

## TRANSCRIPT

### FEDERAL OPEN MARKET COMMITTEE MEETING

January 17, 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. Truman, Associate Economist  
Mr. Pardee, Deputy Manager for Foreign Operations  
Mr. Kichline, Associate Economist (2)  
Mr. Zeisel, Associate Economist  
Mr. Sternlight, Deputy Manager for Domestic Operations  
Mr. Axilrod, Economist

1/17/78

Meeting of Federal Open Market Committee

January 17, 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, January 17, 1978, at 9:00 a.m.

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

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

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

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

Messrs. Balbach, T. Davis, Kichline, Scheld, Truman, and Zeisel, Associate Economists

1/17/78

- 2 -

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

Messrs. Coyne and Keir, Assistants to the Board of  
Governors

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

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

Mr. McIntosh, First Vice President, Federal Reserve  
Bank of Boston

Messrs. Boehne, J. Davis, and Parthemos, Senior  
Vice Presidents, Federal Reserve Banks of  
Philadelphia, Cleveland, and Richmond,  
respectively

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

Mr. Kareken, Economic Adviser, Federal Reserve  
Bank of Minneapolis

Ms. Lovett, Securities Trading Officer, Federal  
Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of  
January 17, 1978

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

CHAIRMAN BURNS. Well, we've had Mr. Truman's report. Are there any questions or comments? Mr. Wallich, please.

MR. WALLICH. The judgment that you expressed, Ted, does that imply that there will be a cessation of or substantial reduction of official intervention from the \$36 billion you mentioned and, if so, that the financing of the current account deficit would have to be partly or wholly by private capital?

MR. TRUMAN. Well, that of course is one of the uncertainties. So far, we've seen an increase in official financing in the last three quarters or so. Certainly, one of the questions is if such official financing does cease--or ceases to be on the same scale--will private financing be available at an unchanged or a rising or falling exchange rate? Looking at the capital account transactions for the past and into the future, it does seem possible that such would be the case. But, I don't think we have any assurance that it will.

CHAIRMAN BURNS. I don't understand that statement. If official financing ceases, it will have to be private financing. The only question is at what exchange rate.

MR. TRUMAN. Right. I tried to insert that--

CHAIRMAN BURNS. Yes, but the question is: At what exchange rate?

MR. TRUMAN. Right, I agree.

CHAIRMAN BURNS. And what opinion are you expressing, if any?

MR. TRUMAN. Agnosticism.

CHAIRMAN BURNS. Well, I'm not an agnostic. I think that if official financing ceased in the absence of some highly significant new actions on the part of this government, private financing would be available at a significantly lower dollar exchange rate. Mr. Partee.

MR. PARTEE. Ted, you reflected on this 7-1/2 to 10 percent, I think you said, decline in the inflation-weighted price of the dollar as perhaps indicating that [the dollar] could be undervalued relative to other currencies. But if that were the case, wouldn't you think that that would be showing up in the trade data with a reduction in imports and an increase in exports?

MR. TRUMAN. Well, most of that improvement has come since the end of September, and that's a little too [recent].

MR. PARTEE. What kind of lags do you have on that response?

MR. TRUMAN. Well, the standard results that the Board staff uses suggest that in general you get a small response to the depreciation on the trade balance four quarters out. That would suggest that you'd have to wait until close to the end of this year before you would get a positive response, and you have an initial negative response, most of which would be occurring under the normal pattern in the current quarter [to] the third quarter. The price adjustment is quite quick; the quantity response is just more delayed and, therefore, the trade balance initially--

MR. PARTEE. Tends to turn adverse.

MR. TRUMAN. Right.

MR. PARTEE. Yes, I understand. But, as I recall, you don't have an improvement for the year in that current account balance.

MR. TRUMAN. No, one of the reasons why, compared with last month, the staff projection shows a flattening out of the trade deficit--but only one of the reasons--is the depreciation of the dollar that we have had over the last three or four months. But, on balance, that might subtract \$1 or \$2 billion from the trade deficit at the end of this year. Most of that [improvement], if it all came and if history is any guide, would come in 1979.

MR. MAYO. Do you consider, Ted, that the new Japanese agreement will contribute anything toward an improvement?

MR. TRUMAN. The trade aspects of the agreement itself--leaving aside the aggregate demand aspects, which could be substantial if they're successful, though one has some skepticism [about that]--shouldn't be too significant directly in an aggregate sense. For example, [the Japanese] promised to reduce tariffs by 10 percent on \$2 billion worth of imports. That's all a volume pass-through, and you're talking about \$200 million, which is not very much. On the other hand, I think there's probably more significance in the fact that there was an agreement--and some foreign producers necessarily are going to hesitate, one would think--to push rapidly further penetration of the U.S. market over the next year because they have seen what can happen.

MR. COLDWELL. Ted, have you seen any evidence of a shift in leads and lags of commercial payments aggravating this pressure on the dollar?

MR. TRUMAN. The data that we have on that are first of all not very good to begin with whenever we do get them, and second they're in part delayed. The evidence that we have--a little bit from the third quarter and for the first two months of the fourth quarter--suggests that in the areas where we don't have data, essentially trade, they will probably be negative in the fourth quarter. We do have data on trade and bank-reported capital flows of security transactions, so where we don't have data on those kinds of transactions--corporate financial transactions--there are reporting errors and omissions. Errors and omissions went negative in the third quarter and it

appears that they will probably also be negative in the fourth quarter, which suggests that they've been running substantially positive--that there have been some [shifts in] leads and lags in pressure on the dollar. But it's [only] suggestive.

MR. [WILLES]. Litton Microwave is headquartered in our District. It was interesting to me yesterday, going back to something you were talking about, Chuck, that after the TV imports were shut off by that agreement, the Japanese converted some of their TV production lines to microwave production lines. We were quite concerned about the impact that would have on trade. But the president of that [Litton] division told me yesterday that with the change in the exchange rates, in the last two months he has again become very competitive with Japanese microwaves--not so much in Japan, where it's a nonprice problem, but in this country and in other countries where the United States and Japan are both trying to put microwave ovens into those countries. So the price--at least in that one relatively small case--clearly seems to be having a very dramatic effect both on what's happening right now and on their outlook for the coming year, which is now much more positive than it was even two or three months ago.

CHAIRMAN BURNS. Mr. Volcker, please.

VICE CHAIRMAN VOLCKER. Well, just a couple of observations, Mr. Chairman. I think all the evidence we have suggests that this trade balance is going to be hard to turn around in any short period of time. And all the evidence we've had since 1971 on the exchange rate changes doesn't suggest that changes come very quickly. The aggregate demand side is very important and we do have a problem of changes in the exchange rate--in some key countries anyway--possibly aggravating the prospects for expansion in those countries and [thus] having a bigger effect on the trade balance short run than the price effects of the depreciation will.

But, I'd like also to look through the other end of the telescope, as it were, in connection with your observation. I think you've made a fair observation that if things aren't done right, we're not going to have private capital inflow at present exchange rates. But I would hope that the converse is also true. If people have a reasonable degree of confidence in what we're doing--and confidence has obviously been very low--and if they have some sense of stability about the exchange rate, it is possible to get a private capital inflow that would finance the current account deficit at a reasonably stable exchange rate. But it's not going to come automatically. Things have to be done to inspire the confidence that the exchange rate will indeed be stable.

CHAIRMAN BURNS. Exactly. Well, if I have the staff's estimates accurately in mind--and you can correct me, Mr. Truman--for 1977 we had a trade deficit of approximately \$30 billion and a current account deficit of approximately \$18 billion. Additions to the reserves of foreign central banks held here, excluding OPEC because OPEC operates the way private individuals or concerns do, were \$28 billion. Therefore, we had a capital outflow of \$10 billion. If foreign central banks refuse to add \$1--this is an extreme assumption, obviously--to their holdings of dollar assets, and if we accept the staff projections for 1978, which do not deviate by more than a decimal from what was achieved during 1977, we'd have a tremendous problem of attracting sufficient private holdings of dollars or dollar assets. It could be done, but not by standing still in the realm of

economic or financial policy. That is, it will be done at some exchange rate, but to do it at anything like the present exchange rate, I think will require very strong and determined financial policy by this country.

MR. PARTEE. One often used to hear, Mr. Chairman, about leads and lags in connection with other countries--I don't seem to have heard the term used with regard to the United States. [I think you said] that the leads and lags have gone against us over this past year.

MR. TRUMAN. Yes, that's what I said.

MR. PARTEE. And there's [unintelligible] of rate change that could occur that could amount to \$10 or \$15 billion or in that area.

CHAIRMAN BURNS. You know, just for the sake of one or two individuals like myself who do not understand technical terms like leads or lags, Mr. Truman, would you explain what it is that we're talking about?

MR. TRUMAN. Well, the simplest way to explain it, I think, Mr. Chairman, is this. If you have an importer, for example, who has to make payment in foreign currency for something he has imported and he thinks that the dollar is going to decline further, he accelerates that payment. He makes it today--borrowing dollars here maybe--rather than tomorrow. It's for economic reasons. That's a lead.

MR. PARTEE. That's a lead.

MR. WALLICH. There is another aspect, though, and that is with respect to [relative] interest rates. Now, you may not put that under leads and lags, but essentially as interest rates rise in the United States relative to elsewhere, people will try to finance their foreign trade in the low interest rate countries. And that again sets up a capital movement that can be very large. I was inclined to think that what Chuck had in mind was this effect.

MR. PARTEE. I had in mind the whole financing effect--the very short-run financing and payment effect, which I think can snap. It's sort of like an inventory change. It can algebraically amount to an awful lot from one quarter to another. I suppose it has been against us and it could go for us. So the sort of more permanent financing problem, so to speak, might not be as large as the Chairman suggests.

VICE CHAIRMAN VOLCKER. Well, if the figures I have in front of me are correct, we had a positive errors and omissions of almost \$10 billion in '76, and a minus, which includes some guessing, of \$3-1/2 billion in '77. That is a swing of \$12 billion or so. Most of the year, of course, had been exceptionally high positives in '76, so I don't know if we'll go back to that.

CHAIRMAN BURNS. Mr. Roos, please.

MR. ROOS. Can I ask two questions? Perhaps they are naive and reflect my lack of knowledge in this field. First of all, if there were a further substantial decline in the exchange value of the dollar under circumstances such as you described, what are the practical problems associated with that? And the second question, if I may, [relates to] signaling to the world our determination to take actions that will in the long run reduce the inflationary trend of our economy as related to other economies involved in dollar exchange transactions. If we from a monetary policy point of view signaled in a meaningful way, in a dramatic way, corrective action in terms of reducing money growth or something like that, is that a major factor that could affect the value of the dollar? Or is that just one of many factors that are equally important in terms of establishing the dollar's value?

CHAIRMAN BURNS. Well, I think that an increase in interest rates would be helpful in making private citizens and business firms around the world more willing to hold dollars or dollar assets. I don't think there's any doubt about that. But in my judgment it would be only the beginnings of an answer. I think the main answer is to be found, even in the way of a bridging action, by selling Treasury securities to private holders abroad. That's something that in my judgment ought to be done and done immediately on a significant scale. And it can be done. It can be done in various ways. As for fundamental corrective actions, I can see only four paths. One is the passage of an energy bill, which would assure the world that we will be conserving oil on some scale and more important that we will be stimulating the development of new sources of energy supply. Second, I think we need an anti-inflation policy on the part of the Administration, something we don't have at the present time. Third, we need tax legislation that is designed to stimulate foreign investment in this country, business investment as well as domestic. That is, direct investment or portfolio investment. Now, these three roads to a fundamental cure are available to us; they are within our power in this country. The fourth avenue is outside of our power--namely, faster economic expansion in the economies in the rest of the world. So, there is something that the Federal Reserve can do. And I think we've taken significant steps in that direction directly and by way of stimulating the Treasury and the Administration, but I think what has happened so far is only the beginning of what needs to be done.

MR. ROOS. If intervention in support of the dollar were to discontinue and there was a further substantial drop in the value of the dollar, does that have all kinds of frightening--

CHAIRMAN BURNS. Well, in my judgment it has. The conventional theory, which is still heard in Washington now and then, here and there, is that when the dollar depreciates, the depreciation will cause exports to expand, imports to shrink, the trade balance to narrow, employment to rise, unemployment to decline, and that is, therefore, one of the major highways to a national prosperity. Now, that conventional theory has a significant element of validity for many countries in the world, but not for the United States. That's because, first, world trade is denominated preponderantly in dollars. Secondly, and far more important, the dollar is a store of value for central banks, multi-national corporations all around the world and also individuals--people of wealth and means all around the world, not only Americans. And when the dollar depreciates, some will seek cover by acquiring other currencies, which means that the dollar will depreciate further. Most individuals and business firms will simply hold on to their dollars and



squirm and wonder in anguish about the future. And when people are in that state of mind, normally they're likely to postpone, if not shelve, spending or investing decisions that they were previously on the threshold of making. And, therefore, a state of semi-paralysis could spread around the world. On top of that, as Paul Volcker very clearly stated at our previous meeting, in some major countries whose currency has appreciated dramatically in recent months, economic stagnation if not actual recession may set in because of the adverse effects of an appreciating exchange rate on export industries. And as far as the United States is concerned, the negative influence stemming from such a deterioration of this or that foreign economy may more than swamp the positive influence on our trade that may flow from the kind of influence that Mark Willes described for this or that firm before. On top of that, and third, in the kind of atmosphere that may be generated in an environment in which the world's major currency depreciates, protectionism may easily spread, here and elsewhere and thereby serve to shrink world trade and world economic development at large. Therefore, I think we're dealing with a very serious threat not only to our own prosperity but to the continuance of prosperity around the world. Mr. Partee.

MR. PARTEE. Well, my difficulty is--and it's the reason I asked Ted that earlier question--that I don't know what a proper exchange rate is for the dollar. I look at that chart across the way from me and it shows that the dollar is still well above the trade-weighted average value it reached in 1973 and in the first half of 1975. It's true that it has come down sharply but it went up very sharply in 1975 and early 1976. We didn't resist very strongly the rise in the dollar in '75 and early '76, and I just don't have an anchor to windward here. I don't have a notion of what the proper exchange rate is from the standpoint of long-run equilibrium in trade and current account balances. What disturbs me about the notion of defending the dollar at a particular point--this is quite aside from the question of moving in to take care of destabilizing conditions in the markets--in a massive way through higher interest rates or intervention or any other policy of that sort is that I wonder if we've picked the wrong point. If the strong basic characteristics are still tending to drive the dollar either down or up as the case may be, I wonder whether we won't lose in the end--lose a great deal--in trying to support the dollar at a point that is not its [equilibrium] point. And since I don't have any idea where the basic [equilibrium] point ought to be, I have great difficulty myself, of course.

MR. WALLICH. We've gotten into a discussion of a stable rate; I think Paul used the term--

MR. PARTEE. Well, the Chairman was talking about a decline.

MR. WALLICH. That's contingent. It wasn't, I think, your thought that we ought to arrive at stable rates. I don't think either the discount rate action or intervention tends to stabilize a rate that for market reasons wants to move in another direction.

MR. PARTEE. I was responding to the Chairman's comment.

CHAIRMAN BURNS. I don't think you have responded to my comment. I interpreted your comment--not your language but the substance of your comment--as being directed mainly to

intervention. As far as that goes, I think I have as little faith in intervention as you do. I have not been in favor of massive intervention. I have tried to hold a tight rein on Mr. Pardee, an enthusiast for intervention on a dramatic scale. What can we do in the way of intervention? We can just influence markets here and there a little and it has no permanent significance. There are literally hundreds of billions of dollars against [us]. How much can we intervene with? I think total intervention so far amounts to about \$1-1/4 billion. Is that correct? All right, suppose we made it \$3 billion; suppose we made it \$5 billion. I don't think it would make any significant difference. I believe, therefore, mainly in bridging action until permanent corrective actions can be taken.

MR. BAUGHMAN. Mr. Chairman, do you see some indication on the part of government of a willingness to move to what you characterize as permanent corrective actions? Or does the problem have to get worse before [that will happen]?

CHAIRMAN BURNS. I think there's some indication, yes, of a willingness to move. Is there sufficient indication? No. Is there a sufficient sense of urgency? Not according to my reading. But I am an impatient man in this field.

MR. PARTEE. Suppose that none of these actions occurred. Suppose that there is no anti-inflationary program, that there is no energy program worthy of the name, and that the tax cut in the end turns out to be hardly at all for business and almost entirely for consumers.

CHAIRMAN BURNS. Well now, why don't you complete the list?

MR. PARTEE. All right. And that Germany and Japan--

CHAIRMAN BURNS. No, and that there are no bridging actions of the kind that I suggested previously. Then go on.

MR. PARTEE. Well, I thought your fourth point was expansion abroad. I wasn't going to throw that in because I don't know what would happen.

CHAIRMAN BURNS. Well, expansion abroad can help enormously.

MR. PARTEE. It reminds me of our discussions of extending credit to New York City. That is, you're talking about bridging actions, but you don't have anything that you're bridging to if in fact those three things don't occur. In that case the dollar, I presume, if it is not competitive today, would have to decline further and we shouldn't resist it. Would you agree with that?

CHAIRMAN BURNS. Well, I don't think I would call it competitive. I would say that the dollar would decline further and that would be a prelude probably to an international recession and, therefore, we should definitely resist it. [As for] the assumptions of inaction that you make, we should do what we can to make those assumptions not come true.

MR. PARTEE. I reckon.

MR. COLDWELL. You two are talking about a time problem. [There's] a short-run problem and a longer-range problem. I can't see just standing by while the dollar depreciates at a rapid pace. But neither can I see a long-range intervention policy.

CHAIRMAN BURNS. Well, on a long-range intervention policy, I'm with you and Chuck. I see little point in it. I would say that, yes, intervention is desirable largely to show the rest of the world that we do care. What do we achieve by it? Very little. As a matter of fact, the rest of the world has talked a great deal about intervention but its confidence in intervention is diminishing. I've talked to central bankers abroad and they're not very eager, the way they were before, to have us intervene on a large scale, even though they have a problem with their export industries and the like. That's because they are concerned about their monetary circulation, and they haven't yet devised sufficient means of offsetting the increase in the money supply that results from our intervention or for that matter from their own intervention. So, I have very little faith in the significance or the lasting value--except for very short-run psychological reasons--of intervention.

Now, there is this. Take the statement that was put out regarding joint action by the Federal Reserve and the Treasury. The new element in that statement was the willingness of the Treasury to enter into swap arrangements and use the resources of the Exchange Stabilization Fund. The value of that statement was not in the fact that there would be more intervention because of Treasury participation. The value of that statement was that it gave notice to the rest of the world that all the talk about the Treasury and the Administration being in favor of a depreciating dollar --and there being some difference of opinion between the Federal Reserve and the Treasury--[was not true]. This was a clear indication to the rest of the world that the Administration and the Federal Reserve were on the same track, interested in protecting the integrity of the dollar. That's the only value in that statement.

MR. LILLY. You suggested the selling of U.S. bonds in European money markets. I gather you're talking about mark-denominated bonds. Or are you talking about--

CHAIRMAN BURNS. Oh, I think these are technical problems I would not [want to spend time discussing]. We have a little committee working on that and I hope that committee has concluded its work. I hope that committee is not going through bureaucratic exercises. By Jove, there will be thunder inside of this shop if it is.

MR. LILLY. Before the thunder, could I ask another question?

CHAIRMAN BURNS. Yes, but we're not finished with--

MR. LILLY. What is the impact going to be on those money markets of a massive sale of bonds by the United States? Isn't that going to raise hell with their rates?

CHAIRMAN BURNS. Well, this is something that we would do only with the closest collaboration of the central banks and governments of other countries and I am assured that that

collaboration will be forthcoming promptly. The device that you mentioned, selling Treasury bonds denominated in foreign currencies, is merely one way of accomplishing the objective and not necessarily the best way.

MR. PARTEE. Well, you'd need to get some kind of a currency guarantee.

CHAIRMAN BURNS. No. Take, for example, one device that the Bundesbank is thinking of. The Bundesbank gets Treasury certificates now, as I understand it, and they're very short-term. Instead, let them be two- or three-year certificates and the Bundesbank can turn around and sell those certificates to its commercial banks and thereby mop up liquidity that had been created in the process of acquiring these Treasury certificates. [But there would be] limited transferability, you see. That is, one commercial bank could transfer the bonds or sell the bonds to another commercial bank but to no one else. There would be no leakages in that case. That's another way of doing it.

MR. PARTEE. That's right. But I still don't [fully understand]. Would the bank that's buying take an exchange risk?

CHAIRMAN BURNS. The bank that is buying in that case would be holding a dollar security.

MR. PARTEE. A dollar security.

MR. WALLICH. That is not the way I visualize the operation.

CHAIRMAN BURNS. The Emminger plan?

MR. WALLICH. I think the idea is to sell D-mark certificates to the [unintelligible] of the government here.

CHAIRMAN BURNS. No, no that's the second plan. There are two different things. One is to sell a dollar security; the other is to sell a Treasury security denominated in a foreign currency.

MR. WALLICH. That's the Alan Holmes plan, if I may call it that. That would be a way for the Bundesbank to absorb bank liquidity. But the Treasury bill in that case--or whatever security it was--would be serving I think as the guarantee feature and not as a means of making the merchant bank take the dollar risk. [Those banks] wouldn't do that.

MR. PARTEE. So the Bundesbank would take the dollar risk?

MR. WALLICH. The Bundesbank takes the dollar risk, that's right. But the Bundesbank's liability would show up in the D-mark obligation, I would think.

MR. LILLY. Doesn't either one of these operations tend to put upward pressure on their rates, thereby narrowing the differential between them and us?

CHAIRMAN BURNS. In and of itself, yes. But the central banks in other countries are capable of taking action to ease credit conditions--not only to offset any such sales of Treasury securities but to go beyond that or independently of that.

MR. AXILROD. Another way of putting that, Mr. Chairman, is that it takes away the downward pressure on rates that comes with the expansion in their credit from the support operations.

MR. PARTEE. But we're seeking a widening in spreads.

CHAIRMAN BURNS. Well, that seeking of a widening spread is entirely consistent with the sale of Treasury securities abroad, provided foreign central banks cooperate with us, which they are eager to do. Technical problems can be worked out.

MR. PARTEE. [Unintelligible] the question when you said the Germans were interested in mopping up excess liquidity in their economy, because that doesn't sound like something they would want to do if they wanted to widen the spread between the dollar markets [and those] in Germany.

CHAIRMAN BURNS. Well, these are not matters of black and white. My language may have misled you here. The Germans are like other people; they have two minds on every issue just as we do. On the one hand, they want to mop up liquidity. On the other hand, they want to stimulate their economy and also to curb inflation. But their thinking is moving in the direction of easing credit conditions. One reason they're thinking of moving in that direction--not the only reason--is that the Americans, thank God, are no longer quite as loud as they were in pointing an accusing finger at the Germans and telling them they must expand their economy. What we're tending to do now [is to talk in more general terms]. That certainly was the line I took in Basle. I didn't say a word to any specific country. I merely indicated that one way among others to solve the dollar problem is for the outside economy to expand faster. Which part of the outside economy or how, I had not a thought about that. And, believe me, you get a much better response out of people, and it comes spontaneously, when you talk in that vein than if you just start pointing an accusing finger at the Germans or at the Japanese. They've become so sensitive that even before that finger starts moving, they're ready to attack in return. Mr. Morris, please.

MR. MORRIS. Mr. Chairman, I find our intervention policy in the foreign exchange markets very troublesome. On the one hand, I'm very much aware that there are limits to what we can do in intervention. On the other hand, it seems to me that if we do decide to intervene--and if we're going to have an impact--we've got to intervene on a larger scale than we have in the past. I think the purpose of intervention is not to soak up dollars, because obviously we can't intervene on a scale sufficient to soak up the volume of dollars around. The purpose of intervention is to instill some element of psychological change in the marketplace and one doesn't do that with intervention on a very small scale. I think there is an analogy to the lender of last resort function. I think back to the Penn Central crisis, for example, where we assured the banking system that we were going to

provide whatever money was needed to cool that situation off. We turned confidence around and we ended up not putting in anywhere near as much as some of the experts thought we would have to put in to turn the situation around. Our present course of intervention seems to me on a very small scale.

CHAIRMAN BURNS. It has been increasing, I'm sorry to say.

MR. MORRIS. [We're] building up some liabilities and we're not producing, on the confidence side, any really vigorous demonstration to the market that the United States thinks the dollar has come to a level that the risk in this operation is pretty small. Now Chuck says, and quite rightly, that he doesn't know where the dollar should bottom [out] and neither do the people in the marketplace. They don't have any better basis than you do for making that judgment. [If we're] intervening at all, I think it ought to be done sparingly and on a large scale instead of frequently on a small scale.

