TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

June 21, 1977

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. Meek, Monetary Adviser

Meeting of Federal Open Market Committee

June 21, 1977

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, June 21, 1977, beginning at 9:00 a.m.

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

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

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

Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Guy, Deputy General Counsel
Messrs. Balbach, R. Davis, T. Davis, Kichline, Scheld, Truman, and Zeisel, Associate Economists

Mr. Holmes, Manager System Open Market Account

Mr. Hudson, Assistant to the Chairman, Board of Governors
Mr. Keir, Assistant to the Board of Governors
Mr. O'Brien, Special Assistant to the Board of Governors
Mr. Gemmill, Associate Director, Division of International Finance, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Messrs. Fossum and Smoot, First Vice Presidents, Federal Reserve Banks of Atlanta and Philadelphia, respectively
Messrs. Boehne, J. Davis, and Eisenmenger, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, and Boston, respectively
Messrs. Brandt, Broaddus, Burns, Sims, and Willey, Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Dallas, San Francisco, and New York, respectively
Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Ozog, Manager, Securities Department, Federal Reserve Bank of New York

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June 21, 1977

CHAIRMAN BURNS. Gentlemen, we are starting a bit earlier, and the reason is that I will have to leave this meeting at about 12:15. I would hope that we could get through with the monetary policy directive by that time; and without interrupting members of the Committee or interfering with the flow of thought, I hope that we can accomplish that. In the interest of trying to accomplish that, I am going to defer the discussion of foreign currency operations until later on in the meeting, and also the special problem that has arisen in connection with foreign accounts, repurchase agreements. These two matters could be taken up readily in my absence.

Also, I'm scheduling an informal meeting--meeting is hardly the word, really--Tom O'Connell will have the right word for it. You know, [in] these days of the [Government in the] Sunshine Act, I'm at a loss for vocabulary--a new lexicon will have to be devised to fit Sunshine. In any case an informal discussion--or [an] informal something--is scheduled for 2:15 this afternoon, and I hope as many of you as can do so will be present. Some recent correspondence with members of the Congress will be discussed at that time, and also some legislative matters on Capitol Hill that are of interest to the [Reserve] Bank Presidents will be discussed at that time. The meeting is of special significance for the Bank Presidents, but I hope that Board members will also attend, because we belong to one family, and these are matters of a mutual concern. One or two matters, actually, I have not yet had an opportunity to discuss with my colleagues on the [Federal Reserve] Board. So I hope the members of the Board could be there as well.

Now, when I leave, Mr. Volcker, the Vice Chairman of this Committee, will of course preside.

We need to act first of all on the minutes of the May meeting. Is there a motion to approve?

SPEAKER(?). Seconded.

CHAIRMAN BURNS. The motion has been made and seconded, and I take it there is no objection. And we will pass now to the report on the state of the economy. Mr. Zeisel, would you be good enough to address the Committee?

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

CHAIRMAN BURNS. Thank you, Mr. Zeisel. The increase in rentals. I haven't followed those figures recently. What has the rise, and the average rise, in rentals been?

MR. ZEISEL. Those figures, I must say, are not the best base that we have, but they come from the CPI, and they show a fairly steady rate of increase in rentals over the last year.

CHAIRMAN BURNS. Of how much?

MR. ZEISEL. I don't have that figure with me, I am afraid.

CHAIRMAN BURNS. I somehow have the impression that the rise in rentals has been below the rise in the consumer price index.

MR. ZEISEL. I think that’s right. But, of course, the rise in the consumer price index, Mr. Chairman, has accelerated considerably recently because of the food and the--

CHAIRMAN BURNS. Does anybody know? We are all homeowners, and we don’t have rental--

MR. KICHLINE. We can obtain that number and provide it in a few minutes for you.

CHAIRMAN BURNS. All right, any question or comment? Yes, Mr. Black?

MR. BLACK. Jerry, could you give us a little bit more on the revised first-quarter figures for GNP? I’m interested more than anything else in why it was revised upward and what final demand did.

MR. ZEISEL. The revision occurred basically in corporate profits repatriated from overseas. Its counterpart on the product side is net exports. So two figures on the income side were corporate profits, which now show a slightly larger rise than they did in the earlier estimate; and net exports, which show a slightly stronger figure than before, and this resulted in an upward adjustment in the GNP projection for the first quarter.

MR. BLACK. Were inventories about the same?

