 4, so I have deliberately exercised the alternative A lower limit. Similarly, I would not at present want to see it go above 5. So that's a minor modification of your suggestion, Mr. Chairman.

MR. GUFFEY. Yes, Mr. Chairman, I think I share the view that you have set forth, and I guess that Paul and Bruce have endorsed. I guess I am fourth now. It seems to me we have taken some rather substantial steps in the monetary policy area in a rather short period of time--30 days--that is, the reduction of the federal funds rate 35 basis points, the reserve requirement action, and the discount rate decrease. It seems to me to be a time for a pause. As a result, I think I would go one step further to the extent that I would like to see us adopt a money market conditions target to ensure, to the extent possible, that we stay at that 4-5/8, in that range, until the aggregates drop out on one side or the other. I would like to lock us in for 30 days to the extent that we can.

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

MR. GARDNER. Gentlemen, I think a pause is a pause. Now we can work out particular selections on the various alternatives, but our forecast contains a belief that there will be a fiscal stimulus. We haven't yet seen exactly what that stimulus will be. Our forecast also presumes that the OPEC price arrangements will be of a certain kind, but we're still faced with a confrontation between the Saudis and the Arab members, and if you are not an Arab member, it's an [unintelligible] thing.

Our year-end sales, our consumer demand, may be good. I'm not persuaded that bank loan demand is on a more normal trend than it has been, but the evidence looks as though we're at the beginning of that stage. As Roger said, in a short space of less than 30 days we've pushed the funds rate down to 4-5/8, lowered reserves, cut the discount rate. I don't think I'm going to find any great controversy among us here at the table. I think it's entirely appropriate that we not further indicate monetary stimulus at this time. And, as the staff has indicated, if we stay where we are and we adopt roughly alternative B, there'll be a slight readjustment in some of the market rates, and I think that would be quite positive in view of our concern about the enormous deficit coming.

Talk about fiscal stimulus--the Chairman made a point that I am very concerned about. For the last three years, we've had enormous fiscal stimulus just by the workings of our budget process. [Unintelligible]. It is also true that we can't get away from the fiscal stimulus easily or in the foreseeable future. I think that we will be meeting next time during Inauguration week. People's Inauguration will be spreading throughout this city. I'd like to see what that inaugurated Administration decides to do next, in fact.

I'd like to stay with B, the same federal funds. We're exactly at the midpoint of alternative B right now, and that is exactly where I'd stay, or thereabouts, for another 30 days.

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

MR. EASTBURN. Well, I guess I come out closer to Governor Coldwell that any of those that have spoken so far. I am encouraged by the fact that the weakness in the economy doesn't seem to be feeding on itself. On the other hand, I am concerned about the very high projections for unemployment that we have for 1977. I do think that fiscal stimulation is necessary, and I do think that monetary policy should cooperate and go along with that stimulation. My preference would be for alternative A, so far as aggregates are concerned, and with a funds rate that would range from 4 to 5 percent. I specify that funds rate because I think, although the Desk may not find it necessary to move, it does provide some more room on the lower side in case that's necessary.

CHAIRMAN BURNS. Thank you, Mr. Eastburn. Mr. Baughman, may we hear from you now.

MR. BAUGHMAN. Well, Mr. Chairman, I am in substantial agreement with what you said, although I believe I am in substantial agreement in some respect with what Governor Coldwell has proposed. A key part of the two proposals seems to me to [have] just a hairline difference. I understood the Manager to respond to a question [by saying] that market rates would likely come up a little if we stand right where we are. I think that would be an unfortunate development in current circumstances and that we should undertake to move just enough to preclude that from happening. And therefore my preference would be for a federal funds rate in the 4 to 5 percent range with a midpoint just a hair below where are now.

I'm also interested in the Manager's comment that the announcement of a small change in the discount rate, even though essentially a technical adjustment, had some modest effect in the market. And it seems to me that the circumstances surrounding that change in rate are essentially the same or possibly even a little more persuasive now--the technical aspects are, at least--than when the change was made, and I think it would be appropriate to make another small change in the discount rate.

We are seeing the banks very reluctantly give ground both on rates charged and rates paid. And it seems to me desirable that [their] slow move be encouraged and continued. In any event, it seems to me that it would be undesirable to [discourage them from] moving a little further in both those respects. That, along with the fact that we're looking at the possibility of fairly small growth in the aggregates, at least temporarily, leads me to the conclusion that we should make just a little further move in the federal funds rate, and probably the discount rate, in the interest of ensuring that we don't get some upward movement in the market rate.