CHAIRMAN BURNS. At this point, let's hear from Mr. Pardee and then I think our discussion can be continued.

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

CHAIRMAN BURNS. Thank you, Mr. Pardee. Mr. Morris made some interesting observations. Frank, you may be right that this is an area where it is very difficult for any one of us, certainly for me, to speak with a sense of authority or great confidence. But there is one thought, a political thought, that I think is tremendously important and ought to be kept in mind. If we were to intervene on a much larger scale such as you suggested then I am very much afraid, and don't ask me to elaborate on this, that certain thought processes and incipient actions that are now in motion within the executive establishment and within the Congress might be slowed down considerably. The feeling may be generated that intervention is taking care of the problem, and that would be a tragic mistake. Therefore, you see, it's a very difficult question. We are intervening more; we could intervene much more. But if we did, we would run the grave risk that the kinds of bridging actions and permanent corrective actions we mentioned--and there may well be others--might be postponed indefinitely. And, therefore, the problem would remain with us and the corrective process that is needed would not get under way or it might weaken. So, this is a political point of tremendous importance in my own mind--and in one way or another we should keep that in mind. It's hard to evaluate, but we cannot ignore it. Mr. Eastburn.

MR. EASTBURN. Question to Scott. You use the terms "orderly" and "disorderly" and "efficient" markets. It would be very helpful to me if I had a more precise feeling about your definitions of those.

CHAIRMAN BURNS. Oh no, why do you ask that?

MR. EASTBURN. Well, because it seems to me that this goes to the issue--to Chuck's issue as to what is a proper exchange rate and when do we intervene and when do we not.

CHAIRMAN BURNS. But, you know, these terms have never been defined, really. I don't object to precision and if Mr. Pardee can answer your question in a way that would be helpful to you, God bless him and the rest of us.

SPEAKER(?). Go on Scott, it's all yours.

MR. PARDEE. First, I want to assure everyone that we do not have a rate objective in mind. We do not know what the appropriate rate is or should be. There are no long-term equilibrium conditions. The underlying elements are changing every day, every week, every month, as changes in oil prices and changes in other fundamentals take place. So, there is no way in which we can establish the right rate or hope to establish the right rate. But there are times when the market does overdo it and moves beyond where we feel the current rates [ought to be based on a] broad element of judgment in terms of economic fundamentals, market sentiment, and policy considerations. They are exaggerated rates; they're wrong. This is the term "erratic fluctuations" that people have used and written into the official literature from time to time.

Now, this is seen in the marketplace, and market sentiment is very important. A reading of market sentiment some say is very important in deciding whether a market is disorderly or not. And some of the elements that Chairman Burns and Mr. Volcker mentioned earlier are very important in my mind in determining whether I think the market is disorderly or not. What are people thinking? How are they reacting to the market? What is the business manager or what is the foreign exchange trader thinking at the current moment if he sees day after day that the dollar is declining, when in his better judgment he thinks it shouldn't be as low as it already is? [If] he sees when he comes in each morning that the dollar is 1 percent lower, then he is not going to buy dollars. He is going to sell dollars even though it's against his better judgment. So, one of the key elements of a "disorderly market" is the response of the business manager to news or rumors--we even had a rumor of a rumor a couple of weeks ago. [For example,] he overreacts to whatever adverse news or rumors come through and yet when positive news comes through, there is no reaction. We had a 6.4 percent unemployment rate [reported recently]. I went into the market afterwards trying to reinforce what I thought would be a positive reaction. It was a big intervention for naught. The market just absorbed the [news]. I got out of there as fast as I possibly could. The market didn't want to hear good news for the United States dollar.

This is the kind of situation in which there is an element of only one-way risks; the trader sees that the dollar is only going to go down. He himself cannot stand up against the market. That's a disorderly market. Now, it's hard to measure. We can't [define it quantitatively]--what percent movement per day or what the width of the spreads are; these are elements in it. But it is a question of reading the judgment of the people who are the participants in the market. This is what I'm dealing with. I'm trying to persuade enough people--managers of funds, exporters, and importers--who all are moving dollars in foreign exchange that tomorrow the dollar won't be 1 or 2 percent lower; it might just as easily be 1 or 2 percent higher, or perhaps it will be about where it is now. So, they can make longer-term business judgments and not have to worry about this tugging match or football game or craps game that has been going on in the exchange market.

CHAIRMAN BURNS. Mr. Pardee, you've made your point. We now all know very precisely what a disorderly market means.

MR. PARTEE. Sounds like a down market to me.

CHAIRMAN BURNS. Mr. Eastburn, do you want to continue?

MR. EASTBURN. Well, as long as we're getting everything out here on the table, I think there is a further question, and that is: What are the risks of disorderliness and what are the gains of injecting order?

MR. PARDEE. [As for] the risks of disorderliness, I think the Chairman answered that before in terms of President Roos's question. If we back out and we have a disorderly market, then all these other things--

MR. EASTBURN. Well, I understood Larry's question to have to do with the value of the dollar--the more permanent aspects and not the fluctuations from day to day.

MR. PARDEE. Well, at this stage as long as only a one-way risk is perceived--that the dollar can only decline--then we'll have the results the Chairman outlined. Until a two-way risk reemerges, which is what we're trying to establish, [that will be the case]. Once a two-way risk is seen, then we'll have better markets, and I can't forecast where the dollar will be.

CHAIRMAN BURNS. All right, thank you. Mr. Balles, please, then Mr. Black, and then Mr. Coldwell.

MR. BALLEES. Mr. Chairman, I'd like to come back to the four essential fundamental corrective measures that you talked about. I'm inclined to guess that unless we really succeed on the second of the two that you mentioned--a successful anti-inflation program by the U.S. government--the other three might not work. That is to say that as long as there are differential rates of inflation of considerable magnitude between here and other countries, it's going to be awfully difficult to get the kind of capital inflow that will offset our trade deficit. And in view of that tentative conviction that I have, I wonder if you could hold forth a bit more on what you had in mind in terms of getting a successful anti-inflation program of the U.S. government, which I think was your phrase.

CHAIRMAN BURNS. Well, I would be very glad to do that and I've recommended such a program. I don't think it's going to be adopted, but perhaps we might postpone that [discussion] because it will not help us, I think, in dealing with the foreign exchange problem that we're on at the present time. Mr. Black, please.

MR. BLACK. I wonder if I might ask Mr. Pardee a question. Scott, would you quantify as far as you can--I realize this is a very difficult question--what portion of the movement against the



dollar is in the form of multi-national corporations and others engaged in foreign business and investors in the normal course of business trying to protect themselves as compared to those who are trying to make money purely out of speculation against the dollar.

MR. PARDEE. Well, I think--

CHAIRMAN BURNS. I'd like to hear the full answer. Would you like to pull over the microphone?

MR. PARDEE. My estimate is that the biggest portion of funds that go through the exchange market essentially comes from the corporations--the broad economic relations that we have in this country as against other countries. We did have a discussion about the role of the banks as speculators during that interim FOMC [conference call] and I'd rather not pinpoint the speculators as the problem. The speculators can go either way; if they felt that the dollar would rise, they'd be buying dollars. This is what I'm trying to persuade a few of them--that maybe the dollar will rise. I think it's more the broad [unintelligible] and not just multi-nationals either. A lot of people buy and sell dollars internationally so I can't quantify it, but I think it's easy to overplay the role of the speculator. It's easy for us to overplay it ourselves since we're dealing directly with banks and occasionally we have to deal with some of these fellows who want to move the rate and it does become a contest of wills. But I wouldn't want to overemphasize it. I think, as Paul outlined in that [conference call], we've got to persuade the whole market that we mean business.

CHAIRMAN BURNS. Mr. Black, I sat down in Zurich just a week ago, on Tuesday, with leading Swiss bankers and asked them that very question. Unhesitatingly each one said that everybody is in it--people from all over the world as individuals and corporations. I asked more specifically about banks, having satisfied myself that American banks are not involved. I've pursued that question with central bankers and they were quite sure that their own commercial banks are maintaining a balanced position in foreign currency; they're checking on that. The sole exception is what some subsidiaries of foreign banks may be doing in Luxembourg. That seems to be a trouble spot--an area from which a significant amount of speculation is generated. And that is something that requires international attention, particularly on the part of the Europeans.

MR. BLACK. When they say "everybody's in it," are they saying they are in it just to protect themselves rather than to speculate?

CHAIRMAN BURNS. Both, is what I was told. You know, the [dividing] line is so hard to draw.

VICE CHAIRMAN VOLCKER. One man's speculator is another man's hedger.

MR. BLACK. Yes, I know it's hard to draw the distinction. But as I see it, and as I perceived what Scott said, I gather that you think there might be a little more of the speculative element than he has suggested.

CHAIRMAN BURNS. Perhaps.

MR. PARDEE. I could give you all kinds of examples, but I don't want to because I'm afraid I'll be giving a misperception.

MR. BLACK. The line is a very fine line. But I think most people--most laymen anyway--think of this as a massive speculative attack. Actually a substantial part of it, an overwhelming part of it, is simply people trying to protect themselves.

MR. PARTEE. Bob, an importer, for example, could [cover] his imports not at all or for three months or for six months or for a year. It makes a tremendous difference in the demand for the currency. And I don't know whether you call it speculation or protection.

MR. BLACK. It's hard to define, and I realize that.

CHAIRMAN BURNS. Mr. Coldwell, please.

MR. COLDWELL. Scott, you seem to be working on an attitudinal problem. How much progress have you made?

MR. PARDEE. Well, the last two days the market has been settled and we have not had to intervene. I haven't talked with the Desk in an hour and a half, but--

MR. COLDWELL. No, I don't mean intervention. I mean in terms of attitude.

MR. PARDEE. I think the point that the Chairman outlined has been gotten across--that the U.S. authorities are there and that this earlier credibility--

CHAIRMAN BURNS. I just hate to see you say that, Scott, because it's a premature judgment, I think. We must not reach conclusions on the basis of what has happened in a day or two days or a week, though I understand your attitude. Two days' peace is a close approximation to eternity.

MR. PARDEE. You didn't let me finish; I was going to give the qualifier. I share your view but so far, so good.

MR. PARTEE. Up to an hour and a half ago.

CHAIRMAN BURNS. Any other questions or comments? Well, I think a motion to approve, with or without a sigh, the transactions of the foreign desk would now be in order.

SPEAKER(?). I so move.

SPEAKER(?). Second.

CHAIRMAN BURNS. The motion has been made and seconded. I hear no objections. Do you have any recommendations to the Committee, Mr. Pardee?

MR. PARDEE. I would simply mention that four swap drawings on the Bundesbank in the amount of \$123 million equivalent of marks are coming up for renewal between now and the next meeting. These are first renewals and need only to be noted by the Committee at this stage.

CHAIRMAN BURNS. Any question about that?

MR. COLDWELL. When do we reach the first second renewal?

MR. PARDEE. April, I think.

CHAIRMAN BURNS. Mr. Volcker has [a comment].

VICE CHAIRMAN VOLCKER. I would note that the Committee in between meetings raised the aggregate limit on its exposure from \$1 billion to \$1-1/2 billion, as I recall. We're now within \$275 million of that. I hope you don't need [additional leeway] if the last two days are a minor omen but when one looks at the perspective to the next meeting I raise the question of whether it would be prudent to raise that limit to give us a little more normal leeway. That limit is actually the binding limit now. We'd normally have a \$500 million leeway between meetings, but this aggregate limit would not provide us with a \$500 million leeway between meetings.

CHAIRMAN BURNS. Well, let me just understand the rules. If we did nothing today, then the Committee would have to be canvassed.

VICE CHAIRMAN VOLCKER. It would have to be canvassed in any event with the \$500 million limit [on transactions between meetings]. But this overall aggregate limit that exists "permanently" is at present closer than the \$500 million normal intermeeting limit. My question is whether they might be brought into alignment, so to speak.

CHAIRMAN BURNS. Well, what is the sentiment of the Committee? I would only make one comment. In the past we have had no difficulty in getting certain types of actions by the Subcommittee and in reaching the full Committee when required; and the Desk has not really been handicapped. However, there may be an advantage in enlarging the Desk's authority so that further consideration by the Committee by telephone or by wire would not be necessary.

MR. PARTEE. I think I agree with President Volcker that the \$500 million in transactions should be the limit. It was intended as the limiting constraint on operations without consulting the Committee. The other is sort of like the national debt limit; it is just hit because [the Desk] might run into [it in the course of executing transactions within] the \$500 million which it is otherwise permitted to do with Subcommittee consultations. So I think [the limit] ought to be raised to \$1.750 billion for the outstanding debt. That's about right, roughly.

CHAIRMAN BURNS. Any other views or any additional views? I hear no objections to Mr. Volcker's suggestion and if I interpret the silence to mean consent--and unless I hear a word I will interpret it that way--I will take it that this is the decision. All right, thank you very much. We'll move now to a report on the economy; Mr. Kichline and Mr. Zeisel will report to us. Would you be good enough to proceed in your own way, Mr. Kichline?

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

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

MR. KICHLINE. [Statement continued--see Appendix.]

CHAIRMAN BURNS. Thank you very much, Mr. Kichline and Mr. Zeisel, for a very illuminating report. I think it would be desirable now for members of the Committee to focus on the broad economic projections made by our staff rather than on technical details. And it would be most helpful if we would indicate general agreement if it exists or such divergences of thought or opinion that members of the Committee may have, looking through the near-term economic future. Who would like to speak first? Mr. Coldwell, please.

MR. COLDWELL. Mr. Chairman, I think the net result of what I am going to say is not going to be a great difference in the average for the whole year. But I see the pattern as significantly different and it perhaps connotes the beginnings of a possible recession at the end of 1978. I think [the staff's] rate of inflation is too low. I think [the projected] rate of [growth in] gross national product in the first and second quarters is too low but I think it's too high in the latter part of the year. As we move [through] the year, I think the impact of the dollar depreciation on our prices and the increased pressure on wages and the minimum wage and the CPI through indexed growth are going to cause greater inflation than [the staff] had planned. With regard to the GNP side, I can see a very sizable gain, perhaps even larger than what you are forecasting--maybe even up to 7 percent real growth in the first quarter--primarily from inventory growth and the impact of this government spending that has just been hitting us. But by the time the second, third, and fourth quarters are coming along I think inflation is going to take its toll. I suspect that housing declines are going to be sharper than [the staff is] looking at. I don't think capital spending is going to have the strength shown. So I am looking for something much weaker in the latter part of next year, Mr. Chairman.

CHAIRMAN BURNS. Thank you, Mr. Coldwell. Mr. Willes next, please.

MR. BAUGHMAN. Could I ask Mr. Coldwell a question, Mr. Chairman?

CHAIRMAN BURNS. Please.

MR. BAUGHMAN. You made reference to the beginning of a recession. Are you talking in terms of slowing growth or an actual decline?

MR. COLDWELL. I am talking in terms of a major slowing of growth.

MR. BAUGHMAN. But which presumably would move on into an actual decline?

VICE CHAIRMAN VOLCKER. Even with the tax cut?

MR. COLDWELL. Even with the tax cut.

CHAIRMAN BURNS. All right. Mr. Mark Willes, please.

MR. WILLES. Thank you. I have one question and then a comment. I don't have a chart on prices in [my set of charts]. Is mine just short or is there none?

MR. KICHLINE. No, we did not discuss prices this morning.

CHAIRMAN BURNS. You don't have prices and I can forgive that because we talk a great deal about prices. I find it more difficult to forgive the absence of the chart on profits. That we don't talk enough about and we don't think enough about.

MR. KICHLINE. Mr. Chairman, I talked about equity prices in my final comment. I think very importantly about profits when talking about equity prices and I am sorry I didn't pull it out more explicitly. But clearly, when talking about a price earnings ratio one is talking about profits.

MR. PARTEE. The material in the Greenbook is consistent with the Chart Show, I take it. There is a price projection and a profits projection in the Greenbook.

MR. KICHLINE. Right.

CHAIRMAN BURNS. I love to hear talk about profits because I am sufficiently old fashioned to think that business profits and the prospect of profits have a great deal to do with the prospects for the economy. The tendency on the part of economists to talk about the money supply and tax changes as if these little adjustments here and there drive the economy I think is entirely mistaken. I think we still have a large private sector and I even thank God for that. What happens in the sphere of profits--and what expectations are with regard to profits--I think is still the main driving force of the economy. But you were going to make a comment in addition to the question, Mr. Willes.

MR. WILLES. Well, I was, and I guess it is very similar in part to what you just said. The [issues] of prices and profits are very closely related in my mind at the moment. Since we don't have a chart on prices, let me look at the chart on the growth rate for real GNP. Governor Coldwell made, I thought, a fairly cogent argument that inflation may be stronger in the second half of next year than the staff is projecting. We have been quite optimistic about business plant and equipment spending for the last nine months, reflecting in large part the area of the country that we come from

where they have been very bullish. We have had real [cause] for the concern in the last two months now and that latest survey didn't help us at all. It was lower than we were expecting.

CHAIRMAN BURNS. The latest survey of--

MR. WILLES. Plant and equipment spending.

CHAIRMAN BURNS. Oh, yes.

MR. WILLES. I had a group from the ten largest corporations in our area in for lunch yesterday and they expressed more caution than they have over the last nine months. It may be that we just have a very funny view of the world, and I wouldn't rule that out at all, but if you look at the chart for growth in real GNP it shows what I would regard as a very strong impact on real economic performance associated with the tax cut. It seems to me that there is at least a possibility that it would not have that effect--that in fact it could be neutral or even negative in terms of business spending. [That assessment stems] from the following point of view: The businessmen that are talking to me are very concerned about inflation and are becoming increasingly concerned about inflation. The statements they are making to me suggest that if they get any more reason than they already have to be even more concerned, rather than spending more they are going to spend less. Depending on how they view a tax cut, particularly if it's not skewed in their favor but is skewed in the direction away from business, you could well see real business spending that is either the same or even less in the face of a tax cut than without it. So, while we have been very optimistic, and we are trying to hang onto that as long as we can, there is a bigger question mark in our mind with regard to the second half of next year than there had been up until now because of the way expectations of inflation seem to be influencing business thinking in our area.

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

MR. MAYO. First on the answer to Mark's question, isn't the staff's answer contained, Jim, in your memo of January 13 where you give the assumptions of 5-1/4 percent M1 [growth] and then 4 percent and 6-1/2 percent on each side? Isn't the 5-1/4 percent line consistent with these charts?

MR. KICHLINE. Yes, it is.

MR. MAYO. So, there are figures down here--

MR. KICHLINE. It is also in Part 1 of the Greenbook. We are projecting an increase averaging close to 6-1/2 percent over the next six quarters.

MR. MAYO. My other comment is really in the form of a question [to] you, Mr. Chairman. There is an assumption through all the staff [materials] here, in the presentation we have just heard and the Bluebook, that indeed there will be a 1/2 percent increase in interest rate ceilings on time deposits. Would you or any other member of the Board of Governors care to comment on that?

It's a preferable, good assumption. Is it a realistic assumption from the standpoint of the Board? Obviously, no official answer is expected.

MR. AXILROD. May I first explain, Mr. Chairman, why we felt it necessary to make that assumption? If we had not made that assumption, we believe the growth in time deposits at banks and thrift institutions would have been so low as to carry M2 and M3 to or below the ranges currently in place. Therefore, we felt in order to have a set of monetary aggregates that was consistent with the Committee's desires and to provide a basis consistent with the Committee's desires we had to make that assumption for the projections. Our alternative would have been to assume a higher M1 growth in order to get that M2 and M3 which, of course, would have eased interest rates and been a fundamentally different monetary policy.

MR. MAYO. I understand completely the reason for the assumption. I was just wondering if anyone would care to comment on the likelihood of action that would validate the assumption.

CHAIRMAN BURNS. Well, let me say just a word about it. I think it is a very reasonable assumption as far as the Federal Reserve Board is concerned. As far as other agencies of the government are concerned, perhaps Mr. Gardner and Mr. Partee who have been active in the [interagency] coordinating committee will have an opinion on that.

MR. PARTEE. I think it's a little hard to speculate. I don't know what Steve would say but the key role here will be played by the Home Loan Bank Board since we have to maintain a 1/4 point differential against the Home Loan Bank Board. That means they have the veto power on an increase in rates. If inflows are sufficiently poor or show clear prospects of being poor, I think the Home Loan Bank Board might conceivably agree to an increase in ceiling rates. It's one of those things that is easier said than done, Bob, but I can understand it. I think if there is a clear need for it, probably the Home Loan Bank Board, with extensive coordinating committee discussion and so forth, might agree to some limited increase in the rate ceilings.

CHAIRMAN BURNS. Mr. Gardner, do you want to supplement what Mr. Partee just said?

MR. GARDNER. Only to say that I don't disagree with his presumption that it indeed has a possibility of being enacted; it's not an ethereal sort of idea at all. The Home Loan Bank Board has [seen] the liquidity positions of the savings institutions declining, and it has been speaking about that for months. I believe, [based on those] conversations, that they are concerned about the availability of mortgage funds in the institutions.

CHAIRMAN BURNS. Has an increase in the ceiling rate been discussed within the coordinating committee?

MR. GARDNER. Not to my knowledge. Not an increase. We have in effect just touched on disintermediation in their comments about their studies of the liquidity conditions of the institutions and the amount of Home Loan Bank Board borrowings that they are using. I think, Chuck, I would fully agree with you. It's certainly not out of the question that the coordinating committee would

agree to consider such an issue, if events incorporated in the staff projection become facts.

CHAIRMAN BURNS. I would make a very definite recommendation to Messrs. Gardner and Partee that conversation on that subject get under way immediately. It will take those fellows at the Home Loan Bank Board at least a half year to make up their minds. And by June or July we are likely to need something like that.

MR. PARTEE. I believe the staff assumption is that the increase [will occur] March 1.

CHAIRMAN BURNS. Well, that means we're already three months late.

MR. GUFFEY. They are also assuming a full half point, which may or may not be--

MR. PARTEE. Oh, I think for some category it would be a half point. A quarter point seems so small relative to the problem. But it might not be across the board; it might just be for a particular category.

MR. MAYO. Chuck, what would the Home Loan Bank Board's basic objection be?

MR. PARTEE. Cost to the S&Ls. They probably would argue that the cost of raising the rate in terms of the drain on funds otherwise available to go into reserves would exceed the cost to the S&Ls of having some outflow of funds. That has to assume a willingness to let the home builders go, but in the last tight money period they let the home builders go.

MR. MAYO. Thank you.

MR. BAUGHMAN. Mr. Chairman, on this point, it seems to me that it's a better strategy to move early on this sort of thing than it is to wait until it becomes a pressing issue and gets widespread publicity and you get a general acceptance of a point of view and a general trend started. Then it seems to me that it's probably impossible to stem disintermediation. In any event, it's going to run a good deal further than it would have needed to run and have more impact on housing starts and the plans and expectations of people in the housing market than if action were to be taken fairly early and before it becomes a big hot political issue.

CHAIRMAN BURNS. Are the staffs talking about this subject?

MR. AXILROD. Our staff is undertaking contingency plans internally, but I'm not aware of any staff discussions among the agencies at this point.

MR. PARTEE. The Home Loan Bank Board has just lost their economic staff. I don't know whom we'd talk to over there.

CHAIRMAN BURNS. I would urge very strongly [that you start]; it takes time to prepare the mind. I think staff conversation ought to get under way and the coordinating committee



discussions ought to get under way. It takes time for these thought processes to mature, particularly on the part of an agency such as the Federal Home Loan Bank Board, in this area. We want to hear now from Mr. Mayo. Do you have any views on the economy you want to express?

MR. MAYO. No, I would merely say that I think the projection is a reasonable one. I would not quarrel with it. Come to think of it, though, I should put in a footnote to my remarks last month on agriculture. Our latest survey on land transactions in the Seventh District, which is always thinner for the fourth quarter than for the other quarters, does indicate for a change at least a stabilization, and perhaps even a turnaround, in the decline in transactions or in the value of farms in the Midwest. So it may be that my alert of a month ago was premature.

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

MR. KIMBREL. Mr. Chairman, I think we too are hearing, as President Willes suggested, more comments about inflationary expectations. The business community seems to be worrying. Maybe it's the uncertainty that exists, but we seem to be hearing more of that. I think net we would come out close to what the staff has projected [though] from our vantage point we would be somewhat less optimistic about housing developments. We don't see that quite as strong over the year as they are projecting and we're possibly even somewhat less optimistic about total automobile sales than they are suggesting. Looking though at the total revenue tax changes--revenue drag--I wonder if the staff has done any projections or incorporated a possibility of any influence from the refunds for this year that might be different from usual--if indeed they might make any contribution to possible spending.

