

## TRANSCRIPT

### FEDERAL OPEN MARKET COMMITTEE MEETING

July 18, 1978

#### 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. Pardee, Deputy Manager for Foreign Operations  
Mr. Kichline, Associate Economist (2)  
Mr. Zeisel, Associate Economist  
Mr. Truman, Associate Economist  
Mr. Sternlight, Deputy Manager for Domestic Operations

Meeting of Federal Open Market Committee

July 18, 1978

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, July 18, 1978, at 9:15 a.m.

PRESENT: Mr. Miller, Chairman  
Mr. Volcker, Vice Chairman  
Mr. Baughman  
Mr. Coldwell  
Mr. Eastburn  
Mr. Jackson  
Mr. Partee  
Mr. Wallich  
Mr. Willes  
Mr. Winn

Messrs. Balles, Black, Kimbrel, and Mayo,  
Alternate Members of the Federal Open  
Market Committee

Messrs. Guffey, Morris, and Roos, Presidents of  
the Federal Reserve Banks of Kansas City,  
Boston, and St. Louis, respectively

Mr. Broida, Secretary  
Mr. Altmann, Deputy Secretary  
Mr. Bernard, Assistant Secretary  
Mr. O'Connell, General Counsel  
Mr. Axilrod, Economist

Messrs. Burns, J. Davis, Ettin, Keir,  
Kichline, Paulus, Truman, and Zeisel,  
Associate Economists

7/18/78

- 2 -

Mr. Pardee, Deputy Manager for Foreign  
Operations

Mr. Sternlight, Deputy Manager for Domestic  
Operations

Mr. Coyne, Assistant to the Board of  
Governors

Mr. Kalchbrenner, Associate Director,  
Division of Research and Statistics,  
Board of Governors

Mr. Henry, Associate Director, Division of  
International Finance, Board of  
Governors

Ms. Farar, Economist, Open Market Secretariat,  
Board of Governors

Mrs. Deck, Staff Assistant, Open Market  
Secretariat, Board of Governors

Mr. Czerwinski, First Vice President,  
Federal Reserve Bank of Kansas City

Messrs. Balbach, Boehne, T. Davis,  
Eisenmenger, Parthemos, and Scheld,  
Senior Vice Presidents, Federal  
Reserve Banks of St. Louis, Philadelphia,  
Kansas City, Boston, Richmond, and  
Chicago, respectively

Messrs. Brandt, Fousek, and Keran, Vice  
Presidents, Federal Reserve Banks of  
Atlanta, New York, and San Francisco,  
respectively

Mr. Meek, Monetary Adviser, Federal Reserve  
Bank of New York

Transcript of Federal Open Market Committee Meeting of  
July 18, 1978

[CHAIRMAN MILLER. We will begin today's meeting with Scott Pardee's report.]

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

CHAIRMAN MILLER. Realized [or] unrealized?

MR. PARDEE. Unrealized is about the same. Our average rate is 2.07; the current market rate is around 2.06-1/2.

CHAIRMAN MILLER. Thank you, Scott. I heard a report this morning--maybe I misunderstood it--that there was a sudden drop in the dollar in the Far East. Is that [true]?

MR. PARDEE. Yes. In the Far East, the Japanese came out with some more trade figures that suggested they would have a bigger trade surplus in June--\$2.3 billion. But we have a case where--that's why I pointed to interest rates here--the dollar tends to firm up in our hours. The dollar was up just before the meeting.

CHAIRMAN MILLER. Thank you very much. Any questions? Henry.

MR. WALLICH. Yes. I just wanted to note that in looking at the cost of the swap in terms of losses that Scott just described, it's worth bearing in mind that we're paying interest at the dollar rate, not at the D-mark rate. I think the staff is working now to figure out how much that difference is and what we might do about it. We get this 50-50 loss sharing, which is fine, but they're taking us on the interest rate. We really ought to split the interest rate between the dollar rate and the D-mark rate in order to make it fair for both sides. We're working on that.

MR. COLDWELL. Scott, do you have an impression of where the major corporations and others are with regard to their position on payments? Are they running a covered position, doing shorts on this, or are they shifting in their leads and lags positions?

MR. PARDEE. Over the course of last fall and winter, many of the corporations did cover well in advance their needs in currencies that they thought would rise. They were, in effect, short of dollars, and that position built up rather substantially. I think a good bit of that was either run off or covered in March and April. Some good [sources] in the market who have contacts with these people think that most, if not all, of it has been run off. I would say that quite a bit still remains to be done. That is, we have leads and lags that could shift in our favor should the dollar continue to firm. This last monthly period has been a very delicate one for these people. They didn't know whether suddenly, with the EC meeting, the Bonn conference, and the dollar declining, they might not go into a new series of selling dollars forward to cover on the expectation that perhaps the dollar will continue to decline. We haven't seen that. So it's a tenuous situation but at this stage I think if the dollar were to start rising, there would be more covering and we'd have a sustained rise in the dollar and a technical reaction on the favorable shift of leads and lags. But there's still some to be done.

MR. COLDWELL. I raised the question because I'm hearing noises from some friends of mine involved in the international area. They are increasing their covered positions.

MR. PARDEE. Well, some of them have been [doing that] in recent weeks. But when you tip a table and something starts rolling down, the question is how much suddenly slides off. When the market balance tipped against the dollar, some of it did slide. We know of some covering that took place. That is, the selling of dollars forward did take place but it wasn't the massive amount that we had last fall and winter.

CHAIRMAN MILLER. We need an action to ratify the transactions since the previous meeting. Is there any dissent from that action? Then we will consider that approved. [Next we have] a recommendation of the Manager with respect to foreign currency operations, Scott?

MR. PARDEE. Yes. It's simply that in August we have coming up for maturity ten individual swap drawings in the amount of \$315 million equivalent of German marks. These will all be for second renewal, which is agreeable to the Bundesbank in view of the progress that we've been making. I don't know if we'll be able to pay them off by the time of maturity--but we'll do our best--so I recommend that we renew them.

CHAIRMAN MILLER. Any questions? May I consider that recommendation approved? Hearing no dissent, it is so approved. Now, while Henry was in Basle, I understand that the Japanese asked the question about activating our swap line. You might mention that to the Committee, Henry.

MR. WALLICH. During the last BIS meeting the Japanese came to me and suggested that we now implement something that

. [The Japanese] are interested in having the System intervene in yen for its own account instead of just as an agent. I said we'd have to discuss this here but gave them very little hope, citing the objections that exist there. The Chairman and I have talked about this and I've also taken it up with Tony Solomon. There seems to be a continued strong feeling that it would not be appropriate at this time to intervene in yen--that is, to support the currency that has the biggest current account surplus. It would undoubtedly arouse a lot of political comment if we were to give any support to the yen for our account. It would also probably be unwise in terms of the prospective losses, considering how strong that currency is in a fundamental sense.

CHAIRMAN MILLER. Unless there's a groundswell of desire to [acquire] yen and intervene, I think we'll respond saying that we do not believe conditions are appropriate for this. If there's a groundswell, those of you who want to [do this can] testify before Congress and explain why we did it.

VICE CHAIRMAN VOLCKER. I will not be a groundswell, Mr. Chairman, but I can see the day arising when a gesture in that direction may be entirely appropriate. I'm not sure we're right there.

MR. PARTEE. As a quid pro quo for something?

VICE CHAIRMAN VOLCKER. Maybe. In a small amount.

CHAIRMAN MILLER. Well, you either should do it enough to be effective [or not do it]. If you do it in a small amount, the static we'll get from it will be more abuse than we--

VICE CHAIRMAN VOLCKER. Well, a small amount for the United States. It might be part of a big program by Japan.

MR. WALLICH. Yes. I could visualize it if this were a concession as part of a package. But as you know, the Japanese have not been terribly forthcoming on their summit package and their trade negotiations.

VICE CHAIRMAN VOLCKER. I think the question is--and I don't want to pursue this forever--that the relationship between the appreciating yen and a change in their trade problems is nothing very apparent in any event and could have, and has had, some unfortunate side effects. At some point I think the rate ought to be stabilized. Whether we can contribute to that through some gesture or at what level, I don't know. I hardly discount in my own thinking a suitable gesture as part of a more general program that is appropriate.

MR. COLDWELL. I'd have to see some fundamentals change before I jump into this.

CHAIRMAN MILLER. Well, Paul's point, I think, is that time may [bring a] change. On the point Henry and I made: In formulating a response, we don't want to make this a "forever close the door" response; it's just in today's conditions. Who knows what will happen in the future?

All right, let's move along then to the economic and financial outlook. We are going to have a staff presentation led off by Jim Kichline.

MESSRS. KICHLINE, ZEISEL, and TRUMAN. [Statements--see Appendix.]

CHAIRMAN MILLER. I would suggest as a procedure that we take a few minutes for any questions of Jim, Jerry, Ted, or others. Then after that I'd like to do once again a go-around and get the inputs from each of you on your [estimates] for GNP. Chuck.

MR. PARTEE. Jim, there's one thing I wanted to clarify that came up in a seminar we had with the Board last week. Some of the papers were distributed to the members of the Committee. If I understand it correctly--although [you] say your last table is put entirely in terms of M1 growth rates and their effect--the projection period of your forecast, extending to 1979, has a monetary policy based on a pattern of interest rate change. That is, your fundamental input is interest rates, not M1. And then there's the additional step from your presumption of the linkage between interest rates and M1. Is that correct?

MR. KICHLINE. That's correct. There's uncertainty on the part of the staff, for example, on the precise nature of the money demand function.

MR. PARTEE. Sure.

MR. KICHLINE. And we believe that the channels through which monetary policy works would be interest rates. So we've stuck with the interest rates at the low end of the ranges in alternative B.

MR. PARTEE. And that's about 8-1/4 percent for the funds rate?

MR. KICHLINE. No, it's higher than that.

MR. PARTEE. It's 8-3/4; the 8-1/4 is for the bill rate.

MR. KICHLINE. Right. And we believe associated with that would likely be a rate of growth in money of 6-1/4 percent. That assumes, as Steve I guess will be talking about in his presentation, some further downward drift in the money demand function. If that were not to occur, then money growth would be stronger, assuming the same interest rates. Or holding money [demand constant], interest rates would rise and the economic activity that we would forecast would be lower.

MR. PARTEE. All right. Thank you.

CHAIRMAN MILLER. John Balles.

MR. BALLEs. The question I wanted to ask Jim, Mr. Chairman, has to do with the 6-1/4 percent M1 growth postulated here for the forecast period, which is through 1979. I don't know how you feel about it yourself, Jim, but we're so concerned about the undermining of M1 in terms of institutional changes, past and prospective, that we have great difficulty doing any kind of a forecast based on M1. So we've shifted to M2, which we found in an earlier period is superior in any event. In our judgment it's getting more superior, probably. What assumptions specifically did you make concerning developments on M1 subsequent to November 1, Jim?

MR. KICHLINE. We have not made any change. In effect, the 6-1/4 percent is premised now on a scenario in which either the automatic transfers do not go into effect or, if they do, the rate of growth of M1 would be adjusted downward sufficiently to offset that impact. So, again, in terms of interest rates you have the 6-1/4 percent interest rate policy but it would require slower rates of growth. We have not done anything here. Steve, perhaps you have something to add.

MR. AXILROD. President Balles, for purposes of the projection, I think the point you raise doesn't matter because the projections are based on a 6-1/4 percent rate of growth in M1 abstracting from automatic transfers. If there's automatic transfers, that rate of growth may indeed be lower but if you added back in the shifts that occurred as a result of the automatic transfers you'd be back to 6-1/4 percent. It's as if the rate of growth in M1 is 6-1/4 percent and with automatic transfers it was reduced to 4-1/4 percent; you'd add back in the extent of the shift from demand to saving deposits and you'd be back to 6-1/4 percent. So the fact of automatic transfers doesn't really matter in the way the projection is developed.

MR. BALLE. I hear what you're saying.

CHAIRMAN MILLER. You're not too convinced but you hear it. Ernie.

MR. BAUGHMAN. Mr. Chairman, I have a question--in fact two of them--relating primarily to the assumptions. If the tax cut assumed were not to materialize and if we were to operate the same monetary policy--assuming it is cast in terms of monetary aggregates--that we would if there were a tax cut, would you judge that that would change your forecast significantly? Or would that particular assumption be fairly well neutralized?

MR. KICHLINE. We have done some exercises, and Jerry may remember some of the details better than I do. But I do remember that for 1979 we believe that stripping out the tax cut is worth about 1/2 percentage point, or maybe a shade more, in terms of real growth for the whole year. You get a bigger bang early on but it fades fairly quickly. So using that, I would say roughly 1/2 to 3/4 [unintelligible] to move down a bit and offset it. I think maybe the low end of the range, 1/2 point, is roughly what we'd be talking about.

MR. BAUGHMAN. With respect to the energy program, you still view that as essentially having a neutral effect--that whatever funds are picked up will be put back in the economy?

MR. KICHLINE. Yes, we do. The Administration's estimate on this crude oil equalization tax (COET) in 1979 is about \$4-1/2 billion. It soon will be distributed. Actually, the formulas that have been worked out provide in 1979 a little bit more distribution and inflow, but it would even out over time. The major impact there, I think, is on the price side. This COET is estimated by us and others to be worth about 0.3 percentage point on the deflator in 1979, 1980, and 1981. So I think the price impact is quite important.

MR. PARTEE. Will that come right at the beginning of the year, Jim?

MR. KICHLINE. January 1.

MR. PARTEE. Yes, because it's a one-time increase for that year.

CHAIRMAN MILLER. Thank you. Larry.

MR. ROOS. Jim, I'm confused about two remarks that I think you made. One is that assuming a 6-1/4 percent M1 growth rate you anticipated a moderating trend in inflation. It looks to me as though the figures show at least a continuation of 7.2 percent, which is not really moderating. Secondly, in your response to Chuck's question, you referred to 8-1/4 percent interest rates and a 6-1/4 percent M1 growth rate. [In] the projections of the price levels you show in Appendix 1 of the Bluebook under alternative B, which is that general scenario, you show interest rates of 8-3/4 to 9-3/4 percent for the fourth quarter of '78 and the first and second quarters of '79. What I'm getting at is that I don't think you can have an 8-1/4 percent federal funds rate--



MR. KICHLINE. No, the difference there is between the funds rate and the bill rate in forecasting. The bill rate tends, through much of the forecast period, to run roughly 1/2 percentage point below the funds rate.

MR. ROOS. That explains it.

MR. KICHLINE. But as interest rates rise, that differential widens.

MR. ROOS. I got it.

MR. KICHLINE. My chart and comments referred to the bill rate but it's consistent in our view with the low [unintelligible] end of the funds rate. With regard to your other question, I may have misspoken--or perhaps you're referring to my comments at the end of my briefing. When I talked about "moderating," it wasn't in terms of the explicit forecast for 1979. In trying to sort out what the problems are, you're looking at in 1979 an explicit forecast--the judgmental or model solution--of weakening real activity and continuing high rates of inflation. [Inflation is] virtually unchanged. One of the problems in this whole scenario is that in '79, '80, and '81 you would like to have lower rates of inflation. But you find that in 1979 you're hit January 1 with an increase in the minimum wage and social security, the crude oil equalization tax, a dairy price support, and it goes on and on and on. So you begin to take care of that and then in 1980 we're scheduled to get it again. So if we stripped out those exogenous price shocks, we would be led to forecast lower rates of inflation. I think that was my statement. If you took away all of these government-mandated programs and had weakening real growth for a period of six quarters or so, it would begin to have effects on the [inflation rate].

CHAIRMAN MILLER. Is that a recommendation, Jim, that we cut those things out?

MR. ROOS. I don't ask this question in an impertinent manner, but do you totally discount the relationship of aggregates growth to prices? Forgetting those exogenous factors, isn't there a relationship between our monetary policy actions--M1 [growth of] 6-1/4 or 7-1/4 and this price level into the future? Isn't that relevant?

MR. KICHLINE. Depending on one's preconceptions, I guess the question, frankly, is: How does monetary policy work? The way we go about this, and certainly in terms of my own view, money does matter. But it matters in that it affects markets and it affects interest rates. It alters decisions, so the level of activity is either higher or lower. And if you were talking about higher rates of M1 growth, you'd be talking about lower rates of interest and more rapid increases in economic activity, and that process would lead to some tightening of markets and upward price pressure. So in my own case, and I guess for the Board's model, the lags are quite long; but I think [inflation] is related to economic activity. That's the channel. You go through the interest rates, decisionmaking, and economic activity route. So in 1979, for example, we do have in our forecast maintenance of relatively high inflation. But at the same time, real money supplies are declining, inflation is running faster than money, and we're getting upward pressure on interest rates. So activity is slowing down and we would like to have, aside from the governmental programs, a slowdown in the rates of increase of inflation. So I think it does matter. It's a question of how

does it matter and how fast. If you had lower levels of activity, you'd expect lower rates of inflation or vice versa.

CHAIRMAN MILLER. Frank Morris had a question. Did he leave? Well then, we'll go to Bob Mayo.

MR. MAYO. My question has been answered.

CHAIRMAN MILLER. Yours has been answered. All right then, we'll go to Philip Jackson.

MR. JACKSON. I think mine has been answered but I'm not positive. Did the President's announcements yesterday about the United States energy policy change any of your energy [assumptions] and the impact on inflationary expectations?

MR. KICHLINE. Truthfully, no.

MR. JACKSON. Let's just say we can live with what he promised. Would that change any--

MR. TRUMAN. Well, in my understanding, the key word in that [communiqué] that was circulated to you was "approximately"--2.5 billion barrels a day by approximately 1985. Now, 2.5 million barrels a day is a current estimate of what the full energy program will give you in terms of savings. Of course, you also have to worry about where you would be otherwise, which is helpful. So it assumes the full 5-piece energy bill, which is consistent with this forecast. On the other hand, it does have the word "approximately" in there. I gather--and all the press reports suggest this--that although the President would very much like either to get his fifth piece or go to something else he has a political problem in that area. And he's not quite clear how he would bring that about and has not asserted anything precisely in that area. But the reference in the communiqué is broadly consistent with what we have. So it could be consistent conceivably at its lower bounds with the absence of the COET, which I guess will give you a little bit of help on inflation. But it's not intended to be [unintelligible].