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

MR. BLACK. Mr. Chairman, I come out almost precisely the way you did. I feel the same way. There is only one point that I might add, and it underscores the uncertainty of the projection of the aggregates in this particular season, as alluded to by Mr. Axilrod and Mr. Volcker. To further confuse the matter, I would say the Richmond staff projections--which we've been experimenting on for a relatively short time, but with some success--show a faster rate of growth than the Board's or the Desk's estimates. Now you all would say [we] haven't had the experience these others have had, and I readily agree, but I also point out that neither do we have the long record of errors.

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

MR. PARTEE. I, too, feel that somehow the move is coming to an end, and it is just really a question of--if I'm right--how we manage the runoff or maybe slight turn up. I have a little bit of a preference for [the position of] Governor Coldwell, which would carry the funds rate down another eighth, and which is almost no difference in positions, but I think I sort of share Ernie's feeling that I would rather now have the market stabilized rather than back up some. And I think it would be more likely to stabilize if we had just a little bit further move. And I also, for some reason, prefer the 3 to 7 on the M1, just because they are round numbers; I don't really have anything to choose from.

That brings me to the second point. I think it really is more important today to determine whether we want the money market directive or an aggregates directive. And perhaps I have been burned too much in the past, but I have a distinct feeling that the aggregates are difficult to project in December and January--I think you can't even say that January is going to be high if December's low or vice versa. It is just very difficult in this period. Now, if you want to impart a sense of leveling out the market, it would be a shame to upset it by unexpected aberrations in the aggregates, which would cause the Desk to have to move. That is, at least with this period [of] 30 days that we're talking about. So I would think that a money market specification is a proper specification.

And taking Governor Coldwell's number, what I think that would mean [is that we] would be leaving the funds rate at around 4-1/2 percent, which I would define as 4-3/8 to 4-5/8, where it now is. Unless the aggregates on average are at the bottom end or top end of the range--[in which case] we should move on toward the 4 percent or the 5 percent [ends of the funds rate range]--but only in that case [do] I think we should move.

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

MR. MAYO. These are exceedingly small differences, and I think most of us emphasize this. I find myself, too, Mr. Chairman, in the group favoring the 4 to 5 percent range. I favor a bigger range than 3/4 of a percentage point, somehow--constitutionally--and have for many years. I think we have tended to narrow the range too much. I feel that the difference between 4-1/2 and 4-5/8 is again very minor, but I like the psychology of at least seeming to tip our hat in the direction--internally, at least, to let the new cut in the reserve requirement work its way through market psychology without feeling that we have some sort of a duty to offset it.

I also feel that the monetary aggregates are sufficiently difficult to predict here, and I would widen the range just a little bit on the M1 and M2. I would go from 2 to 7 on M1, and I would go from 9 to 14 on M2, because I don't think we really want to make any significant moves within those ranges. I don't feel that they are too broad if we were to do that. I still have a bottoming out philosophy that doesn't say go down straight but, really, make a saucer. And "make a saucer" to me includes a recommendation again on 1/4 percentage point on the discount rate to make it clear to the market [unintelligible], in effect keeping our credibility as a System in the recognition of the market here and our flexibilities.

These are all very minor adjustments. I could live with the prescription just as you gave it, Mr. Chairman, but I prefer just a little bit here. I don't want to call it fine tuning, but I must apologetically say, I suppose, that is what it is.

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

MR.BALLES. Mr. Chairman, first as to your general observations on the state of the economy, I can certainly share those. I would interpret, however, your prescription for a pause a little bit differently. One of the ways I would interpret it is to take actions such as Governor Coldwell and three or four others have talked about that would preclude any backup in the market in short-term rates. Therefore I come out in favor of the federal funds range that he and others have tried to--

CHAIRMAN BURNS. May I say a word about that. You see, whenever we stabilize--today or next month or three or six months--whenever you stabilize, you should expect a small backup in rates because the market will tend to be ahead. Just a footnote.

MR. BALLES. I understand that. Having heard that comment, I guess I would still favor a posture that would keep rates at about their present levels as far as the open market short-term rates are concerned. And I say that simply in view of my own conviction that, while it's encouraging to have seen this rash of good economic news that came out in the latest monthly statistics--as Lyle himself put it in summary--we can't be absolutely certain. You have to have a high degree of certainty that the pause has in fact ended. It probably has, but to some extent the jury is still out, and I would prefer to resolve doubts on the side of ease.