MR. AXILROD. Well, on average we expect roughly the same magnitudes as last year, or somewhat larger actually, with the bulk of the increase occurring in March. But this is a projected pattern at this point and we really prefer to have some experience as January and February develop. We are expecting [refunds to be] a little bit greater in February before incorporating any very specific assumptions. If this pattern that I have here is accurate, it would indicate to me perhaps a little more money supply increase in March than we are projecting. We have not made any specific allowance yet because I think it's somewhat premature at this time.

CHAIRMAN BURNS. All right. Thank you, Mr. Kimbrel. Mr. Eastburn now, please.

MR. EASTBURN. Thank you, Mr. Chairman. Well, I would have some sympathy for the view that Governor Coldwell expressed about the longer-run outlook and the possibility of recessionary developments next year. This is supported by the views that I get in Philadelphia which, of course, are biased by the very slow activity that we have there. [There is] concern about inflation and the intractable nature of it and concern about the dollar, with no light on the horizon so far as the solution to that is concerned. There is one aspect that I think might work on the other side in a small way and this is in the housing area. It occurs to me that one of the phenomena that is different this time than in the past, so far as the housing sector is concerned, is the strong tendency on the part of individuals to use [real estate] as the main way of hedging against inflation. It is clear when you talk to real estate people that families are seizing on this as the way to protect

themselves. Given some sustaining flow of mortgage money, it would seem to me that housing might look better, given this strong demand factor at this time, than it may have looked in the past. Perhaps you might react to that.

MR. KICHLINE. That's an important element in our thinking. It's one of the reasons that we believe the same mortgage rate this time around would have less impact on curtailing demand for mortgages than in the past. From the past performance of prices in that sector, I think it is quite clear that consumers are willing to take on additional mortgage debt. The proportion of mortgages relative to other debt has been running higher for some time and we would expect it to continue because of the inflation aspect. So it's one of the reasons we would assume that over the forecast period we will have perhaps higher starts than we would have thought if we were doing this back in 1973, for example.

CHAIRMAN BURNS. Gentlemen, I think that we can't conclude our economic discussion quickly and we shouldn't try. So I suggest we take a coffee break now. When we return, we will have a short executive session and then resume our discussion of the economy and I shall call on Messrs. Balles, Morris, and Wallich in that sequence. Now, let's take a break.

[Coffee break]

CHAIRMAN BURNS. Gentlemen, we will turn to consideration of a couple of items that can best be taken up in Executive Session. First, we will have a report from our General Counsel, Mr. O'Connell, on the Merrill case. Tom, would you be good enough to report to the Committee?

MR. O'CONNELL. Yes, Mr. Chairman. I believe there have been distributed to the members of the Committee, Mr. Chairman, some information sheets that were transmitted to the Solicitor General on this matter. Very briefly, the Solicitor General has until February 8 as a terminal date to make his decision as to whether to seek certiorari in the Supreme Court in this Merrill decision. At this point in time, we are scheduled--we being the Committee's staff and lawyers from the Board--to appear before the Deputy Solicitor General, Mr. Easterbook, tomorrow morning at 10 o'clock to be given the opportunity to vocalize views, exhortations, positions that had been transmitted in the form of a written letter to the Civil Division's Assistant Attorney General. That was forwarded several months ago now. By dates in latter December, as you will note, both the Chairman of the Economic Advisers as well as the Treasury Department have affirmatively supported the Committee's position in urging the Solicitor General to seek certiorari on the issue enjoined. At this time, there has been a negative recommendation forwarded by the Civil Division, which is the first body within the Department to make a recommendation to the Solicitor General. In several conversations with that office, Mr. Chairman, the feeling at the present time is that there is not a strong affirmative case to be urged before the Supreme Court, but they state that quite honestly it's still an open question. I think tomorrow [after giving] our position, within perhaps 5 to 8 days we will have a decision out of the Solicitor General. If tomorrow's meeting does not favorably impress the Deputy Solicitor, we will then be given an opportunity, I believe, to address the Solicitor General personally on this point.

CHAIRMAN BURNS. Well, I think I can speak a little more affirmatively on that. I've had a conversation with the Solicitor General on the subject of procedure, having first made delicate inquiries as to the propriety of talking with the Solicitor General on the issue. After receiving absolute assurance that it was entirely proper to talk with the Solicitor General, I had a telephone conversation with him. My understanding is that before he acts on this case, he and I will sit down and talk this over at length. Therefore, such a meeting will still take place.

MR. O'CONNELL. May I add, Mr. Chairman, as the Committee is also advised by materials in front of it, that action has been undertaken from the Board here to urge legislative relief of a nature suggested by the Court of Appeals in its opinion--namely, that there be an amendment to the Federal Reserve Act that would direct the withholding of the Committee's directive for a period until the next succeeding meeting. That's because under the Freedom of Information Act exemption number three requires that there be such a statutory mandate in order to enable the Committee to rely on that as a [reason for] withholding its directive. Such a letter was addressed to Mr. Proxmire, with supporting views and positions in a letter signed by the Chairman to Mr. Proxmire.

CHAIRMAN BURNS. Well, that letter followed a personal meeting with the Senator. I've had a similar meeting with Mr. Reuss. And copies of the letter and the accompanying memoranda sent to Mr. Proxmire will be sent to Senator Brook, Senator Power, Senator MacIntire, and likewise to the Chairman of the House Banking Committee, Mr. Reuss, to the Chairman of the Subcommittee concerned with monetary affairs, Mr. Parron Mitchell, and also to the ranking Republicans on the full Committee and on the Subcommittee. Those letters have not yet gone out, but they will be sent today. I do think that we have a fair chance of getting legislative relief but I don't think I can responsibly say more than that at this time. Anything else on the Merrill case now? Any questions to Tom on the Merrill case?

All right, let me turn to the second item. The second item pertains to the procedure with regard to the longer-range targets. I want to discuss procedure and procedure only in this Executive Session. As you may know, a hearing has been scheduled for January 31. Yesterday, I learned that Mr. Reuss has cancelled that hearing. I have no letter from him. I really have a verbal communication with some accompanying gossip. I will not tell you what the gossip is; that's irrelevant. Now the next question is when [the hearing will be rescheduled]. I have to proceed by stages and I may confuse you in the process because there has been a new development just a moment ago, and I have not absorbed that fully into my own thinking, so I hope you will bear with me. This new development I will mention at the end. While I am talking about the earlier development and my reaction to it, I will simultaneously be thinking of the new development and how it fits into the picture.

MR. LILLY. Tell us how you do that!

CHAIRMAN BURNS. I'll tell you how I do that but I won't take the time right now. Let me make some assumptions which appear to me to be reasonable but, of course, there is no way of telling whether or not they will turn out to be valid. The first assumption is that Mr. Miller will

assume office on February 1. My next assumption is that he will be requested to testify on monetary policy. A date may be suggested, and I think he in turn is likely to respond that he needs a little time to prepare for that. My final assumption is that he will be granted that time and, therefore, the hearing might be scheduled no sooner than, say, February 15 and possibly a little later. Now in making these assumptions, if we were to proceed today [on] a decision on longer-range targets, a month or so would elapse before they would be announced to the [Congressional] Committee. That is quite a long interval. First, there is a possibility of leaks. I feel reasonably secure in this [organization], though I have been shaken up, as the rest of you have, once or twice in recent years. A more important consideration is that in a period of a month there may be new developments of a sort that would influence our thinking and I don't think we ought to be bound for a period that long by a decision reached today. Third, I believe that Mr. Miller deserves the opportunity to participate in such a decision. For all these reasons, I'm inclined to think that the wise course would be for us to discuss the longer-range targets, to seek a consensus, but not take the vote and to regard the consensus that may shape up as having tentative value and that only. The final decision will be taken later on--possibly through a telephone hookup or possibly at the next formal meeting of the Committee. Now, that would have been my recommendation and still is, subject to a qualification stemming from a new development--by now five minutes old--on which I shall presently comment.

The new development is a telephone call from a member of the staff of Mr. Reuss's Committee requesting that we, the Federal Open Market Committee, submit our long-range targets to Mr. Reuss in writing. That's the message that came to me. I indicated I would honor no such message transmitted from staff by word of mouth with an indefinite element as to date, et cetera. However, if we get a written letter--and I requested that within the hour--then the Committee will respect it. The chances are we will receive such a letter. If the letter requests that we present our decisions in writing by, say, February 1 or thereabouts, in that case-- [A note has come in for me so] we may have the answer right now. I will finish my sentence. In that case, my recommendation would be that we proceed in the normal fashion and reach a decision today.

Now I will read the note. I'll read the note anyhow, but it's not the note I want to read: "Chairman Reuss on behalf of the Committee will invite Chairman Miller to testify before House Banking pursuant to..." and so forth and so on. "After the next FOMC meeting in February, assuming Miller is confirmed..." Well that's reasonable, very reasonable. "...Chairman Reuss on behalf of the Committee also plans to invite you..." where "you" is Arthur Burns "to testify before House Banking after Miller is confirmed so that you could say goodbye to the Committee and the Committee could say goodbye to you."

SEVERAL. Hooray.

CHAIRMAN BURNS. Therefore, I may have the opportunity of saying goodbye and I may also have the opportunity of hearing goodbye. Gentlemen, I think that we will discuss long-run ranges. In the meantime, a letter may or may not arrive before we conclude. If a letter does not arrive, then my recommendation is that we seek a consensus, not vote, and then take it up later. In view of this, I think the time to take it up would be at the next regular meeting of the FOMC. On

the other hand, if the kind of letter that Mr. Guenther has indicated Mr. Reuss will be sending does arrive while we are still in session, and if the letter is at all reasonable--and as you well know, we've learned over the years that Mr. Reuss invariably is a reasonable man who only makes reasonable requests--I think we will proceed. Or my suggestion to you is that in that event we proceed in normal fashion to reach our decision. Any question or comment?

VICE CHAIRMAN VOLCKER. Do we now have the option, Mr. Chairman, even if the letter arrives, of replying to the letter and saying that in view of this note [indicating] that he's going to be inviting Mr. Miller [to testify] after the next meeting that we didn't want to make the decision [today on the longer-run ranges]?

CHAIRMAN BURNS. We have that option. But whether it--well, that raises a subtle question that I'm not going to express. But it does raise subtle questions for the Committee to decide. This time I'm going to be the traditional Chairman who will keep the peace and if he has any views, he will communicate them only to his own conscience and God. Mr. Guenther.

MR. GUENTHER. Mr. Chairman, Paul Nelson--and forgive me for not putting it in the note--did indicate that there will not be a letter asking for the written views of the FOMC. This forthcoming request for Miller to testify is in lieu of the earlier thing that he was pushing.

CHAIRMAN BURNS. Oh. Well, that clears up the matter. Then my suggestion would be that we defer consideration of the longer-range targets until the next meeting of the FOMC.

MR. PARTEE. Seconded.

CHAIRMAN BURNS. I think that's pretty clear. What do you think?

MR. COLDWELL. Normally, we would take it up at this meeting.

CHAIRMAN BURNS. Yes, but--

MR. COLDWELL. We are getting off our schedule in considering it. There are some implications to that. Still, given the request for Miller's testimony after the next meeting, on balance I prefer to wait.

MR. LILLY. [We] can do it in April again.

CHAIRMAN BURNS. We could have a two-month interval or a three-month interval from that point on.

MR. GARDNER. Well, I feel that in view of the imminence of a decision of some kind on Merrill, it might be very wise to put it off at this point. We'll know whether the Solicitor General is going to take the appeal to the Supreme Court.

CHAIRMAN BURNS. That helps there.

MR. PARTEE. That helps on that.

MR. BAUGHMAN. Is there anything specific in the law with respect to the timing of the appearances [of the Chairman before the Congressional Committees]?

CHAIRMAN BURNS. I don't believe so. I think the law is very flexible on that. As a matter of fact, as our lawyers read the law--I might test [unintelligible] of the legal profession as I join them now and then--the semi-annual hearings can even be held simultaneously, [or rather in] the morning before the Senate and the afternoon before the House. Never mind whether that's desirable or not; that would be consistent with the language of the law. My guess is that the procedure that we have followed is very agreeable to the staffs of the Committees and to the political figures involved.

Well, I think we have the procedural question neatly resolved and we want to thank you, Mr. Guenther, for this time carrying communication from staff to staff. The one thing I tried to insist upon is a written communication rather than staff to staff arrangements. This is, I think, an exception to the general rule but, since it is such an agreeable outcome, the [exception] is well justified.

MR. GUENTHER. [My] staff will now leave, Mr. Chairman.

CHAIRMAN BURNS. Yes, I think we are ready to resume our regular meeting.

MR. BROIDA. There is a button here that I press [to call in the other staff members], Mr. Chairman, and I have no evidence that it works.

MR. ROOS. Mr. Chairman, is there any problem in terms of communication to the world and the press as to why we are postponing [the decision on the long-run ranges] for a month? [I wouldn't want] our friends throughout the world to say that it's our inability or our confusion [that led to the postponement]. In other words, is there a problem in terms of the market?

CHAIRMAN BURNS. I doubt it. I think it's simply that the hearing has been postponed and, therefore, [it is proper] to do it.

MR. COLDWELL. Will that hearing postponement be made public?

CHAIRMAN BURNS. I think it will be made public by the House Banking Committee. Depending on what they do, we may or may not want to put out a very simple brief statement. I think you'd better talk this over, Joe, with Ken. It may be desirable for us to put out a very simple factual statement on the assumption that what the House Banking Committee does in the way of a

statement will be inadequate from our point of view.<sup>1/</sup>

Well, we were in the process ages ago of considering [the economic outlook]. I don't know but I believe the last person we heard from was Mr. Eastburn. Is that correct? Mr. Balles, may we hear from you now?

MR. BALLEs. Well, I would just like to make a few comments, Mr. Chairman, about the Board's staff forecast, which I find a very plausible one. It is somewhat more optimistic with regard to the second half of this year and going into '79 than that held by my own staff and in that regard I share some of the views previously expressed by Governor Coldwell and I think by President Eastburn. Just a word as to why we are somewhat less optimistic--to the extent of expecting a real growth rate possibly under 3 percent by the second half of the year: It's simply a different view on how much effect the fiscal stimulus will have on consumer spending. That seems to be the biggest part of the whole difference. A tax cut of around \$17 billion is really not all that big, even when contrasted with the \$11 billion tax cut of 1964-65, which at that time amounted to 2-1/2 percent of disposable income. The currently proposed cut will amount to about 1 percent or less of disposable income even before the social security tax increase, which would reduce it by about one-third. So in short, our staff is not all that optimistic about getting as much bang--consumer spending principally--as in the view held by the Board's staff. Hence, we would be a little less optimistic about the second half of the year and the early part of '79.

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

MR. MORRIS. Mr. Chairman, we had a rather interesting discussion among my board members as to why we are getting such a sluggish upturn in capital investment in this recovery. One of my business directors by the name of Miller raised this proposition, which he feels [is true based on] his own firm and from talking to people and businessmen, that businessmen perceive investments in this climate to be considerably riskier than investments in earlier periods. And they have responded by shortening the payoff period required to authorize investments. He says the common payoff period now for investment is 4 years, whereas in the early '60s it was 8 years and in the early '70s, 6 years. I think if the business community is applying a criterion that severe--that is, a payoff period of 4 years--it's very clear that an awful lot of investment would not be able to meet that sort of criterion. So they are only going ahead with that limited body of investment in which they have confidence they can get it through in 4 years. Does that jibe with your observations, Dave?

MR. LILLY. Well, yes. I was going to state it a different way. I think what is occurring is that plants are being recycled; [we're seeing] new equipment and rearrangements within plants but we're not getting new plants. You have an increase in capacity as well as an increase in productivity of some kind, but you also have a diminution in the pressure for longer-term investment. I also think that new plants by and large have been built abroad. This is only a hypothesis, but I think it's one worth exploring. It may well be that our capacity figures are not

---

<sup>1/</sup> Secretary's note: At this point the Executive Session ended.

accurate at all and in terms of the total industrial [complex] we may actually have a great deal more capacity than our capacity measurements indicate. I got ahead of myself.

CHAIRMAN BURNS. Thank you, Mr. Morris and Mr. Lilly. Anything else, Mr. Morris?

MR. MORRIS. No.

CHAIRMAN BURNS. Mr. Wallich now, please.

MR. WALLICH. I don't find the staff's forecast unpersuasive. It's not far from the range of other forecasts. I am puzzled about how the story is going to unfold eventually. We are now in a very long-lived expansion. Nothing has happened that would lead one to think that it would end with a bang, so if it ends, it will be with a whimper. And if it ends that way, there is no real need for [the economy] to turn down. It could be a growth recession from which we could emerge. This has happened before. It bothers me that the [expansion] is being kept alive with stimulation, a tax cut, very late in the game. Monetary policy will in some form be supplying the means to finance all this. And I'm asking myself what we are building up as we go through this year and maybe through next year, with considerable government deficits in the face of an economy that ought to be righting itself and arriving at some kind of full employment equilibrium, full employment balance of the budget. Nevertheless, with all these concerns, I don't see the [economy] turning down with a tax cut ahead and a tax cut that is potentially variable; if the situation were very weak late in '78, it could be beefed up. With investment pressing increasingly on capacity limitations, forecasts now get us into the 87 percent capacity utilization range. I think there ought to be enough momentum there to carry the economy forward and that's the hypothesis on which I'd be willing to go.

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

MR. WINN. Mr. Chairman, I have several comments. First, I'd like to urge us not to get trapped in the traditional kinds of statistical reporting--particularly in the housing area, which has been quite crucial to developments to date, with home modernization and repair still representing a rising and major portion of the total. To the extent that new housing starts may turn down, I think it is crucial to know what is happening in modernization and repair because it's really the total expenditure in [the housing] area that determines what is happening. As you know, the figure is now \$33-35 billion in [the modernization and repair] category and I think we just ought to incorporate that into our thinking about what's happening in this area.

My second comment is that I haven't any quarrel with the sort of traditional kind of approach we have for an analysis but I suspect it won't happen that way. In the last two weeks, I have noted perhaps the biggest change in sentiment, if psychology means anything in terms of future behavior. I can't tell whether it's the weather, the stock market, the foreign exchange market, newsworthy developments, inflation, or concern about what's happening here in Washington, but there's a very marked change--with people who didn't think they would cut back on plans, planning to cut back at the moment. Now, to the extent that [sentiment] can swing that fast negatively, it can also change



the other way. And, unlike Phil's view, my feeling is that we may not get quite as robust a first half in spite of the momentum we have. And if psychology changes as a result of the market outlook or peace in the Middle East or a thousand external events that really aren't factored into these [forecasts], you have the basis, I think, for maybe the reverse--for the second half [to be stronger] as contrasted with what the economic analysis will tell us here. I'm surprised and puzzled by the very sharp change in sentiment that Mark reflected in part in his comments, but the feelings are quite sharp and they tend to spread very quickly, as you know.

CHAIRMAN BURNS. Well, I want to pause at this point. I want a show of hands, particularly on the part of our Bank Presidents. How many of you have sensed or experienced a similar development in your own region among the businessmen whom you see and have contact with? [Pause] How many have sensed the opposite?

VICE CHAIRMAN VOLCKER. To a very minor degree.

MR. GUFFEY. To a very minor degree or no change.

MR. BAUGHMAN. I would say not to a minor degree. We have seen spectacular retail sales for this [period].

CHAIRMAN BURNS. Yes, but you come from a foreign country!

MR. LILLY. Do you use the peso down there?

MR. BAUGHMAN. I hear it referred to periodically!

VICE CHAIRMAN VOLCKER. My reading of this, for what it's worth, Mr. Chairman, is that I had not recognized some of the ebullience that has been expressed earlier around this table about capital spending; it was not reflected in my business contacts by and large. I have not noticed any distinct change but, if anything, I think there is some strengthening recently in that the worst things that people expected to happen around the middle of [last] year have not happened and the economy looks a little better. [As for] capital spending, [businessmen] seem to feel a little more confident about it than they did last summer.

MR. BLACK. I'd agree with that, Paul. I was comparing December to January.

VICE CHAIRMAN VOLCKER. December and January, I find difficult--

MR. ROOS. In terms of the attitudes of the businessmen in our District, they have been concerned for the past year about our ability and the economy's ability to come to grips with inflation. That is unquestionably their number one concern. Whereas their sentiment has not changed, those who have followed carefully developments in monetary policy, at least in our area, are losing some confidence in our willingness or our determination to do what they feel is necessary to come to grips with inflation in the 12, 24, or 36 months ahead. That's where some

pessimism is occurring because they see the growth rate in money having persisted above our ranges for nearly 12 months or more now. And that is recognized, at least in our neck of the woods, if I can use that expression, as a harbinger of inflation. If there has been an increase in the negative attitude on the part of leaders of our larger businesses it has been [because of] concern about this inflation problem.

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

MR. PARTEE. Well, Mr. Chairman, I must admit that I am happy that we don't have to focus on the longer-range targets--if I may use the term--at this time, because I have some qualms about the economic situation that may be somewhat resolved in a month. On the other hand, they may not be. But within a month we'll have the specific formulation for the tax program from the Administration and will see what the Congressional response is. We will have whatever kind of anti-inflation program is going to be proposed and, again, will be able to evaluate it and see what the response is. We might even see whether momentum is possible again on getting some energy legislation, which right now we--or at least I--have really very little feel for since Congress hasn't returned to Washington at this point.

First of all let me say I agree with Governor Coldwell that in the very short run the outlook is good for rising output, rising activity, simply in reaction to that stupendous surge in retail sales in the fourth quarter of the year. I do believe that production has run behind final sales and now there will be an upward adjustment in production in response to that final sales number. That may, however, [result] in rapid inventory accumulation if at the same time final sales flatten out, which they quite possibly could do. So, the concern I have has to do with the second half of the year, not the first half of the year. And there I'm a little disturbed by capital spending prospects. They haven't come along as well as I expected. I was disappointed by that plant and equipment expenditure survey, too. The stock market is very bad, really. That price earnings ratio on Jim's chart is fantastically poor; it's even below what people used to think was a conventional price earnings ratio in the '30s. And that's not a very good indication of the prospect of the kind of business confidence that would lead to rising capital spending.

I'm also very concerned about the mortgage market. We have said and I've said at times that there was an awful lot of excess credit being [generated] in the mortgage market and, therefore, the mortgage market could decrease in size significantly without greatly affecting the prospects for housing. But again, the chart Jim--or maybe it was Jerry--presented this morning on the housing area gives me pause. For example, it shows that the volume of homes sold has reached 5 million units. Now, if you assume 5 million units and an average value of \$40,000, which isn't too far from a [likely] average--I don't have one specifically in mind--that would be \$200 billion a year. There is an association, I am sure, in the turnover of used houses to support new home sales just as there is an association in the car market with used car sales supporting new car purchases. So I'm not sure there is as much fluff in that mortgage market as we have conveniently imagined. I hope to have some work done on that in the next month to see whether that's a reasonable prospect or not. So, in fact, if you had a rather considerable drop in willingness on the part of mortgage lenders to lend, you could have a rather sizable expectational and then real impact, I think, on the new

housing market. I'm also impressed by that chart on outstanding mortgage commitments at savings and loans. They have gone up like a rocket. The total outstanding commitments seem now to be about \$32 or \$33 billion.

MR. KICHLINE. \$34 billion.

MR. PARTEE. \$34 billion. If I were a savings and loan, and I had this many commitments outstanding and I suddenly became more concerned about my cash flow, my reaction would be to stop making new commitments. And that could have quite a pronounced effect, it would appear. I'm a little concerned. I'm just not sure how this housing area is developing. It could be on the weak side.

I've said before that I was bothered by the prospect--what I consider the unlikely prospect--that there would be another year of very high car sales. The staff forecasts are pretty high for car sales, even though in that chart they had on car sales it looked like an irregular downward zig-zag movement as 1977 went on. And I was interested in the note in the Redbook, Bob, that there seems to be quite a lot of doubt about sustaining sales out there in your area, as expressed by the Detroit economists too, I believe.