CHAIRMAN MILLER. Frank, we missed you for a moment, and we're going to pick you up now.

MR. MORRIS. All right, sir. Jim, the problem I have with this whole scenario is that we are projecting moderate growth rates through 1981 under conditions of very severe financial strain without generating a recession, all of which seems to me very improbable. It seems to me that the more probable case would be a recession beginning sometime in 1979 or at the latest 1980--producing quite a different array of results than this. I think this [forecast] is sort of a test tube product, but it doesn't conform to the probabilities as I see them.

MR. KICHLINE. Well, one of the difficulties when you look ahead is that it is often hard to perceive what sources of strength might emerge. It is a traditional problem we have. And perhaps here it is also a case where it is difficult to see the swings that might develop. When you look back in history, we have these wild swings and they don't show up in most forecasts. I would say that

we have a reasonable forecast--one that we are comfortable with given the assumptions--but I would weight the risks on the downside. I don't think there is any danger of significance at this point of a large overshoot, given the assumptions; I think the danger is clearly on the downside. I am comfortable with what we have, but I just don't see the sources of imbalances and problems that will get you into this recession. It is very difficult to put that forth today as the most probable forecast.

CHAIRMAN MILLER. Gentlemen, I have four names left on the list. I suggest I run through them and then perhaps we will do a go-around, in which case any other comments or questions will be brought up. Bones, do you have a question?

MR. KIMBREL. Quickly. Jim, I didn't detect any comment on inventories. But in the Greenbook you [have] pretty conservative [numbers] over this period. Do you feel comfortable with the continuing situation we have with the inventory outlook?

MR. KICHLINE. Yes. I would like to share the wealth here, so maybe Jerry can answer that. He has been looking at inventories particularly.

MR. ZEISEL. The inventory situation doesn't look like it contains any major significant imbalances. There are some reports of a back-up in inventories of consumer nondurables. But that is the sort of thing that usually can be run off rather quickly and we don't seem to be seeing any progressively larger problems developing. So for the moment things look reasonable; and our projections implicitly assume that businessmen will continue to maintain a conservative posture.

CHAIRMAN MILLER. Roger.

MR. GUFFEY. Thank you, Mr. Chairman. My question revolves around your projection for the first quarter of 1979 premised upon the tax cut. What are the elements of that tax cut that give a kick early in the year and then die off so quickly? It seems to me that on the [consumer] side at least we won't realize that until we have gone through the year.

MR. KICHLINE. I think in the National Income Accounting, though, you get it at an annual rate. You get the full effect.

CHAIRMAN MILLER. There is a change in the withholding immediately, isn't there?

MR. KICHLINE. That is right but it is annualized. So you get the full impact of that immediately.

MR. GUFFEY. But in terms of consumer expenditures, if you follow it into the economy, it is spread over the full year, right?

MR. KICHLINE. Yes, and we have most of the impact occurring, frankly, in the first half; there is still some there later on but it fades. In addition, we have assumed some impact [from] the investment tax credit, which might be in the fourth quarter to the first quarter in terms of the

shipment and delivery of goods. It is retroactive, so we may get some of that bunched into that [period].

MR. PARTEE. Roger, spending would rise to a higher level. Then it would stay at that higher level and since the GNP [unintelligible] first difference is right in the first part of the year. I think that is the reason.

MR. GUFFEY. But that is coupled, for those of us who pay taxes, with social security tax increases, so there is some question of whether you get any kick at all in the first quarter.

CHAIRMAN MILLER. Henry.

MR. WALLICH. Jim, you have alternative levels for inflation and unemployment, which if I read this correctly are roughly of a 1-to-1 nature. One percent more inflation saves you 1 percent on unemployment and vice versa. How does that check with the numbers that we frequently hear from Charlie Schultze and Art Okun where a much less favorable tradeoff is assumed? I think something like 1 percent on unemployment gets you a 0.2 percent reduction in inflation. Also, there's the widespread argument that the Phillips curve, which this seems to imply, is really an unstable construct and doesn't have any validity for the longer run.

MR. KICHLINE. With regard to the Phillips curve, that is a debated issue that has generated much journal literature and I presume it will continue to do so in the years to come. In the model, obviously, we have an implicit Phillips curve relationship. It is stable. The tradeoff in the model relationship is much more favorable than that which you get, for example, from Arthur Okun or from George Perry at Brookings. The latest work I have seen from Brookings on this is by George Perry and his findings were that over a year's time period if the unemployment rate averaged 1 percentage point higher, you can have roughly 1/3 percentage point less rate of increase in prices. [Our model's tradeoff] is larger but in fact there are some difficulties in interpreting that tradeoff because we have in addition these exogenous price shocks that come on here. Also, it depends on the time horizon you are talking about. After the end of three years, in 1981, what we are catching is a large part of the impact going into prices and out of the real [side]. If you look at a 1-year horizon in which you have the unemployment rate 1 percentage point higher than it would have been, the price differentials begin to narrow. But in the model, ultimately, money is neutral. That is, you will get the impact on the price side eventually (in eight or ten years) and the real side effects will all disappear.

MR. WALLICH. Thank you.

CHAIRMAN MILLER. Phil Coldwell.

MR. COLDWELL. Jim, you have made two variable assumptions in this, as I hear you--a 6-1/4 percent rate of growth in M1 and a lower end of the interest rate spectrum. If you were to modify the interest rate assumption, what impact would this have on your model?

MR. KICHLINE. If you modify the interest rate, then we would share alternative GNP scenarios. We do have an assumption of the low end of interest rates defined by alternative B. If,

for example, one wanted to opt for looking at interest rate levels that are a bit higher, such as at the midpoint, we have enough sets of books around now, in terms of the alternatives, to give you other combinations. It looks like a level of interest rates around the midpoint of "B" would be close to the interest rates that we have for the low end of "C." So on this table that I distributed, a rate of GNP growth, for example, in ['79] averaging 2.6 percent is associated with 5-1/4 percent money. Those interest rates are pretty close to those in "B;" they are a little bit more stringent. I'd edge that number up to a bit closer to 3--2.8 or 2.9 or whatever. So that is a combination. Do you want to hear others?

MR. COLDWELL. No, that's fine. I was just curious which way things would move in terms of the impact on GNP, prices, and unemployment. You would say, for example, that your 1979 figures would give me a rough estimate of what you would expect on real GNP, prices, and unemployment.

MR. KICHLINE. Right--perhaps a little bit less impact if you choose mid-alternative B interest rates and look at 5-1/4 percent money. Again, those are rough.

CHAIRMAN MILLER. Gentlemen, we have quite an interesting process. We have the Redbook. We have the Greenbook and the Bluebook and we have the presentations and your questions. Then we finally come around to the recent procedure of asking you for your individual judgments of what you see in terms of three critical elements in the next four quarters. Why don't you pick up your pencils for a moment and let me remind you to jot down the figures that would be the staff figures. We will be asking you to give your own reactions. So, first is the real growth of GNP from the second quarter of 1978 to the second quarter of 1979; the staff projection is 3.7 percent. The next is the gross business product fixed-weighted price index over the same period of time--our measure of inflation, if you will. And there we have a staff figure of 7.3 percent. The third figure is the rate of unemployment in the second quarter of 1979--that is, at the end of the four-quarter period. There the staff is looking at 5.7 percent, which happens to be the same figure as in June. So, those are the figures. Last time I went around [the table] counterclockwise, so what about going clockwise this time and starting with Henry.

MR. WALLICH. I think the possibility that these figures may not materialize is quite considerable. The chances are still that we will make it without a recession but I think the chances have increased that we might have a recession. Full employment has come upon us more rapidly than we thought and you might say that we again missed the right timing for a soft landing. We should have moved a little earlier, realizing as we do now how quickly unemployment was coming down. That was quite unanticipated. So we confront now some considerable imbalances in the economy with very little room for maneuver for accommodating them. Inflation is mounting; if I am skeptical of anything in the staff forecast it is the moderate inflation forecast. I see next year as one of very strong wage contracts and the possibility of a wage explosion in the organized sector carrying over into other prices. So that seems to be the most vulnerable aspect of the projection. Other than that, I would say that these numbers are perhaps the most likely single outcome but the probability of its being realized I think has diminished in recent months.

CHAIRMAN MILLER. Thank you, Henry. Phil.

MR. COLDWELL. I don't believe this is all that inherently stable. Looking at the figures I jotted down before I came here, I would put the range of GNP in this coming period at 2-3/4 to 3-1/4, the price deflator from 7-1/2 to 8, and the unemployment rate probably running in a range of about 5-3/4 to 6-1/4.

CHAIRMAN MILLER. Any particular comments?

MR. COLDWELL. Only that I think the possibility of having Henry's soft landing is still a possibility. I think we could reach that if we have some appropriate government policy to dampen this [inflation]. My figures for the price deflator are very high, largely because I question whether we are going to do the appropriate things in all of the government to correct this. Consequently, I am fearful that the price side is going on up. The unemployment side I think is the most favorable of the whole package.

CHAIRMAN MILLER. Thank you. Frank.

MR. MORRIS. Well, Mr. Chairman I think we are headed for a recession in 1979. I don't know whether it is going to start in the first half or the second half, so I have a range for real GNP of 1-1/2 to 3 percent. The 1-1/2, of course, will be if the recession starts in the first quarter. Therefore, I am more optimistic on prices in connection with this scenario since I have noticed in recent years a very coincident behavior between the rate of real growth in the economy and the rate of change in prices, without much of a lag. So I would expect something like 6 to 6-1/2 on prices in that kind of situation and obviously the unemployment rate above 6 percent by the second quarter of the year.

VICE CHAIRMAN VOLCKER. Why are you so sure about a recession?

MR. MORRIS. Well, I think we are building up financial pressures in the system.

VICE CHAIRMAN VOLCKER. Because of the financial side.

CHAIRMAN MILLER. Thank you, Frank. Ernie.

MR. BAUGHMAN. Mr. Chairman, I think we still have significant expansive elements in the economy and I share what I think is the staff's view that the distortions are not yet great enough, and that it will take a fair time for them to become great enough, to terminate the expansive influences. And I think there is still some possibility of achieving something that might appropriately be labeled a "soft landing" ex the inflation aspect. So I would still [expect] something on the order of 4 percent or just slightly under on GNP, about 7-1/2 percent on prices, and something a bit under 6 percent on unemployment.

CHAIRMAN MILLER. Thank you very much. John.

MR. BALLE. Well, for some months now, Mr. Chairman, my staff has been somewhat less optimistic than the Board's staff. I consider their--

CHAIRMAN MILLER. You've been being proved right from meeting to meeting.

MR. BALLEES. I am not sure that we will be; that is still a forecast. It has to do with the second half of this year and going into 1979. I think the Board staff's view was very well articulated. It is a very plausible package and yet there are different scenarios, which I became especially aware of over the weekend when I met with the ABA's economic advisory committee--the top economists from the major banks in the country. There was quite a divergence of opinion within that group and I would say, Jim, that your forecast would definitely rank among the most optimistic that I heard. There were some others among that group who would have been optimistic but some were at the other end of the scale and, like Frank, were definitely expecting a recession.

More or less by accident rather than design here, our staff forecast has come out with what I would call a growth recession. Specifically, to nail down the numbers, we look for less strength in real consumer spending than you do. We had it about flat from here out into 1979 and the underlying reasons for that have to do with the feedback of current and prospective inflationary developments on consumer attitudes--especially coming down to the bottom line that we expect the saving rate to rise somewhat. We expect the constraining influences of debt repayments relative to personal income--take home pay--to begin to make themselves felt. If you believe that scenario, then there is probably going to be some feedback on inventory positions with businesses. That is, by the first two quarters of next year there may be a raft of orderly corrections of excess inventories, especially at the retail level if real consumer spending does in fact flatten out. And that could even have a bit of a dampening effect on real capital spending, which we expect to grow at about a 5-1/2 percent rate through this year and into 1979.

As for where we come out on the bottom line as compared to your forecast of real GNP of up 4 percent this year, we are almost identical--just a shade under it. But for next year as a whole you have GNP up 3.9 and we are at 2.7. If you take it from the fourth quarter of '78 to the fourth quarter of '79, you are at 3-1/2 and we are at 1.9. That is just the difference in the assumptions and that starts principally with consumer spending. We show less strength on residential and a little less strength on business capital spending. And as a final element, our methodology differs from yours Jim, in this sense: We have used the midpoint of the present M2 range as a part of our methodology. Of course, you have more monetary stimulus now than you had previously because you've got M1 at 6-1/4. To make our forecast fully comparable to yours, we would have to be assuming a somewhat higher M2 growth, which I would not recommend. But that is one of the reasons our forecast, I guess, is a little less optimistic than yours.

MR. AXILROD. President Balles, excuse me, but Jim's forecast assumes the midpoint of the M2 range.

MR. BALLEES. Oh, it does?

MR. AXILROD. Yes. It is a difference of the assumption on the relationship--

MR. BALLEES. Okay, if that is the case, then we don't have inconsistent monetary assumptions. But if this view of ours happens to be right, and who knows, starting about the fourth quarter of this year we would show GNP rising about 2.7 percent and then quarter by quarter after

that going into 1979 we'd show 2.1, 1.6, and 1.9. That is, I would have to say, a growth recession. We think we can avoid an outright recession but I certainly wouldn't rule out the possibility of that developing. I have my fingers crossed on this growth recession of ours, hoping--and maybe it is wishful thinking--that we can avoid an outright recession.

CHAIRMAN MILLER. John, perhaps at the break you can get how it works out on these quarter-to-quarter figures consistent with the others, because I think you have to do a little calculating there.

MR. BALLE. Unfortunately, [the way] we slice things up is the third quarter of '78 to the third quarter of '79. We haven't--

CHAIRMAN MILLER. Well, if it is possible.

MR. BALLE. We will do that; yes we could easily do that.

CHAIRMAN MILLER. Thank you very much. Mark.

MR. WILLES. Thank you, Mr. Chairman. For reasons that Henry and Ernie articulated more clearly than I can, I have come up with these most likely numbers: real GNP of 3-1/2 to 4, but with the risk clearly on the downside; inflation of 7-1/2 to 8, with the risk in that case on the upside; ending up with an unemployment rate of around 6 percent, with the risk on the upside.

I would like to make one comment if I may, Mr. Chairman. And that is that it seems to me that this particular exercise in the current state of the economy depends very crucially on what we individually forecast monetary policy will be, because I think people do respond to monetary policy more quickly than they used to. I don't think the lags are as long. And that is particularly true in terms of the impact that they perceive monetary policy will have on expected rates of inflation and how they then build that into their forecasts and spending decisions. Because of that, it seems to me that in reviewing things like the simulations the staff put together, which I personally found very useful, there is a problem. I like the tradeoff [in the staff's model] much better than most that I have seen come out of the models. Nevertheless, there always is a problem in trying to model the way people form expectations and then behave [based] on that. It is possible, for example--going back to the question that Chuck raised--that you could have higher interest rates and have that consistent with more rapid real economic growth. [That could occur] if the higher interest rates were generated by lower rates of growth of money and if that, in turn, made people expect lower rates of inflation and, therefore, in response to lower rates of inflation and lower uncertainty associated with inflation they spent more. It seems to me it is that kind of possibility that we need to keep very carefully in mind as we think about the likely course of events over the next year.

CHAIRMAN MILLER. Thank you very much. Bob.

MR. MAYO. Well, Mr. Chairman, I think the economy is still quite healthy and is growing vigorously and I don't find implausible--at least over the next year--the staff's forecast of a slowdown in economic growth. I think it is likely to be achieved partly because the expectational



caution being generated, which we hear so much about, may indeed avoid the excesses that produced the last recession and may extend the expansion at least through the year ahead, as we see it. Just to round the figures off, I come out with 3-1/2 percent for real GNP growth, and I think that would be a very good record in terms of a long-term trend, given the problems that we have before us. I am a little more concerned on the price index; I would come out more like 7-3/4 than 7.3 percent. And I think the 5.7 is a fluke on unemployment and I would say we would have at least 6 percent by this time next year.

CHAIRMAN MILLER. Thank you, Bob. Roger.

MR. GUFFEY. Thank you, Mr. Chairman. I, too, think that the economy has a lot of vigor in it. But the assumptions for the forecast figures that I will give probably put a little more emphasis on what I think monetary policy is going to have to do in the period ahead, and thus reduce the growth that we would otherwise expect. As a result, we expect a GNP of around 3-1/2, which is something less than the last time we were asked to give these figures.

CHAIRMAN MILLER. You've got one more quarter on it now, though.

MR. GUFFEY. Okay. I think it was 4 plus the last time; I would scale that down simply because of the role I think monetary policy has to play in the period ahead. So I have 3-1/2 for GNP. I agree with Bob Mayo in that I think the 5.7 is a fluke so two quarters from now we will have about the same level [of unemployment] but it will be 6 percent as measured. And for prices, the deflator will be 7-1/2 or I would think in a range of 7-1/2 to 8 percent.

CHAIRMAN MILLER. Thank you very much. Larry.

MR. ROOS. I would project--and again I predicate what I am saying on the assumption that we will keep M1 growth at 6-1/4 percent--real GNP at 3 percent, the deflator at about the same 7.3 percent that the staff had, and unemployment at 6 percent. I would echo and support wholeheartedly the remarks of Mark Willes. I think the biggest factor, far overriding all of these exogenous factors that we read about and talk about so frequently, is monetary policy. And regardless of the interest rate consequences of stating a goal for money growth and sticking with it, I think that would be the most stimulative action that we could take. If the Chairman of this group made clear that we are determined to hold money growth at 6-1/4 percent and he said that for everyone to hear, I think that would encourage capital spending. It would clear the air. I think very few people in the real world have confidence that we are really going to conduct monetary policy in a manner that will hold money growth at that targeted rate.