MR. ZEISEL. Inventories were unchanged from the earlier figure.

MR. BLACK. But you did mention the figures on final demand in percentage terms, and I was trying--

MR. ZEISEL. Final demand [was] revised up to a 4.2 percent real rate of growth for the first quarter.

MR. BLACK. That’s the one I missed; thanks a lot.

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

MR. EASTBURN. A comment and a question. I noticed in the *New York Times* that there was a listing of forecasts for 1978--some 35 forecasts. Which, as I read what the Greenbook has, would put your forecast at the upper end of the list, probably at the top end of the list. I have some reservations as to whether that will materialize, and I’m partly influenced by some meetings that we have been having in the last couple of weeks with several dozen businessmen, and I must say, sentiment is very pessimistic. Partly this is a function of the fact that it’s being held in Philadelphia, and the Philadelphia area is not very strong, and there is a special problem attached to that. But I think that the degree of optimism is very low.

We had one participant express this quite eloquently. He said, “In the past, I have always had a kind of well of optimism that I could dip down into and draw when there was a shock,” and he said, “My well has run dry.” And shocks do come along to the economy--so, I think that, first of all, the forecast--

CHAIRMAN BURNS. Do you want to elaborate on that--the grounds for pessimism as voiced at the meeting?

MR. EASTBURN. Yes, I think it’s a function of several things. One is the fact that businessmen feel lost, that they don’t know where things are going, that the old rules no longer apply, that they don’t know what government is going to do, particularly in the area of energy. And although they have become used to uncertainty, I think the degree of uncertainty is a great deal stronger than they have had in the past.

This year has led, I think, to distrust of what the consumer is going to do. For example, one retailer talked about his doubts and uncertainty. I pressed him for his forecast for sales in the second half of the year as compared to the first, and he said the second half is going to be about as good as the first. And I said, how can you be so pessimistic? And he got off on costs and various other uncertainties.

CHAIRMAN BURNS. Now, wait now. When the retailer says that, I would interpret it to mean that the increase between the first half of 1976 and the first half of 1977 is of a certain magnitude and that he expects that the increase from the second half of 1976 to the second half of 1977 will be of the same magnitude, which is that’s the way retailers tend to talk or tend to think. Well, that is not necessarily a pessimistic statement--it doesn’t necessarily mean at all that retail sales will be flat in the second half of this year.

MR. EASTBURN. That was the way I interpreted it--that, in fact, his forecast is not pessimistic, but his attitude is pessimistic. And I suspect that the pessimism is overdone in many cases, but I think it is there and is reflecting itself in attitudes toward capital spending and willingness to take ventures and to move out in the near future. My question has to do with the forecast projections--to what extent this is judgmental and to what extent it represents models.

MR. ZEISEL. It’s very heavily judgmental.

MR. EASTBURN. Is there a difference between what the model is saying and what the--

MR. KICHLINE. The model is weaker, and particularly consumer spending is weaker. And the pattern on inventories is such that, at the end of the projection period, accumulation of inventories is about the same. But in the earlier periods, the model is considerably weaker, which would give you a somewhat weaker second half, particularly, than the judgmental forecast.

But I think the major difference is in this consumption area, which is clearly weaker. And you end up with slower growth of real GNP over this projection [period] if you take the monetary assumptions [as being] the same and just run the model without any judgmental influence.

MR. PARTEE. Is the increase in the saving rate larger on the model than it is in the--

MR. KICHLINE. Yes, right. That's what happens. The saving rate drifts up higher. I might note that it looks like the model is indeed going to be off on the consumption sector in the first quarter and second quarter. It clearly understated the degree of spending.

MR. ZEISEL. The model doesn't sustain capital spending as strongly as we--

CHAIRMAN BURNS. Can't hear you.

MR. ZEISEL. Excuse me, Mr. Chairman, the model does not sustain capital spending as strongly as we do judgmentally into '78.

MR. EASTBURN. Well, I think these differences may account for our tendency to be somewhat lower.

MR. ZEISEL. Of course, the relationship of consumption to capital spending and the generation of income is obvious.

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

MR. BALLES. Mr. Chairman, I would like to ask a question about the Board staff forecast, mainly to clarify my own understanding of what's been happening here. As I look over the inflation forecast made monthly since the first of the year, we know it has been moving up steadily, starting off with a forecast of 5.5 percent for the year, May to January. It's now up to 6.2 percent. Over that same period, your forecast of real GNP has, on balance, remained virtually unchanged, your January forecast being a 5.7 percent increase for the year, and your latest June forecast being 5.8 percent.