Then finally, I was wondering some months ago how the weakness in the foreign situation would come to affect us. It is now more obvious that it can come to affect us. Our balance of trade has not shown any improvement; that continued to deteriorate as the [past] year has gone on and apparently may deteriorate, or at least not improve, in the immediate future. The price of that has been a surplus of dollars in international markets that has caused the dollar to decline, is going to accelerate domestic inflation, is causing concern abroad, and may be the source of instability in world economies. I believe that our staff has a projection of accelerating growth abroad in the coming year--by about 1 percentage point or something like that you said yesterday, Ted. [You expect] some acceleration in growth, yet as I look at the charts we have on industrial production and employment and things like that, they're not moving anywhere. So I wonder about whether that might continue to be a very grave source of concern and maybe even an exacerbated concern as the year goes on.

The final point I want to make, Mr. Chairman, is that I also think there is a rather hefty allowance for the immediate impact of a tax package in the projection. It's quite a bit considering the offsets in rising tax rates and social security and unemployment compensation and so forth. It seems to me, just judging it without having seen the work that went into it, a rather higher multiplier than we experience on average; it may well be a time when we will get a lower multiplier than average.

So I guess I feel that the immediate outlook is okay. I'm not prepared to say that there is likely to be a recession by the end of the year, but I do think that there are problems in the outlook as '78 goes on. And when we get into '79 we may in fact get to that point where the growth rate is so low that the economy tends to stall.

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

VICE CHAIRMAN VOLCKER. Well, when I listened to the staff, Mr. Chairman, I was going to make a very brief comment--and I'll still keep it brief--that the overall pattern of the projection is reasonable to me. And maybe that's enough. [As for] modifications, when I heard Mr. Coldwell right off the bat, his modifications were in the direction that I would make them--with perhaps more rapid growth in the first half and slower growth in the second half. I don't come away at this point with quite the same feeling of a threat of recession or quasi recession in late '78 or early '79 that he expressed, assuming this tax cut does come on stream as the staff has projected. So, while I would in my mind modify the pattern somewhat in that direction, I think it's fair to say that the overall pattern that's projected here I don't find at all troublesome.

Just a word about the stock market and profits and plant and equipment [expenditures]: It does seem to me that those price earnings ratios are so low in part because the stock market has come to realize that the profits aren't real when they are being compared there--that real profits are overstated. That is another way of referring to the profits problem, which you already referred to. And much does hinge, I think, on the outlook for plant and equipment--not so much [over most of] this year perhaps as the very end of the year and continuing into next year--[in terms of] the sustainability of the recovery on improving profits. Again, the tax program we get obviously will bear upon that. I'm assuming that that will be reasonably satisfactory [and I'm] thinking that the danger of a recession at this point is not great.

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

MR. GARDNER. Well, I don't want to revisit all of the discussion. I have accepted the staff's forecast and I feel reasonably comfortable with it. We've been through a long recovery, excessively long, and we've looked for ghosts almost at every meeting since it started. I have my own personal theory that in time--although there are new ghosts at this meeting--[others will join] the consumer, who demonstrated [a willingness to spend] in the last quarter of the year. And prior to that time [the recovery was] driven by consumer spending. Eventually, others will begin to sense that it's time to meet this marketplace, if consumer spending continues. And we have in prospect a fiscal action, which would put more money into the hands of consumers. Somebody suggested that the theory of a lack of confidence or confidence wearing out is a possibility. There are obviously technological changes; there are new markets and new activities. Some constraint will be put on imports; I don't know altogether how much. But if I were a businessman, I would see some opportunity and I would have a belief in a longer term for the recovery. I'm not trying to make the second half of the year more questionable, along the lines that Phil has suggested. I don't necessarily agree with that. In all, I can accept the staff forecast and I look at some point to a change in the general disposition of business confidence as well as consumer confidence. I've been waiting a long time; I may never get there. But still there's more to be heard; there's a possibility of pluses occurring in that area. So, I don't object to the staff forecast at all, and I think all told we'd better design our directive in accordance with it because we may have more demands for lending--more demands for funds as the year progresses.

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

MR. LILLY. Well, just to finish up what I started with in answer to Frank's question, for the reasons I gave I don't expect business fixed investment to spurt in the next year. So we are back where we've been right along and that's dependent on the consumer. I think I agree with the general comments I've heard here that the next six months are going to be reasonably good because we do have an inventory building program that's going to have to go on. But I'm very worried about the second six months and I'm going to have a great deal of interest in watching from the outside what happens here, as signals are sent out as to what [the Committee is] going to do about the economy in the second six months [of the year].

CHAIRMAN BURNS. I think you've paid a very high compliment to this Committee and the degree of influence that we can have. Well, thank you, Mr. Lilly. Mr. Baughman next, please.

MR. BAUGHMAN. Mr. Chairman, just a couple of comments. I'm reasonably comfortable with the staff projections in general terms. I thought I might report that on the plane coming in from Dallas yesterday there were a number of Texas farmers, presumably coming to Washington to demonstrate. We have had a fair amount of demonstrations going on in Texas. But we have just summarized the January survey of agricultural lending in the District and it's not possible to find in those data any really bearish information. Now, it's not positive; it's not on the plus side. It is on the negative side insofar as there are changes, with the exception of farm real estate values where the survey reports, surprisingly enough, small increases between the fourth quarter of last year and the January survey of this year. There's some increase in the proportion of banks which say that from their point of view their loans are higher than they would like them to be [given] their deposits. There's a significant increase in the number of banks that report they are laying off loans to correspondents and to nonbank lending agencies. They're reporting increases in demand for loans to finance feeder cattle and the storage of crops and also for farm operations and reduced demand to finance farm machinery. But, these are all the kinds of adjustments that one would expect to find and they are all of fairly minor magnitude. I just wanted to report that as an indication, even though there are indications of distress in this sector, that in our particular region it still does not appear that things are falling apart.

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

MR. GUFFEY. Yes, Mr. Chairman. With respect to the staff's forecast, I think we have been marginally higher for the last couple of quarters than the staff in its forecast so this time maybe they have come closer to what we had believed in the past and still believe may occur in the future. One thing that does trouble us with respect to their forecast for the fourth quarter is the kick that seems to [come] from the tax decrease. Our staff does not believe the effect that might occur in the fourth quarter will be of quite the magnitude that is projected by this staff.

Lastly, [let me] follow up on Ernie Baughman's comments with regard to the agricultural sector and particularly the banks that service that sector within the central part of the country. Although [their financial conditions] are tight, there isn't any great concern apparently at this time

that there will be any foreclosures or in the alternative, any inability to meet the credit demands when they arise, and that would be in the spring at the planting season. So, by and large, there's no euphoria running through the agricultural sector. I don't think the strike has had any great effect nor will it. And when the snow melts and the sun comes out next spring and the sap begins to rise, I think there will be a lot of activity going on in our part of the country and the strike soon will be forgotten--not the reasons for it, but the strike itself will be forgotten.

CHAIRMAN BURNS. Thank you, Mr. Guffey. Mr. Black, would you like to add any comments?

MR. BLACK. Mr. Chairman, every point I wanted to make has been made. I would say simply that all of us recognize that the uncertainties are greater now than at almost any time in the forecast. I wouldn't have a lot of confidence in any particular forecast now for the next six months. I wouldn't quarrel a lot with the staff's forecast. It's probably about as good as anyone could do. Like Governor Wallich, I see no excesses that I think will lead to a recession, but at the same time I have the same doubts voiced by many people about the strength of housing and plant and equipment expenditures. So, if I had to deviate any from the staff projection, I think we could have a period of somewhat less rapid growth than they're projecting toward the last part of the year. The thing that impressed me recently more than anything else was the abrupt shift in the attitude of our directors between the December meeting when they were at the height of their ebullience and the January meeting when they toned it down considerably. [They were] still fairly optimistic but it was a marked change, more than I've ever seen between two months.

CHAIRMAN BURNS. And do you have a judgment as to the reasons for the change?

MR. BLACK. Well, I think it's partly your failure to be reappointed and the absence of any definitive action on taxes or inflation. Over-regulation on the part of government, all these uncertainties, and the decline in the dollar I think played a big part. All of these things that we have all been concerned about I think are just beginning to take their toll a little more.

CHAIRMAN BURNS. Thank you, Mr. Black. Would anyone else like to comment on the state of the economy? If not, let me just say a few words. First, it is useful to remember that over many years now those of us who have been involved in economic forecasting have almost invariably expressed doubts about the second half of the year relative to the first half. It's just useful to keep that simple fact in mind. Second, I say without any fear of contradiction that though there have been intimations of recession--and they may turn out to be right--I don't think anyone here could make a good case for it as of today. The case may come 1, 2, 3, or 4 months later on. The case does not exist today, except as a gut feeling or an intuitive judgment. A reasonable factual case I do not think can be made as of today.

Next I must say that the spurt in consumer spending which has made some people happy has disturbed me. It is being financed in very large part by credit. We're having something close to an explosion of credit in the consumer area. Installment credit and mortgage credit have been used in large part to finance consumer spending. I believe that the spurt will not continue and I certainly

hope so. On home building, I'm with the staff or more optimistic than the staff. The significant point I think has been mentioned. You know, the American public, in contrast to some or many of our politicians--perhaps most of them--is very deeply concerned about inflation. People all over the country have been asking themselves the question: What can I do to protect my family? What can I do to protect my children, my family, and myself against the ravages of inflation? And gradually the thought has evolved and is spreading rapidly that, on the negative side, putting money in the bank or a savings and loan account is no protection. Buying bonds, Treasury bonds or corporate bonds, is no protection. Buying common stocks is no protection. It used to be a major protection but it no longer is. Then what is left? Well, gold or paintings. But the average man cannot invest in gold; he doesn't know how. It's not something he's accustomed to. Likewise with paintings. What will he turn to? Well, there is farm real estate, a remarkable record there. But the average man doesn't know how to buy farm real estate. He realizes that location can make an enormous difference. But there's one thing the average man is capable of doing. If he doesn't have a home, he can buy a home. If he already has a home, he can buy another. The average man is also capable of judging neighborhoods. All he has to do is get into an automobile or walk and he can locate areas where the prospect of maintaining good conditions in the neighborhood or some improvement are pretty good over the next ten years or twenty years. People can do that. And they're doing it in increasing numbers. It's surprising to me. I hear it from college professors; I hear it from young people; I hear it from my own children. The movement is spreading.

And the interest rate on mortgages? Yes, what Mr. Partee has said may well turn out to be right, but I don't think people are going to be deterred by an increase in mortgage interest rates of one half of one percent or even a full one percent. And the money will be available at a somewhat higher interest rate. So, I believe that this will continue. Whether that is a cause for optimism or not is something else again. We may easily get ourselves into a condition of overbuilding in this area, such as we had in 1972-73, but in the year ahead we'll have plenty of activity in this field.

As for business capital expenditures, I have learned over the years--I believe correctly--to pay far more attention to orders for business capital goods, to contracts for commercial and industrial construction, to the rate of formation of new businesses, and to appropriations for business capital expenditures. I pay far more attention to indicators of this type than I do to the surveys of the Commerce Department. Is it still Commerce and the SEC or is it solely Commerce now? It's solely Commerce now? And [those indicators] I think have been more accurate. I think the recent survey--sure, it may turn out to be right--understates the trend that is likely to develop. On balance, I think we're going to have a pretty strong economy in the months immediately ahead; how far ahead I don't know. But over the longer run, I think we ought to continue worrying about inflation; we ought to continue to worry about the kind of environment that exists for business capital spending; and we ought to worry about the unemployment of black people, particularly youngsters. And we certainly ought to worry about the position of the dollar in foreign exchange markets, which has very dangerous possibilities for our own economy and also the future of the entire international economy. Well, that's all that I would want to say.

I think we ought to turn now to the [rest of our agenda]. Just a word on the longer-run targets; we're not going to take them up today. That will be deferred until the next meeting of the

Committee. We still have to hear about the operations of the Desk and reach our decisions on current monetary policy and on these two special items we have to consider. Therefore, I think we simply have to return after luncheon and perhaps we can move speedily after luncheon. But, right now, before we break for luncheon, let's see if we can't dispose of items 7 and 8 on the agenda. First, there's the memorandum of discussion for 1972, and our Secretary, in accordance with the tradition, has a recommendation to make on that question. Mr. Broida.

MR. BROIDA. Mr. Chairman, the staff proposes that the Committee authorize the release of the 1972 memoranda this month, which would be on the usual schedule, with the few deletions indicated in the second of the two memoranda distributed. [The deletions] were requested by the Bank of Japan.

CHAIRMAN BURNS. Any questions about that recommendation? The motion has been made and seconded and I take it, approved. Let's move to item 8. And Mr. Volcker, when you try you can be not only fairly lucid, but even remarkably brief, and this is the time to try for it.

VICE CHAIRMAN VOLCKER. Well, I will be assisted by the fact that it has been long enough since some of this technical stuff came up that some of the details will recede into my unconscious instead of the conscious. I think the issues are simple enough here. We have discussed the role of the Federal Reserve and these RP agreements at some length for foreign accounts. This is a matter which is controlled by the Federal Open Market Committee, and whoever does it--the New York Bank either acting for the System account or acting for itself--needs the authority of the Open Market Committee. The issue that arose, you will recall, is that there is some doubt about their tax status. A couple of months ago we got a ruling from the IRS that the tax status was all right, assuming that the Federal Reserve is acting as principal. They call these loans consistent with their earlier tax rulings. If the loan is made with the United States and even more with the Federal Reserve in one form or another injected as principal, we fall under the exemption that says that for a government instrumentality [such] transactions are exempt from withholding tax. So, we are cleared on tax grounds and proceeding. We have had experience in doing these with the Federal Reserve Bank of New York as principal for the System Open Market Account. The earlier practice was to do these with the New York Bank as principal when the System account was not operating. When the System Account was operating in the market anyway, we'd do it through the System account. When the question arose as to the tax status, all of them were channeled through the System account and that has been the practice for the last six months or so.

I would summarize by saying that after analyzing the technical side of this I don't think it makes much difference which way we do it. There are very minor advantages and disadvantages that seem to be offsetting. I don't think that's a distinction that we need to linger over, but the question does seem to me to be one of what public posture we want to take, and that is related in a sense to a legal question of what authority we think is necessary for the Committee to openly give either the Bank or the System account. We can technically operate in a satisfactory way with any of the options that are presented in the memorandum.



The options, very briefly--there are four of them--consist of the following. The first option assumes that we do them all through the System account and wouldn't [involve] anything in terms of changing the directive. The directive vaguely talks about international as well as domestic matters and we don't explicitly have to say anything. We can just do what we've been doing for the past six months. The second option also assumes they'd all go through the System account but it would explicitly change the directive to give recognition to that. The third option says return to the previous practice where they would be done in the name of the New York Bank as principal--it was as agent earlier--when the System account is not operating and do it through the System account when the System account is operating. Explicit notice and authority would be given to the New York Bank to act as principal in these transactions. The System account side would not be touched. And, Mr. O'Connell, in looking at this [proposal prefers] the fourth option, which would in effect make it explicit on both sides. That is, the Committee gives authority both to the New York Bank and to the System account to operate in these repurchase agreements for foreign accounts on the assumption that we would revert to the earlier practice of the New York Bank doing it when the System account is not operating and the System account doing it when the System account is otherwise operating.

The questions that I think are relevant here are: (1) Is there any substantive difference between these approaches or technical differences in the approach to the market? My answer to that is there is no significant difference between any of these. (2) Should we state the authority explicitly and in effect give public notice? My own feeling is yes--that that's the clean and open way to do it and we shouldn't hide behind this very vague directive we now have, which does vaguely refer to international developments, but I think in a different context. So, my own feeling is that we should [give] explicit notice of whatever we do. (3) Should we run it all through the System account? My own preference is to revert to the earlier practice to avoid any question ever arising that in some sense the System account is being distorted, not for pure open market operations to affect the reserve base or domestic level of interest rates or for purposes of affecting international markets in the most general sense. [Unintelligible] some question arising of whether we are distorting what's going through the System account in order to take care of this essentially procedural and operational matter for foreign central banks. So, answering the questions in that way, I do have a preference and I have recommended to the Committee that we take either option three or four. I have no very clear preference between those two. Four is a little more inclusive in that it ends any possible question about the authority of the System account itself to operate. I don't think that is necessary in the light of past history. Three just gives the authority directly to the New York Bank. In either event, I would visualize that we would operate, as I said, through the New York Bank when the System account is not otherwise engaged. When the System account is otherwise engaged and, therefore, it's a convenience for the System account also to handle these foreign transactions, it will handle the foreign transactions. So, I would recommend that as the substantive way to proceed--either option three or four does that--and it's entirely a matter of how inclusive you want to be in stating the authority. I don't know whether Mr. O'Connell wants a word on the preference between options three and four.

MR. O'CONNELL. Just to the effect, Mr. Chairman and Mr. Volcker, that I agree with the analysis that Mr. Volcker has given us as to the placement of priorities or emphasis on the

alternatives. I recommended, as reflected in attachment D, the amendment to both the functional aspects and the outstanding authorization only in the judgment that such an authorization would then make specific the authority with respect to the alternative actions, either when SOMA is involved or if the New York Bank is acting as principal in these transactions. I think it's more inclusive and perhaps from my point of view as a procedural matter is preferable. Technically, I think either alternative 3 or 4 would functionally serve Mr. Volcker's stated purposes and the purpose with respect to the Internal Revenue Service.

VICE CHAIRMAN VOLCKER. I might just add one further point, Mr. Chairman. We had some discussion earlier when this came out about the appropriateness of charging for this service. From my point of view, we would intend to charge in the future a 2 basis point charge. The market practice--where private investment companies might do this for foreigners, including foreign central banks--seems to be to charge either nothing or something up to 5 basis points, with some obviously in between, [generally] a 1 or 2 basis point charge. A 2 basis point charge, according to our analysis, would clearly cover our cost and more than cover our cost. The remainder I would think of as perhaps a very minor charge for acting as principal in these transactions, and there is some theoretical risk. I don't think it's more than theoretical; if the dealers on the other end don't deliver the securities, we would have to make good, and that is only theoretical. The securities are there to margin the account; they do margin the account in effect, but for acting as principal I think we can justify some charge. Part of the philosophy that would lie behind the charge, which I interpreted the Committee as being in favor of earlier, is that we have no interest in competing with the private market unnecessarily and some little charge reflects that concept as well as making it clear that we would cover any costs involved.

MR. PARTEE. You would do 2 basis points on [transactions by] both SOMA and the New York Fed?

VICE CHAIRMAN VOLCKER. Either way.

CHAIRMAN BURNS. Gentlemen, I want to put a question to the Committee, and I may or may not have a suggestion depending on the answer to the question. I'd like to have a show of hands--and this time [not] only including members of the Committee but also the Bank Presidents who are not technically members of the Committee--indicating whether you feel really qualified to act on this issue. Would you feel comfortable? I don't feel comfortable acting on this issue. I haven't studied it sufficiently; I don't understand it and, therefore, I want to know how many of my colleagues are in my unhappy position or are in a much happier position. So how many of you feel really qualified to reach a judgment on the question?

MR. PARTEE. Really qualified?

CHAIRMAN BURNS. I'll modify it. How many of you feel reasonably qualified to reach that judgment? Well, all right, most of you feel reasonably qualified; therefore, I will not make my suggestion. What is the sentiment of the members?

MR. WALLICH. Could I ask a question? What is the criterion for whether the System Open Market Account is operating? Is this a question of that day or that minute?

VICE CHAIRMAN VOLCKER. Essentially that day, as [the Desk's management] plans their operations. If they're going to be withdrawing reserves, this is a way of withdrawing them anyway. This gives them an option. If they're going to be supplying reserves, they might as well supply a few more to take care of this.

MR. WALLICH. So a great majority of operations, then, would go through the SOMA.

VICE CHAIRMAN VOLCKER. I think the earlier experience--if I remember correctly, Peter--was that about two-thirds went through the System account and one-third through the Bank. Now, that is partly because of the tax and loan accounts; the Treasury accounts at the Federal Reserve have been moving up and down so much. If that were steadied, that proportion might shift some, I suppose.

MR. COLDWELL. Mr. Chairman, I would feel comfortable with either 3 or 4. I happen to have a preference for 4 because it states [the authority] more clearly.

MR. PARTEE. I would agree with that. I think it's very [important] to avoid [options] 1 or 2, not because of the operations that are engaged in here, but I just don't like having a precedent of using the open market account to support an activity. Because once you support this activity, you can support other activities and I think that's the reason for avoiding 1 and 2. I think 4 is probably a little better than 3.

CHAIRMAN BURNS. All right, any other view?

MR. BLACK. Mr. Chairman, I was not clear on one point and I asked Peter Sternlight to clarify it for me earlier. It might be helpful to some in the group. In the event the New York Bank is acting as principal in matched-sale purchase agreements, it would make an equal amount of repurchase agreements in the market. I thought that's what it said, but I was not absolutely certain. He said that is what it does.

VICE CHAIRMAN VOLCKER. We're just a pass-through except that we act as principal for tax purposes this way.

CHAIRMAN BURNS. Gentlemen, so far I've heard a slight preference for option 4. Is that generally agreeable? I hear nothing to the contrary and that's the Committee's decision. Looking at the clock, would 2:15 be a reasonable time to reconvene or would 2:30 be better?

SPEAKER(?). 2:15.

CHAIRMAN BURNS. [The time we will reconvene] is officially 2:15.

[Lunch recess]

CHAIRMAN BURNS. Mr. Sternlight, we are ready for your report now, please.

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

CHAIRMAN BURNS. Thank you, Mr. Sternlight. Are there any questions? Mr. Baughman.

MR. BAUGHMAN. What would be your impression, Peter, as to the market's impression of your funds rate target or objective at the present time?

MR. STERNLIGHT. I'd say the predominant view now is that we're aiming at 6-3/4 percent, although there's a little bit of lingering uncertainty that maybe we're going to be heading toward 7 percent within a short time.

MR. BAUGHMAN. Thank you.

MR. PARTEE. Peter, it seems to me that that was an awfully large market adjustment to the news over that weekend--one of the largest I can ever recall, as a matter of fact. Do you think it was because quite a few people thought that 7 percent would be the target? And as they focus in on 6-3/4 percent, is there a chance of more of a rally in that market?

MR. STERNLIGHT. I think that's possible, Governor. I think one reason it was large was that people were very much taken by surprise by the move and there was a lot of lightening of inventories that went on right away--very immediately, the first thing Monday morning. I don't know how much further improvement there might be as the idea is further instilled that 6-3/4 percent is the objective. I would think perhaps not too much.

MR. PARTEE. It has backed down some.

MR. STERNLIGHT. It has backed down some.

MR. PARTEE. I guess every bill and even the intermediates have backed down a little.

MR. STERNLIGHT. The bills have come down about 10 or 15 basis points from where they went initially and there has been maybe 6 or 8 basis points of improvement in other sectors. There is perhaps room for somewhat more but I wouldn't think a whole lot.

MR. KIMBREL. Peter, if we are anticipating a Treasury financing we attempt to accommodate that. If we were to move to, say, 7 percent, how much time [would that give us]? When would the Treasury be announcing?

MR. STERNLIGHT. They will be announcing a week from tomorrow on their quarterly

refunding operations.

MR. KIMBREL. Presumably then we have a week.

MR. STERNLIGHT. I would think so. Then again it depends on what sort of financing they do. If they follow the recent pattern and have auctions, then there is a little more flexibility as to the timing of anything the Committee would consider. There's been some talk in the market of coming with a fixed price issue on this occasion, which I think could circumscribe the flexibility of adjusting the funds rate target.

CHAIRMAN BURNS. Mr. Kimbrel, please.

MR. KIMBREL. That was my question.

CHAIRMAN BURNS. All right, any other question? If not, is there a motion to approve the operations of the domestic Desk?

SPEAKER(?). So moved.

SPEAKER(?). Seconded.

CHAIRMAN BURNS. A motion has been made and seconded and [hearing no objections we have] a vote to approve. Mr. Axilrod, we're ready for your comments.

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

CHAIRMAN BURNS. Thank you Mr. Axilrod. Are there any questions? Very well, we're ready to turn to our deliberations on monetary policy. I have only one word to say in the way of a suggestion to the Committee and that is in view of the serious foreign exchange problem that we continue to face, it would be a serious mistake to entertain a reduction of interest rates at this time. I am going to call on Mr. Volcker first and then other members of the Committee, Mr. Eastburn, Mr. Morris, Mr. Coldwell, Mr. Mayo, Mr. Wallich, and Mr. Black. Paul, it's all yours.