CHAIRMAN MILLER. Thank you very much. Bones.

MR. KIMBREL. Mr. Chairman, I, too, think there's a lot of strength left over this period. I am somewhat pessimistic, though, about the collective bargaining calendar, the possibility of an oil price boost, the impact of the minimum wage and social security increases, and the stagnation of productivity. That brings me to feel that the GNP growth may be about 3-1/2. I have prices at about 8 percent and unemployment probably at 6.

CHAIRMAN MILLER. Thank you. Dave.

MR. EASTBURN. Well, I would like to second what Henry started with and some of what Frank said. My most probable forecast is very close to the Greenbook forecast, with 3-1/2 percent GNP, 7-1/2 percent for inflation, and 6 percent for the unemployment rate. But I am nervous about this because it is taking place in a very high inflation environment and I suspect that to say that the risks are on the downside is probably to minimize that likelihood. One reason relates to the kinds of things that Frank pointed out--financial stringencies. I think that was well brought out in the charts that Jim showed and it was supported by some discussions that I have had in the last week or so with small businessmen. We often meet with big businessmen but never met with small businessmen, and it's quite clear that they have a cash flow problem and have had one for some time. They are at the end of the line as far as receivables go. If you were to have the kinds of financial pressures which Jim's charts indicate happening at the corporate level, you would see that it is exacerbated even as you get into smaller business. And I think some substantial change in their expectations would have a negative effect on the economy.

CHAIRMAN MILLER. Thank you. Willis.

MR. WINN. Mr. Chairman, I am intrigued with the games economists play and I think we must not forget that it is a game. As I look at Africa, the Middle East, South America, and the Far East and the problems in municipal finance at home and in some other areas, it seems to me that there are a number of factors we haven't put into our models to judge their impact. So I think we need to be reminded that we are playing this game. I personally think that momentum is still running very strong, and I would suspect that we still will achieve by the second quarter of next year 3-3/4 to 4 percent real GNP growth. I am more pessimistic on the inflation outlook, with the wages and structuring by business people and others to try to offset some of these things, so I am 8 percent plus by the middle of the year, and I have a 6 percent unemployment rate.

CHAIRMAN MILLER. Thank you, Willis. Bob.

MR. BLACK. Mr. Chairman, at this point I have to declare my sympathy with Barry Bosworth's observation the other day that it is very difficult to distinguish between a forecast and a prayer these days. I think the real outcome is pretty well indicated by the degree of inflation that we end up with, and I can't help but echo the remarks of Mark Willes about this. They struck a very sympathetic cord. We don't disagree strongly with the profile of the Greenbook for the balance of this year, but we do believe the staff is a little low on the inflation side. And when we go to the longer run, we would become considerably less optimistic than they are on that end. We think the underlying rate of inflation is about the 7.2 percent or so that they are talking about and we think it will probably accelerate to 8 percent or so as we move into the next year.

MR. PARTEE. But that's not the average for the four quarters.

MR. BLACK. No. Well, I guess it's pretty close to it. But if this is the case, then I think we will see more disorder in the foreign exchange markets and we will see further sizable increases in interest rates and a correspondent deterioration in business and consumer confidence. And if this is the case, then I certainly would [forecast] lower real GNP growth than they are projecting and my

best guess would be that we would slip into a recession early next year. So when you get down to the specific figures, I would like to emphasize the prayer part on this. I come out at 3 percent on the real GNP and [for the deflator] pretty close to 8 percent--maybe 7-3/4 to show my sense of moderation, Chuck, on that. And if we do succeed in getting away with only a growth recession, I'd say 6 to 6-1/2 percent on unemployment. I'm not sure it will be that favorable if inflation gets away from us. I think it could become worse than that. If you want some spurious accuracy, I'll put 6.2 in there.

CHAIRMAN MILLER. We will give you the range. Chuck.

MR. PARTEE. I think the difficulty in providing the numbers that you have asked for is the question of the precise timing of the probable recession. If the recession comes early, the numbers will be much lower for the year, the four quarters. If it comes late, it may indeed be that the staff projection will be right, which doesn't get even into a growth recession until the second half of 1979, and that is a real possibility. I was worried about a recession within the forecast period beginning the last time and I guess I feel that way still--in fact, maybe a little more strongly. I agree with much of what Frank said. I think that the financial tensions projected here are very great and almost certainly imply a recession in the foreseeable future without quite getting the timing straight on that. The other feeling that I have that is different from a month ago is that last month I was worried about a bulge in demand in the third quarter. I don't think that is [likely]. I think instead that the demand is quieting and quieting fast. It appears that consumers indeed have been buying in anticipation of higher prices, borrowing from the future. And I think we can expect lower consumer spending in strategic areas--in cars and other durables and houses too--as we get into the fall. So if it comes down, I am prepared to incorporate--almost--the staff's real GNP within my range, which would be 3 to 3-1/2 for the next four quarters.

CHAIRMAN MILLER. It is 3 to 3-1/2, which now includes 3.7?

MR. PARTEE. It is pretty close, yes. On inflation, I am not quite as bearish as some of my associates on my right, but I do think it is unlikely that inflation is going to slow very fast with the kind of wage increases in prospect and with the increases in the minimum wage and in social security taxes early next year. I would put the inflation rate between 7 and 7-1/2 percent for the next four quarters and rising in the latter part of that period. Because of that, I think there is going to be more labor force participation than the staff has projected and, therefore, my unemployment range would be rather wide. It would be from 5-3/4, which is fairly consistent with the 3-1/2 percent real GNP, all the way up to 6-1/4 for the second quarter of next year on the presumption that we could have more labor force growth than [the staff assumes].

And I want to agree with many of my associates around the table in that I think monetary policy can have some influence in making this outlook not quite so [adverse] as otherwise. In particular, I think it could have some influence in reducing the probability of a marked slowing in the economy next year in the spring and summer. But to do so I'd say we would have to avoid the kind of financial tension that is being produced by monetary policy rather than just hope that somehow, as a philosophical matter, people will feel that if there is less money growth that means there will be less inflation in the future.

CHAIRMAN MILLER. Thank you, Chuck. Philip.

MR. JACKSON. I will give you some end results and then I will explain how I get there because I think we are in a situation where, unfortunately, annual averages don't tell us anything about the course we are really talking about. I would guess that real GNP growth will be in a range of 3 to 3-1/2 percent, inflation in the 7 to 7-3/4 range, and unemployment probably in the 6 to 6-1/2 range.

How do we get there, though? It is my judgment still that we will see a third quarter that is stronger than expected, primarily as a result of the carrying forward of the increase in personal income related to the increases in employment we have seen in the second quarter. I would be inclined to think that continued inflationary expectations will carry forward consumer buying at least through the second quarter and maybe even through the third quarter and the beginning of the fourth. I don't see the impact of housing and contract construction taking place quite as severely as some of you do. It strikes me that if we got the starts figure that we have today and the contract figures, it will be a good while before the actual economic impact of those activities wash through that result from the lower starts and lower construction that might take place.

I don't see that monetary policy is quite as stringent today as some of you do. I recognize it's having its impact; perhaps it's only in combination with the increased inflation that we have that it is putting pressure on financial institutions. I don't see it as quite as severe as some of you do. I do see the inflation situation getting much worse and having an impact. For that reason, while I think we will continue to see a better second half for 1978 than is generally anticipated, my guess is that 1979 will degenerate and go down much more sharply than in the staff forecast; it may be in the 2 to 2-1/2 range toward the end of that period. I guess on average [we may get] these figures but the pattern certainly would be a stronger front and a weaker back end.

CHAIRMAN MILLER. Thank you. Paul.

VICE CHAIRMAN VOLCKER. Well, I can give you a staff forecast, which happens to be relevant in the sense that it is almost exactly the same in nominal GNP as the Board of Governors staff forecast. There is a little difference in that the prices are higher and the real is lower--in each case by about 1/2 percentage point over that period. In other words, real growth would be about 3-1/4, prices about 7-1/2, and the unemployment rate a little lower than 6 percent. I do think there is some chance of more exuberance, if that is the right word, or more anticipatory buying--either by consumers or by businesses in the form of inventory or conceivably a little bit in plant and equipment--in the next quarter and the current quarter particularly.

It's very hard for me to see a recession before the end of the year. And if we get a tax cut at the end of the year, it's very hard for me to see a recession developing in the first or second quarter. Therefore, while I recognize the risk of a recession, it's a little difficult for me to see one in this time perspective. And I would think the risks in that sense are pretty symmetrical, where the major risk is of the price increases having more momentum than the forecast suggests. I do think we are going to get a recession sooner or later, but I share Phil Jackson's feelings that the financial pressures have not built up to the point of producing one in the next year. Conceivably we could get it by the end of 1979 but that is too far ahead for me to foresee at the moment.

CHAIRMAN MILLER. Thank you, Paul. I am just looking quickly at the means [of these figures] for members only. Art has given me some figures showing that [compared to] the staff's real GNP growth of 3.7 percent, for members the consensus comes out at 3.7. Is that what you're saying?

MR. BROIDA. No, two are above--

CHAIRMAN MILLER. There are two above and three below.

MR. BROIDA. Five below.

CHAIRMAN MILLER. And five below. Now I'm getting it. Why don't you tell us what it is? Turn your microphone around and give us the straight dope.

MR. WALLICH. Are we averaging here recessions and continued expansions?

CHAIRMAN MILLER. Sure. We are averaging all kinds of things.

MR. BROIDA. What I did was to take the midpoints every time anybody mentioned a range and if someone said 6 or a little below I made it 6, and so forth. For real GNP, the staff forecast is 3.7. [Of the Committee members,] there were two who expected higher rates--one 3-7/8 and one almost the same at 3-3/4. One was at exactly 3.7 and five were below it, with the lowest being 3.

MR. PARTEE. That doesn't come out to the numbers. We have 10 who have spoken.

MR. COLDWELL. The Chairman hasn't given his.

MR. BROIDA. On prices, the staff figure is 7.3. [For members,] there is one at 7-1/4. All the others were above that, ranging from 7-1/2 to 8-1/2. On the unemployment rate, the staff had 5.7; there were seven at 6 and one at 6-1/4. Why I have only eight, I am not sure.

CHAIRMAN MILLER. Can you count this one up? There is an interesting thing because the range on the real GNP from the lowest figure cited to the highest is 1-1/2 to 4 and prices go from 6 to 8-1/2 and for unemployment it's 5-3/4 to 6-1/2 percent. There is not much I can add. I think the conversation has been very helpful. We have seen a lot of common viewpoints and some variations of the theme. I would say that the most discouraging thing about inflation is the number of things that are going to be happening over which we have no control but they feed inflation. The staff did some studies for my testimony last week at the House Budget Committee and the calculation Jim came up with is that the minimum wage increase on January 1 will add almost 1/2 percentage point to inflation next year. And the increase in the social security tax on January 1 will add 0.4 percentage point. So you're talking about almost a percentage point. In fact, some other extraneous factors there added it up to about 1 percentage point on inflation just from those factors. Naturally, I have proposed--

MR. JACKSON. Oil.

CHAIRMAN MILLER. The 0.3 [from] oil, I am more sympathetic. We are going to have to do something to constrain that; we may have to absorb that. The others we have within our power. As I said, I recommended in my testimony that we defer the minimum wage for two years and nobody screamed, but nobody rushed in with a bill. So, if any of you would like to introduce the bill I am sure it would be welcome. Reserving the right to change my mind, in preparing my testimony for next week, Steve, I would think that we are talking in this period about 3-1/2 percent growth. We are going to have to average the four quarters. On prices, I'd say 7-1/2 probably and on unemployment 5-3/4 to 6. That would be my guess, and I am not far off from what everybody else had. That is how I see the situation.

The most important announcement that I have is that coffee is ready and I suggest we take a break for a few minutes and come back and see if we can struggle with setting some long-term ranges.

[Coffee break]

SPEAKER(?). Inflation has taken over the food industry, Mr. Chairman. It is obvious that the donuts are smaller!

CHAIRMAN MILLER. We now face the task of our quarterly fixing of long-run ranges. At the last meeting I suggested a couple of things for you to be thinking about and I called your attention to a letter I received from Chairman Reuss asking us to give consideration to raising the upper limit of the M1 growth ranges. I also called your attention to the probability that over the next twelve months, the next four quarters, M1 would get a little murky with the automatic transfer going into effect for M1 on November 1. I asked you to think about whether anything should be [done] there. We have had some comments, but let us start off first by having some introductory observations by Steve and then we will open it up for your views on that.

MR. AXILROD. Mr. Chairman, I would first like to give some factual background for the Committee to ponder in considering its decision on the longer-run aggregates ranges. And then I'll present, in effect, some arguments for and against certain changes with regard to M1 and the broader aggregates. On factual background I would note--and I'm sure the Committee is well aware of it--that in the year ending with the second quarter of 1978, the most recent policy year, M1 and bank credit ran well above the top ends of their ranges. M1 growth in the year just ending was around 7.9 percent; the top end of the M1 range was 6-1/2. Bank credit was running 11.3 percent; the top end of its range was 10 percent when [a range for] the Q2 '77 to Q2 '78 period was established and it is now 10-1/2 percent. On the other hand, M2 and M3 have been running well within their ranges. M2 growth in the year ending with the second quarter of 1978 was at 8.6 percent; the top end of its range is now 9 and it was 9-1/2. And M3 growth was around 9.9 percent; the top end of its range was 11 and is now 10.

In the first half of 1978 the same set of relationships obtained. M1 and bank credit were above their ranges by about the same amounts as they had been for the full year. M2 and M3, however, were further within their ranges; M2 growth in the first half of this year [slowed] to 7.7 percent and M3 to 7.9 percent. So very clearly we have a phenomenon where M1 growth, as well

as bank credit, is strong relative to the whole set of relationships that the Committee had viewed. The stronger growth in M1 reflects, we believe, the shift in demand for M1 relative to GNP. It is stronger than the staff and the Committee had earlier assumed. There are a variety of ways of looking at that and one of the methods most commonly employed--and the one we have used--is to compare the money growth predicted by the money demand equation in our quarterly econometric model with what actually happened. That is, the model says there's a relationship between M1 growth and GNP and certain short-term interest rates with a certain lag structure. What did the model predict relative to what actually happened? For about eleven straight quarters, beginning with the fourth quarter of [1974], the model was very consistently predicting more M1 growth given the GNP and interest rates than we actually got. That's what we kept referring to as the downward drift in money relative to GNP. Since then, in the last four quarters--the third and fourth quarters of 1977 and the first and second quarters of 1978--there has not been any further downward shift in terms of what the model would have predicted. The increase in money predicted by the model has been virtually the actual increase in money, given GNP and interest rates.

Our assumption that is built into the GNP forecast and built into the Bluebook is that there will be a further downward drift again of modest proportions--about 1.8 percentage points of downward drift. That is based on the idea that with interest rates as high as they are and are becoming, institutions will more actively market substitutes for money. And [our view is] that the public has been sensitized since 1974 to their earnings loss with high interest rates, compounded by the effect of inflation, so we believe they will become more desirous of substituting. It is quite likely that the model, which was through 1974, does not have that built in. So that is the basis for our assumption of a further downward drift. I might add that there are other ways of looking at this. The DRI model money demand equation would predict money pretty much as we predicted it, for GNP and interest rates. That is, if you look at that model, you would not observe a downward drift given the set of relationships between money, GNP, and interest rates that we have predicted. I hasten to add that most other models, however, would give a downward drift.

With that background, I would like to present some argumentation with regard to M1, M2, and M3. The fact that money demand has been running strong, of course, is the reason why we have assumed a 6-1/4 percent M1 increase. Now, this assumption in itself argues for raising the range. In fact, it argues for making 6-1/4 percent the midpoint. Given the normal error distribution around our assumption of a midpoint, it would argue for raising the range to where 6-1/4 is the midpoint--somewhere in the range of a little less than 5 to a little less than 8 percent. On the other hand, automatic transfers, which will go into effect on November 1, suggest that actual money growth may be lower than 6-1/4 percent or so because people will shift out of demand deposits into savings deposits in some amount. Thus, in practice, it may be desirable to raise only the upper end of the range by some amount--and not necessarily raise the whole range--to take account of this shift in money demand. Any increase would have adverse announcement effects regarding the willingness of the Committee to fight inflation. But the larger the increase, the greater the risk of these effects and the more likely it is that the market will believe that the Committee may have given up some on the fight against inflation. To minimize such a possibility, the Committee may wish to consider an increase of the upper [end] of the range of only 1/2 percentage point. I think this sort of an increase would minimize the adverse announcement effects; the upper end would still be lower than recent growth rates, so it would point in the direction of restraint. And it might just be attainable. On the other hand, if you do that, it may make the market come to believe that

you have some intention of really hitting it or otherwise why would you make such an adjustment. Therefore, if you don't hit it, there is some danger of eroding credibility even further.

With regard to the broader money supply ranges, they too, like M1, imply a substantial rise in velocity over the next year relative to historical experience. I believe they might be attained, however, given the movement out of deposits to market instruments that we have been seeing and that is likely to develop, as interest rates remain well above ceiling rates. Thus, the recent experience of being within their ranges clearly suggests no need for an upward adjustment at this time, even though the velocity increases are somewhat out of keeping with historical experience. In any event, any upward adjustment--particularly if M1 were adjusted upward--would be clearly interpreted as an inflationary move and would be quite counterproductive from the Committee's viewpoint. The Committee may also wish to consider lowering these ranges, particularly if M1 were adjusted upward as a countervailing move to that. I believe there are strong arguments against lowering these ranges, against even dropping the lower end but not touching the top end. The principal argument, of course, is that that would very clearly imply considerable pressure on thrift institutions and even banks to a degree and more pressure than may be desirable given the present stringency in the mortgage market.