Given the fact that monetary policy has been roughly steady in this period, I guess one would normally expect, with roughly constant monetary policy, the same projection for real growth but increasing inflation. Something has got to be a balancing factor there. Are you expecting higher velocity now than you were, for example, at the first of the year, or just how do you get this result?

MR. ZEISEL. Well, we have gone through a period in which the economic information that's come in has grown progressively stronger. The evidence, for example, of consumer markets has been for a considerable degree of consumer optimism, apparently. Retail sales have been very strong, and we have been going through a process recently of revising upward our estimates of consumer outlays.

The other area where we have shown additional strength to support continued [economic growth] [has been] residential construction, which has proved to be substantially stronger than we had thought it was [going] to be six months ago. And this has proved the basis for a very strong growth as well. So that, basically, while the information on prices has been on the negative side, the information on real demands has been on the positive side. And I think this has been the key that has allowed us to get what otherwise might seem to be an inconsistent set of adjustments, to wit--rising prices without any negative effect on real output.

MR. KICHLINE. I think also the interest rate side--I don't recall precisely what we had for interest rates, but I do know by this time we had anticipated higher market rates, so that if velocity is pretty much on course, I think what is off is indeed that interest rate levels are less than we had anticipated given the kind of strength in economic activity that we now see developed.

MR. BALLES. Well, net-net, I was guessing that what was happening was that implicitly your velocity forecast has risen over this period, because normally you would expect a combination of steady monetary growth and inflation to produce some reduction in real growth, and yet you don't have that. Am I interpreting your figures correctly? You are expecting higher velocity.

MR. KICHLINE. I think that's right. I don't have the numbers back in the January-February period. It's clear that over the balance of the projection period, we have M1 velocity rising at around a 7 percent annual rate, which is really very high, as you know.

MR. BALLES. I noticed that in the Bluebook. I thought it was awfully high.

MR. KICHLINE. Let me just note that we do have some numbers on this residential rent index in the CPI, and in '75 and '76, that index had been rising at around a 5-1/4 percent annual rate. And in the first quarter of this year, it's 5.8 percent. The monthly pattern is, February, a 3.6 percent annual rate, 6 percent in March, 8.4 percent in April. So we seem to be on a somewhat rising pattern for that particular measure of rents.

MR. EASTBURN. That's gross rent, that's not net rent, which is a little bit--

MR. KICHLINE. That's right.

MR. EASTBURN. Net rent may well have gone down, based on those figures.

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

MR. PARTEE. Jerry, I was surprised how pessimistic your comments were regarding prices. I was surprised because I'm not that pessimistic, obviously. But I wonder whether what you're picking up in the GNP forecast, and second quarter forecast in particular, isn't a reflection of past increases, principally in food prices. If you look at wholesale prices of industrial commodities, the rise is slowing. That's particularly true at the raw stage of industrial commodities, but it's also true of industrial commodities as a group. Indeed the [total] wholesale price index was up quite a lot less in May than before. And I know that the sensitive industrials in our weekly index have been declining in the last couple of months. That's just a few items, but perhaps indicative of reduced pressure in the market.

And if you look at the hourly earnings index, why it seems to me the performance is really pretty good. Year over year [in May], the increase was 6.9 percent; [for the] month, the increase was a 5.7 [percent annual rate]. But this far into a recovery, it seems to me that that's a pretty good performance for wages, and it implies that unit labor costs are not, at least at this point, accelerating, looking through the bobbles you get up and down.

I assume that the forecast you have given us is largely based on higher food prices. But even there, the impression I had is that the agricultural situation is better, rather than worse, than it was a couple of months ago in basic terms, because it's rained, and the wheat's coming in, and that kind of thing. It might have some temporary effect in holding back meat animals and things like that in the market and give you a little increase in prices. But sort of fundamentally, as I look at the picture, it's improved in the last two or three months with regard to the price outlook, rather than deteriorated. Are you going to comment on that?

MR. ZEISEL. Yes, you are perfectly right. My view of the price situation has deteriorated along with, I guess, my perception of what seems to be happening. You are perfectly right, also, the adjustments at the moment are very largely in the food component. Those prices came in much larger than we had anticipated for the last couple of months and have resulted in our raising our estimate of second-quarter food price increases--doubling them from about the 6 percent range.