VICE CHAIRMAN VOLCKER. Mr. Chairman, perhaps in January it's worth a sentence or two in looking back at the previous year. Governor Gardner referred to the ghosts that we saw. Maybe some of them were more than ghosts, but I know I found myself thinking that we had produced the right compromise here repeatedly. I guess I've expressed that view in past meetings. Looking back at the year as a whole and looking at what's going on now, I must confess as a backdrop that I wish we'd been just slightly more affirmative on keeping the aggregates under control on the basis of all that we now know. Just to come up to date in looking at our recent action, which was clearly triggered by international considerations, I find myself feeling that that's not really inappropriate on domestic grounds either, against what we see as the current and at least fairly near-term six-month prospective strength in economic activity. The little boost that we see now in M1, against the earlier overshoots, [is one reason for] the concern that I have that we may

face the problem of overshoots in the future.

Our interest rate projections have not been good but they all go in the direction of [our] facing the probability of needing somewhat higher interest rates as we move ahead. So, against all that, I'm not unhappy even on domestic grounds with the action that was taken recently. I do think we have a general problem, which Mr. Roos I think referred to most strongly earlier, of credibility or confidence in terms of what we are doing to the aggregates. So, qualitatively, I feel pretty comfortable with one view of what we should be doing now--certainly not [move] lower as you just said in terms of interest rates in view of the international situation and I would say even the domestic situation. I do not feel that necessarily any further steps should be taken right now and I don't counsel that. But I do feel that if the aggregates show much sign of life here in the weeks ahead, we ought not to delay a move and we ought to react pretty promptly to it at least in a modest way.

Now I translate that into the numbers. Boy, it's hard sometimes to get these qualitative thoughts into numbers and I have somewhat the feeling I expressed last time--that we [should] have a money market directive on the downside and an aggregate directive on the upside. But instead of proposing anything so radical as that, it seems to me that something like the "C" specifications on the aggregates are in the right direction and express the view that we should be slow, very slow to ease--in fact, should not ease in this period--but be alert on the upside. In fact, I would prefer on the M1, not on the M2 I think, to even go a half percent lower--make it 1-1/2 to 7-1/2 percent. On the federal funds rate, at the risk of being accused of fine-tuning, I think my qualitative view could be best expressed by saying a range of something like 6-5/8 to 7-1/8 percent would be appropriate with a 6-3/4 percent midpoint. So, in effect, I'd not give ourselves room to move down but give ourselves a little room to move up. The alternative, I suppose, would be something like 6-1/2 to 7-1/4 percent. That widens the funds rate range. It bothers me a little bit in terms of the discussion we had last month about keeping the federal funds rate range at the moment at a half [percentage point]. Also, it may connote on the high side the possibility of going higher than I really mean at this particular point in time, so I guess I would state, at the risk of a fine-tuning accusation, a range of 6-5/8 to 7-1/8 percent with the 6-3/4 midpoint. And I think an aggregates directive under those circumstances would be appropriate.

MR. LILLY. 6.625 to 7.125.

VICE CHAIRMAN VOLCKER. If that's the correct arithmetic. I'm not sure I know how to do that!

MR. LILLY. I just wanted to be sure we had the third decimal point correct!

VICE CHAIRMAN VOLCKER. It takes three decimal points to go in eighths; I know that.

CHAIRMAN BURNS. Well, now that we've converted a fraction into a decimal--and if you're comfortable about that--we can proceed. Thank you, Mr. Volcker. Mr. Eastburn next.

MR. EASTBURN. I think Steve [Axilrod] is right that we are going to have to be in the process of raising money rates as we move forward. However, having taken the action earlier this month that was taken, I would prefer to stay about where we are at this time with respect to the funds rate. Like last time, however, I feel that the spreads that we have on the [ranges for the] aggregates are larger than we need, particularly on the M1 measure. And as long as we stick with the money market directive, it doesn't give adequate incentive to the Desk to move the funds rate soon enough. So rather than move toward the alternative C specification, I would prefer to stick with the alternative B aggregates and reduce the upper limit of the M1 range to something like 7-1/2 percent. And I'd urge the Desk to move on the funds rate if [that limit] starts to be approached.

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

MR. MORRIS. Mr. Chairman, while I did not support the increase in the funds rate range, I agree with you that [given] the situation [in the foreign exchange markets] we cannot permit rates, in the short term, to decline. So I would support alternative B with the money market directive.

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

MR. KIMBREL. Mr. Chairman, I guess I would prefer alternative C. Although Mr. Volcker has fine-tuned it, I would hate to see the funds rate moved down any, so rather than that, I think I prefer to see [a funds range of ] 6-3/4 to 7-1/4 percent, particularly after Mr. Axilrod's statement and the Bluebook's [indication] that we may very well have to move earlier than later. So I would prefer to see that composition at the moment.

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

MR. COLDWELL. Mr. Chairman I would like to stay where we are at 6-3/4 percent. I would put a caveat on that only [if] the aggregates appear to be growing very strongly--by that I mean even the 8-1/2 percent specification in "B" would be acceptable to me. I'd prefer the 6-3/4 percent midpoint and be willing to go with a 6-1/2 to 7 percent formulation or something like that. I don't really care; I just want to hold [the rate] at 6-3/4 percent.

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

MR. MAYO. Thank you Mr. Chairman, I guess I have less confidence in the January seasonal adjustment factor again than some of my associates around the table. Given that, I have some difficulty in going back to an aggregates directive. I still feel that in this environment a money market directive is quite appropriate. I would not want to see the Desk move, if the [M1 growth] rate even gets to 8 percent. I would prefer to see us get together on the phone if it does that for the period of two months. But I just don't have that confidence in the figure. I am a monetarist over a long period of time; I'm no monetarist on monthly changes. I really prefer 3 to 8 percent to the 2-1/2 to 8-1/2 percent for M1, although that may be quibbling. Perhaps as a qualification to what I just said--and I'm not being a monetarist--I think we ought to tighten up [the width of the

range]; the 6 point difference is a little too big for me on the M1 with reference to the current period. I would like to see us get together on a telephone meeting if we get close to that 8 percent just to discuss the situation again.

On M2, I find the lower end of that 5 to 9 percent range unacceptable. I don't think it [is] relevant at all to suggest that we might ease, giving equal weight to M1 and M2, if [M2] gets down to 5 or even 4 percent. I would use the same lower range for M2 that I use for M1 because it becomes irrelevant. The reason we would get down to 4 percent, say, for M2, would be a reason that is inconsistent with our idea of easing. It would be a response of disintermediation, which requires a different brand of aspirin. I would stick to the 6-1/2 to 7 percent [on the funds rate range] though, Mr. Chairman, with the 6-3/4 midpoint. But like last month and the month before, I would suggest that our directive not say 6-3/4 percent but say "the current rate." Anybody can look it up, it is true. But I think there is enough stability in the 6-3/4 percent right now that we can use "current rate" and not use a specific digit regardless of which type of directive we employ.

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

MR. WALLICH. Well, I share Bob Mayo's thought that we ought to tighten the M1 range. We've moved to a 6-point spread under conditions of always fearing an explosion. That fear for the month of January seems to have diminished considerably. So I think we could go back to a narrower range. I share the feeling that we should not allow the funds rate to go down, mainly for international reasons. And, therefore, I arrive at an asymmetrical relationship. In principle, I'd like a wide funds range, but on this occasion I think we should make the present level also the lower limit, but stay at that limit and go to as high as 7-1/4 percent if M1 [comes in strong]. I would make the M1 range 3-1/2 to 7-1/2 percent. That means really that we stay at 6-3/4 percent on the funds rate, and [if] the aggregates are very surprisingly weak, we get a chance to review our situation. I think in a difficult situation where we're trying to reconcile domestic and international factors simultaneously, it may be necessary to have more frequent communication. As far as M2 is concerned, I'm reluctant to give it as much weight now as we do. We give it equal weight and it seems to me now it is in a state of transition, so I would remove that paragraph. But I have no difficulty with the alternative B range of 5 to 9 percent.

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

MR. BLACK. Mr. Chairman, our best guess is that with current money market conditions, we'll get a growth in M1 of something like 6 to 6-1/2 percent in January and February and a rate of growth in M2 of maybe 7 to 7-1/2 percent. As Steve Axilrod suggested, we too are becoming increasingly concerned over what we perceive to be the developing financial situation in the late winter time and early part of the spring with heavy Treasury borrowing superimposed upon heavy borrowing by state and local governments and heavy private credit demands. So we would agree with his assessment that it's very likely that we're going to have to move the federal funds rate up to resist supplying reserves necessary to support growth in the aggregates that would otherwise take place. This leads me to the conclusion that we ought to resist any movement in M1 much above 6 to 6-1/2 percent and in M2 much above 7 to 7-1/2 percent. So, I would favor narrowing



the aggregates spread, as Messrs. Mayo and Wallich have suggested. My figures would be 4-1/2 to 8-1/2 percent for M1 and 5-1/2 to 9-1/2 percent for M2. And I would want to widen the federal funds range to 6-1/4 to 7-1/4 percent or--to use Governor Lilly's decimal system--to 6.250 to 7.250.

CHAIRMAN BURNS. .25000.

MR. BLACK. That's right. And I would interpret this asymmetrically, as Governor Wallich suggested, in that I would move up to 7 percent if it appears that the aggregates are moving beyond the midpoints. But from the standpoint of the international situation and also the past overshoots in M1 in particular, I would not want to move down below 6.750. And I would favor an aggregates directive and, if we can do anything about it, raising the Regulation Q ceiling by .50.

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

MR. PARTEE. Well, Mr. Chairman, with a sigh, I would admit that this is no time to back the money market down--it having made this very difficult transition to a somewhat tighter condition. I think we have set in stage forces that may weaken [economic activity in] the second half of the year, particularly in the housing and mortgage area. And I would say that the rate structure is still in a very sensitive state in any event. That is, to me at this particular point and assuming there isn't a change in Regulation Q, I think the Committee needs to assume no change over the next month. There could be one, but it's a hard thing to bring about. There's quite a difference between a 6-3/4 and a 7 percent funds rate. There's a lot more difference between 6-3/4 and 7 than there is, say, between 5 and 5-3/4 or something like that because we're in such a sensitive state. I also would like to point out that some of the numbers that have been floated around indicate on the aggregates really quite a restrictive policy if in fact we have a 12 percent nominal GNP. Was it 12 percent nominal GNP, Steve? Is that what you said?

MR. AXILROD. Yes.

MR. PARTEE. You might expect that we would get M1 growth of as much as 10 percent in the quarter. It may be less than that but the odds will be in the direction of a high number. On M2, although Paul was talking about overshooting, I find that in the fourth quarter--that is, from September to December--the annual rate of increase was under 7 percent. Now, a lot of people have identified M2 growth roughly with nominal GNP growth. That certainly wouldn't hold for a quarter, but I think if you've got nominal GNP running around 12 and M2 running around 7, say, for an extended period, that would certainly indicate future difficulty for the economy that we would be bringing about. I don't see that we are over-utilizing our resources or that the prospects for a boom are so strong that that kind of crunch policy is called for at this time.

To sum it up my view would be that we ought to have a money market directive because of the great importance of the interest rate level at this particular juncture, so we might as well be forthright and say that the range is 6-3/4 percent for a bottom and I wouldn't want to go over 7 percent for the top, with a 6-3/4 "midpoint." And I would accept the idea that under those circumstances we could perhaps reduce the range for M1 to 5 points, to 3 to 8 percent, although

[given] where we start out--at the bottom of our federal funds rate range--the lower numbers on those aggregates don't mean much because we're not going to ease unless we have a special meeting of the Committee or a wire from the Chairman or something like that. So again, I would take 6-3/4 to 7 percent, with a midpoint of 6-3/4 and a money market directive with aggregates ranges of 3 to 8 and 5 to 9 for M1 and M2 [respectively].

MR. BALLEs. Mr. Chairman, I too share your views about not letting interest rates drift down at this time in view of the international situation. I also share Paul Volcker's view that the uptick that we've had may not have been inappropriate in view of previous overshoots. Based on the discussion of the economy this morning and as we see the outlook, the specifications of alternative B are generally satisfactory in terms of a federal funds range, with the assumption that we would stay in the near term at 6-3/4 percent and not go up unless there's a pretty good reason in terms of threatening overshoots. Just to complete the picture, I would join those who view the 6-point spread as being too wide on M1 and I would like to see it come down perhaps to a 2 to 7 percent range, although I could live with the 5 to 9 percent on M2. And all things considered, I prefer the monetary aggregates directive this time.

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

MR. ROOS. Mr. Chairman, in my judgment the prospect of inflation remains as serious as it has ever been. M1, as we know, has grown more than 7 percent for the last 12 months. Since March of last year it has grown at an 8.4 percent rate. The problem remains that we have repeatedly said publicly that [our M1 target is lower than that]. If we intend to do something to alleviate this problem, I can't see any more favorable time to at least take initial corrective action. Unemployment has dropped somewhat and as you said earlier, Mr. Chairman, there is no real evidence other than possibly gut feelings on the part of some of any real softening of the economy. The international situation cries out for doing something about the inflationary problem and I'm just totally convinced--I could be wrong--that if we don't take some action now under these circumstances, we're going to have to take action 6 months or 12 months from now and the problem will have gotten worse. I liken what we have done in the last year sort of to the alcoholic who should do something but he takes a little drink this time and another little one and he's always going to do something down the road. Well, I don't think we have done what we might have done over the past year in terms of gradually reducing the rate of growth of money. If we put off [resolving] this inevitable problem, we're going to have to take the step in the future and I think quite conceivably we would be forced to act under less propitious circumstances, perhaps at a time when applying the brakes would really entail a much greater risk to the economy than a gradual reduction would at present.

To me the problem is one of either assuring, if we took a 2-1/2 to 8-1/2 percent range for M1, that by golly we would stick to the midpoint in terms of the growth in M1--the midpoint between those two being 5-1/2 percent--or I think more realistically, we should reduce the upper [limit of the] range. We've set ranges until we're blue in the face. We've exceeded those ranges for such a long time that we're just deluding ourselves if we think that we are really doing anything to correct the excessive growth in the money supply. So, with that, I would urge at the most an upper limit on

the M1 range of 7 percent, with perhaps 2 or 2-1/2 being the lower limit of the range. I could certainly go with the M2 range under alternative B. I would prefer a 6-3/4 to 7-1/4 percent range for the fed funds rate and I would prefer an aggregates directive to a money market directive.

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

MR. WINN. Mr. Chairman, in attempting to follow what's going on, I got lost over the year-end. Was there any change in the way we calculate these numbers?

MR. AXILROD. You mean the way we calculate the money supply?

MR. MAYO. You mean the base?

MR. WINN. Yes, the money supply.

MR. AXILROD. No, there's been no change.

MR. WINN. I didn't know whether we lost part of the year-end in January or it came back to December or what. I wondered what happened there. This was probably my ignorance, Mr. Chairman.

MR. AXILROD. We have not received any benchmark numbers, if that's what you're asking.

MR. WINN. Yes, maybe. I am concerned about the disintermediation as an adjustment factor here ahead, so I think I'd be inclined to go with "B,"--3 to 8 and 5 to 9 percent [for the aggregates ranges ] and 6-1/2 to 7 percent [for the funds rate] this month, with an aggregates emphasis.

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

MR. GUFFEY. Let me say first of all that I am delighted with what occurred in moving to this 6-3/4 percent [funds rate], maybe for different reasons. I think domestically we're at the point where we should be at the moment. Because of the events that are ahead of us, I think that's probably where we should be. That is to say, I would like to associate myself with Governor Partee, Governor Coldwell, and perhaps others who would structure the directive so that we would not move from the 6-3/4 percent [funds rate] unless the aggregates begin coming in at a fairly rapid rate. As a result, I would suggest alternative B and would also narrow the ranges on the top side down to 7 or 7-1/2. But I'd structure the directive in the money market conditions [formulation], with it being a good bet to stay at 6-3/4 percent unless the aggregates begin to grow very rapidly.

CHAIRMAN BURNS. Thank you, Mr. Guffey. Mr. Lilly next, please.

MR. LILLY. Well, as one of the troika who voted not to increase the [funds] rate last time, I

thoroughly agree that the last thing we should do is try to retreat to that old rate. I would say, however, that I am very much concerned about the state of all of these markets. The money market has certainly been going through some real gyrations; the international market has certainly been going through a lot. And the stock market is reflecting some uneasiness--all of which says to me that now is the time to pause and hold our breath and wait for things to cool off a little. I particularly feel this way because we are so close to a substantial disintermediation point. So I'd come down for alternative B with a money market directive and a 6.75 to 7 percent range, with 6.75 being the middle. I'm not quite sure how that works! What I'm saying is don't move from that 6.75 percent until you just really have to.

CHAIRMAN BURNS. Thank you, Mr. Lilly. Mr. Baughman next, please.

MR. LILLY. Oh, I left a zero out on that!

CHAIRMAN BURNS. We can add zeros all over.

MR. BAUGHMAN. Mr. Chairman, I find alternative B generally acceptable, but I like the suggestion that we use 6-3/4 percent as the bottom--or the "midpoint," or whatever you want to call it. It does seem to me that the tops of the ranges there are high for the current circumstances, so I would prefer a directive with lower tops on the ranges by as much as, say, 1 percentage point for both M1 and M2. And it seems to me that we probably should have a monetary aggregates directive as well.

CHAIRMAN BURNS. Thank you, Mr. Baughman. Mr. Willes, please.

MR. WILLES. Thank you Mr. Chairman. I guess I remain convinced that the best way we have of unraveling the very strong expansion that we have is to fail to deal as aggressively as we can with inflation. Everything inside me says now is a great time to pause. But I am persuaded by Mr. Roos's comment that we are not likely to have a better time than right now, given both the international situation and people's perceptions of the unemployment rate and so on. I think if nothing else it would be desirable to limit it and reduce the upper range for M1 so that we would have a little better chance to in fact get within the long-run targets where we want to be. The 2 to 7 percent I think goes in that direction. On the federal funds rate, the argument on the bottom I think is correct. The way I'd prefer to see the Committee deal with that would be to [adopt] 6-3/4 to 7-1/4 percent.

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

MR. GARDNER. Well, I haven't much to add to all that's been said. I would like to see the ranges brought down a little. I can accept the 1-1/2 to 7-1/2 percent President Volcker suggested and the 5 to 9 percent or even some modest shaving of the top there. But I'm curious about this 6-5/8 to 7-1/8 percent, using fractions [of eighths on the funds rate range]. I don't quite know how to handle that. The other idea is to bring the [intermeeting] funds rate span to an even narrower range; several have suggested 6-3/4 percent as the lower end. When we get through with this we

are going to be down to one rate; we're not going to have a range. Therefore, I'm confused. But I would add  $1/4$  to the 7 percent [top]. If that requires you, for orderly discussion, to bring the  $6-1/2$  up to  $6-5/8$  percent, okay. Otherwise, I would add a  $1/4$  to the 7 and go with the lower range for M1 as Paul suggested.

CHAIRMAN BURNS. Well--

VICE CHAIRMAN VOLCKER. If there is any confusion about what I meant by  $6-5/8$  to  $7-1/8$  percent, Mr. Chairman--

CHAIRMAN BURNS. Oh, be careful.

VICE CHAIRMAN VOLCKER. What I mean is Mr. Partee's  $6-3/4$  to 7 percent.

CHAIRMAN BURNS. Gentlemen, I need a little time and I ask you all to relax because the fractions could become so minute, so delicate, so varied. [Pause] Gentlemen, I have a suggestion to make here and please don't question me too closely because if you do, you will find that I have quickly run out of knowledge. The numbers are before me. They're not easy to summarize and I am not going to try to summarize them. Therefore, I make a suggestion that we vote on the following: an M1 range of 3 to 8 percent, an M2 range of 5 to 9 percent, a federal funds rate range of  $6-1/2$  to 7 percent, but with a strong inclination not to go below  $6-3/4$  percent, and a money market directive. Now, that is my best effort to extract a consensus on the variety of numbers and nuances attached to the numbers that I have heard around this table. Are there any questions, gentlemen?

MR. ROOS. Mr. Chairman, in my deepest affection for one of the most effective Federal Reserve Chairmen, I won't ask for a recount, but, sir, is there any possibility of shaving that upper limit down a little bit below 8 percent on M1? It would be a shame--you know, I don't want to be a troublemaker at this meeting--

CHAIRMAN BURNS. Well then, let's have a show of hands on the upper limit of  $7-1/2$  percent. Is that reasonable? I tried to give some recognition to a suggestion made by several members of the Committee that the range be narrowed somewhat. But going from a range of 6 points to 5 points I think would be adequate for one meeting. Let me repeat then the suggestion to the Committee. We can vote on the following: an M1 range of  $2-1/2$  to  $7-1/2$ , an M2 range of 5 to 9, a federal funds range of  $6-1/2$  to 7, but with a strong tendency not to go below  $6-3/4$ , and with a money market directive.

MR. WALLICH. Could I ask a question? What is the operational interpretation of a strong tendency or strong inclination not to go below  $6-3/4$  percent? You have made this more important now by lowering the lower end of that M1 range.

CHAIRMAN BURNS. Well, Mr. Sternlight, you will have to live with that, but why don't you attempt an interpretation of that and if you need help, we'll try to supply it.

VICE CHAIRMAN VOLCKER. Can Mr. Sternlight assume in that interpretation that we leave a phrase about the international situation in the directive?

CHAIRMAN BURNS. That definitely ought to be in there.

MR. STERNLIGHT. Well, I assume that this would mean not moving below 6-3/4 percent--not even considering a move below 6-3/4 percent--unless we were down at the low end of the ranges. And if we were down at that low end, we would want to be in touch with the Committee.

CHAIRMAN BURNS. Well, that's perhaps a little stronger than I intended.

MR. WALLICH. Yes, I like that.

CHAIRMAN BURNS. Nobody even heard my comment.

MR. PARTEE. That's a low end on average.

CHAIRMAN BURNS. Mr. Broida, I think is following a suggestion that we use "at about the current level" rather than 6-3/4 percent. All right, since there are no further comments, will the Secretary call the roll, please?

MR. BROIDA.

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

Unanimous.

CHAIRMAN BURNS. This may be the last--well, it will be the last meeting that I'll be presiding over. I want to say just one word. I don't think I've said it before. I am very pleased that at this last meeting of mine the Committee was unanimous. Thank you very much.

VICE CHAIRMAN VOLCKER. Mr. Chairman, if I may have a point of personal privilege, as Vice Chairman of this Committee. I remember when I was first elected. When I arrived here you told me--indeed you announced to the Committee--that the job wasn't going to be very

1/17/78

52

onerous. And I think that prediction, as many others, was borne out. I did get the minutes accepted a couple of times, I think. I may even have gotten some transactions that were already completed accepted once or twice. It wasn't more than twice, I'm sure. But you know in another way, I felt this was a very onerous job, Mr. Chairman, psychologically. Every time one thought one was prepared to make a brilliant or even sensible point, the Chairman would make it more eloquently and state it more effectively. He always anticipates you. He's always better prepared. And he brought an enormous experience in analyses of business cycles and a judgment that I think is clearly matched by no one else around the table or outside this table. In a way, that was psychologically onerous but it certainly made all our jobs much easier. And I have the feeling, if this indeed is your last meeting, Mr. Chairman, that we all are going to find it a bit more difficult in the future. We are going to have to carry a little more weight on our own--not just in analysis but in backbone. I can't think of any greater tribute for this Vice Chairman to give the Chairman of the Committee. I also might say, judging from some newspaper reports I have seen, that I have always appreciated a Chairman who smokes a pipe. But we will miss you very deeply, Mr. Chairman, and I am sure I can speak for every member of this Committee. [Applause]

CHAIRMAN BURNS. Gentlemen, I'm very grateful to all of you and to you, Paul. You have my warmest thanks and very best wishes for a bright future that you personally and other members deserve. Thank you very much.

END OF MEETING

E.M. Truman  
FOMC Briefing  
1/17/78

As a prelude to Mr. Pardee's report on recent exchange market developments, I would like to offer a brief report covering a longer time period.

Since the end of 1976 the trade-weighted average of the dollar against the G-10 currencies has declined by over 7 per cent; virtually all of this decline has occurred since the end of last September when substantial concern about our trade deficit intensified. Since December 1976, the Swiss franc and the yen have appreciated by over 20 per cent against the dollar; the pound sterling, the German mark, the Belgian franc and the guilder have appreciated 10 to 15 per cent; and the French franc rose about 6 per cent. Over the same period, the Canadian dollar and Swedish krona have depreciated against the dollar by 7 and 11 per cent, respectively.

These substantial exchange-rate changes have been accompanied by almost \$36 billion in net purchases of dollars by the major foreign central banks since the end of 1976, almost twice the size of our current-account deficit last year. The Bank of England purchased

of the \$27 billion in net dollar purchases in the first 10 months of last year. Since the end of October,

have accounted for almost all of the \$9 billion in net dollar purchases. How much lower the dollar would be today if it had not received such massive official support we do not know.