Finally, Mr. Chairman, the issue about dropping M1 entirely has been raised. The main argument for that at this point, of course, is that there are large uncertainties with respect to the automatic transfers, which may go into effect after November 1. Thus, it is very difficult to set a range because one does not know how promptly and to what degree the public or the banks are going to respond to this innovation. In addition, of course, there is a certain awkwardness about the range because the actual growth has been so far out of line with the target; this provides a kind of incentive to ditch the target and there is a good reason.

There are arguments against dropping it and I believe some fairly strong ones. First, the automatic transfers will not be effective until November 1 and, in any event, there are still legal uncertainties. We have not had a ruling on the request for an injunction yet. Second, even if it is dropped, the market probably will still pay attention to M1--and I believe with very good reason, since our research indicates that M1 is the principal financial element that foreshadows GNP and, therefore, it is a sensitive monetary indicator. And people are unlikely to give up on it unless there is a very strong and obvious technological innovation that is disturbing it. Thirdly, I don't believe dropping M1 will solve the problem of market attention to weekly money supply figures. That problem, I think, has been abating recently. In any event, without M1 the market will focus on M2, which has also very large variations in it--and larger than M1. For example, M2 rose \$5 billion in the week of July 5.

Finally, Mr. Chairman, and in a way convincing to me, I believe that it would be very undesirable for the Committee to be left with only one operating variable in the short run [unintelligible] at the moment--that is, M2. For M3, we don't have data to permit that to be a short-run operating range. And I believe two [variables] are preferable from the viewpoint of providing both operational flexibility and a better basis for judging special circumstances. For example, it would be desirable to have a less interest-sensitive M1 in place as a target, in judging M2 in a period when a decline in market rates may be leading to reintermediation and vice versa in



a period when a rise in market interest rates may be leading to disintermediation. Mr. Chairman, those are the comments that I would offer to the Committee on these issues.

CHAIRMAN MILLER. Steve, I think you have talked yourself into something. Now let us see if you have talked the Committee into something. Phil you had a question.

MR. COLDWELL. Not a question, Mr. Chairman.

CHAIRMAN MILLER. All right then, a comment.

MR. COLDWELL. I would like to try to put a rationale in front of the Committee here by taking a look at the purpose, the public perception, the performance, and the prospects--the four "Ps" if you wish. It seems to me that the purpose of our long-range targets is to provide a guide that the FOMC can use to, in effect, have a forward framework for its short-run decisions. Public perception, unfortunately, has been conditioned to low rate goals, and a noticeable move upward could damage our credibility to some extent unless carefully couched. Our performance obviously has not been good in the last year for M1. But it has been good on M2 and M3. And I would not back away from that position. The prospects, though, seem to be that there is no real expectation of being able to hit a 4 to 6-1/2 percent range in the coming three months. And I would not like to make this long-range decision to encompass the change in the automatic transfer. I think we can look at that next time.

It seems to me that these four points imply, obviously, some basic philosophy on how much lag we look at [in terms of the] impact of policy. It may highlight some of the differences between an aggregate and an interest rate policy, and it assumes certain velocity changes. I think the Committee ought to be looking at putting this long-range growth in the perspective of economic growth slowing in the third and fourth quarter. But with what we are already looking at--in my opinion, an insufficient amount of restraint--the timing of this change is unfortunate, but there is not much we can do about it. So what I would recommend is for the Committee to consider announcing a policy shift away from M1--a modest shift at the moment by perhaps taking M1 as being 1/4 and M2 3/4 of our average. I would accept the 4 to 7-1/2 percent for M1, which gives it a midpoint of 5-3/4, not 6-1/4. I would go 6 to 9 on M2 and 7 to 10 on M3, with the midpoints of their long-range goals being 1/2 point less than what the staff has suggested. I would announce these [decisions as being] a result of inflation and our failure to meet the more restrictive goal, but with it clearly implied, if not explicitly stated, that we are going to meet this goal. I think the velocities are going to be higher than the 2 to 3 percent range the staff is telling us. I suspect they are going to be 4-1/2 to 5 percent. I have some backing out of the data, which Steve sent around to the rest of the Board, for the average in the four quarters prior to the peak.

CHAIRMAN MILLER. Thank you. We have quite a few hands up, so let's go on and get other reactions. Frank.

MR. MORRIS. Well, Mr. Chairman, I would like to first comment on the Bluebook page IV-3, which estimates the impact of automatic transfers on M1. The text states that this is based on the 1976 experience with NOW accounts in New England. The problem with that rationale is that the NOW account began in New England in the summer of 1972. It seems to me that the 1973 or

1972-74 experience with NOW accounts is much more relevant for the initial period than the summer of 1976 experience because the NOW experience taught us two things. The first was that the public changes its habits very slowly. The savings banks in Massachusetts and New Hampshire were advertising vigorously during the first two years of NOW accounts and the rate of growth of NOW accounts during that period was very slow. It took a lot of hearsay and people talking to each other, in addition to advertising, to really get the thing moving.

So I think these estimates of the impact of automatic transfers on the growth of M1 are greatly exaggerated. I think that in the first year the impact is going to be very small--not only because the public changes its habits slowly but also because banks are reluctant to adopt expensive innovations unless they are forced to do so by competitive pressures. In the case of the NOW account, we had the competitive pressure of the thrift institutions offering this very attractive instrument, which drove the banks into also offering it. If we had had a situation where the banks had been offered NOW account powers but not the thrifts, I think the growth of the NOW account would have been exceedingly slow because the banks would have been reluctant to push a product that they knew was going to cost them a lot of money.

Now, in the case of the automatic transfer, both of these factors--the fact that the public does not change their habits very quickly and the reluctance of the banks to adopt expensive innovations unless forced into it--are going to work very strongly in the first year or two because in most states the thrifts will not be able to offer a competing instrument. In the State of New York they will and in a few other states where [thrifts] have demand deposit powers. But by and large around the country the S&Ls and the savings banks are not going to be able to offer a competing product, and the development of the automatic transfer is going to be based on inter-commercial bank competition generating pressures for change. So I think we should not have the hope that the automatic transfer is going to restore the kind of the relationship between M1 and M2 that we would like to see happen in the year ahead. I don't think that is going to happen.

I sent out a note indicating my feeling that we ought to nonetheless take the advent of automatic transfers as a public rationale for doing something that we ought to do anyway, and that is to move to a single M2 target with M1 and M3 given as memorandum items. By that I mean that we'd express the target in terms of M2 and say in our records that associated with it we would expect x rate of growth for M1 and y rate of growth for [M3]. I think there are important reasons for making this change. First,--

CHAIRMAN MILLER. I assume everyone got a copy of your memo.

MR. MORRIS. They should have. First, I think the dynamics of the changes in the payments mechanism are going to force us sooner or later to move to a broader concept of money. We already have in the case of New England some \$2-1/2 billion of transactions accounts that are not in M1. Forty percent of these are not in M2. If what has been going on in New England for several years is going to move eventually to the rest of the country, which I think will happen, I think we are going to have to move to broader and broader concepts of money. I would even propose M3 now if it were operationally feasible. But since it is not, I think we ought to leave the transition for the moment to M2. So, sooner or later we are going to be pulled into the direction of broader measures of money as being the most relevant.

Secondly, the problem that we've found with having two targets is that their relationship varies over the business cycle. That is, in easy money periods you would expect the structure of [comparatively] high M2 relative to M1, and in tight money periods you would expect the growth rates to converge. That being the case, if we are going to keep two targets, we should be moving toward raising the M1 range relative to M2. But, politically, that is simply not a feasible thing to do. I think any upward revision in the M1 range would create a substantial stir in the markets. It seems to me that we have a situation reasonably well attuned to making a shift that I think we are going to have to make ultimately anyway toward a single broader [measure of money].

CHAIRMAN MILLER. Frank, on your proposal, what would your proposed ranges be?

MR. MORRIS. I would keep the present range of 6-1/2 to 9.

CHAIRMAN MILLER. 6-1/2 to 9. You would announce that as a primary range. And what would you have in the memo items as the ranges for the other aggregates?

MR. MORRIS. I would use higher levels for M1 than are given in the Bluebook with automated transfers since I don't think they are going to have that big of an impact. I would use the "without" figures as a basis for the range in M2.

CHAIRMAN MILLER. Which one?

MR. MORRIS. The "without."

MR. PARTEE. You wouldn't have a figure for an M1 projection?

MR. MORRIS. I would say "We would expect...."

CHAIRMAN MILLER. So are you going with the 4 to 7-1/2 that Phil mentioned or the 4 to 7 or what?

MR. MORRIS. I would be a little leery about changing the M1 range, even though I don't think--

CHAIRMAN MILLER. You might leave it as a memo item at 4 to 6-1/2.

MR. MORRIS. 4 to 6-1/2 is reasonable.

CHAIRMAN MILLER. How about M3--the same?

MR. MORRIS. I think I'd be inclined to leave all the numbers the same and simply change the emphasis.

CHAIRMAN MILLER. Okay. Very interesting proposal. Henry.

MR. WALLICH. I would argue very strongly for not changing the present M1 range, and not changing any of the relationships of the three aggregates. First, there are substantive reasons for proceeding as I suggest. We have for a long time had an unrealistic M1 target; we've lived with that by utilizing base drift. We have adjusted it, in effect, from quarter to quarter and we [operated] essentially on a very modified money supply or aggregates target. We have been more nearly on an interest rate target. At the present time I think the dangers of ignoring sudden upward movements on the interest rate, as might come from observing a tight money supply target very closely, are particularly great.

Now, we probably are going to have automatic transfers and I am impressed by what Frank says--that they might not produce very much of a change. I can visualize, because of the very fact that NOW accounts have been talked about so widely nationally, that people would be prepared for them now and would be interested in taking advantage of them. I wouldn't write this off. In the least favorable case, I think Steve predicted an improvement in velocity--if you can call it that--of 1 percentage point and the maximum I think you had was 3.

MR. AXILROD. We used four New England states as an upper limit, not as the average, of course.

MR. WALLICH. Yes, so that it might be in the range of 1 to 3 percentage points on growth or equivalent of growth depending on the [unintelligible]. At that time then, we could use [the new accounts as a reason] to get away from an unrealistic M1 target. We have lived with it for a long time and I think we might live with it for another quarter or two.

Let me point to what I think would be the consequences of changing the ranges or the relationship of the aggregates in any major way. I am sure you have all been discussing the implications of our discount rate action when asked questions by the press; I have gotten this abroad. Everybody is looking at us wondering whether we are about to move to inflate ourselves out of an oncoming recession. And if we do anything like this, there will be a very general and uncontrollable reaction among central bankers abroad, in the press here, and I would guess the general public [to the perception] that we have turned. And to say what we might say--that there is a technical adjustment and we haven't changed our thinking at all--will be taken as a major policy change for fighting an oncoming recession rather than continuing to fight inflation.

Since that isn't, as I see it, this group's view or intention, we should not give a misleading signal in that direction. The only way to avoid giving that misleading signal is not to make a public statement to that effect but to stick for the time being with the M1 targets certainly. On M2 and M3, I have great misgivings as to their meanings. I think M2 is not a factor that determines economic activity. M1 transactions balances one can say ought to have some relationship in influencing activity. Savings deposits influence activity in a very indirect and remote sense, namely by making people feel a little more liquid and so they will spend their M1 a little faster. But that is a far cry from saying it is a determinant. And that is of course what our research shows: that M1 is what has the close relationship to [income] and determining it even though the velocity fluctuates; and that M2, even though it has a statistically close relationship, is really not a [determinant] relationship. So I would stick with M1, not give any weight to M2 or M3, and for the present exercise today I would leave all three targets unchanged.

CHAIRMAN MILLER. Gentlemen, I am pleased to say that three speakers have consumed 25 minutes, so I would like to set lunch for 3:00 p.m. Or can we get away from the speechmaking and get down to the nitty-gritty? I appreciate the comments; they are very good. But we will be here all day if we do that, so you have your choice. I think you've got to tell us what you think and leave out all the rest of it if you don't mind. Dave Eastburn.

MR. EASTBURN. Yes sir. I would opt for staying where we are with the long-range targets, and the reason is not for any positive rationale but mostly because there are disadvantages in almost every other way we might go. There are disadvantages in raising the ceiling for M1 and there are disadvantages in lowering it. So I would keep it just as it is and I think this will help you, Mr. Chairman, in your public comments with the Congress and also serve our policy needs.

CHAIRMAN MILLER. Thank you, Dave. Chuck.

MR. PARTEE. Well, Mr. Chairman, everybody's talking public relations. Since we are not supposed to talk very long, I won't talk economics except to say that based on the relationship between money growth and nominal GNP growth in the past year with a 210 basis point increase in the federal funds rate over the past year I would say that the [M1] increase everyone would associate with their desired nominal GNP growth in the next year would be at least 7-1/2 percent. So my forecast is that M1 will go up at least 7-1/2 percent next year, and that is based on an 11 percent nominal GNP. You can have more inflation or less inflation and more real growth or less real growth and probably some further movement up in interest rates even to keep it to 7-1/2. We have a record that anyone can look at that says in the past year M1 has gone up 7.9. And we have in my view the probability that in the next year it will go up 7-1/2, maybe minus a half or so for the automated transfer but that isn't a very big factor--I agree with Frank--initially in what we do there.

So the question is: Will we in the end be better off to continue to hold 4 to 6-1/2 percent as our desired target and continue for another year to exceed that target by a very substantial margin, which as I look at the figures I assure you we will do? I think the answer is no. I think we have gone along here with an actual growth rate that was far in excess of our targets and that the honest, rational, intelligent thing to do is to recognize that M1 growth has exceeded the target over a protracted period and that is because there has been a great deal of inflation in the system, which is induced by wage increases and government actions and things like that. And therefore, we hope to be moving down as we are able to within a reasonable range. I don't think 7-1/2, as I think about it, is enough, Bill, for the top. I would put the top at 8 and go with maybe 4 to 8 on the weak grounds that perhaps automatic transfer will make it possible to get down to the bottom of the range. Perhaps it would have some effect in reducing the inflation psychology but I do think the time has come to recognize what is the fact of the case, and that is that the money supply is increasing faster than we have been prescribing for a long period of time.

I am not prepared to go to M2, as Frank suggests, as the primary or only driver of the operation and my reason for that is that I feel we don't have enough control over M2 to do that. That has large certificates in there that are not subject to interest rate ceilings; we could have a blow-up in the issuance of large certificates by banks and that's quite uncontrollable on our part. On the other hand, it has a lot of ceiling rates in it, which we might not be able to raise because this

is subject to veto by the Home Loan Bank Board. To take M2 is to put ourselves to a degree at the mercy of either the banks with their marketing strategy or the Home Loan Bank Board. So I just don't think we ought to be [using M2] as our primary driver. I agree with Frank that we will have to come to a different definition; I think what it will include is transaction-type accounts no matter where they are, whether at [savings] banks or member banks or nonmember banks. But that is something, I think, for the future rather than for this time. So my proposal is: an M1 long-run target growth range of 4 to 8, expressing the hope that we can be moving down in that range with the passage of time; and for M2 and M3 the ranges as specified in alternative B by the staff.

MR. BAUGHMAN. As now published, it doesn't include the large CDs, does it?

MR. PARTEE. It doesn't include negotiable CDs of 350 banks but it includes large CDs that are non-negotiable everywhere. It includes negotiable CDs at the banks under that top 350 group. And it has been a major mover in the behavior of the time deposit component of M2.

CHAIRMAN MILLER. Mark Willes.

MR. WILLES. Thank you, Mr. Chairman. I feel very strongly that we ought not to change the long-run ranges, and for more than public relations. Steve made a comment about a further downward drift in money--if [the staff estimate] is right--that was 1 percent. I think that's the number you used, Steve. With the growth in money in the past quarter, we have base drift of 1 percent. So just to keep the existing ranges would mean not really 4-1/2 to 6 but 6-1/2 to 8. We have had, as Chuck mentioned, 7.9 percent growth over the last four quarters. If you look back, we have had above 7 percent growth in money for a very long time now. And I don't see how we are ever going to deal with the inflation problem unless we do something to bring the rate of growth of money down. If we were to do that, I think we could have a very positive rather than a negative impact on the outlook for a recession. So I would like to keep the long-run ranges both for M1 and M2 where they are today. I would heartily endorse what Chuck said on M2. We have no basis at this point to make the kind of switch that [operating on M2] would imply, and I think we should be very, very careful before we do that.

CHAIRMAN MILLER. John Balles.

MR. BALLE. Well, Mr. Chairman, I would support the views that have been expressed by Governor Coldwell and President Morris. I am one of those who is an M2 believer. Well over a year ago we circulated a paper to everybody around this table that pointed out that prior to about mid-1975 M1 and M2 moved closely together and, therefore, were giving about the same monetary signal. And that was true, I might add, even in [times] of high interest rates like 1974. [After] we circulated that paper, with the subsequent monitoring that we have done, we are still convinced that in these periods of divergent growth rates of M1 and M2, M2 is giving the better signal. It's not that it's a [unintelligible] factor, but it's giving a better signal of future GNP, real or nominal, than M1. I would be prepared [to operate on M2] for that reason, and especially in view of all of the uncertainties that are surrounding M1 behavior in the future. Frank thinks the coming on stream of the automatic transfers will be pretty slow. I happen to think it will be a little faster, based on my conversations with banks. But overall, M1 has become so contaminated--if that's the right word--by institutional changes, past and prospective, that I think we should move toward greater weight

on M2. And I would suggest 3/4 weight on M2, despite the reservations that Chuck has, which I don't share. As far as the ranges are concerned, I think a good case has already been made by earlier speakers. Net net, I would leave them unchanged.