MR. PARTEE. 6 to 12.

MR. ZEISEL. 12 for the quarter. And this is, in itself, a shock. There are elements in wholesale food prices that are still to come through to retail--coffee is a particular case.

MR. PARTEE. But there we've been reading of reductions.

MR. ZEISEL. What we have been getting unfortunately--well fortunately--

CHAIRMAN BURNS. Wholesale price of coffee has been coming down. But the retail price has been below the wholesale.

MR. ZEISEL. That's correct. That's exactly--

CHAIRMAN BURNS. Therefore that can rise.

MR. ZEISEL. --so that, as the Chairman points out, the reductions we are seeing really are going to prevent future increases from being as large as they would otherwise be.

CHAIRMAN BURNS. Are going to limit or possibly prevent--

MR. PARTEE. Isn't that a favorable factor? To limit or possibly prevent the increases that otherwise would have occurred--[that's] an improvement, isn't it?

CHAIRMAN BURNS. Yes, in that one factor.

MR. ZEISEL. That's correct. In that sense, Governor, I had commented that we may be getting some of the price increases clustered in the second quarter that we had anticipated might occur in the second half--

CHAIRMAN BURNS. I don't know what this debate is about. I'd like to have the question clarified. Looking at the projections by our staff, the second quarter estimate on prices is a 7.1 percent annual rate, and then the figure falls in the next two quarters to 5.8 percent.

MR. PARTEE. I was referring, Mr. Chairman, more than anything else, to the pessimistic tone of Jerry's comments about the worsening in inflation. Simply all that the--

CHAIRMAN BURNS. He was simply anticipating Mr. Eastburn's comment.

MR. PARTEE. If I may suggest a different explanation, it is that there has not been a deterioration in the inflation outlook that we did not previously foresee; the amount of increase, particularly in food prices, that [we] did not build in [resulted from] the winter and the early spring drought and that kind of thing--and, indeed, that fundamentally there really has not been [an underlying] deterioration. At least that would be what I would submit on the basis of my reading of the figures.

MR. ZEISEL. I think there's a certain validity in that Governor--

CHAIRMAN BURNS. I would join Mr. Partee. I'm impressed by the decline that has occurred in wholesale prices of food stuffs and industrial raw materials since mid-April--I wish I understood it better--and that is a favorable development on the price front.

MR. WALLICH. Mr. Chairman, I find it difficult to believe that this isn't going to go into wages at some point. These CPI increases--with a lag, I suspect--are going to influence hourly earnings.

MR. PARTEE. Well, they could, but they haven't yet.

MR. WALLICH. Well, yes, but there's a lag in these--

CHAIRMAN BURNS. Well, you say they haven't yet. The figures that I have in mind on wages that I try to follow relate not to average hourly earnings but to compensation per man-hour in the private nonfarm sector. The quarter-to-quarter fluctuations--these quarterly figures are unreliable. I follow [the compensation data] on the basis of a moving 12-month period, and what that shows is a steady acceleration over the past five quarters. Gradual, but without a break. So the wage curve including fringe benefits, which the average hourly earnings figure omits, does show acceleration.

MR. PARTEE. As you know, the problem that I have with that is that the last quarter in the series includes the minimum wage increase and the increase in Social Security taxes. I think it tends to give you an overly high reading for this most recent--

CHAIRMAN BURNS. Yes, that may well be. The jump is largest in that quarter, Chuck, and therefore, allowing for that, perhaps you still have the acceleration, though I'm not sure.

VICE CHAIRMAN VOLCKER. My impression is the same as yours, Mr. Chairman. There has been a slight deterioration in the wage pattern. We also, at this stage, expect to get slower growth in productivity, I think. And the wage-cost element in the economy strikes me as being less favorable than I had hoped earlier in the year--not by a major amount but moving in that direction. And I must say I am struck by the kind of deeply ingrained expectation of businessman and others in giving wage increases. There seems to be very little resistance to a kind of 8 percent or higher level. No willingness to look forward to a decline in the rate of inflation. And a kind of feeling that it's only fair to give 8 or 10 percent.

CHAIRMAN BURNS. Well, I don't know whether it's only fair or only necessary.