We have estimated that since the end of 1976 the price-adjusted depreciation of the dollar has been 7-1/2 to 10 per cent; that is, the nominal depreciation of the dollar plus our slightly better than average inflation performance have improved our price competitiveness by 7-1/2 to 10 per cent. These calculations suggest to some observers that the dollar is currently undervalued and will recover. On the other hand, the staff expects a continuation over the next six quarters of a U.S. trade deficit of around \$30 billion and a current-account deficit of close to \$20 billion. These projections suggest to some that downward pressure on the dollar will continue.

Notes for FOMC Meeting  
January 17, 1978  
Scott E. Pardee

Mr. Chairman:

The current phase of our intervention operation dates back to late September. Between late September and the last FOMC meeting, the dollar had declined by 8 percent against the mark, and our swap debt in marks had swelled to \$630 million equivalent.

From the December 20 FOMC meeting through January 2, the dollar declined by a further 4 percent against the mark, and we had increased our mark indebtedness by a further \$214 million. If anything, trading conditions were more disorderly than before. The market was simply ignoring anything positive and reacting only to news or rumors that reinforced its concerns toward the dollar.

Our inability to restore order rested on three problems. First, although most market participants and government officials here and abroad believed the dollar to be unrealistically low, many market participants feared that the dollar would eventually go lower in view of the continuing large U.S. trade deficit. This prognosis was, and is, open to debate but it was so widely held that the dollar had little resiliency when it came on offer.

Secondly, following the earlier efforts by the U.S. Treasury to encourage an appreciation of the yen and the mark, Administration officials had little credibility when they shifted ground and said they were really in favor of a strong dollar. In the absence of concrete measures to bolster these statements as through an energy policy, market skepticism had progressively deepened. Indeed, the statements themselves often backfired because they carried the wrong code words. In efforts to explain policy, U.S.

officials had fallen into the habit of saying that we were intervening only to counter disorderly conditions. To floating rate purists the only is a badge of honor suggesting a clean float. To the dealer in the market, seeing the dollar drop in disorderly trading every day, the only became pejorative. It reinforces the belief that the U.S. authorities were engaging in benign neglect--or worse, the new term malign neglect, a euphemism for competitive devaluation. The debate over U.S. intentions further eroded the dollar's resiliency.

Thirdly, in the confused and highly speculative atmosphere which developed, our usual covert techniques became of limited effectiveness. The desk's continuation of these techniques in the face of increasing market disorder was taken as further evidence of a lack of resolve by the U.S. authorities.

Under the more active intervention approach adopted on January 4, in which the Federal Reserve and the Treasury shared jointly, the Desk's objective has been to reestablish a sense of two-way risk to the market. On several occasions, we operated forcibly to encourage a rise of dollar rates. This was not done with a rate objective in mind. Rather the effort was to demonstrate to market professionals, and to the world at large, that dollar rates can move up as well as down--that selling dollars short is not as sure a bet as it was.

Our shift of tactics has been broadly welcomed by the international financial community, not to mention central bankers. Nevertheless, many people in and out of government question what we are doing. Some want us to do more and express disappointment that we aren't being forceful enough. Others want us to do less and express disappointment that we have engaged in what they consider an exercise in

futility. The daily press and the wire services which feed into trading rooms featured these critical comments, giving heart to the bears on the dollar and scaring the very few bulls who may be around. Nevertheless, we are more interested in regaining the respect of the market than of entering into a last ditch battle with the bears.

To indicate our intentions, we reverted to a technique used sparingly before, that of making a two-way price--placing a simultaneous bid and offer for marks--when we approach banks either directly or in the brokers' market. By this approach we not only work toward re-establishing two-way trading in the market at times when bid-asked spreads are unusually wide but we have occasionally bought marks which served as additional ammunition later on. We have no intention of making a market permanently; it is not the central bank's function. But during this period of extreme uncertainty, thoughtful people in the market are pleased to see that someone is making an effort to reduce exchange rate volatility and make the market function more efficiently.

So far, the dollar has recovered by a net 4 percent and on recent days trading conditions have settled significantly. The Federal Reserve's debt in marks has risen by a further \$381 million, which corresponds to the amount done by the Treasury. As the operations mounted during the period, our total debt in marks amounts to \$1.225 billion, a record. The Desk requested and received FOMC authorization to increase the limit on the overall open position from \$1 billion to \$1.5 billion. We also received approvals as needed both by the full Committee and by the Subcommittee on exceeding intermeeting limits specified in the procedural instructions. Again, I would defer changes in those instructions until the experience has been carefully reviewed by the staff and the Subcommittee as decided last month. I might note that we have some \$275 million

leeway left under the \$1.5 billion net open position authorized by the Committee. I would hope we could keep within that limit.

#### Recommendation

Between now and shortly after the next FOMC meeting, some four swap drawings on the Bundesbank, in the amount of \$123 million equivalent of marks, are up for renewal. These are first renewals and need only be noted to the Committee.

James L. Kichline  
January 17, 1978

Introduction -- FOMC Chart Show

The staff's forecast of likely economic and financial developments prepared for this meeting of the Committee has been updated for 1978 and extended to include the first half of 1979. As part of the forecasting exercise we altered several of the underlying monetary and fiscal assumptions. The monetary assumptions were changed to correspond with usual practice while the fiscal assumptions were changed mainly to incorporate a tax package expected to be announced later this month by the Administration.

The principal policy assumptions are displayed in the first chart of the materials distributed this morning. For monetary policy, we have assumed growth of  $M_1$  at a 5-1/4 per cent annual rate, the midpoint of the existing longer-run range, but have shifted forward the base level to QIV/1977. We have also assumed growth of  $M_2$  will average 8-1/4 per cent at an annual rate over the forecasting horizon. These assumptions are consistent with longer-run Alternative B in the Bluebook which includes an increase of 1/2 percentage point in deposit ceiling rates during the first half of this year. On the fiscal side we have included a \$25 billion tax cut--2/3 going to individuals and 1/3 to businesses--mainly effective in October, the beginning of the next fiscal year. Unified budget outlays of \$457 billion in fiscal year 1978 remain unchanged in our forecast and are about \$3 billion less than Administration estimates. Outlays in fiscal year 1979 are assumed to be in the neighborhood of \$500 billion. Delay in achieving passage of an energy

program has led us to postpone implementation of a wellhead tax from early this year to mid-1978.

Mr. Zeisel will now review recent and prospective economic developments.

CONFIDENTIAL (FR) CLASS II-FOMC

*Material for  
Staff Presentation to the  
Federal Open Market Committee*

*January 17, 1978*



## **PRINCIPAL ASSUMPTIONS**

### **MONETARY POLICY**

- Growth of  $M_1$  averaging  $5\frac{1}{4}\%$  annual rate from QIV 1977 base
- Growth of  $M_2$  averaging  $8\frac{1}{4}\%$  annual rate from QIV 1977 base

### **FISCAL POLICY**

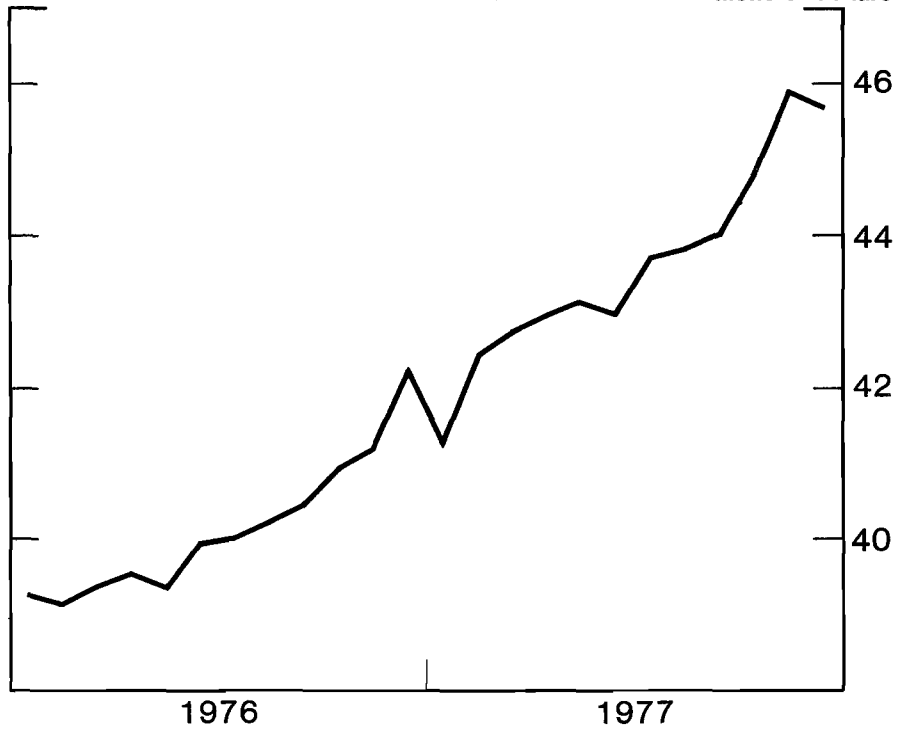
- Tax cut of \$25 billion in FY 1979
- Unified budget expenditures of \$457 billion in FY 1978 and \$500 billion in FY 1979

### **ENERGY PROGRAM**

- Wellhead tax of \$3.50 per barrel on domestically produced "old" oil beginning mid-1978

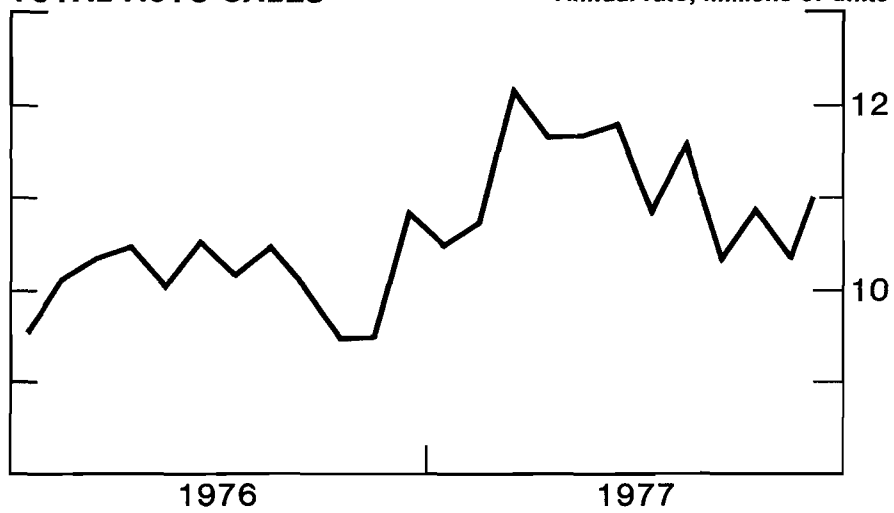
**RETAIL SALES**  
**Less Autos and Nonconsumer Items**

Billions of dollars

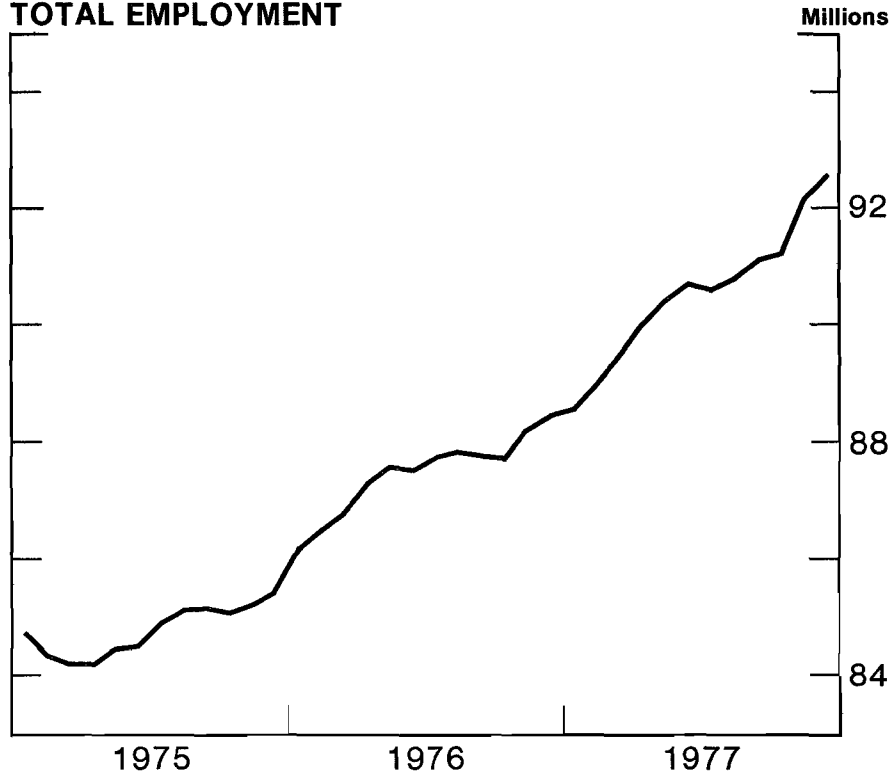


**TOTAL AUTO SALES**

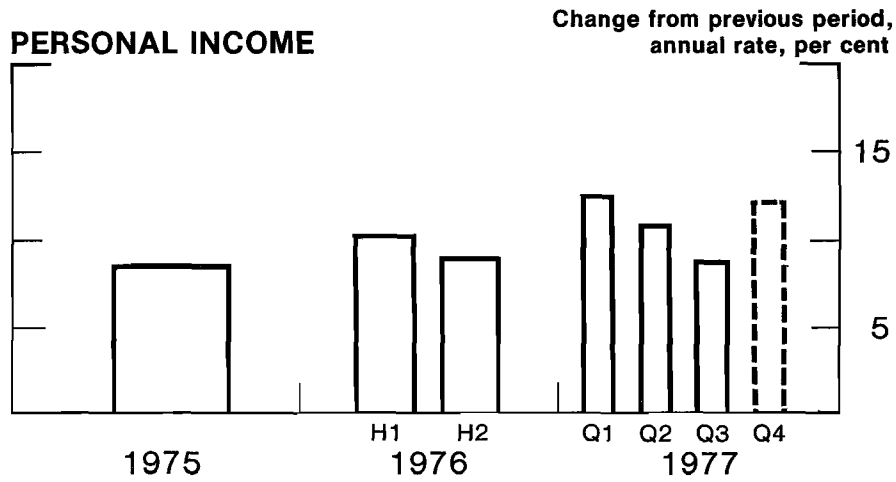
Annual rate, millions of units



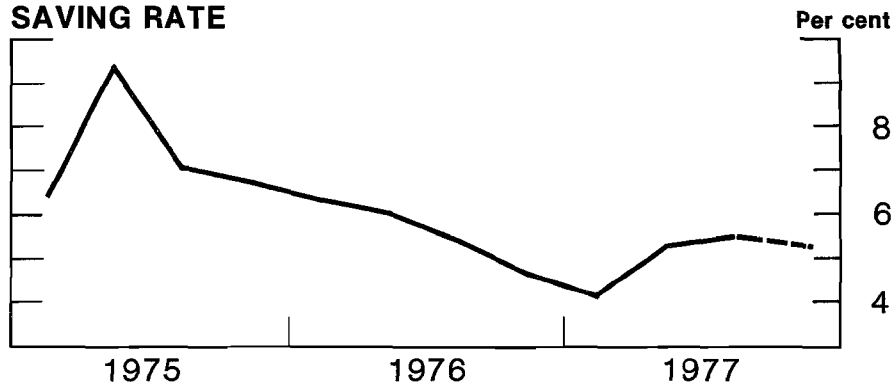
### TOTAL EMPLOYMENT



### PERSONAL INCOME



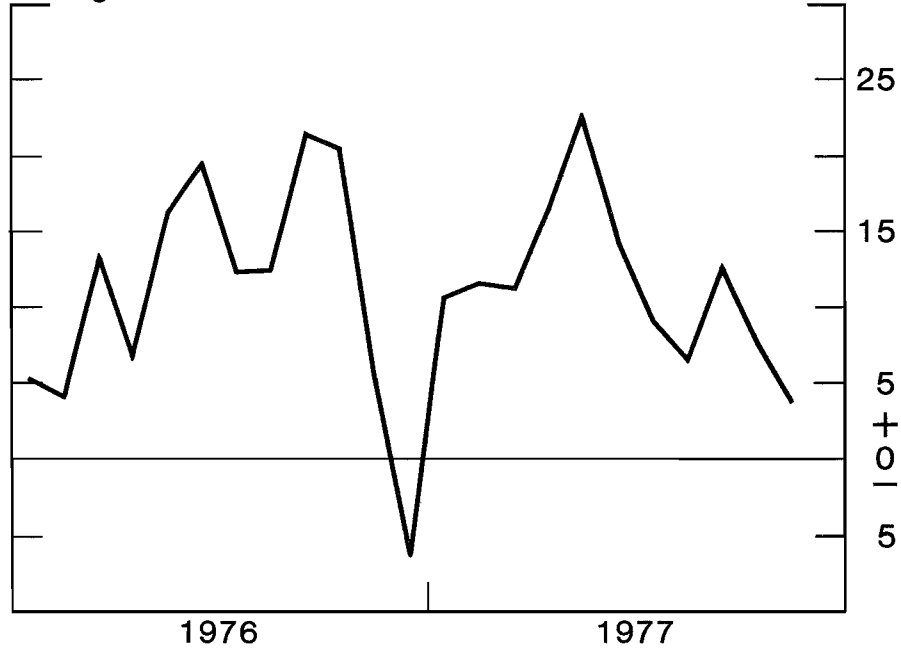
### SAVING RATE



### MANUFACTURERS' INVENTORIES

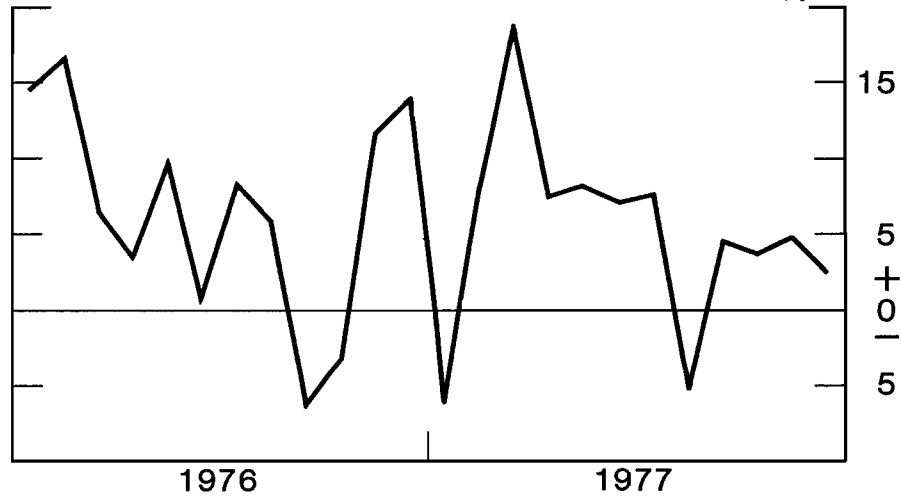
Change in Book Value

Annual rate, billions of dollars



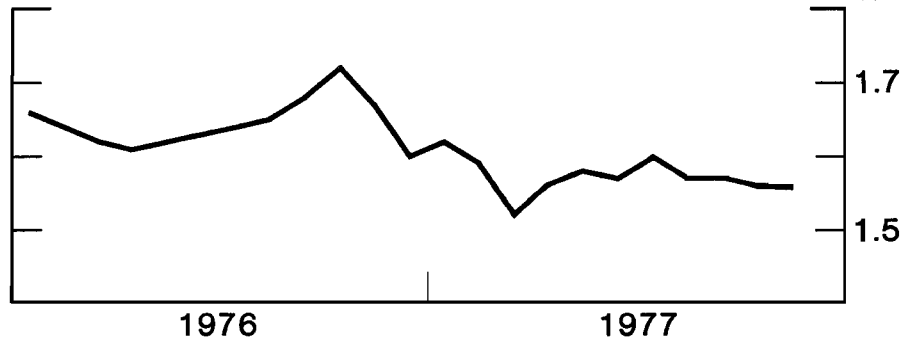
### INDUSTRIAL PRODUCTION

Change from previous month, annual rate, per cent

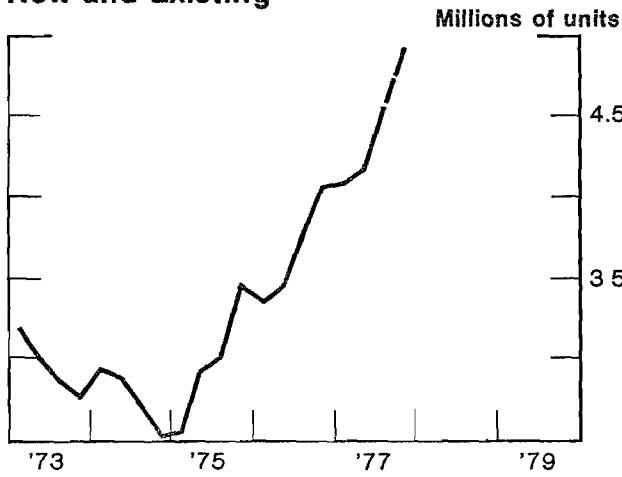


### RATIO: MFG. INVENTORIES TO SALES

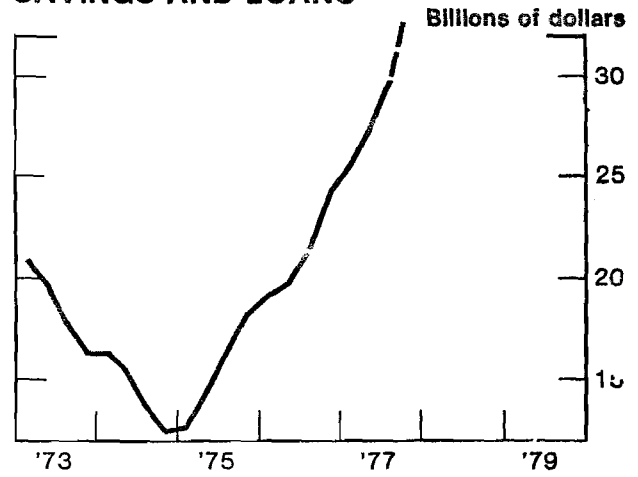
Ratio



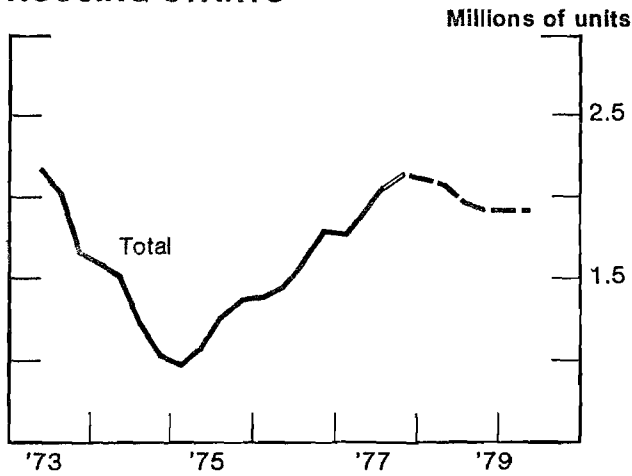
**HOMES SOLD**  
New and Existing



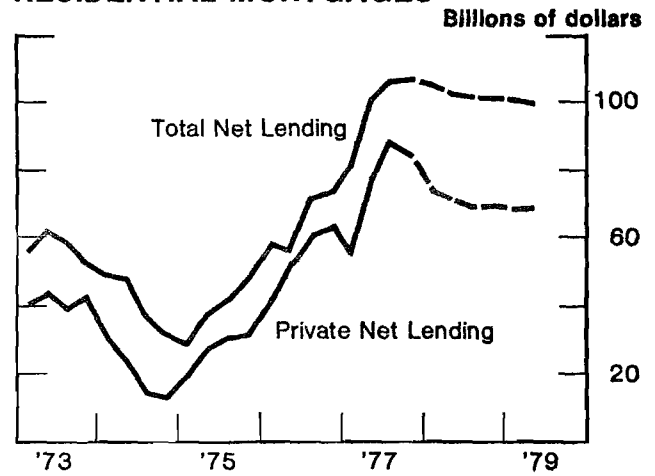
**OUTSTANDING MORTGAGE**  
COMMITMENTS AT  
SAVINGS AND LOANS