CHAIRMAN MILLER. Thank you, John. Bob Mayo.

MR. MAYO. Mr. Chairman, I find myself in complete agreement with Chuck Partee on the M2 arguments. I think this would be exactly the wrong time to move to a broader measure, even though I am enthusiastic in the longer run for more properly defined money supply concepts than we have to date. In the long run, Frank is right. Right now I think it would be a bad mistake for the reasons that Chuck gave. Rather than repeat those I'll go on to my other point. I must say that Henry Wallich expressed exactly the way they [feel] on the foreign side. [I have] some question on Frank's statements on the likelihood of the demand deposit/savings demand shift effect. I would keep the targets exactly where they are--not just for public relations. But I will admit that if you use that term loosely to incorporate foreign relations, corporate relations, and market relations, I think it is a legitimate concern. And I would not want to be in the Chairman's shoes to have to go up and try to defend any change in either target at this point.

CHAIRMAN MILLER. Thank you, Bob. Paul Volcker.

VICE CHAIRMAN VOLCKER. I suspect this discussion, Mr. Chairman, suggests the need for reviewing the definition of M1 that we have now.

CHAIRMAN MILLER. I think so. I think it's one thing we must discuss at the end of this.

VICE CHAIRMAN VOLCKER. I would urge that that be done. I certainly have some unhappiness about the general method of setting targets that we have. Frank distributed one possible reform and [it's one] that we had also looked at earlier and I am not sure that it is perfect. But we have had so much base drift recently, and the target we set is something of a farce recently in terms of failing to deal with or recognize the base drift problem. I don't know how we should go about it but I really think we ought to talk about it before the next quarters. So far as the substance of the decision this time is concerned, for all the reasons that have already been suggested, I am among those who do not favor dropping M1 with all its difficulty now, primarily because of arbitrary factors in M2 during a period of potential interest rate ceiling pressure. I can recognize the logic of raising the range on M1, particularly the upper end of it. I don't see how we can, consistent with the kinds of concerns that Henry has ably expressed, think of going above 7, really, on top of the base drift, on top of the automatic transfer, [and the] increase in velocity certainly going in that direction. At this point, going above 7 would clearly give the wrong signal. I would be very worried about going to 7. If we go to 7 on the long-term target, I think there is all the more burden on doing something in the short run to indicate that we really intend to keep to that target. I don't know whether the Committee will be willing to do that or not.

CHAIRMAN MILLER. I think that's the point that Steve made--that if you don't do enough and then you fail to meet it, you have a double loss.

VICE CHAIRMAN VOLCKER. That's right. I think we really have to balance an increase in the target with some move that makes it credible that we are going to meet it. So I come out thinking that kind of combination might be tolerable. I can't see going above 7. I would prefer to leave it unchanged for the reasons that have already been expressed by a number of others and I won't prolong it.

CHAIRMAN MILLER. Many rationales will lead to the same [conclusion]. Bob Black.

MR. BLACK. Mr. Chairman, I distributed a table similar to the one that I did the last time which I was also pleased to see was quite similar to the one Bill Poole prepared for Frank. It is a tribute since I very much admire your work. To get down to it very quickly, I would propose that we try to work the rates of increase over the yearly period down from the 7.9 we had in the quarter just ended to 7.5, then to 7, and then down to 6.8 and then 6.4. That is about 3/8s of a percentage point drop [for each quarter]. That is certainly gradual, but it's certainly a perceptible move. At the same time, I don't think anybody could accuse us of slamming on the brakes. And if we follow this course with M1, I think we can do the same sort of thing with M2. So on this basis, we would recommend leaving the M1 range unchanged, but I think we probably ought to announce publicly that we expect the rate of growth in M1 to be coming in near the top of the range or maybe even above the top of the range for a while. This approach would keep us from having all the unfavorable effects that Henry described in announcing a change in the range and at the same time make it possible for us to counter either the charge that we intend to tighten too sharply--because I don't think this is too sharp a tightening--or that the target is so low that we don't have any intentions of hitting it. As you will notice in this last line, we do come down to [a growth rate of] 6.4. So I would leave them all unchanged. I'd rather work toward hitting them.

CHAIRMAN MILLER. Thank you, Bob. Ernie.

MR. BAUGHMAN. Mr. Chairman, Henry Wallich's comments adequately expressed my views. I would simply underscore that 4 to 6-1/2 today means about what 5 to 7-1/2 meant three months ago. And that is a fairly significant upward adjustment for the targets, it seems to me, and is adequate for the time being. So, "B" captures my views at the moment.

CHAIRMAN MILLER. Thank you very much. Roger.

MR. GUFFEY. Thank you, Mr. Chairman. I don't know quite how to say this. I've listened to the people around the table and I give great credence to what has been said about the international perception. But it bothers me that we may be underselling our critics and watchers in the sense that if we [stay] with no change--[4 to 6-1/2] on M1--I think we have as large a credibility problem as if we go the other way and recognize the realities and raise the upper end to some extent. That is to say, if we were to publish an M1 target of [4 to 6-1/2] it is almost laughable in view of the track record we have now built--with 7.9 percent in the most recent period of time. Thus, I would suggest that we do indeed raise [the top of the range], with an adequate explanation. But rather than going to the 7-1/2 or 8 percent that has been suggested around the table, I would adopt much of what Paul Volcker has already suggested, which is moving to 7 with some action by the Committee--not only by rhetoric but also by action--to demonstrate that we really intend to hit 7 percent. I guess I am encouraged by Steve Axilrod's statement that 7 may be doable. But the fact



of the matter is, if it is doable, and if it's believed, that is a much tighter monetary policy than what we have been following in the past and one which is not too tight, perhaps, to push us over the hump. So I would propose that we indeed go up, recognizing reality, but do it cautiously to 7 and do something about it on the short run.

VICE CHAIRMAN VOLCKER. Mr. Chairman, in terms of what is doable and not doable, my understanding of this morning's discussion was that 6-1/2 is doable.

MR. PARTEE. I don't believe it.

MR. MAYO. Yes, in Bob's table, I think--

VICE CHAIRMAN VOLCKER. The staff should believe it.

SPEAKER(?). Yes.

MR. WALLICH. Well, a benefit of the automatic transfer--

MR. AXILROD. President Volcker, what I was trying to say was that if you did not have automatic transfers, it would be like saying [6-1/2] was the midpoint of a range which would be more like 5 to 8 [these] days.

MR. MAYO. But even without automatic transfers, Steve, wouldn't you agree that base drift makes 6-1/2 doable?

MR. AXILROD. Well, I--

MR. MAYO. I think it does.

MR. WALLICH. Base drift makes anything doable.

CHAIRMAN MILLER. Now we need to hear from Philip Jackson.

MR. JACKSON. Well, gentlemen, first I would urge that we not take into--

CHAIRMAN MILLER. Phil, excuse me. Roger, I assume the others are the same then?

MR. GUFFEY. Yes, leave M2 and M3.

MR. JACKSON. First, I would urge that we not take into consideration in establishing the targets the prospective change in the regulations that might occur as of November 1 with regard to automatic transfers. It strikes me that what we are really doing is continuing to set long-range targets for the purpose of operating until we set another long-range target. We are far wiser to continue to set long-range targets without recognition of any prospective change because whether the change will take place is uncertain. And in an uncertain economic world, it is foolish in my

judgment to set a regulation into that picture, as uncertain as that is. We can certainly do so with a reduced degree of uncertainty in October when this takes place.

Second, I would urge that we not shift the basis of operations to M2 for all the reasons stated. I would urge us for goodness sakes to please let's get to work and get these aggregates redefined before the year-end so we can get some rationale restored to our policy. I've felt that way for a long time and I am glad some of you have finally agreed with the great wisdom that I had earlier!

Third, it is my judgment that we cannot ignore the consequences of increased rates of inflation. Therefore, it's tragic but [true] nonetheless that our continued devotion to unrealistic targets for M1 is foolishness. The present rates of inflation and the future prospective exogenous forces that will sustain it, if not accelerate it, make it even more foolish. For that reason, I think it is important that we go ahead and set a higher target range on M1. I would argue for [raising the upper limit to] 7-1/2 percent. This implies increased velocity. And while I recognize Phil Coldwell's argument that the average velocity for previous peaks of the cycle is about 4 percent, unfortunately, the most recent experience we had was 4.6 percent in the fourth quarter of 1973. I would hope that we would not achieve the velocity we are proposing by achieving the relative increases in interest rates that that period produced and the consequences that period produced. So for that reason, I would argue for increasing the [top of the M1] range to 7-1/2 percent, keeping the other ranges as they are today. And it is my judgment that not only can it be explained to the public but that it should be explained to the public.

CHAIRMAN MILLER. Larry.

MR. ROOS. Mr. Chairman, I will be very brief. I have several observations. One, I would invite the attention of the Committee to the last page of the staff presentation which says unequivocally that 7-1/4 percent for M1 growth will result in 8.2 percent inflation in the year 1980. Without being specific, I would observe that the year 1980 is going to be a unique and important year and that perhaps the economy would be an issue very much on people's minds in 1980. I believe that inflation is the number one issue impeding capital investment. It is the number one issue in the minds of the people of this country today. It is going to be the number one issue, if it is not brought under control, in 1980. I believe that there is a direct relationship, and we can demonstrate it, between the growth of M1 and, after a lag period, the rate of inflation. I take total exception, though, to the point of view that the control of M1 or any other aggregate is not doable. We can control it. Peter Sternlight can sell or buy securities. It can be done. And what we do today on setting the targets for the next year will either come back to haunt us or come back as good cheer to us in the year 1980 when I assume there will be a certain amount of attention paid to what the rate of inflation is. So, I would recommend that we go with "B" and try to stick to the midpoint--and not try to tell ourselves that this is not doable--because I believe it is doable, Mr. Chairman. And if we say it is not, we are just excusing our ineptitude.

CHAIRMAN MILLER. Bones.

MR. KIMBREL. Mr. Chairman, I've heard the comments about the fact that we have not been hitting the ranges and that we ought to adjust them, and I am completely unimpressed at the moment. I think the timing could not be worse. It would tend to confuse the markets at a time

when they are already uncertain. It would contribute to our credibility [problem] even more. I would strongly opt for maintaining the ranges exactly as they are, with a dedication on our part to be more diligent in attaining those ranges.

CHAIRMAN MILLER. Thank you very much. Willis, you have been very unusually quiet. Wouldn't you like to be heard from?

MR. WINN. I thought that was the instruction.

CHAIRMAN MILLER. Not that quiet. We want to hear from you.

MR. WINN. It seems like we have backed ourselves into a win/lose posture no matter which way we go, which is not the way I like to look at alternatives. To minimize our risks, it seems to me that the status quo, for reasons that have already been expressed, would be the best posture.

CHAIRMAN MILLER. Well, thank you. I think we have heard from everyone on this subject. You will be impressed to know that of the voting members, not counting myself who has not yet indicated [any view on this], only three would change M1 by raising the upper limit. And there is one non-voting member who would do the same. So, unless there are changes of opinion, it looks as if there is a fairly overwhelming majority to maintain the present ranges for M1 regardless of what I would say. I don't know whether you would like to stop there and give a reaction; M2 is a little more complicated. I think there was only one suggestion of a change on M2 and only one suggestion of a change on M3. I will come back to bank credit. What is your pleasure? It seems to me that the--

MR. PARTEE. I would like to ask all this great assemblage who believe in maintaining the range on M1 what they would say about the way to get growth down within the range. Are you going to get down within it? Are you going to raise interest rates 300, 400, 500 basis points? Is that what you would have the Chairman say to the [Congressional] committee?

MR. BALLEES. May I respond to that? I think the Chairman has an excellent opportunity to spell out the fact of great uncertainty--and great disagreement as a matter of fact--in judgments within the Committee on the behavior of M1 over this entire period, especially because of the automatic transfers. Therefore, the significance of the M1 range is necessarily sharply diminished for that reason. Deemphasize it even if we make no formal change in our 50-50 weighting just to recognize the facts of life--the great uncertainty.

MR. PARTEE. You would permit him to say: Well, that's our range but we may exceed it.

MR. COLDWELL. You would almost have to say that.

MR. MAYO. We are going to come closer this time, Chuck, than we have; and very frankly, base drift helps us do that.

SPEAKER(?). There are two sentiments that I hear, Chuck. One is that we are going to have these ranges and explain later our going over them. The other is that we are going to have these

ranges and live within them. And those will be the debates at our following meetings. It seems to me that is what the issue is.

MR. PARTEE. You are giving him a very difficult assignment.

MR. BALLEES. Could I ask just a quick question of Chuck? I am interested in why you are so certain, Chuck, that M1 is going to grow at that 7-1/2 percent rate [that you mentioned] over the entire period starting with the second quarter of this year.

MR. PARTEE. Well, because almost everyone has a forecast for nominal GNP that is in the vicinity of 11 percent for the next year. Some have more inflation and less real, some have more real and less inflation. For example, the Chairman stated his point estimates at 3-1/2 and 7-1/2. That is about 11 percent nominal GNP; it is a little more actually, because there is a compounding effect. [So, my belief is based on] observation of the relationship that we have had now for a few years running between M1 growth and nominal GNP. Last year, that is in the year [ending in the second quarter]--with the second quarter as a given although it is a projection--we had a money increase of 7.9 percent. And on average from the second quarter of '77 to the second quarter of '78, the fed funds rate went up 210 basis points. It seems to me that it is just very likely that we are going to have more than the staff's 6-1/4 percent projection associated with that interest rate increase if we have something like an 11 percent nominal GNP. And I think it would be a disservice for this Committee to seek a smaller increase in nominal GNP than 11 percent over the next year, recognizing as all of you do that there is going to be in any event quite a lot of inflation in the figure, because to do that is to seek a recession. I don't think it is the purpose of this Committee to seek a recession in the United States economy.

CHAIRMAN MILLER. May I just make one comment? I think what we have seen happen is that we have gone from something like 4-1/2 to 5 percent real growth with 6 to 6-1/2 percent inflation to something like a 3 to 3-1/2 percent rate of [GNP] increase with 7-1/2 to 8 percent inflation, coming out with the same nominal activity. That has put us in a very strong dilemma because the only area we can really operate on is to squeeze down that real growth because the inflation lags and we have built in with the legislation [a substantial amount of inflation]. We've got that very serious problem.

MR. COLDWELL. Mr. Chairman, can I make one point?

CHAIRMAN MILLER. Yes, Phil.

MR. COLDWELL. [There is another] reason I opted for a slightly higher rate in M1 as well as the other things I have already said. [If we retain the current range] I think we are giving up an opportunity here to say to the Congress: Look, the Administration and the Congressional actions of the past year and those forthcoming in the first quarter of next year are the cause of this rise in inflation. We are giving up the opportunity of telling them that if they would defer the minimum wage increase, stagger out the increase in the social security taxes, and take stronger action to reduce the deficit, we could live within the smaller range of growth in M1. I think we would give up something important by not being able to say that.

CHAIRMAN MILLER. I don't know, because actually the threat that we would squeeze more is more of a threat than what we would give up. I [think] Congress has reacted more from a fear that we would tighten.

MR. COLDWELL. I think we are forecasting a tightening.

CHAIRMAN MILLER. I am saying that while I am concerned about all of this, I think we'd be more likely to persuade them to do something legislative if they felt the other choice was tight monetary policy. I don't know.

MR. PARTEE. Well, I think that the Coldwell proposal, which I would accept, does imply a considerable further increase in interest rates.

MR. COLDWELL. Oh yes, no question about that.

MR. ROOS. Mr. Chairman?

CHAIRMAN MILLER. Yes, Lawrence.

MR. ROOS. I don't think we should lose sight of the fact that anything that enhances inflationary expectations will lead to an increase in interest rates, too. If people think that we have lost control of our ability to deal with inflation, inevitably that will cause interest rates to rise. Long-term rates are rising now. We are going to end up in the same pickle either way, and I would rather have us end up with lower inflation and temporarily higher interest rates than have inflation drive these rates up.

CHAIRMAN MILLER. You all have heard the discussion. It has been very thorough and interesting. Are there any candidates to switch votes? If not, there is a majority, I am afraid. We just have to vote; that is all.

VICE CHAIRMAN VOLCKER. I feel I could go to 7 but I'd hate to go to 7-1/2. The argument just comes too close to saying we have had a lot of inflation and, therefore, we will increase our targets.

MR. BALLEES. Mr. Chairman, you are the one who is going to have to face the music.

CHAIRMAN MILLER. I can live with anything. I have to learn to do that because, when you vote, there is not much else I could do. What are my other choices? It is a very sneaky way to ask for my resignation!

MR. BALLEES. If I could just follow up: I, for one, would certainly be interested, if you care to share your view with us. I assume everybody else would. I don't think I heard you express your view.

CHAIRMAN MILLER. I think my preference would have been to make some upward adjustment in the top of the M1 range--how far I had not decided--because I think we have a better

chance of restoring credibility. Even if we went to 7, we would have a chance at least to come nearer to our goal. With 7-1/2, I admit that you begin to raise serious problems with the international area and, in fact, you raise [problems] with other forces. But I have a hard time seeing us getting into the 4 to 6-1/2 percent range. No matter what we do with interest rates, I think we probably are going to live with overshooting, but we have been doing that for quite a while. The Committee may later decide to bring about a control of M1 to get it in the range. If so, I think we will trigger a recession, and that would concern me too.

MR. BALLEES. Mr. Chairman, I wonder if this would make any sense at all, even though I discarded it in my own thinking: If you are going to raise the upper end of the range by 1/2 point, for the reasons that have been set forth earlier, you could take some of the sting out of the announcement effect of that by dropping the lower end 1/2 point at the same time and making an impassioned speech about the tremendous uncertainties that lie ahead in M1, given the prospect of automatic transfers and how that will turn out--in fact, whether it will turn out. And you could sort of reduce M1 to a memo item type of treatment, which Frank Morris suggested.