And I would certainly hope also that the so-called pause would not apply to the discount rate. I think several people have spoken about that, and I would like to add my endorsement of a further cut in the discount rate, simply in view of the fact that we have still a very important [Federal Reserve System] membership problem with us. To the extent we keep the discount rate a penalty rate over an extended period, as we have done, it doesn't help the membership problem, and it could be helped a little, I think, if we kept that rate closer in line with the open market rates that we've already produced through the general thrust of our policy. And finally, I would favor, for reasons that Governor Partee has cited, a money market directive.

CHAIRMAN BURNS. Thank you, Mr. Balles. And now Mr. Wallich.

MR. WALLICH. Mr. Chairman, I don't see a great deal of strength in the economy. The current data have improved, as one would expect if we're not going to switch paths. I think the monetary aggregates are not that strong, and M2 I see largely overstated. If there were a fiscal policy push ahead, I would say that no monetary policy stimulation would be needed at the present time. What impresses me is the outlook for a significant fiscal push, and for the big leverage that it seems to have, and for the lateness [with] which it seems to impact. And it raises the question to me whether we're again in danger of mid-expansion over stimulation. This has happened before, and it has led to an acceleration in the latter phase of the expansion when actually we should be phasing down to the long-term growth rate for a soft landing. This is what mainly gives me pause now--suggesting that we should continue easing a little more. I add to that, as others have, the weakness of the dollar, the high rate of wholesale prices--materials prices.

Well, given these concerns, which now I think are more on the upside than the downside, I'd go pretty close [to] alternative B. Except I would like to see the funds rate widened on general grounds--I guess that would be from 4 to 5--and the aggregates seem all right to me: 4-1/2 to 6-1/2; 9 to 13. I think the funds rate might well be asymmetrical and stay at 4-5/8. [Unintelligible.]

I continue to prefer an aggregates directive. And while the present aggregates directive is all right, I would like to add that, since it doesn't give one a choice in either quarterly periods, perhaps we ought to think about providing a choice, making it more to the short-term ranges than to the long-term ranges. Otherwise, two times out of three, the aggregates directives isn't very meaningful unless we've openly incorporated the longer-run specs--

CHAIRMAN BURNS. Move to specify the short term.

MR. WALLICH. Unless we move to specify the short term.

MR. PARTEE. Do you mean by using a word other than "moderate"?

MR. WALLICH. No, by using numbers.

CHAIRMAN BURNS. All right, thank you, Mr. Wallich. Mr. Jackson.

MR. JACKSON. I didn't think the economy was in grief as some people thought [during] the past months. [Unintelligible]. As the first quarter begins to unfold, how [unintelligible] is the third and fourth quarter of 1976. The first quarter might continue to be the type of economic growth that is going to produce social nonsatisfaction despite the economy's satisfaction. As far as monetary policy is concerned, I do think that it would be appropriate to use the money market directive at this time because of these decisions and it would be foolish to create unnecessary noise as a result of statistical circumstances. Since we've become so extraordinarily precise about how we do these things, I would like to point out that if we go to 4-5/8, that would mean that we would come down 6 basis points from where we were last week, which is one-third of the way down to the 4-1/2 that people argued for. And I think that illustrates the problem of trying to be so precise. I would hope that the Desk would understand that if we center on 4-5/8, [unintelligible] on the low side or on the high side, which probably wouldn't have a material difference, and we'd all end up being happy.

CHAIRMAN BURNS. No, wait, we were all going to be happy. Now you continue, but just keep us on a happy note.

MR. JACKSON. I was going to say, if we are going to go in that direction, I would prefer the 2 to 7 range for M1; the other ranges are okay. But if prices move, the difference in the projection [unintelligible] and in Richmond. The center of the world here is moving south.

CHAIRMAN BURNS. Well, I don't think we are going to find a dissent around this place. Thank you, Mr. Jackson. Well, it's very appropriate we return to the south, no, we stay south, where the center of the world is. Mr. Kimbrel, please.

MR. KIMBREL. Mr. Chairman, I am encouraged by the timely movement of the interest rates. The fact that M1 has been growing generally within the long-term guidelines. [Unintelligible] of course pointed out here, late December, early January often finds us with a volatile money supply, and this brings me to what you suggested yesterday, that there are times for pause. And I very much think that this is one of those. With all of the action, it seems that if we were to provide any additional stimulus at this time, we might be pressing unduly.