**HOUSING STARTS**

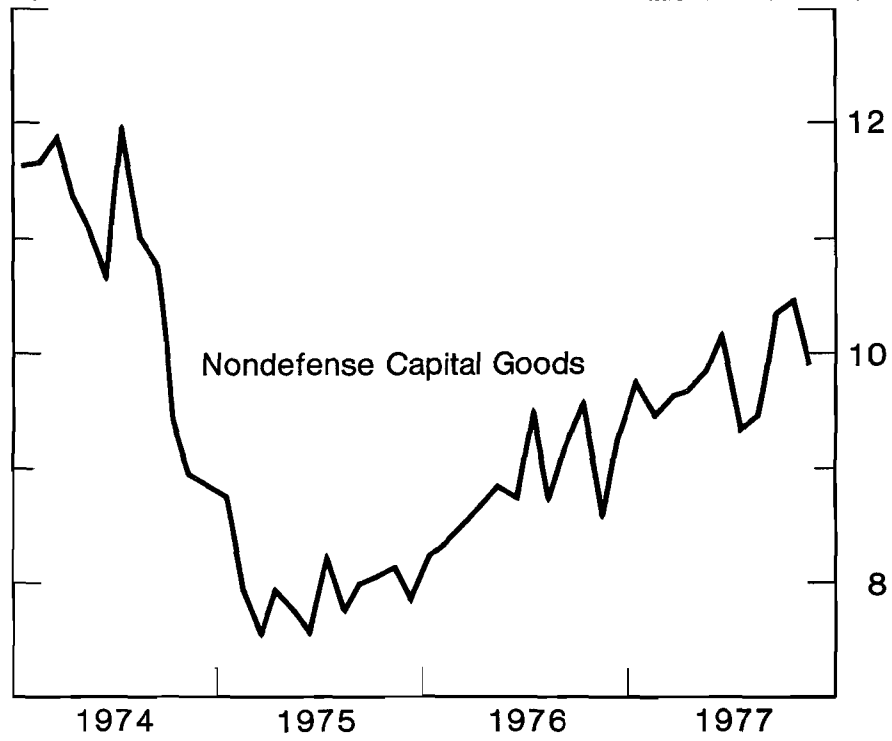


**RESIDENTIAL MORTGAGES**



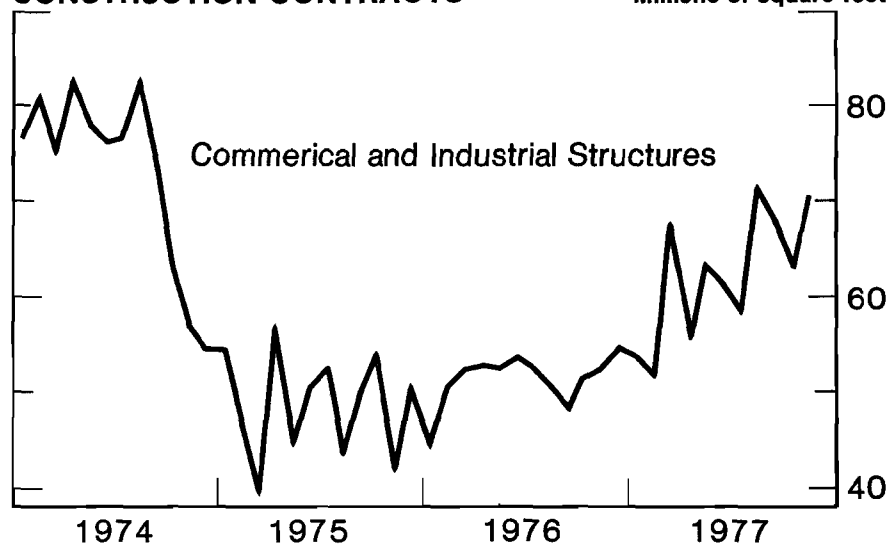
### REAL NEW ORDERS

Billions of 1972 dollars



### CONSTRUCTION CONTRACTS

Millions of square feet



**IMPACT OF SCHEDULED AND  
ASSUMED TAX CHANGES\***

Calendar years, billions of dollars

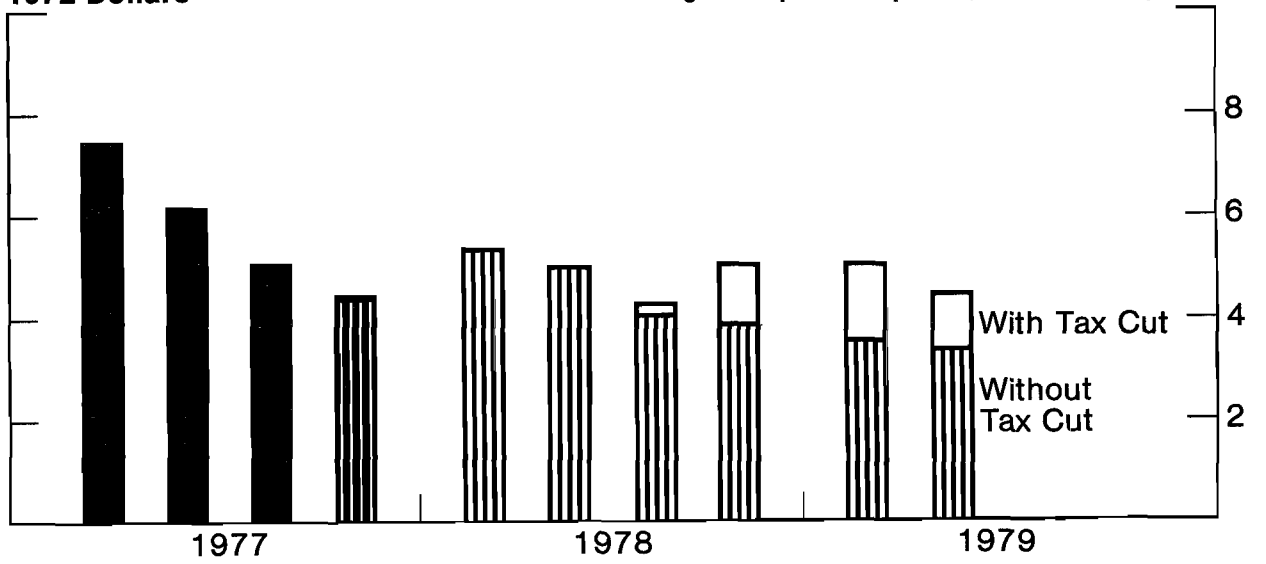
	1978	1979
<b>TOTAL TAX INCREASES</b>	<b>\$ 16.1</b>	<b>\$ 31.1</b>
Mandated Increases		
Social Security Taxes	5.3	11.7
Unemployment Insurance	2.8	2.9
Revenue Drag <sup>1</sup>	8.0	16.5
<b>TOTAL TAX REDUCTIONS</b>	<b>\$ 6.0</b>	<b>\$ 25.0</b>
Assumed Changes		
Personal Income	4.0	16.0
Corporate (Net)	2.0	7.0
Unemployment and Excise		2.0
<b>NET ADDITIONAL TAX</b>	<b>\$ 10.1</b>	<b>\$ 6.1</b>

\* Relative to 1977 base

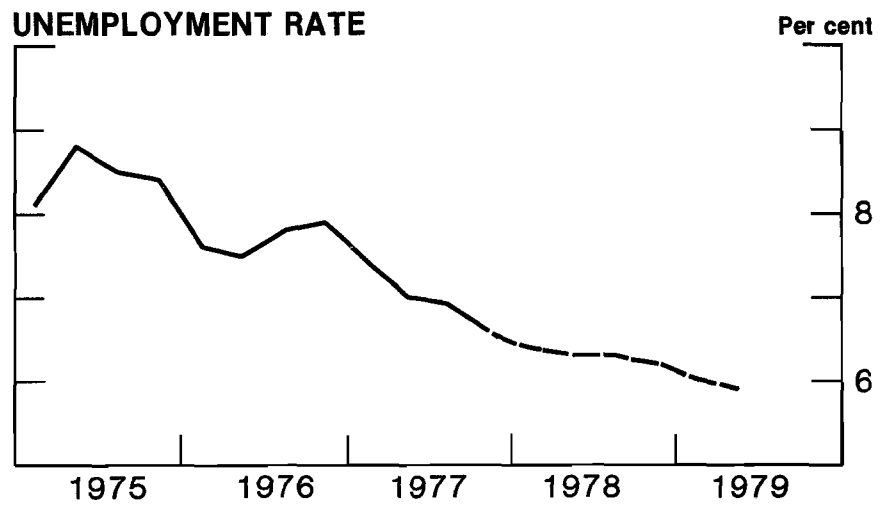
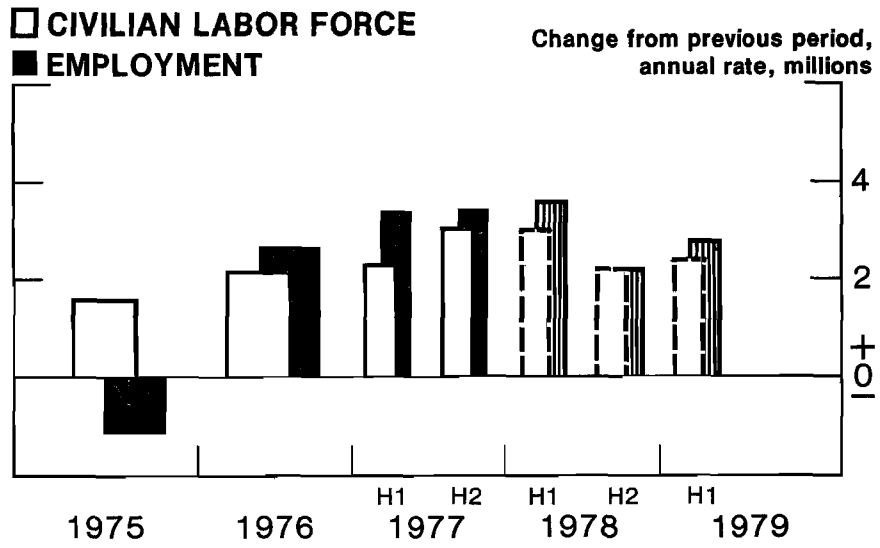
<sup>1</sup> Impact of inflation and progressivity on tax receipts

**GROWTH RATE REAL GNP**  
**1972 Dollars**

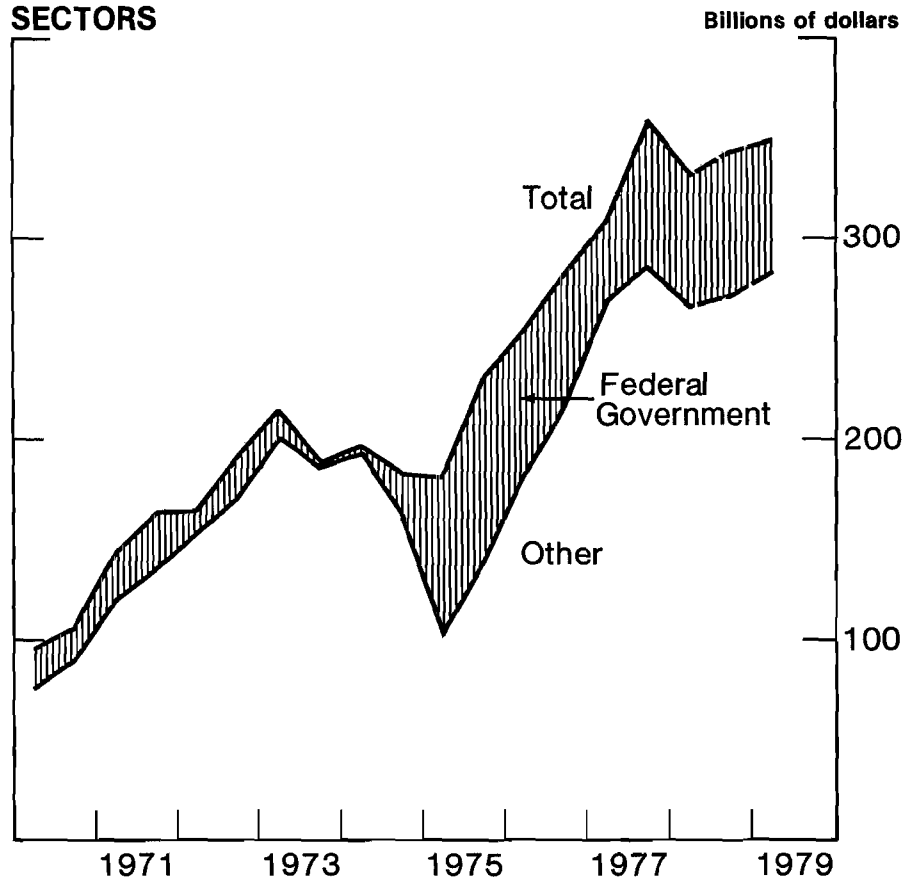
Change from previous quarter, annual rates, per cent



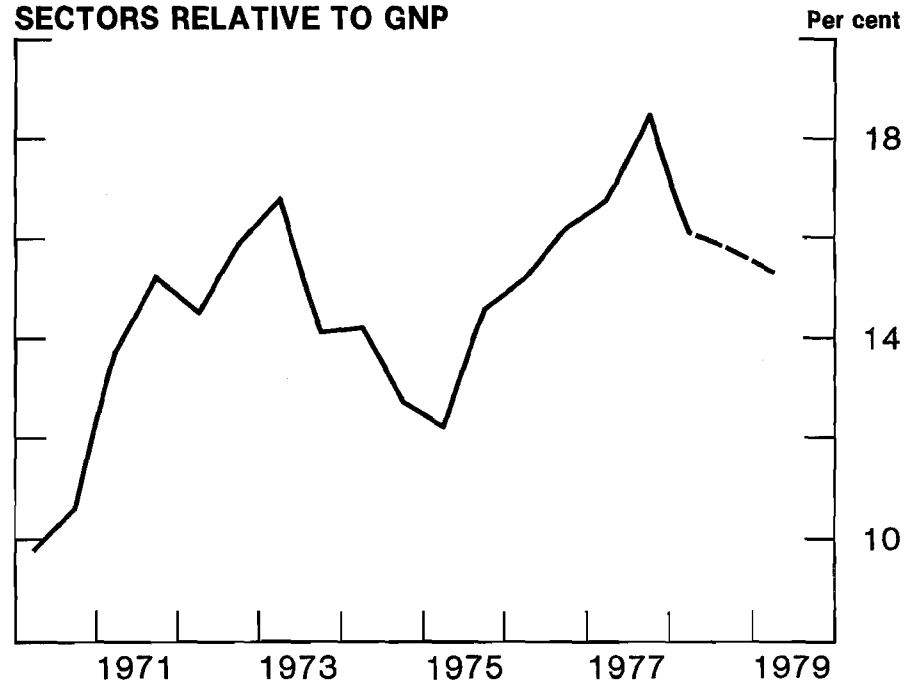




**FUNDS RAISED BY NONFINANCIAL SECTORS**

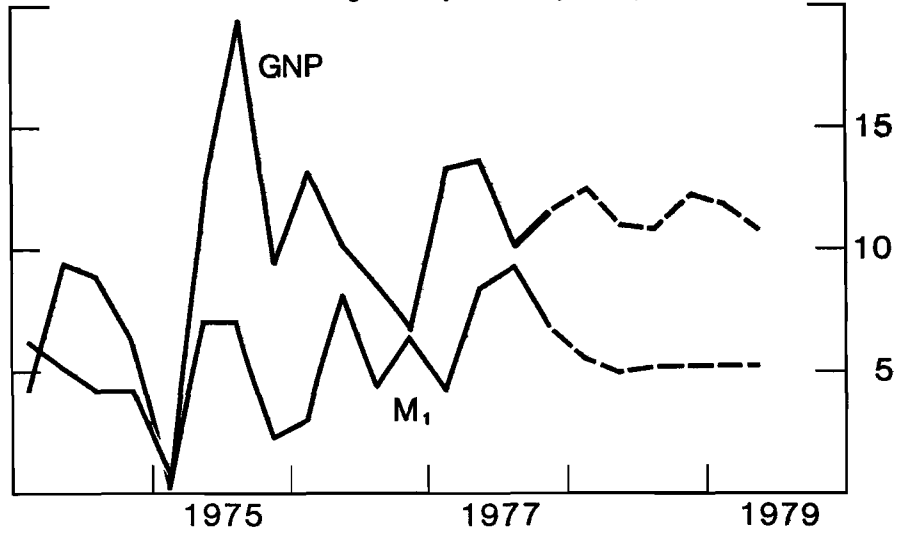


**FUNDS RAISED BY NONFINANCIAL SECTORS RELATIVE TO GNP**



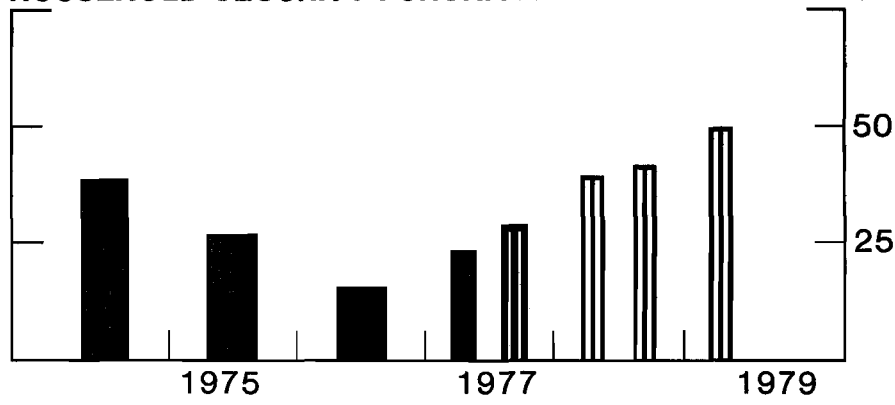
### GNP AND M1 GROWTH RATES

Change from previous quarter, annual rate, per cent



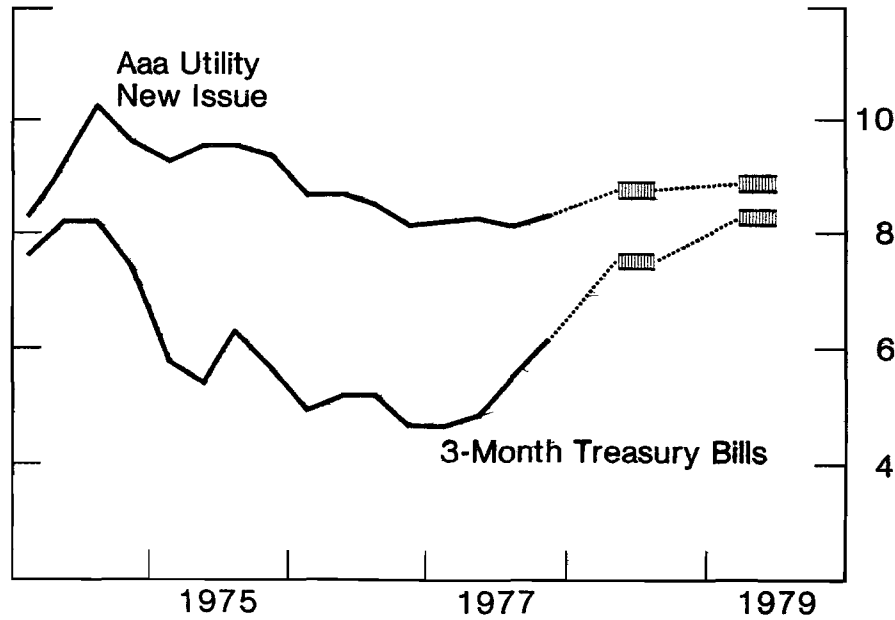
### HOUSEHOLD SECURITY PURCHASES

Billions of dollars

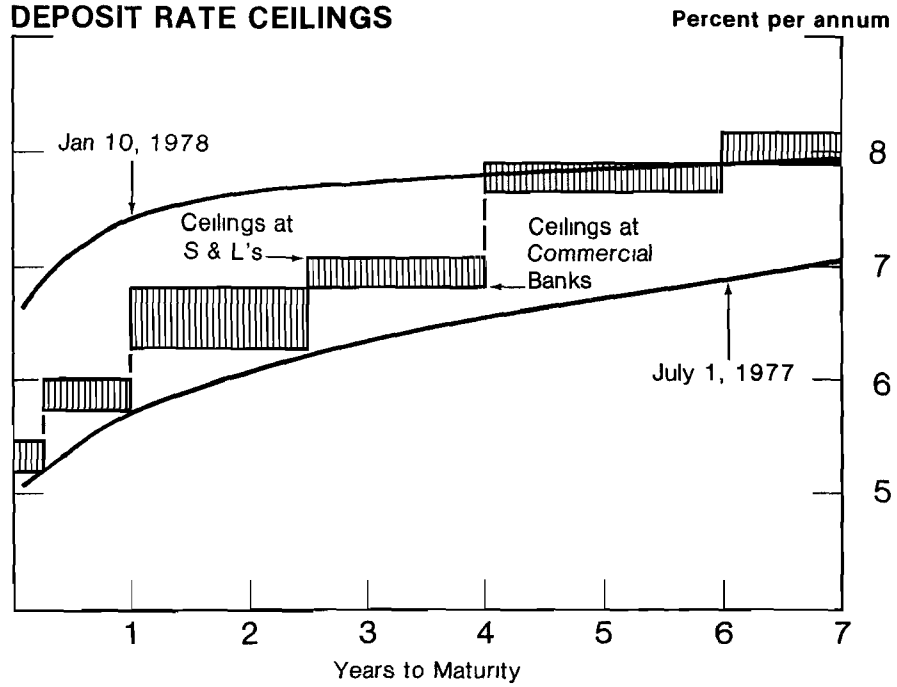


### INTEREST RATES

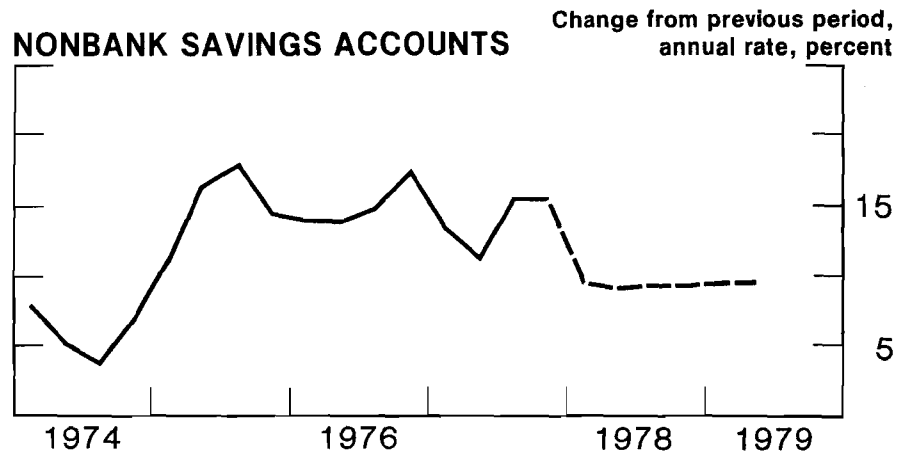
Per cent



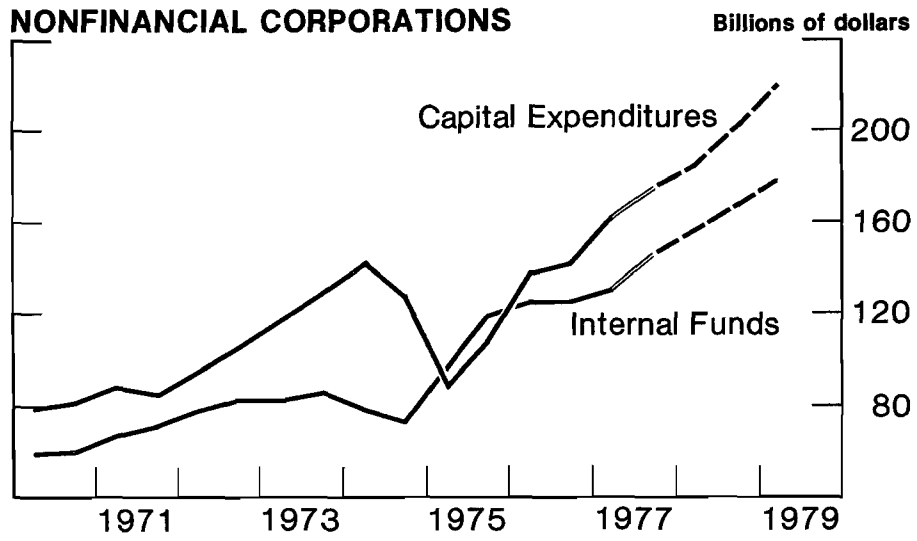
### TREASURY YIELD CURVES AND DEPOSIT RATE CEILINGS