VICE CHAIRMAN VOLCKER. Well, they certainly argue it's necessary. They're certainly not going to be willing to take a fight or strike or anything. Well, I don't think it's terribly unusual for the big negotiated settlements. It's obviously not the average increase. But the general feeling of no resistance because they think they can't presumably--and they think that the prices are going to go up in the following year to justify--it seems to me to be very strong, and we have made very little impact on breaking it.

While I have the floor, let me just say that I certainly have noted--pessimism may be too strong a word. But the strongly increased caution of the business community that Dave Eastburn talked about has been reflected to me, too, and I haven't been able to quite figure out why it takes place during a period when the economy has been expanding more rapidly. Maybe the stock market had something to do with it. I don't quite know why it has happened, but I have detected this mood of great caution, apparent on the surface anyway, in the business community.

CHAIRMAN BURNS. I'd like to say a word about that. There are businessmen complaining. And businessmen are complaining about the atmosphere of uncertainty in which they live; and they don't know what will happen to taxes, and don't know what will happen to our antipollution legislation, and don't know what kind of energy bill Congress is going to write eventually, and this undoubtedly is retarding business capital investment.

At the same time, while businessmen are complaining all over the lot, their overt actions--as expressed in orders for capital equipment, as expressed in appropriations for capital expenditures, as expressed in plans for actual expenditures, as expressed in plans for actual expenditures, the successive survey reports--do indicate increasing spending. And I would interpret that to mean that optimism fundamentally is gradually gaining ground. There is a return of optimism, but it's much slower than one had any right to expect at this stage of the business cycle, and particularly in view of the rate of utilization of capacity. According to our index, we are up to 83.3 percent, and the peak was only 88 percent.

Businessmen are complaining. They are paid good salaries--one of their functions is to complain. They're justifying the salaries that they earn partly by complaining. They have reason to complain--I don't question that. But I would not take that as an index of the underlying attitude. Yes, I want to listen to them, and I do, plenty. I have taught myself to do that. But I also watch what they actually do. And there I see, increasing slowly, a slow return of confidence. That's my reading.

MR. EASTBURN. As long as you are talking about this, there may be some function in age, because I happened to speak to a group of young businessmen who, by definition, had to have been president before they were 40, and they could not be over 50 and still attend this meeting over the weekend. They were all very exuberant about everything, in fact so much so, that approximately 80 percent of them indicated with a show of hands that they thought monetary policy ought to be tightened--that things were running well.

CHAIRMAN BURNS. That's interesting.

MR. PARTEE. That is in the Southeast. I think--you were talking about the New York attitudes, and Dave, Philadelphia. It may be a reason how effective some [unintelligible].

CHAIRMAN BURNS. What about New England?

MR. MORRIS. Well, I think in general we are more optimistic than Paul suggests [for] New York. I think we have seen our capital goods industries continue to rise in orders--a feeling that capital spending is about to get going. I think New England is pretty optimistic at the moment. Not bullish. No one has been looking for a boom, but no one really wants a boom, and I think there is a pretty general degree of satisfaction for the way things are going.

MR. WALLICH. Well, I think, Mr. Chairman, these things need to be interpreted in the light of what we have heard about investment predictions. If [the estimate is] correct, despite our belief that investment is peculiarly low, then we don't need to attribute this to business pessimism if the objective facts as embodied in the model seem to say that investment should be even lower. It must be the peculiar result that the objectives, factors--despite what I would have thought--point toward low investment. Excess capacity, cost of capital, and whatever goes into that equation.

CHAIRMAN BURNS. I don't know what goes into that equation, but I would have said, and I still say, that objective factors, putting aside uncertainty about legislation, point to increased capital investment.

MR. WALLICH. That's been my intuitive interpretation, too, and I am surprised at what the equation says, but I think one has to pay attention to it to some degree.

CHAIRMAN BURNS. Well, maybe you do. Everyone has to speak for himself. I have managed to get to my present age without paying much attention to what these equations have to say. And I haven't done too badly in judging the business situation. I see no reason for learning these things at the present time. However, if our staff can teach me what they know or think they know in an hour or so, I would be very glad to listen to them.

MR. LILLY. I think, when you listen to businessmen comment, you forget that they look at you as "Washington," and it's an opportunity for them to sound off on what they think is the matter with the government and their state of affairs. I think lot of what you hear is being addressed to trying to correct the situation in Washington rather than reflecting their own state of affairs. Because business is damn good--

CHAIRMAN BURNS. Well, you talk to--

MR. LILLY. --let's not kid ourselves.