I also have just one more observation. And that is, there seems to be almost unanimous acceptance that there will be a rather generous fiscal stimulus. Of course, the only thing unresolved is the magnitude. If, indeed, that magnitude should not be [forthcoming] or [it acts] in a different manner, it's generally assumed we could possibly see some erosion of confidence. I'd hate to see that happen, and I think we could judge that better a month from now. I would be happy to see us stay very much the way we are, with the money market proposal related to alternative B--exactly where we are.

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

MR. MORRIS. Mr. Chairman, I think the choice that we face today, between a pause and another modest direction of ease, is a difficult one. I don't feel any overwhelming conviction [about] which course is correct. I think a strong case can be made for a pause. But I think, on balance, I come down on the side of another modest move in the direction of ease, for two reasons. First, I think that monetary policy is the only policy that can be operating while the

Congress is deliberating fiscal movements. And what we do today cannot influence the real economy while the Congress is deliberating. I think we can affect the mood and the psychology, and given the fact that there is some reluctance on the part of the Congress to move dramatically on taxes, it seems to me that the better [mood] could have something to do with the kind of fiscal package we have.

I think we are all feeling better about things than we were a month ago. And I think one of the contributing factors to this is the decision we made a month ago to take another step in the direction of ease and the response we have gotten to that move from the bond market and the stock market. I think that clearly is an element in the better feeling. Because, as Lyle said, in the absence of the assumption of a fiscal stimulus, he would not have revised upward the projection on the basis of the numbers that have come in during the past month.

The second thing that influenced my judgment is that I think we're in a situation where another small move in short-term money rates can have a fairly significant impact on long-term rates. I am thinking in particular about the posture of insurance companies today, which I think are probably in the most liquid condition that they have been for the past 15 years. They have been staying short in the expectation of putting their money out at higher rates than they could get at the time. At least the Boston companies are now getting very restive with this policy. It is costing them so much to stay short that I think one more modest move on short-term rates could produce quite a change in response in investment policies in the case of insurance companies. You could have quite a healthy effect on the long-term market.

So, for this reason, I would propose that we establish a funds rate [range] of 4 and 4-3/4, instruct the Manger to gradually move the rate down to 4-3/8, and pick the figures for the aggregates to correspond to this. I recognize that there is a cost associated with this and that is that, later on in 1977, if we do what I suggest, we are probably going to have to take restraining action a month or so earlier than we would otherwise have to. I think that's the bullet that we're going to have to bite sometime next year anyway. And it seems to me that, on balance, I think the case is stronger for another move now.

CHAIRMAN BURNS. Several members of our Committee have not yet spoken.

MR. WINN. I'm afraid our differences are a little bit like Shakespeare--much ado about nothing. But I'd weight it, I think, to come out with just a little more nudge to break the institutional barriers here--the stickiness of the prime, the reluctance to lower rates in these other areas. I think just a little more time, a slight inducement, might be helpful for the overall environment. So I think I'd come out with a 4 to 5 percent range for federal funds and probably 3 to 7 for M1.

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

MR. LILLY. Well, I feel the same way. As you know, I think the long-term rate is very important, and although an eighth isn't very much, it does have a leverage effect on longer-term rates, and I would come out for a 4 to 5 funds rate.

MR. ROOS. I support alternative B for the reasons that have been cited.

CHAIRMAN BURNS. Mr. MacLaury.

MR. MACLAURY. I'm not going to try to revise or change my views on the basis of these relatively minor differences. One thought that occurred to me during the conversation though--we are very much aiming at a funds rate target today and we are likely to do that much of the time. And the suggestion for widening the band on the Ms ranges is consistent with the focus on the funds rate. And Paul Volcker's "viscosity" [concept]--as we move away from a particular rate also emphasizes that. My concern--I think Chuck Partee mentioned, for example, that he wished we had a better view of the appropriateness of a given relationship between M2 or M3 and the economy--my concern is that I wish we had some sort of a guide as to what the appropriate funds rate is, for the rate of movement in the funds rate, if we are going to continue to focus on--as I think we are doing--the funds rate as our handle. I feel even more at sea, I guess I would say, with the inappropriate [connection] between movement in the funds rate and the economic consequences thereof than I do with the imperfect M2.