MR. PARTEE. But it is very hard to imagine that getting--

CHAIRMAN MILLER. I think that would be perceived [in a way] that might [work] against us. Look, we can live with whatever you vote because we are going to be back [reviewing these long-run ranges again] in three months. We also are going to have a lot of other hot issues around town. To a degree, there will be a divergent interest in this while we do membership and a few other things.

VICE CHAIRMAN VOLCKER. Move the question.

CHAIRMAN MILLER. Will you call the roll, Mr. Broida? Look, I think we need to do this. We need to focus on M1 because it does not look like there is any sentiment that would get a consensus for changing [to] M2 or M3. Let me call your attention to the recommendation in alternative B that the bank credit range be increased by 1 percentage point on each end. Only a couple of you mentioned that specifically. Are all of you accepting of that associated bank credit range? Are there any implications of that higher range that disturb you?

MR. COLDWELL. I would prefer not to make that change.

CHAIRMAN MILLER. Let's vote on that separately. Let us first take M1.

MR. WINN. Point of information, Mr. Chairman: In the bank credit numbers, are we getting the foreign bank credit in that picture or not? Is it just loans to domestic companies?

MR. ETTIN. It's everything except the agencies.

MR. WINN. That is not the branches here but the foreign banks?

MR. ETTIN. Foreign branches and foreign-owned banks operating in the United States are in the statistics; foreign agencies operating in the United States are not. We hope to revise [the definition of bank credit] to include those in 1979.

MR. WALLICH. Loans from foreign banks I think are what you asked about. In other words, Barclays lending [unintelligible]. But that is a big factor in this.

CHAIRMAN MILLER. Doing it without operating through a branch? I don't think it would be picked up, would it Ed? If it is a direct loan from a British bank to a U.S. company, it will not be picked up.

For M1, let us just say maintain or revise upward. We know what we mean.

MR. BROIDA.

Chairman Miller	I would revise upward
Vice Chairman Volcker	Maintain
President Baughman	Maintain
Governor Coldwell	Revise upward
President Eastburn	Maintain
Governor Jackson	Revise upward
Governor Partee	Revise upward
Governor Wallich	Maintain
President Willes	Maintain
President Winn	Maintain

It's 6 to 4 to maintain the M1 range.

CHAIRMAN MILLER. I will switch my vote and go along with the majority. Does anybody else want to be associated with this?

MR. COLDWELL. I see no reason to create a major division on this point because I think we're going to be back at it in October, so I will go with the majority.

MR. PARTEE. I maintain my negative.

CHAIRMAN MILLER. You are going to maintain your negative.

MR. JACKSON. I maintain my position.

CHAIRMAN MILLER. Okay, we have two dissents. All right, thank you very much. Now, on bank credit, do we take the current range or the alternative B range? I am willing to go with the range in alternative B.

MR. BROIDA.

Vice Chairman Volcker	In all honesty, I am willing to go either way
President Baughman	I will take the "B" range

President Coldwell	Current range
President Eastburn	“B”
Governor Jackson	Current
Governor Partee	It doesn't make that much difference; I'd suggest 8 to 11.

CHAIRMAN MILLER. To be consistent with the other vote, you have to go for “B.”

MR. PARTEE. No you don't, because there are an awful lot of sales of non-money instruments.

CHAIRMAN MILLER. All right, go ahead.

MR. BROIDA.

Governor Wallich	“B”
President Willes	“B”
President Winn	I would go for the current range

I guess there are 5 for “B,” 3 for the current range, one no comment, and one 8 to 11.

MR. PARTEE. I will change mine to “B.”

MR. COLDWELL. So will I.

CHAIRMAN MILLER. Anybody else? All right no dissents on that. Thank you very much, I think.

One word: We do need to do some work. We have Larry's suggestion and we have Frank's suggestion and we did not have time, obviously, to [give them much] attention. We know we need to redefine the aggregates. I think the staff had a proposal on that when I first arrived here, which I thought was a very excellent proposal, but the Governors were not interested at the time. Now I find they are.

MR. JACKSON. Correction: Some of the Governors were not interested.

CHAIRMAN MILLER. I'm kidding you. I am just teasing. There were other pressures at the time. I think what we need to do, Steve, is to see how we should organize a method to come back to this Committee with a series of options or possibilities, perhaps through a discussion phase and then a perfecting phase. With all these choices--pluses and minuses or pros and cons for this way or that way--let's get some direction before we do too much detailed work.

MR. ROOS. Mr. Chairman, if it were feasible, could we possibly let an economist from each of these points of view get in the discussion?

CHAIRMAN MILLER. Why don't we get Steve to round up the right kinds of specialists to help us look at the pros and cons of various options?



MR. AXILROD. We will get a balanced group and then I would like to come up with four or five options. I wonder whether we will have three or four dissident opinions.

CHAIRMAN MILLER. No, we don't need that. I think it is more [unintelligible] to go through the exercise. All right now, I think we still have a question from our Secretary.

MR. BROIDA. Mr. Chairman, normally we would record a single vote for the longer-run targets. Is my understanding correct that we will have two dissents and the explanation will be that those members would have preferred raising the upper limit for M1 and that there are no dissents with respect to the bank credit ranges?

CHAIRMAN MILLER. That is right. All right, let's see if we can catch up. We are now at the point where Steve, the Committee's economist, is supposed to have some comments on prospective financial relationships. He did not have any, did he?

MR. AXILROD. No, I have no comments.

CHAIRMAN MILLER. Have we heard from Peter Sternlight yet?

MR. PARTEE. No, he hasn't said a word. No, he [isn't] finished.

CHAIRMAN MILLER. Now we will have the report of open market operations since the [previous] meeting from Peter.

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

CHAIRMAN MILLER. Thank you very much, Peter. We need a vote to ratify the transactions since the previous meeting. Hearing no dissent, we can consider that approved. Steve, do you have any further comments?

MR. AXILROD. No, I don't, Mr. Chairman.

CHAIRMAN MILLER. Considering the thorough discussion we have had on the economy and on the monetary situation, I suggest that I call the names alphabetically, first of the voting member and then of the nonvoting members. I would suggest, if you wouldn't mind, that you first give us a quick rundown--you can refer to page 12 of the Bluebook--on your suggested short-term ranges for M1, M2, the federal funds range, and what you consider [appropriate to do] quickly. Let's see whether we have any wide variances of opinion. If everybody seems to be coming out together, I think we can shorten the discussion. If we have wide variance of opinion, let's come back and air [our differences]. Ernie Baughman.

MR. BAUGHMAN. Mr. Chairman, my views are pretty well captured in alternative C. It seems to me that that would call for a 1/4 point increase in the federal funds rate promptly. It seems to me that the market is expecting it and actually installing it would tend to put the dealers back into a [more] conventional operating position whereas they are operating on an oversold position in the anticipation that something like this is coming along.

CHAIRMAN MILLER. Phil Coldwell.

MR. COLDWELL. Mr. Chairman, my recommendation to the Committee would be encompassed in the following: 4 to 8 percent for M1, 5 to 10 for M2, and a 7-3/4 to 8-1/8 percent funds rate range with a skewed midpoint of 7-7/8, to which I'd move promptly. I do that deliberately.

CHAIRMAN MILLER. I thought it was deliberately.

MR. COLDWELL. I think it is desirable to take another notch in this but not as great as a full 1/4 percentage point on a prompt move. I don't think we have excessive restraint on the economy yet. In fact, I don't really see much restraint in the change. You will note that the ranges as given do move us down and if the Committee is really serious about its 4 to 6-1/2 percent long-run range, it must start moving down from the very high level of M1 growth that has been in effect. Inflation is obviously unsatisfactory--both the present and prospective rates--and I think there are some excess demands both internally and for foreign goods, which can be moderated by monetary policy actions.

CHAIRMAN MILLER. Thank you. Dave.

MR. EASTBURN. Well, I would pause for this month and go with alternative A or B. That would seem to me consistent with the kind of economic uncertainties that were revealed in our discussion. And those aggregates ranges would be satisfactory to me; I would wait and see what happens next.

CHAIRMAN MILLER. Thank you, Dave. Phil Jackson.

MR. JACKSON. I would move up 1/8 on the federal funds range to 7-5/8 to 8-1/8, with instructions to the Desk to go to 7-7/8 promptly. I think the ranges stated for alternative A or B--5 to 9 and 7 to 11--are satisfactory.

CHAIRMAN MILLER. Chuck.

MR. PARTEE. I would go with alternative A or B. I really would have preferred an M1 range of 5 to 10. Remember, we are including July and it still may be a bulge month of some size. So, I guess I would [propose] an alternative M1 range of 5 to 10. I certainly think we have had enough movement in interest rates for the time being. The figures that Peter was reciting on the increases over the last month were very substantial and I do think that we have a lot of restraint in [unintelligible]. It certainly is occurring in the mortgage market in every major city in this country and I think it is broader than that. I think it is part of the explanation for the behavior of the stock market--the increase in capitalization rates that has occurred over the time. So, I would very strongly wish to remain at 7-1/2 to 8 [on the funds rate range] with a 7-3/4 midpoint.

CHAIRMAN MILLER. Thank you, Chuck. Paul.

VICE CHAIRMAN VOLCKER. Well, I think we have a timing problem here, Mr. Chairman. I heard an awful lot of talk this morning, both before and after the break, about the inevitability of interest rates going up. It is an argument whether they are going up by 1 or 2 or 3 percentage points. I'm not at all sure that they are going up as much as 1 percentage point but if it is all that much in that direction, I would rather have a little more of it sooner rather than later. I think it would be a mistake not to move now, so I would certainly go to the 7-3/4 to 8-1/4 percent funds rate criteria and I rather like Governor Coldwell's specifications on the aggregates--moving them a little lower. I actually had 3 to 8 on M1 and 6 to 10 on M2 but his were very similar. I think I'd go to a money market directive with those kinds of aggregate numbers so we don't move too readily above the 8 percent. I would be reluctant to go above that.

CHAIRMAN MILLER. An 8 percent midpoint?

VICE CHAIRMAN VOLCKER. An 8 percent midpoint. I would use the money market directive so that we would not move readily above that but I would allow that possibility. [And I'd move] fairly promptly to give it a nudge.

CHAIRMAN MILLER. Henry.

MR. WALLICH. Well, I think we can do without an interest rate increase at this time. If we do 1/4 every two months we will do 3/4s over the rest of the year to January and I think that is what one can now foresee as likely. So I would stay with 7-3/4. I would like to see an upward move triggered more readily than a downward move, so I would reduce the M1 range to 4 to 8 and the M2 range to 6 to 10, but with a money market directive so that we are in an asymmetrical position. Then it's only when the upper limits get triggered that there should be a move.

CHAIRMAN MILLER. Thank you, Henry. Willis? No, I'm sorry, Mark is next. I am not very alphabetical today. I didn't mean to leave you out, Mark.

MR. WILLES. It might have been just as well, Mr. Chairman! If I could, I'd just make one comment on interest rates, since there seems to be so much concern about rising interest rates. We seem to accept easily the notion that if we want to look at real wages we adjust for inflation, and that if we want to look at what is happening to profits and depreciation, we adjust for inflation. Most of the economic theory that I know says that if you want to look at the real bite of interest rates, you also adjust for inflation. And interest rates adjusted for inflation are not high at all. I think that is the sense that Phil probably means when he says we are not very tight. In fact, we have had negative real rates of interest on Treasury bills, for example, for over two years. This is in contrast with periods in the early '60s and most of the '50s when real rates of interest not only were not negative but they were positive.

I don't see how we can deal effectively, when we are at full employment, with accelerating inflation and still have substantially negative real rates of interest. So it does not bother me to have interest rates go up; I think they should go up. If they don't go up, I think we are simply guaranteeing more rapid rates of inflation, which will then guarantee, in turn, higher interest rates. One of the most stable and profound relationships we have in all of economics is the relationship between inflation and interest rates, and I don't think we hold [inflation] down by failing to move

interest rates up now. So I think we ought to make another move. I think that the federal funds range ought to be 7-3/4 to 8-1/4 and that all of the numbers I have heard so far [for the M1 and M2 ranges] are too high. They will not move us in the direction that we need to go. I think something like 3 to 7 percent would be more appropriate for M1.

CHAIRMAN MILLER. Thank you. We will now come to Willis.

MR. WINN. Thank you, Mr. Chairman. I am concerned about the momentum I see on prices, attitudes, and even real activity, in view of our past experience of waiting and then having to raise rates too sharply. I share Paul's feelings that I would rather do it now than later, as I felt last month. Therefore, I vote for alternative C for the funds rate, with 4 to 8 and 6 to 10 as specifications on the aggregates.

CHAIRMAN MILLER. Thank you. John Balles.

MR. BALLE. I will make this brief because my speech has already been given by several here, especially including Mark Willes. I think we do need to have a link between our short-run and long-term ranges. Unless we move at some point, we are going to have the overshoots everybody has complained about this morning. Therefore, I would go essentially with alternative C, but I would like to see the upper end of those ranges reduced by at least a point or so.

CHAIRMAN MILLER. Thank you very much, John. Bob Black.

MR. BLACK. Mr. Chairman, I would go for 4 to 8 on M1 and 5-1/2 to 9-1/2 on M2. I'd adopt the federal funds range for alternative C, move immediately to 8 percent, and use an aggregates directive.

CHAIRMAN MILLER. Thank you. Roger Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I think we have had quite a lot of movement [in interest rates] and, as a result, I'd prefer not to see an additional movement come out of this meeting. But to insure that we do indeed move if we have strong growth in the aggregates in the intermeeting period, the prescription that I would prefer is 4 to 8 on M1, 5 to 10 on M2, with the existing 7-1/2 to 8 percent funds range, but with an aggregates directive. That means, if I interpret it correctly, that if the July-August growth rate for M1 approaches 7 percent, for example, we would indeed move to 8 and quite likely we would be at 8 percent under those circumstances by this time next month. I think that would be all right, but I would hate to come out of this meeting moving to 8 percent. So, the important aspect of that, in my view, is that we have an aggregates directive with those ranges.

CHAIRMAN MILLER. Thank you, Roger. Bones.

MR. KIMBREL. Mr. Chairman, I would like very much to see us continue to lean against the price trends. And I would like alternative C with the federal funds rate shown there, M1 at 4 to 8, M2 at 5 to 9, and an aggregates directive.

CHAIRMAN MILLER. Bob Mayo.

MR. MAYO. Alternative C is acceptable to me, Mr. Chairman. I would not be in any hurry to get to 8 percent but if it comes naturally in the Desk's operations, I would just let the funds rate go to 8. I wouldn't want to see it go over 8; I would be a little uncomfortable about that without a meeting, but I think "C" is still my preference. And I would accept [the specifications in] "C" on the M1 and M2 ranges as well.

CHAIRMAN MILLER. Thank you. Frank Morris.

MR. MORRIS. Mr. Chairman, I would like to support a federal funds range of 7-1/2 to 8 percent. I would stay at 7-3/4 until the aggregates triggered a move to 8 percent, but I would lower the triggering points to 3 to 7 for M1 and 5 to 9 for M2.

VICE CHAIRMAN VOLCKER. But it is already triggered. By the projections we have, it is already triggered.

MR. MORRIS. It would be triggered if it came in over the projections. The projections are [for M1 growth of] about 7 percent.

CHAIRMAN MILLER. I will now say last but I will not say least, that's for sure. Larry.

MR. ROOS. I would go with [the views of] either John Balles or Mark Willes.

CHAIRMAN MILLER. I thought so. I'm beginning to learn. Well, let me take a quick look at this. Let me suggest to you a couple of thoughts that I have. One is that I believe--and I have said this publicly--that we are in a period of difficult decisionmaking. It has been easy over the last year to raise the federal funds rate 300 basis points or whatever has been done from the low point of last year. Is that right?

MR. PARTEE. [Unintelligible.]

CHAIRMAN MILLER. It has been easy to see all of that in a period when the economy was growing rapidly in real terms and there was considerable slack. Now we have had restraint on for some time. I guess my concern here is that continued restraint, while logical in economic terms, is likely to trigger a recession at this time. And if [we have a recession], I think the stimulating effects of fiscal policy that will [occur as a result] will take away our restraint and we will have accomplished nothing except to leave the Federal Reserve probably in a less effective position to deal [with the situation]. That is why I think this is a very difficult period. If we do what the textbook would tell us to do, we may start a chain of events that will work against us. If we fail to do it, we may regret it, so it is a [difficult decision]. We get paid here for making tough judgments. On balance, I would prefer alternative A or B except that I believe I would narrow the federal funds range to 7-3/4 to 8 percent.

And I liked a suggestion that was given to me for the wording of the directive: The directive would say that if the M1 and M2 rates of growth appeared to be significantly above their

midpoints, we would go up [on the funds rate] but we couldn't go down without a meeting, in effect. So we'd keep it at 7-3/4 and there's no likelihood of it moving lower but we have prospects, as we see the aggregates, of it moving on up to 8 percent. I think that would be my preference. I don't like the situation that has been developing where each day after an FOMC meeting the market takes over and decides that we have raised the rate 1/4 and puts it into effect and then tells us. I think we need a little more chance to regain some flexibility; so that would be my preference. I don't know what the census comes out to. In terms of the midpoint, among the voting members we have four at 7-3/4, two at 7-7/8, and with a couple of questions, four at 8. Is that right?

SPEAKER(?). [Unintelligible.]

CHAIRMAN MILLER. Well, let's ask the question. Mark, did you want to go to 8 percent immediately?

MR. WILLES. Yes.

CHAIRMAN MILLER. And Willis, did you want to go to 8 immediately?

MR. WINN. The timing is not that important.

CHAIRMAN MILLER. So then it really is more like three 8s and the others around 7-3/4 and 7-7/8. I don't know whether or not we have the makings of something where we are all agreeable or not. I don't know if you like my suggestion of a very tight range and we don't go down in that range but could, and probably will, go up to 8 before the next meeting.