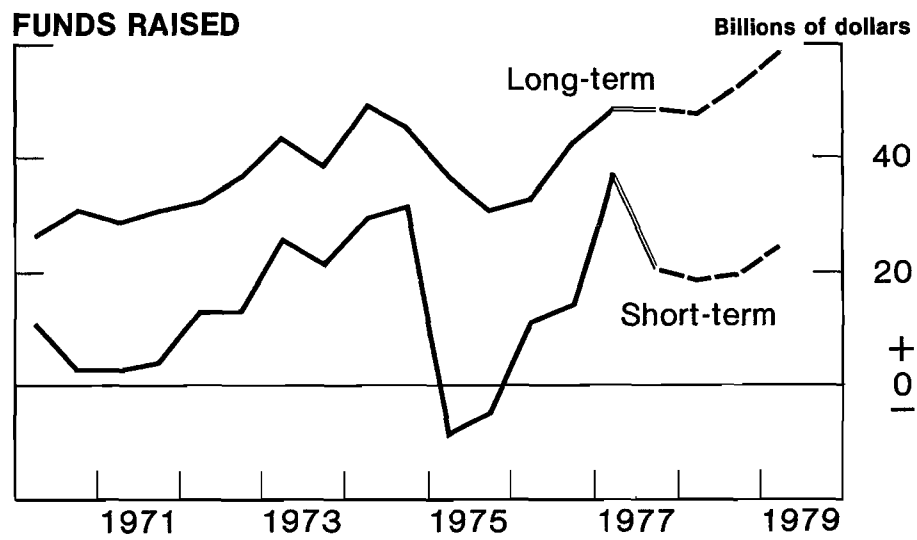
### NONBANK SAVINGS ACCOUNTS



### NONFINANCIAL CORPORATIONS

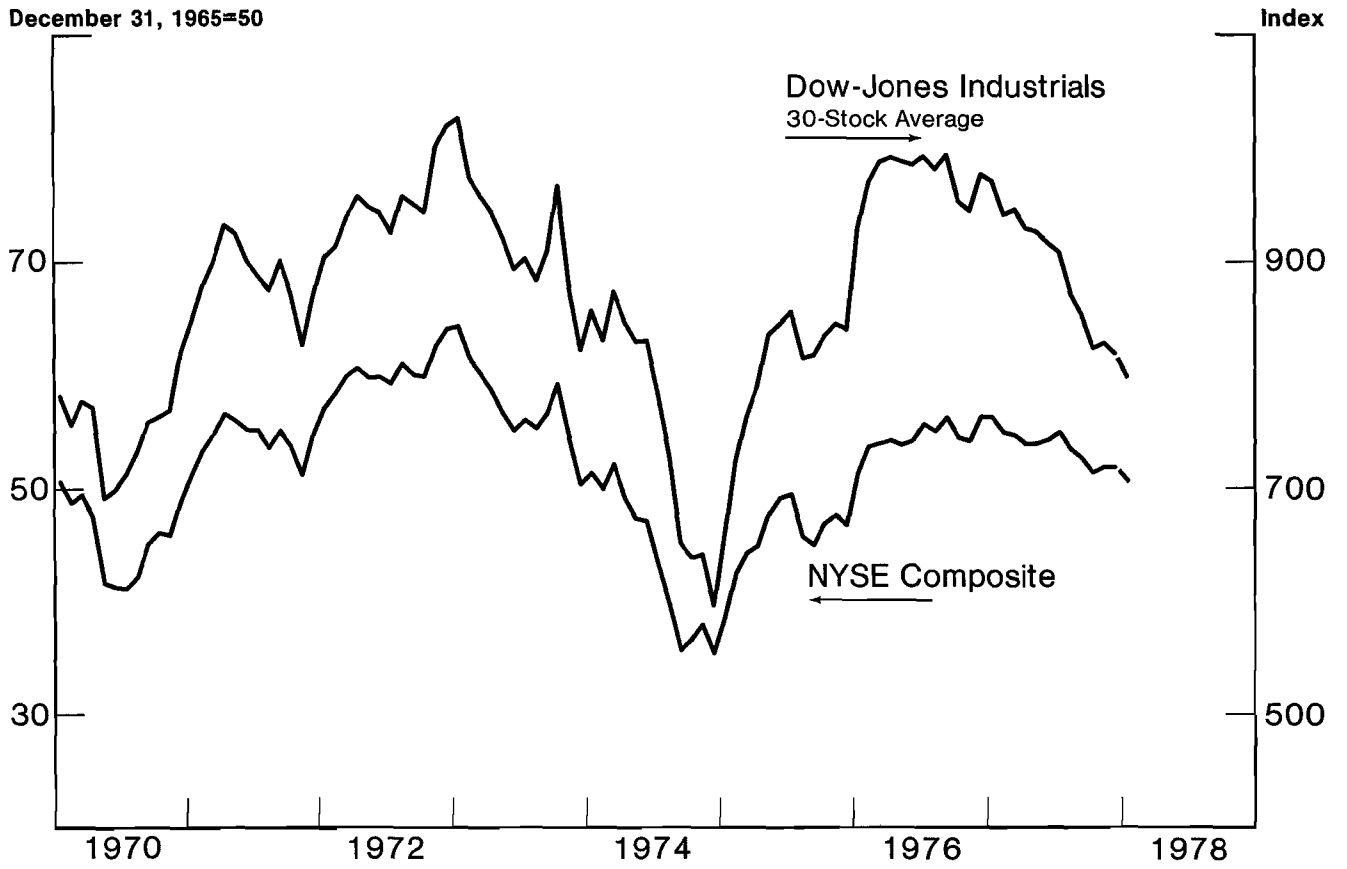


### FUNDS RAISED

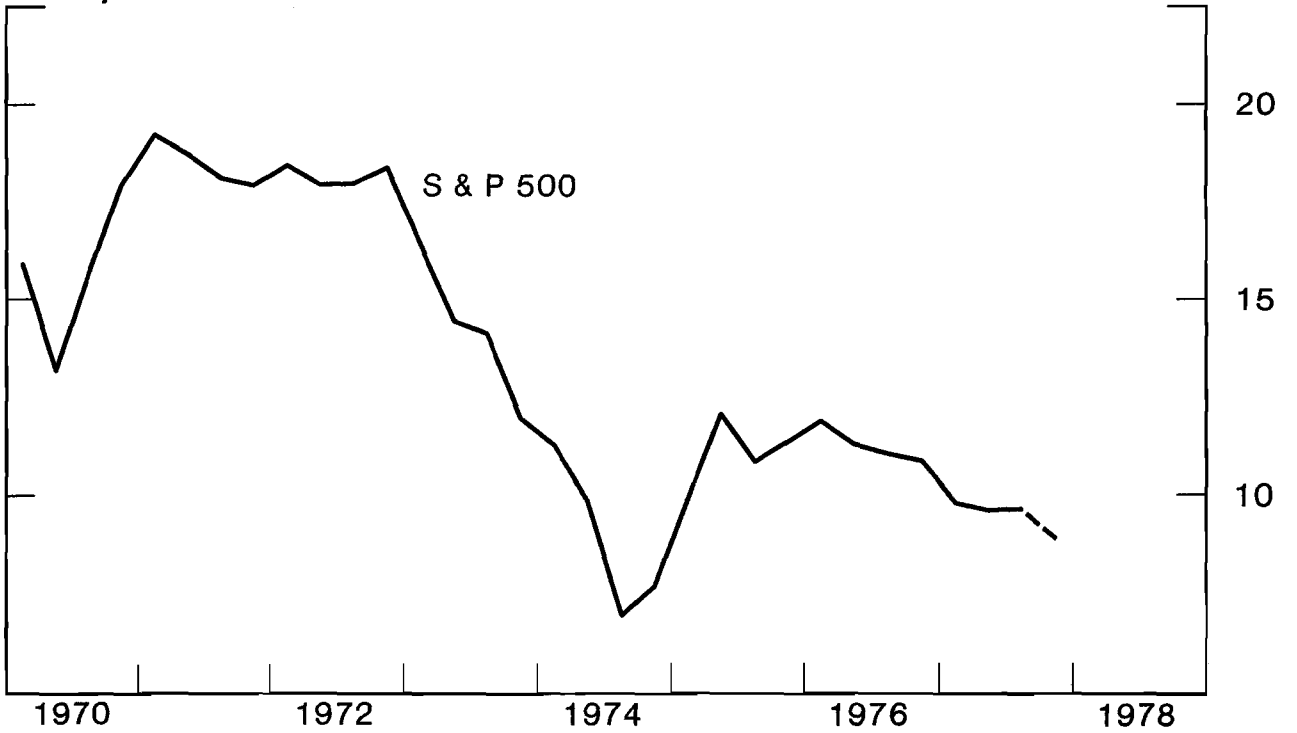


# STOCK PRICES

December 31, 1965=50



# PRICE / EARNINGS RATIO



Joseph S. Zeisel

FOMC BRIEFING  
January 17, 1978

The economy ended the year on a distinctly upbeat note. Growth of real final sales in the last quarter was apparently the strongest for any quarter in 1977. Housing outlays picked up vigorously, but the major source of increased buoyancy has been retail sales--portrayed in the top panel of the next chart. Despite a slight dip in December, retail sales excluding autos and nonconsumption items rose in the fourth quarter at the most rapid quarterly pace in over a decade.

Unit auto sales however--the bottom panel--have not shown the strength in recent months exhibited by overall consumer demand. Although sales picked up in December, the pace remains below that of early in the year and the industry has cut back on its production schedules somewhat. But basic underlying demographic and other determinants of demand continue to be favorable and the most recent slowing may reflect the tendency for auto sales to suffer somewhat when other retail sales are extremely strong.

The next chart pinpoints a major source of the recent strength in consumer demand--the substantial growth of employment, which rose by over a million in the fourth quarter. Gains in payroll employment have been more modest but still very substantial. And, as indicated in the middle panel, there has been a comparably vigorous rise in personal income. Thus--as the bottom panel shows--in contrast to last winter, the strength of consumer demand recently has not been at the expense of a sharp decline in the savings rate.

But the surge of consumer buying along with the increased strength in homebuilding recently, apparently caught producers by surprise. And, as is evident in the top panel of the next chart, inventory accumulation in manufacturing was at a sharply reduced rate in the past few months. As the second panel shows, gains in production have been modest recently, in response to the slower pace of demand that had prevailed through the summer. It is this combination of increased sales and reduced production which cut the rate of inventory accumulation sharply.

Thus, despite strong final demands, real GNP growth in the last quarter probably was held to about  $\frac{4}{4-1/2}$  per cent annual rate, somewhat less than we were estimating last month.

It is clear, however, that the ground has been laid for a substantial improvement in industrial activity over the next few months. Inventories are now quite lean relative to sales, as is evident in the bottom panel, and businessmen are bound to adjust production schedules upward, if only to keep stocks in line with <sup>increased</sup> sales levels. This should contribute to the resumption of a more rapid rate of GNP growth in the first half.

But it also seems likely that once the impetus from this inventory adjustment fades, in the absence of a tax reduction <sup>package,</sup> / underlying forces in the economy would tend to slow the pace of overall growth. Among these forces are first, a likely reduction in the contribution of residential construction during this coming year. Demand for housing remains strong, as is clearly evident in the top panels of the next chart, which show total home sales and outstanding mortgage commitments. But we expect that starts <sup>will</sup> soon begin to decline



in response to tighter mortgage market conditions, reflecting recent reductions in the flow of funds to thrift institutions. However, as noted, we have assumed that Regulation Q ceilings will be raised in the spring, and as is suggested in the last panel, we anticipate that government support programs will partly offset declines in private mortgage lending, helping to thereby/avoid any precipitous decline in construction activity.

Another source of potential drag later this year could be the performance of business fixed investment, which has remained a disappointment throughout this recovery. As is evident on the next chart, indicators of the near-term outlook for capital spending, such as new equipment orders and construction contracts, have continued to rise on average. But they have not shown the degree of expansion necessary to ensure a sustained rapid growth of capital spending. In fact, the rate of growth of orders has slowed recently. Moreover, the latest Commerce survey of capital spending plans showed an increase of only 10 per cent for 1978, as compared to the nearly 14 per cent realized in 1977, which suggests a reduced contribution of investment spending to overall growth as the year progresses.

Finally, and particularly important, is the burden on the economy-- as detailed in the next table-- of already mandated new taxes for social security and unemployment insurance, as well as the continuing revenue drag resulting from the interaction of inflation and a progressive income tax structure. Together, these various factors involve a drain on the income stream of about \$16 billion between 1977 and 1978. There is an impact of about the same magnitude in 1979.

As indicated in the lower section of the table, these fiscal restraints would by 1979 be offset in substantial measure by the \$25 billion tax cut which the Administration reportedly will present to Congress, and which we have incorporated as an assumption in our projection.

Without the proposed tax cut, we have projected that the rate of growth of real GNP would moderate throughout 1978--as indicated in the next chart--and average under a 4 per cent rate in the first half of 1979. However, with the tax cut, the staff now projects a rate of growth averaging about  $4\frac{3}{4}$  per cent for the next six quarters. Following the surge in activity expected early this year in association with inventory building, growth is expected to moderate somewhat until late in the year when consumers initially respond to the reduction in personal taxes. Investment spending is expected to react modestly somewhat earlier, to the liberalized investment tax credit, assumed to be retroactive to January 1st. By the first half of 1979, real GNP growth is projected to be over 1 per cent greater than in the absence of the tax cut.

The stronger activity projected under these assumptions should stimulate employment gains--the final chart. But even with a more moderate increase in the civilian labor force than we have recently experienced, the projected rate of real GNP growth of under 5 per cent is likely to have only a limited impact on unemployment. We now anticipate that the rate may drop to about 6 per cent by mid-1979 from last month's  $6\frac{1}{2}$  per cent level.

Mr. Kichline will complete the presentation.

James L. Kichline  
January 17, 1978

FOMC BRIEFING

The financial counterpart of our GNP projection is contained in the flow-of-funds forecast. The top panel of the first chart in the financial presentation shows the volume of funds raised by nonfinancial sectors. We expect most sectors to reduce their borrowing pace in the first half of this year compared to the record rates experienced in the second half of last year. Borrowing later this year and into 1979 is expected to rise somewhat reflecting the continued large requirements of the Federal Government and a pick up in business credit demands. But in the aggregate, total funds raised will likely decline relative to GNP, the bottom panel of the chart. Such a development is often associated with tightening credit markets and we believe that will be in store during the forecast period.

The top panel of the next chart indicates that nominal GNP is expected to expand quite rapidly relative to the assumed 5-1/4 per cent growth of  $M_1$ . To hold down  $M_1$  expansion will likely require appreciable further increases in the Federal funds rate, as discussed in the Bluebook, and will be associated with a large rise in velocity over the forecast period. The process of inducing economies in the holding of  $M_1$  balances will encourage purchases of securities by households, another way of looking at tightening financial markets. Interest rates on Treasury bills are expected to rise to around 7-1/2 per cent by mid-year and to move a little above 8 per cent in 1979. Bond rates are also expected to rise but comparatively little, reflecting the still wide

yield differentials and continuing strong demands for bonds on the part of institutional investors.

Higher market interest rates will take their toll on deposit flows to banks and thrift institutions. In the next chart, the top panel indicates that effective rate ceilings on savings and time deposits at banks and S&L's were above yields available on Treasury securities in all maturity ranges as of July 1, 1977. By early this year, however, only the longer-term deposits at S&L's were marginally attractive.

Recent evidence indicates interest bearing deposit flows at banks and thrift institutions have decelerated and we anticipate continued moderation. The growth of deposits at nonbank institutions projected in the bottom panel allows for an increase in time deposit interest rate ceilings of 1/2 percentage point during the first half of this year. With slower deposit inflows, of course, depository institutions will need to rely on other sources of funds, including borrowings, run-down liquid assets, and tighten lending terms and conditions. These developments are likely to impact importantly on the mortgage market.

The nonfinancial corporate sector remains a key element in both the economic and financial outlook. The top panel of the next chart indicates that the forecast incorporates substantial growth in nominal capital expenditures (including inventory investment) by non-financial corporations. Internal funds are also expected to be rising considerably--partly because of corporate tax reductions. The resulting external financing gap (the difference between the two lines) thus remains manageable; the gap is projected below that in 1974 and corporations now are in much better financial shape than at that time.

We expect that corporations will rely quite heavily on long-term sources of funds--the bottom panel--given the expected availability and cost of funds in the bond market as well as their desires to limit erosion of liquidity positions.

Our projection, however, incorporates a sharp decline in equity issues in 1978 and 1979 reflecting the disappointing performance of equity prices--the next chart. The decline of the Dow Jones Industrial Index has been especially large and highly visible during the past few weeks. Moreover, the Dow Jones Index performed poorly throughout 1977 and the more broadly based NYSE index has also been trending lower although it has held up better than the Dow Jones. In view of the sizable gains in corporate profits in the past two years, the price earnings ratio has moved lower and indicates the high cost of capital. The performance of equity prices remains an element of concern in the outlook in regard to business spending, potential adverse impacts on consumer spending, and the general state of confidence.

REPORT ON OPEN  
MARKET OPERATIONS

Mr. Sternlight made the following statement:

Desk operations for about the first two thirds of the period since the December meeting of the Committee were aimed at achieving a Federal funds rate around 6 1/2 percent--the center of the 6 1/4 - 6 3/4 percent range adopted in December. In the final third of the interval, following the January 6 announcement of a 1/2 percent increase in the discount rate and the Committee's adoption of a 6 1/2 - 7 percent funds range, both essentially because of the weak dollar and disorderly conditions in the foreign exchange market, the Desk pursued the Committee's related instruction to raise the funds rate to around 6 3/4 percent over the next few days.

Behavior of the monetary aggregates, taken together, was reasonably well within the Committee's ranges and provided no reason to modify the Desk's approach. Estimates of  $M_1$  growth for the two months ending in January gradually strengthened over the period, ending the interval in the upper part of the range but still well within it. On the other hand,  $M_2$  estimates tended lower over the period, and most recently were well down in the indicated range.

Through the first half of the period, the funds rate exceeded the Desk's 6 1/2 percent objective, owing to reserve shortages in the holiday-shortened weeks, and particular pressures around the year-end statement date. The Desk had some difficulty in supplying needed reserves, even after getting good cooperation from the Treasury in reducing their balances. Troubles in projecting reserve availability compounded the problem. The market appeared to understand these difficulties, however, and remained confident through

early January that the System's objective was still 6 1/2 percent even after some days of trading closer to 6 3/4 and even 7 percent. Very briefly, January 5 and 6, the funds rate did return to around 6 1/2 percent, but starting January 9 the Desk began to push the rate higher, reaching about 6 3/4 percent by January 12. The funds rate pushed higher yesterday--to about 6 7/8 - 7 percent--despite strenuous Desk efforts to provide reserves, but came down this morning. The market perceived the Desk's intent to raise the rate beginning January 9, and this together with the higher discount rate produced higher interest rates across a broad front. While market participants initially were uncertain of the extent of the Desk's firming move, with some expecting a quick move to 7 percent, the predominant view now is that the System is seeking a rate around 6 3/4 percent. Still some uncertainty lingers, particularly as the market seeks to factor in the heightened official concern over the international position of the dollar.

Early in the period, the Desk sought to fill enormous reserve needs produced largely as a result of higher Treasury balances. The System made outright purchases of \$707 million of Federal agency issues and net purchases of about \$1 1/4 billion of bills in the market, as well as some \$200 million of bills from foreign accounts. Substantial repurchase agreements were made in the market almost every day from December 20 to January 5, with especially heavy activity around the year-end days. Reserves were absorbed from January 9 to 11 through matched sale-purchase transactions in the market and outright sales of about \$350 million bills to foreign accounts. Most recently, the Desk provided reserves again, buying nearly \$700 million of bills in the market last Friday, and arranging

repurchase agreements yesterday. Each day, matched sale-purchase transactions were arranged with foreign accounts.

Interest rates moved a little higher over the first two thirds of the period and then jumped sharply on January 9 following the discount rate rise and the Desk's perceived move towards a higher Federal funds rate. The moderate rise early in the period reflected the market views that expanding credit demands were likely to result in higher rates as the new year unfolded. In the last few days, rates have come down a bit as the market gained some confidence that the System was not pushing toward additional firming in the money market. Treasury bills were auctioned yesterday at about 6.54 and 6.76 percent for the 3- and 6-month issues, up from 5.99 and 6.34 percent just before the last meeting, but off from 6.68 and 6.85 percent on January 9.

For intermediate term Treasury issues, 1 - 5 years, yields rose about 35 to 50 basis points for the period. The two-year note to be auctioned tomorrow is expected to go around 7.55 - 7.60 percent, compared with 7.20 percent a month earlier. For longer Treasury issues, yield increases were about 25 to 35 basis points. While the yield moves caused dealer losses, these were not extreme as inventories were moderate.

In the Treasury 2-year note auction tomorrow, \$1 billion of new money is to be raised. Another \$2 billion or so may be raised in coupon issues in the quarterly refunding to be announced a week from tomorrow. Maturing issues in the hands of the public come to \$5 billion in that refunding. The System Account holds \$2.6 billion of those February 15 notes and we would plan as usual to roll these over into new issues in about the proportions offered to the public.



FOMC Briefing  
January 17, 1978  
Stephen Axilrod

Since the last Committee meeting, growth in M-1 has shown somewhat more strength than projected, while growth in M-2 has displayed somewhat less. Partly in consequence, the 2-month ranges presented for consideration at this meeting encompass somewhat slower growth in M-2 relative to M-1 as compared with ranges adopted at the previous meeting. For instance, alternative B specifies the same 2-1/2 to 8-1/2 percent annual rate for M-1 adopted by the Committee at its last meeting, but for M-2 the staff now expects growth to be in a 5 to 9 percent range--about a percentage point lower than projected at the last meeting. Sizable shortfalls in the time and savings deposit component of M-2 relative to earlier expectations, as well as recent upward market rate adjustments, account for this change.

Interest rates on intermediate-term U.S. Government securities--which had risen 20 to 30 basis points during December--rose another 15 to 25 basis points following the discount rate action and are now above effective ceiling rates on small-denomination time deposits at banks in all maturity categories. Thus, flows of funds into deposits subject to ceilings at banks and thrift institutions are likely to continue at a reduced pace, and could come under further downward pressure depending in part on the attractiveness to individuals of the terms set by the Treasury on new issues to be offered in the sizeable refunding operation to be announced a week from Wednesday. The ability of thrift institutions to attract funds through deposits has also become more restricted.

While the potential diversion of funds from interest-bearing deposits to market instruments further complicates the interpretation of M-2 and M-3 as over-all indicators

for monetary policy, reduced deposit inflows to thrift institutions do suggest developing pressures on mortgage terms and on the considerable willingness (evident in the latest data available through November) of institutions to commit funds to housing. Recent mortgage rate increases have been most pronounced in the secondary market--where yields have risen 25 to 35 basis points since the end of November--but primary market rates have edged up in the past few weeks.

I would expect any upward pressures on the money stock that may develop in the period ahead to continue to focus mainly on M-1, though there could be some spillover effects on M-2. The recent upward adjustments in short-term rates following the rise in the discount rate and the funds rate may exert only a relatively minor restraint in growth in M-1. Short-term rates have increased 20-35 basis points on balance since the discount rate action. I doubt that these rate increases will lead to very substantial adjustments in banking lending or portfolio policies. Indeed, unless the commercial paper rate rises further from its current level, bank loan rates to businesses are not likely to adjust upward from the levels to which they had tended -- as indexed by the 8 percent prime loan rate -- just prior to the discount rate increase. Thus, there may not be strong additional restraint on banks' willingness to supply credit and in the process create money as a result of recent policy moves.

At the same time, the economy's need for demand deposits for transactions purposes should be quite sizeable. Nominal GNP is projected to increase at about a 12-1/2 percent annual rate in the first quarter, up about 1-1/4 percentage points from last month's projection for the period. The associated transactions demands for money could exert a strong pull on demand deposits at current market rates. If short-term rates do not

rise over the next few weeks as a result of efforts to restrain actual M-1 growth, the staff would expect such rates to have to begin rising shortly thereafter.