CHAIRMAN BURNS. Thank you, Mr. MacLaury. Anyone else like to speak? There is virtual unanimity among the members of the Committee on M2, all of which means that we don't really care so much about M2 and that our love still goes out to M1 and to the federal funds rate. As far as M1 is concerned, there is the range under alternative B--2-1/2 to 6-1/2 has the edge in the expression of views around the table.

As far as the federal funds rate is concerned, six members of the Committee favor a range of 4-1/4 to 5, another six members of the Committee favor a range of 4 to 5. One member of the Committee who is in favor of a range of 4 to 5 expressed a certain preference for an asymmetrical midpoint, that midpoint being 4-5/8, and therefore by the faintest margin there is a preference for 4-1/4 to 5. I doubt whether additional debate would resolve the question. The differences are very small. We might have more of a difference on the directive. Now, I think myself that a money market directive at this particular time is the wiser course. Let's have a show of hands on those who favor a money market directive.

MR. BROIDA. Eight.

CHAIRMAN BURNS. Well, the differences are very, very fragile, tiny. No difference at all, really, on M2. Two members of the Committee did not express any numerical wishes. Everyone in favor of 9 to 13.

MR. PARTEE. If we're decided on a money market directive--I gather there was a consensus for that--why don't we regard the center spot of the money market directive as being 4-1/2--4-5/8. Then I think you'd have virtual unanimity.

CHAIRMAN BURNS. Well, we could. But do we want to, really? I think this Committee is in danger of excessive fine tuning. Why not leave it to the Desk?

MR. PARTEE. I happen to think it's a good thing to give the Manager a little range.

CHAIRMAN BURNS. Well, he has a little range. The range would be--well, we'll vote a range for him.

MR. PARTEE. I meant as his target.

CHAIRMAN BURNS. Well, I think we ought to give him a little more room than an eighth.

MR. PARTEE. Well, he hits it within four or five weeks from now.

CHAIRMAN BURNS. No, I don't think that's realistic or fair to the Desk. Why do we want a Manager? We'll get a clerk and tell him this is his business. The Desk must have some discretion. Although you know we've heard a lot about the desirability--well, one member of the Committee--and I can't name him because I don't know who he is, and if I did, I wouldn't say--a note arrived at my desk and reads as follows: "All these fellows who argue about federal funds rate flexibility are suddenly worried about a little market backup." Well, we're all very human.

Gentlemen, I'm going to put the following to a vote: a money market directive and the specifications under alternative B.

MR. BROIDA.

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

Unanimous.

CHAIRMAN BURNS. All right, what else do we have?

MR. BROIDA. Two small matters.

CHAIRMAN BURNS. Oh yes, the release of the 1971 Memoranda of Discussion. Would you be good enough to comment on that.

MR. BROIDA. Mr. Chairman, the staff recommends that the Committee follow the usual schedule and release the Memoranda of Discussion for 1971 in January. We've reviewed the memoranda and recommend that the consultation with the National Bank of Belgium and the Treasury--two short passages--be withheld. They're identified in the attachment to my memorandum.

CHAIRMAN BURNS. Any question or objection? I hear none, and therefore the recommendation is accepted. There is a memorandum from Mr. O'Connell; would you be good enough to comment?

MR. O'CONNELL. Yes, Mr. Chairman, thank you. This memorandum--item 10 on the agenda--is for the Committee's notation and for the record of the Committee. The recommendation is that paragraph 2 of the Authorization [for Domestic Open Market Operations] be left in place even in light of the fact that a statutory authorization enabling the Reserve Banks to purchase government obligations directly from the Treasury expired as of November 1. That's section 14(b) of the [Federal Reserve] Act, which at the present moment has a de facto suspension, and [this memorandum] would bring this to the Committee's attention.

The memorandum recommends that the Committee note the de facto suspension of that statutory authorization. The staff's expectation is that, early in the next session of the Congress, there will be new legislation enacted that will extend the authority of the Committee to authorize direct purchases. Therefore, I recommend that paragraph 2 remain as it is. The Committee has noted for its record its awareness of the de facto suspension, with assurance from [me] that if, within a relatively short period, there is no congressional action, I will bring forth a recommendation that paragraph 2 be deleted accordingly. Mr. Chairman, that's all I had to recommend.

CHAIRMAN BURNS. Any discussion? I take it, in view of the silence, that the recommendation of the general counsel is accepted.

[GAP IN TRANSCRIPT: Setting date of next meeting and adjournment]

[END OF TRANSCRIPT]