MR. PARTEE. Mr. Chairman, I would suggest that the 7-3/4 and 7-7/8 people are very close together. And 7-3/4 to 8 percent is an extremely narrow range; it is much more like a money market directive. How about going to 7-7/8 as the midpoint with that 7-3/4 to 8 percent range and make it a money market directive?

CHAIRMAN MILLER. I have no objection, personally.

MR. PARTEE. I think I would buy that.

MR. COLDWELL. What does that mean, Chuck? You move to 7-7/8 immediately?

MR. PARTEE. Well, pretty soon. There is this financing--

CHAIRMAN MILLER. I will tell you what Peter will tell you. He will have a hard time maintaining 7-7/8 because this is a very, very fine line, isn't it, Peter?

MR. STERNLIGHT. I think it would be difficult to implement. Once we'd gotten there, then the market could perhaps over time be made to understand that is what we wanted. But the process of getting it up just 1/8 without everybody thinking we want it up 1/4 is impossible.

MR. WALLICH. You could tell them.

CHAIRMAN MILLER. Henry Wallich has a novel idea. He said "tell them," just like we have said we've always wanted to do. If Congress would let us, we'd issue the directive this afternoon!

SPEAKER(?). Who's on first?

MR. COLDWELL. Chuck, I think I could buy your formulation if we took the ranges down to around 4 to 8.

MR. PARTEE. I think if you had a money market directive, you might be able to do that.

CHAIRMAN MILLER. Well, let's listen to Peter for a moment. You are going to have a hard time maintaining [an increase of] 1/8.

MR. STERNLIGHT. I think it may be hard to achieve that 7-7/8 without overshooting.

CHAIRMAN MILLER. I think we all ought to be aware of that.

VICE CHAIRMAN VOLCKER. [Unintelligible.]

MR. COLDWELL. [Unintelligible.]

MR. EASTBURN. It might not be the most undesirable thing in the world to have a little uncertainty just as to where that is and let it move.

CHAIRMAN MILLER. Can you operate between 7-3/4 and 8?

MR. STERNLIGHT. I think so, but again, there would be a risk that the market could assume that we wanted 8 and it could take a while to batter it down from the 8 percent level.

MR. JACKSON. I would argue that the operating considerations that you have outlined probably are the best compromise for the diversion of the positions of the people on the [Committee]. That is, shoot at 7-7/8 and recognize that you may miss it [within] about the range of judgments that we have been discussing.

CHAIRMAN MILLER. Steve, do you have any thoughts? You usually have some good thoughts.

MR. AXILROD. Mr. Chairman, I certainly share Peter's view [given] that the market had been at 8 yesterday and it's at 7-15/16 today. It is going to be difficult to fine-tune it. So, I would think that it may be desirable for the Committee to decide whether it should stay right around where it is, whatever that is--if it's a 7-3/4 to 7-7/8 range--until the aggregates more clearly suggest [you ought] to let it go up toward the 8 percent. I think you would end up somewhere above 7-3/4 percent for a while or a shade above. Then if the aggregates come in strong relative to the decided

ranges, you could just let it go to 8. But I think an effort to push it to 7-7/8 will probably push it to 8.

MR. COLDWELL. But an effort to hold it down to 7-3/4 would be difficult

MR. BAUGHMAN. We are already at 7-7/8.

MR. STERNLIGHT. Well, I think we at the Desk would like to have some idea in mind of what we are to aim for.

VICE CHAIRMAN VOLCKER. If I understand these current projections, with the ranges we most recently discussed, you're almost at the point where you would go toward 8 anyway, unless instructed otherwise.

MR. PARTEE. Not with the money market directive.

VICE CHAIRMAN VOLCKER. Well, not quite but darn close to it.

MR. PARTEE. Well, if you take 4 to 8, it really does cut it [close]. There is no question about it.

MR. JACKSON. All you have to do is have one week in July and you are in.

VICE CHAIRMAN VOLCKER. Our projection is already 9.

MR. COLDWELL. Mr. Chairman, I wonder if I might suggest something. I suggest that we formulate instructions to the Desk to resist 8 percent until the end of this week and early next week and then, checking the aggregates, move gradually on up. If it moves to 8, accept it but choose between 7-3/4 and 8.

CHAIRMAN MILLER. What is the Treasury situation this week?

MR. STERNLIGHT. There is an auction of 1-year bills tomorrow and 2-year notes on Thursday. And then they will announce a week from tomorrow the terms of the August refunding, which will probably be about a 6 or 7 billion dollar [offering].

CHAIRMAN MILLER. What is the proper thing to do if we expect to get to 8 percent?

MR. AXILROD. Mr. Chairman, may I suggest that the Committee could simply instruct the Manager to aim at a federal funds rate in the 7-3/4 to 8 percent range over the next few days, without making a strong restraining effort to reduce it. I think that the funds rate then could very likely be up around 7-7/8 to 8 percent because the financings are coming up and you really would not want to give a misleading signal. And then if the aggregates are strong, he would more clearly let it move to around 8. I think that, in effect, sanctions where you are now and doesn't have the Manager taking any strong actions that might be misleading in this period where we are coming up to a large refunding as well as current offerings this week.



CHAIRMAN MILLER. Could that be bought by a majority of the Committee?

VICE CHAIRMAN VOLCKER. We are in effect saying it's going to be played around 7-7/8 to 8 in the very next period.

MR. AXILROD. Or 7-3/4 to 8. It may bounce back to 7-3/4 some days; it may not.

MR. COLDWELL. Let it bounce a bit.

CHAIRMAN MILLER. I don't think there is anything wrong with that. One, two, three, Paul?

VICE CHAIRMAN VOLCKER. That's all right with me, I think. I assume we are going with these lower [M1 and M2 ranges of] 4 to 8 and 5 to 10.

MR. COLDWELL. 4 to 8 and 5 or 6 to 10.

MR. PARTEE. I don't think 5 to 10. I think [the M2 range] ought to be 6 to 10. I don't want to cut it too much [because of] the time deposit component.

CHAIRMAN MILLER. Does 4 to 8 work on that instruction, Steve?

MR. AXILROD. Well, if our projections are anywhere near right, that pretty much assures that we will be at 8 fairly promptly if that is the upper limit of the range.

CHAIRMAN MILLER. That is all you do.

VICE CHAIRMAN VOLCKER. That means you're frozen for the next month.

CHAIRMAN MILLER. That's why I'm not sure if we shouldn't go ahead and have the ranges a little wider, because--

MR. PARTEE. You could make these ranges to 5 to 9 and 7 to 11. I would prefer that.

CHAIRMAN MILLER. Yes, 5 to 9 and 7 to 11 because you're just making a decision to operate at 7-3/4 to 8 and you're really going to be operating at 8 percent at the next meeting.

MR. AXILROD. Our uncertainties about July and the seasonals and all that seem to me to argue for a wide range in this period.

CHAIRMAN MILLER. [If growth is] more than that, we certainly ought to [bring] the Committee back in consultation.

MR. COLDWELL. I don't believe I could accept that high a range. I think that's too much. If we are really headed to try to restrain this, we should not be accepting a 5 to 9 range.

MR. PARTEE. That is a midpoint of 7.

MR. BAUGHMAN. [The midpoint] doesn't mean anything with a money market directive.

VICE CHAIRMAN VOLCKER. Can we try 7-3/4 to 8 on the understanding of 4 to 8 and 6 to 10?

CHAIRMAN MILLER. What was that, please?

VICE CHAIRMAN VOLCKER. Can we try 4 to 8 on M1, 6 to 10 on M2, and 7-3/4 to 8 on the funds rate, conducted in the manner Mr. Axilrod has just described?

MR. PARTEE. With a money market directive.

MR. COLDWELL. Cap it at 8.

VICE CHAIRMAN VOLCKER. That seems to be where we are.

MR. PARTEE. That is as high as I am going to go.

CHAIRMAN MILLER. Yes.

MR. COLDWELL. I'd put the cap at 8-1/4 with a consultation at 8.

VICE CHAIRMAN VOLCKER. Well, I would prefer that but--

MR. JACKSON. If you put an 8 percent cap now, if it's inconsistent, you'll get a consultation anyway. So you get the same result.

MR. COLDWELL. Not necessarily, if we're talking about 7-3/4 being [unintelligible] too.

CHAIRMAN MILLER. Let's see if we can make this wording [acceptable to] get a majority vote here. Let's look on page 3 at the operating paragraph. The first problem is line 57, [or] page 2, line 43. Steve, on the formulation we are talking about, what does that line read?

MR. AXILROD. I think that it could read "about the current level" because that could refer to the last very few days and the Committee understands that as 7-3/4 to 8 percent. So I don't see any problem with that.

CHAIRMAN MILLER. All right, it's "initially at...about the current level." Then "Subsequently, operations shall be directed at maintaining...7-3/4 to 8 percent....In deciding on the specific objective for the federal funds rate the Manager shall be guided mainly by the relationship between the latest estimates of annual rates of growth in the July-August period of M1 and M2 and the following ranges of tolerance:..." Now, 4 to 8 and 6 to 10 have been suggested and I want to ask again, does that create a problem?

VICE CHAIRMAN VOLCKER. It doesn't create a problem for me, but if most people wanted to delay [a rise in] market interest rates--

CHAIRMAN MILLER. All right then as we go on we will say "If, giving approximately equal weight to M1 and M2, their rates of growth appear to be close to or beyond the upper or lower limits...." We will use the money market emphasis. That is a suggestion and proposal. Are we all clear on that? Use 7-3/4 to 8 on line 45, 4 to 8 on line 50, and 6 to 10 on line 54.

MR. COLDWELL. May I get a clarification of the understanding?

CHAIRMAN MILLER. Yes, the understanding is that the current level is above 7-3/4 but not yet at 8.

MR. AXILROD. In the last two days, it has been in the 7-3/4 to 8 percent range.

MR. COLDWELL. I really wanted a clarification that if the M1 and M2 figures came in strong and you moved up to 8 and they still came in strong we would have another consultation.

VICE CHAIRMAN VOLCKER. It is not clear to me--it's a matter of simplification--why we need those lines 42 and 43 that say "shall be directed initially" at one thing and subsequently at another thing. The ranges are narrow anyway. Why don't we just say "during the period until the next regular meeting System open market operations shall be directed at maintaining a weekly average...."

CHAIRMAN MILLER. I like that a little bit.

MR. PARTEE. I think that is perfectly okay with this very narrow range.

CHAIRMAN MILLER. I think that would be perfectly acceptable. Are you with us on that? [Instead of] directed "initially at maintaining" just say "at maintaining" the weekly average within the range, right? Gentlemen, can I have a show of hands of those on the Committee who are voting if that would be acceptable? Yes, a straw vote.

MR. BAUGHMAN. Could you just run through the specific numbers again?

CHAIRMAN MILLER. Now it says "During the period until the next regular meeting, System open market operations shall be directed at maintaining the weekly average federal funds rate within the range of 7-3/4 to 8 percent. In deciding on the specific objective for the federal funds rate the Manager shall be guided mainly by the relationship between the latest estimates of annual rates of growth in the July-August period of M1 and M2 and the following ranges of tolerance: 4 to 8 percent for M1 and 6 to 10 percent for M2. If, giving approximately equal weight to M1 and M2, their rates of growth appear to be close to or beyond the upper or lower limits of the indicated ranges, the objective for the funds rate should be raised or lowered in an orderly fashion within its range." And then we have the regular paragraph about consultations if we are getting out of whack. It doesn't give the Desk much leeway.

SPEAKER(?). It sure doesn't.

CHAIRMAN MILLER. Peter can set the dial and go on vacation.

VICE CHAIRMAN VOLCKER. That is what he intends to do!

CHAIRMAN MILLER. Do you have any final comment before we nail you up on this one?

MR. STERNLIGHT. I think that should be workable, Mr. Chairman.

CHAIRMAN MILLER. Yes, I want it to be workable because we really shouldn't push something on you that is foolish.

VICE CHAIRMAN VOLCKER. It is workable, but I take it on the understanding that the Committee recognizes there is a substantial chance you are going to end up at 8 percent in a week or so.

CHAIRMAN MILLER. [The market will] probably take it away from us. That is probably what will happen. There's nothing wrong with that. Now may we have a show of hands--a straw poll--of those who are voting members? We should be able to count ten, I think.

MR. BROIDA. Seven.

CHAIRMAN MILLER. Those who don't like it?

MR. BROIDA. Three. It adds up.

CHAIRMAN MILLER. Now shall we do an official vote? I'll vote for it.

MR. BROIDA.

Vice Chairman Volcker	Yes
President Baughman	No
Governor Coldwell	Yes
President Eastburn	Yes
Governor Jackson	Yes
Governor Partee	Yes
Governor Wallich	Yes
President Willes	No
President Winn	No

The vote is 7 to 3.

CHAIRMAN MILLER. Gentlemen, we have a vote of 7 to 3. Thank you all very much for your patience. Now we have the matter of item 7; [you received] a memorandum. Tom O'Connell is here to explain it but I think it is self explanatory. And I think we would be wise to leave our

language in force on the assumption that the Congress will act promptly. If it doesn't, we will have to [act]. In the meantime, we can't implement it and we know that. Is that all right with everyone? Then I would like to confirm the date of the next meeting as Tuesday, August 15.

Now I would like to do something that I rarely do at these meetings. I would like to stand up and I would like to say before we have our Executive Session that this is the last meeting at which Art will be present as Secretary. He has been with the government for 37 years and decided he doesn't like it, so he is getting out! He has been with the Board for over 30 years. I have known him only for the short time that I've been here and I have found him to be what you have known him to be--extremely able and a great colleague. He has made my life so pleasant by keeping me in bounds here--running this meeting through me and telling me when to tell you off for speaking too long and that sort of thing, which has made it all workable. It has been a great experience. I am really going to miss you, Art.

If you all don't know this, he has decided to finally take a permanent job. So he will be going to work for the American Enterprise Institute with a fellow you may know, Arthur Burns. They are going to be looking over our shoulder and telling us what we are doing that is wrong. When they look at the last eight years, they will have to explain that to themselves. Art, I just want to wish you all the best on behalf of the Committee and everyone here as well as all the associates from the System. We do wish you well and I will miss you. We hope to see you around now and then.

And now I think we need a short Executive Session before we adjourn for a 1:30 lunch.

SPEAKER(?). Mr. Chairman, may I have just two minutes? I would like to bring to the attention of this group the fact that the financial problems of our city are not all the theatrical exhibitions of our current mayor. We do have a very critical problem in the area, unlike New York City, which managed to get rid of most of the short-term debts and got them over into long-term [borrowings]. We had about \$41 million in short-term debts at the moment the market foreclosed. They have been dipping into the funds and there is a deficit in the various [sinking] fund accounts for the cemetery and the waterworks, and all of the other sorts of setups. There is a current deficit of around \$2 to \$2.2 million a month in terms of the general funds account and the city has outstanding debts against the electric illuminating company [unintelligible] and total about \$3 million. [There are] debts against the gas company, [which] has not collected, and the telephone company; all of their accounts have continued to run. The banks are not heavily exposed in terms of any single one in this area but I think it's really going to call public attention to the fact that in the first place most of the government accounts are not audited and second that there has been a great deal of transfer from one fund to another--the [unintelligible] concept in terms of the management of city financing departments. I think this is going to come to a head with some very hard choices for communities. We have in addition a school system that is also bankrupt or virtually close to it because under the integration order they can't get any tax increases passed. They have already tried two or three times now. Both of these factors are going to come to [a head] this fall irrespective of what happens in terms of--

CHAIRMAN MILLER. It is a tragedy isn't it, to see that happen? Thank you for your report. We will now go into Executive Session.

Is John here now? Gentlemen, last meeting we had a discussion, as you know, of the security situation. I know that it was a new subject and that not everyone felt there was adequate time to deal with the issue. We are back here today, by popular request, to allow for further thoughts and expressions. Those who have access to information about security feel there is a real danger. I think we have pretty good information that there has been an interception and a pretty good sense that there may be abusive use of that information for financial advantage. We can't prove that, probably, and we all want to work toward a secure voice communication system, which will allow us to maintain the present [practices], but we have cost and time inhibitions. The question was whether we could have an interim procedure for a period of time. We are looking first toward immediately getting a completely secure line between the Board and the New York Federal Reserve Bank. And ultimately we're looking toward technological development that would allow a completely secure line to all the Reserve Banks or if not, whether we couldn't have an interim procedure at some point with the leased lines and a certain reduction of risk.

John would you just add anything you want to add? Let's see how people feel about it. The procedure had been suggested that certain sensitive information--the [Desk's] program, for example--be omitted from the morning calls or that the President be omitted from the calls and that a Governor here on a secure line might monitor the situation during the interim until we get a secure system for the entire network. We weren't authorizing spending \$850 million at the moment; we were authorizing the first step to get a secure line from Washington to New York.

MR. DENKLER. The critical aspect, technically, is that of extending beyond just a point-to-point link between here and New York. As we pointed out earlier, any conferencing of three or more stations involves a rather astronomical rise in cost. To tie in the twelve Reserve Banks with the Board would amount to about \$800,000, over half of which would be just the so-called conference bridge that is necessary to tie in the twelve stations. So we are proceeding with the point-to-point link, which will provide secure communications between here and New York. At the same time, somewhat coincidental of that, we are going ahead with the plan to link all the Banks with cable--safe telephone communications that will provide a modicum of security. It will provide security against the most vulnerable aspect of regular telephone communications--that is, microwave, which is very easily intercepted. Now, of course, that in our present mode would not be used for the morning market call. There would be no way of tying in another Bank [and having it] secure between here and New York and that Bank. So, we are up against the technical problems of that.

VICE CHAIRMAN VOLCKER. Why can't you use [unintelligible]?

MR. DENKLER. Because the secure link would be between Washington and New York. To add a third station requires a conferencing capability; you can't have half secure and half open.

CHAIRMAN MILLER. The unsecured line can't hear the secure lines, so you have to go to an unsecured line to deal with the whole thing. That is the problem. You would have to go unsecured from New York to Washington, which is very vulnerable to being tapped, because it is well known [that communications between the two occur]. And the cable can be tapped at so many points that it is extremely vulnerable.

MR. DENKLER. The Washington and New York areas are the ones that are most vulnerable to microwave intercept.

CHAIRMAN MILLER. A land line is vulnerable to being tapped.

MR. COLDWELL. It is a discrete tap.

VICE CHAIRMAN VOLCKER. I am sure you can, but how vulnerable is it? How much is the difference between-- Let me state the question straightforwardly. As I understood from earlier discussions, and as I thought of it myself after the previous meeting, the question that I have and I think some others had is: Given the microwave is too vulnerable--we will assume that for the moment--isn't there a large difference in vulnerability between the microwave and the leased line without going to the secure link? And if that is true, is it possible to continue on the leased line basis, possibly pending the secure link, which some people think may be worth it? I would add: if the quality is good enough. If the quality is mediocre, forget about it, based on my earlier experience with these things. If the quality is really good maybe it is worth the \$800,000. You can use it for a variety of purposes.

CHAIRMAN MILLER. Well, I am from Missouri on spending \$800,000 because the only things you'd use the line for are unsecured other uses. You wouldn't use it for other secure uses. So you can get the leased lines and [save] money on it.

VICE CHAIRMAN VOLCKER. You could use it for Committee meetings and--

CHAIRMAN MILLER. Well, that is so rare.

MR. PARTEE. Wouldn't the problem in your suggestion be that the obvious line to tap would be the New York to Washington line?

CHAIRMAN MILLER. Sure.

VICE CHAIRMAN VOLCKER. Sure, but how "easy" is it on that line? I don't know.

CHAIRMAN MILLER. Extremely. The thing is that now foreign agencies are undoubtedly monitoring by microwave. Those same foreign agencies would have to employ another technique. They can't do it from their physical facilities. They would have to have somebody go out and do it. They can hire those people, to be perfectly blunt, for a fee. Then you also open it up to non-foreign interveners who think there is a lot of money to be made through organized crime by tapping into financial information. We don't know whether they have been active or not, but foreign [entities] have been active and could very easily just say fine, if we can't get it by microwave, we can get it by tap. I don't say that their risk is less because they have to go through the trouble and they could always possibly be detected in some sort of maintenance program. But those wires are just in so many places, and they are so relatively easy to identify. The taps nowadays, I believe, actually can be done without a physical connection, too, which makes that even more vulnerable. That is a fairly new technique. All you need is, in effect, an induced sensor

that will pick up and translate this into voice. So it is not that hard, and it's mobile. It can be done anytime and over and over again. Bob.

MR. MAYO. Mr. Chairman, I have thought long and hard before deciding to say this, but I guess partly growing out of my experience in the Nixon cabinet, I must question the basic premise. We say here it is known that information from these intercepts is being used, among other things, to develop economic intelligence on the United States and to improve the bargaining position of foreign governments in dealings with public and private organizations in the United States. I think I am a fairly imaginative guy, but I can't quite figure out how any information derived from the morning call, most of which--with a couple of key exceptions--is known by the end of the day anyway, is going to affect one way or another the evaluation of the economic intelligence information on the United States.

In the absence of any known threat in this regard--that is, known to me--I then turn [to whether it] is also possible that information gained from telephone eavesdropping is being used to engage in financial market dealings for the purpose of financial gain. Do we actually have any evidence that any dealer or any broker, or any outsider for that matter, is capitalizing on this? I must say that there is a tendency that exists in the government--and I think particularly in the Federal Reserve, Mr. Chairman, for understandable reasons [because] we must be secure on so many of our operations--[to exaggerate]. I don't feel that this is a security risk, though I realize I am probably talking about something that I have only partial information on. But I am concerned that we may engage in an exaggerated response where the actual threat is kind of a bogeyman. Am I out of order in saying this?

CHAIRMAN MILLER. No, no, not at all. We must explore this. On the first point--John, you will have to clarify this--I understood the information to be just a report on what microwave intercepts are being used for. It had nothing to do with the Federal Reserve, but was generally on how they are being used. And I think there is pretty strong evidence that in wheat transactions or whatnot they have been used to substantial advantage and may even have caused some of the inflationary problems we are dealing with around this table in terms of what happened in 1973. I don't know, but that is the evidence. In terms of other market transactions, I don't know. There is a pretty good indication that we are a target to being intercepted now. Then you begin to break down. No, I don't know of any linkage that can tell us of a transaction that took place by using this intercept to go short or to buy securities in knowledge of a market movement by the Federal Reserve. But the problem is that we don't know how they use it or where, or even in what secondary markets it could be used. It is certainly true in our experience that the foreign powers involved have no qualms about making money if it gives them off balance sheet funds.

MR. MAYO. Well, I can see the potential threat and I suppose an ounce of prevention is worth a pound of cure. But I don't see any real threat and I personally am willing to take the risk. But, of course, I am not in your position, so I--

CHAIRMAN MILLER. No, I think we should do this together. If the value of the morning market call monitored by a President rather than a Governor has enough benefit--public benefit and benefit to the System--to outweigh that potential risk which is undefined, then we should go ahead with the calls. If the benefit of that call outweighs the risks, we should continue for a period of



time--for two or three or however many years we need to get to where we have new technology that will make this [secure communication] more realistically available.

MR. MAYO. I think it does, Mr. Chairman, if I may continue just for a moment. Granted, there are many occasions when our participation as individual Presidents monitoring the call consists of saying "yes" and "I haven't any comments" when the approach [being contemplated] is more or less an orthodox one. But there have been many, many occasions in my experience--and I know some of the others I have talked to about this feel the same way given their experience--where there has been a positive contribution. There is rarely a Governor on the call; Paul doesn't participate in it because his people are there. I think it is perhaps important that one of us do it. And I must say, selfishly, from a regional standpoint that I think it is part of my job description to be able to say to my board of directors and to my banks that yes, one of my functions is the participation, when called upon, to serve my duty on the morning call. It keeps the System as a whole in a much more orderly way of looking at things.

CHAIRMAN MILLER. Well, Bob, I think we all ought to decide. The point, I guess, was to leave it unchanged--not that a Governor would be monitoring but we'd make that assignment if we went this way. We haven't implemented this yet, as I understand it. We are still doing it the way it was. Is that correct?

SPEAKER(?). Yes.

MR. MAYO. You haven't very many Governors even when you have seven, and there is so much work to do. I think it--

CHAIRMAN MILLER. Well, would you please write a letter to the Senate and House Banking Committees to explain that to them?

MR. PARTEE. The only comment I was going to make, Mr. Chairman--I'm sure everybody is quite aware of it--is that of course any President or Governor is quite welcome to join the call either here at the Board or in New York even.

MR. MAYO. Sure. That is true.

CHAIRMAN MILLER. Yes, no doubt about that.

MR. MAYO. But it's haphazard. That is physical presence by chance.

CHAIRMAN MILLER. That is by chance.

MR. PARTEE. That's right.

CHAIRMAN MILLER. If you were in New York or if you were here, you could do it. But you could not if you were in neither of those places.

MR. JACKSON. I think the only discussion we ought to have is not whether the cost of getting a secure line to New York is--

MR. MAYO. The cost is not material to my point.

MR. JACKSON. We ought to do that. The only discussion is whether we extend it throughout the System. It is my judgment that [that decision] could well be made by all of you collectively and individually to see whether or not you think spending \$850,000 is worth it.

MR. MAYO. Well, it probably isn't quite that simple though, Phil, at this point. What I am arguing for is the status quo.

MR. JACKSON. You are arguing for not even putting in the secure line between here and New York?

MR. MAYO. I see no objection to that.

CHAIRMAN MILLER. It won't do us any good.

MR. MAYO. It wouldn't do you any good if you have an outsider on the call.

VICE CHAIRMAN VOLCKER. It would be an improvement to have leased lines. I think everybody would agree with some improvement in the--

MR. MAYO. I think that's right.

CHAIRMAN MILLER. Well, we can use them for other things.

VICE CHAIRMAN VOLCKER. Sure.

CHAIRMAN MILLER. But not with the cost of the secure--

MR. ROOS. Paul, have your people indicated how often--this can be rough--any of us Presidents ever adds anything to that call? I ask because I sure as hell don't. Maybe it is my own weakness or ineptitude--I'm using that word again. Our people think it is a laughable process.

VICE CHAIRMAN VOLCKER. I've talked to quite a few of you individually about this since the last meeting and many of you have raised it with me. Peter can talk directly on how many Presidents ever say anything specifically. I think there is quite a different attitude among some of the Presidents. Some of them do feel it's important to stay in touch and keep their people in touch. And I think I can say from the standpoint of the Desk that it is a disappointment to them to know they have to present their thoughts in an orderly way--and kind of pass scrutiny even--if nobody says anything for three months in a row. On balance, I think it is a healthy thing for them to have to present the program in an orderly way. But my--

MR. PARTEE. And they wouldn't feel that way if it was just a Governor!

VICE CHAIRMAN VOLCKER. No, the second part you'd get the Governor; the first part obviously you can't.

CHAIRMAN MILLER. The reason for the monitoring by the substitute Governor was to have that discipline. But there was another suggestion I had made and that is that there is no reason not to give the President a rundown on the market situation, all of which is publicly known, and inform him later in the day of the action. And the President can critique it and say, "That was a mistake; learn from that and don't do it again." It is not correcting in advance but correcting after the fact--that kind of approach.

MR. MAYO. But it is difficult, Mr. Chairman, for any President to read between the lines as to the reasons and so forth. The telegram is cold.

CHAIRMAN MILLER. After [the program] has been implemented, of course, [someone from the Desk] can call you and explain it to you in complete detail. He can say this is why we did this and we want you to know why and please if you have any thoughts in thinking about tomorrow and so forth, is this the kind of approach that makes sense?

VICE CHAIRMAN VOLCKER. My recollection of this, going back to the mid-1950s when I was once upon a time on the Desk, was that it was supposed to be a Governor and a President on the call. And through the years the Governor fell off.

MR. MAYO. Disappeared. I think that is right, Paul.

MR. WALLICH. One reason is the timing of Board meetings.

CHAIRMAN MILLER. Yes. Well, what is your pleasure, gentlemen? This is a case where there is certainly no built-in fixed position on our part.

MR. MORRIS. My feeling frankly, Mr. Chairman, is that we can get by for a while without the participation of the Presidents but that we ought to seek to develop a secure communication system, which we could use for a lot of other things as well.

CHAIRMAN MILLER. I think in several years, with the growth in the market for this sort of thing--it is going to be needed more and more just for commercial reasons because the intercepts are very damaging to all kinds of communications. You are going to find more and more equipment and costs coming down and more and more techniques. Look what happened if you bought the first mini-computer: Five years later you could buy six times the power for one [half] the cost of the original. And that is what is going to happen here. That's why I'm not worried about our solving it long term. I'm just a little bit stingy about spending \$850,000 when I think probably for a quarter million dollars in three or four years you will get a better deal.

VICE CHAIRMAN VOLCKER. You cannot hook an ordinary lease in New York or Washington--one that is secure. The garbage in between is the problem.

CHAIRMAN MILLER. You can have two phones. A guy can be talking with two phones.

SPEAKER(?). Maybe I didn't understand the question.

CHAIRMAN MILLER. Are you talking about extensions?

VICE CHAIRMAN VOLCKER. I would think the most vulnerable link is between New York and Washington. That is where everybody is looking.

CHAIRMAN MILLER. That could be secure. And you can't be on the same line and understand that elsewhere, but you could be on a separate line.

VICE CHAIRMAN VOLCKER. Even if it is unscrambled with one hand and transmitted through a box onto the other speaker.

MR. AXILROD. You would have an elaborate system there. Peter might be able to give all the unsecured information on the regular call on the leased line and give the secure information to the Board on the squawk box and then communicate one or two seconds later on the regular handset to the Presidents.

VICE CHAIRMAN VOLCKER. You can't connect them up electronically, then?

MR. AXILROD. No, but you could do it at least two ways.

CHAIRMAN MILLER. It would be far too expensive to connect it electronically. It would be a whole research department project.

MR. BALLE. Mr. Chairman, I wonder if there is some possibility of beefing up the content of the daily wire that all of us get in any event. Admittedly, it is after, rather than before, the fact, but that would not preclude a one-day-later critique or whatever, if that could be done. Speaking personally, that would be a perfectly adequate solution. I would feel pretty much the way Frank has expressed himself, as long as we weren't precluded from critiquing the [program] even if it is after the event. My experience is that it has [not] occurred often but, when it does occur, it seems important. I don't see that we would be prevented from a little postmortem instead of a comment prior to the time the program is imposed. And I don't think much would be lost in the process.

CHAIRMAN MILLER. Dave, do you have a comment?

MR. EASTBURN. Well, I would support that for another reason. And that is that in my experience the most frequent contribution that a President makes in the phone calls is not on the techniques of the day-to-day call but if he feels the Desk is not moving promptly enough or is moving overly promptly [relative] to the directions of the Committee. [The President on the call] is kind of a burr in the saddle. And I think he could be as effective at that after he has had the news as he is at the moment [of the call] because it is a day-by-day cumulative process.

CHAIRMAN MILLER. Well, certainly, before implementing anything we should work out a procedure. We should have an assigned President to continue to be in the loop in some way. That is certainly true. How do others feel?

MR. GUFFEY. Mr. Chairman, I would endorse what Bob has said. I think it is important to maintain the integrity of the System, as it has been in the past. I would ask a question that has not been raised otherwise as to whether or not the supplier of this material--and I'm talking about the bridge principally, which I understand is the big cost item--who wants to develop and market this is prepared to go on a lease arrangement with us for some time to prove the product. We indeed used this arrangement when I was on the call last year. Apparently there was a bridge in place at that time. We were using a scrambling device. I was talking to Kansas City and I had a device set in my office. What I am really suggesting is that a cooperative effort or some sort of reasonable lease arrangement might be possible.

MR. DENKLER. I do know that they will lease the security equipment itself on the bridge. I have not asked that question.

MR. GUFFEY. It seems to me that they are new in the business and if the Chairman's forecast is right--if mass development is going to take place in the period to come--this company will be in the forefront. And if they have us as a touchstone to sell, it may be very advantageous for them. I would like to see us look into that.

CHAIRMAN MILLER. The thing with that is that you pay for it, though, [in] a lease. Also, I think that--

MR. GUFFEY. You would want [the cost] to be reasonable.

MR. DENKLER. At this stage of the game, it would be a unique--

MR. MAYO. But I understand there is also competition in this, Mr. Chairman. There is at least one other company--it has three initials--with the same research and offering the same service and it expects to come out with something.

CHAIRMAN MILLER. We hope this competition is going to develop.

MR. MAYO. Well, that may work [in favor of going] the lease way.

CHAIRMAN MILLER. This particular system has been being developed for several years at Rome airbase through an Air Force contract, and is reported to us to be one of the most--

MR. DENKLER. It may be that there are other alternatives, Mr. Chairman. I am continuing to look at them. The demand in the private sector is very strong right now, as you say, for this type of solution. If suddenly one should appear, I certainly would be very interested.

MR. MORRIS. Mr. Chairman, when we look for this new system, I think we are in dire need of a greatly improved hard copy transmission system as well.

CHAIRMAN MILLER. Yes, we are going to do that. We need [to assess the] fallout of this whole discussion. I think we are undoubtedly going to lease lines where we would have control of our network and could use them 24 hours a day to transmit facsimile on a high speed basis. We are testing now and the pay-out for that will make this all very economical. You don't get a pay-out for the other. You make one call a day for an enormous investment and maybe one call every quarter for the FOMC.

MR. MAYO. The wire has a delay of 2 to 3 hours; at least that is my experience.

CHAIRMAN MILLER. Oh yes.

MR. MAYO. And the facsimile could, I think, be done immediately.

CHAIRMAN MILLER. If we get that done, you are going to get a much better copy, a much more readable copy. Some of this other stuff is very hard to decipher.

MR. AXILROD. The wire actually is done here around 12:30 or 12:45.

SPEAKER(?). I will secure that wire, by the way.

MR. GUFFEY. We don't get it until after 1:00 or 1:30 our time in Kansas City.

MR. COLDWELL. Mr. Chairman, I think we ought to go ahead with the New York lease line arrangement and work toward the idea of additional hookups and the security device.

CHAIRMAN MILLER. Why don't we also, Phil, draw up a procedure that takes account of a system that would keep a monitoring President in the loop to the maximum degree we can and puts a Governor specifically in the loop? And let's work toward the proposition that we want to return to the present system whenever we can get a feeling of security--when the equipment is available and the costs are right. [We'll move] promptly to improve our facsimile transmission.

MR. BALLEES. [Unintelligible] out of the Board then.

CHAIRMAN MILLER. What is the security on that line?

MR. PARTEE. But it's after the fact.

CHAIRMAN MILLER. Yes, the reason that is not considered secure is that everybody in the market knows by then.

MR. MAYO. But it really isn't after the fact. It indicates that there may another round of repurchase agreements necessary in the afternoon and so forth. So it is a real--

MR. AXILROD. [It provides] preliminary indications of the aggregates [figures].

MR. MAYO. Sure.

MR. AXILROD. They are not quantitative, because the quantitative--

CHAIRMAN MILLER. Yes, all of these things need to be better secured, there is no question. And that can be done. I think if you can get a lease line with the facsimile you're going to get much better security. As I said, we are going to have a 3:00 lunch. Nothing will happen in thirty days; we are going to keep exploring it. Gentlemen, the Presidents will meet in this room after lunch. We have just one brief item.

END OF MEETING