CHAIRMAN BURNS. --yes, you talk to a lot of businessmen. You have been devoting a good part of your energy [to that]. What is your sense of the thinking of the business community?

MR. LILLY. Well, they just hate Washington. All of the regulations are driving them up the wall. The biggest problem they have is that, instead of having no energy policy, we have a non-energy policy now. No one has been able to make any plans in terms of where to put a plant because they just don't know what's going to happen in the energy field. And until that energy policy question is cleared up, I think you are going to have a great deal of hesitancy on expansion of industrial capacity. [Unintelligible] its business is damn good, and they all will admit it privately, but they won't agree that the government is damn good. And that I think is what you are hearing--

MR. MAYO. Of course, Dave, they never have and they never will. I think that's part of the--

MR. LILLY. I'm not speaking of any specific government, I'm just saying--

MR. MAYO. No, *the* government. But I think this is a characteristic of the business community.

MR. LILLY. I do, too.

MR. MAYO. We have to evaluate [it] in terms of degree of decibels--it's a little different. And I guess I basically come out much as the Chairman does. That businessmen are paid to complain, and you have to--this is very sensitive--we do not have any index of businessmen's complaints. We have to judge it by what they are doing in spite of the complaints, and business is good. Even the one of the most profitable huge food companies in the Midwest--worldwide--the chairman told me the other day--"Well, it's pretty good, Bob, but it could be better." But that was in view of an outstanding record for the first quarter and for 1976, and he is one of the highest paid executives in the United States. That's his way of expressing things. And you get used to this. And you evaluate differences in the way they say it.

MR. LILLY. Another thing you should also be concerned about--as a concern about the future--and that's the farmer. And I do not agree with Jerry in terms of the estimated price increases. In farm products, I think you got a situation where you are going to have a bumper crop--that's certainly the way it looks today--and it's going to have a downward pressure on prices, both meat prices and grain prices.

SPEAKER(?). Mr. Chairman?

CHAIRMAN BURNS. Let me just interrupt for a second. The consumer price index has just been released, and it shows an increase in the seasonally adjusted figure for May, of the overall index, of 6 tenths of 1 percent. Yes.

MR. ROOS. We have continuing meetings with major heads and treasurers of our major corporations in the area. They are optimistic, but I think we are overlooking, at least from my point of view, one issue there--they are certainly disturbed about regulation, they are certainly disturbed about uncertainties--but the one underlying concern that they have expressed to us is their concern about prices and about inflation. We have not met one of these individuals--and this is not an exaggeration, we have been with scores of them--who has not said, "For heaven sakes, do everything you can to protect us from further inflation." Now, I don't think that factor has been given sufficient--maybe credence is the wrong word--but attention this morning. I think that worries them as much as energy. That worries them as much as regulation. And they don't see a real pattern, they don't have real optimism over the long pull as to the probability that our inflation rate is really being reduced.

CHAIRMAN BURNS. Well, that's a very important observation [unintelligible], that the high rate of inflation means a deterioration in business profits. And partly because of the behavior of wages and raw materials prices, and partly because of our tax laws and our accounting practices, businessmen in periods of inflation have to pay income taxes on phantom profits. And they have learned that. And accounting is one of the most backward of our professions. You know, there was a time when businessmen looked forward to a time of inflation because they saw wages lagging, prices soaring, profit margins rising, the stock market roaring, but things don't work that way any longer. Businessmen now know it. And I think that's why they speak and think as they do on the subject of inflation. Mr. Wallich, we want to hear from you now.

MR. WALLICH. I have a couple of questions concerning rather minor aspects of the data you present. One has to do with corporate profits. I see that some of the inventory valuation adjustment and the capital consumption allowances in the first quarter was $40 billion, which is more than one-quarter of profits before tax; in other words, very large. You then have it going down in your projection to a much smaller sum, $26 billion, which is one-seventh of the then-expected profits. My question really is, what makes it so large now, and what hope do we have that it will decline, given that the price trends aren't all that favorable as projected.

MR. ZEISEL. I'm just searching for them. I'm sorry.

MR. WALLICH. On page I-7 of the green pages in the Greenbook. And a little below the middle of the page.

MR. ZEISEL. I'm a little surprised at the rate of growth of the IVA in the first quarter that you cite, Governor. I thought it was somewhat below that in the--actually below $30 billion. We would anticipate a more moderate rate of increase in the IVA because we do have some moderation in the rate of price increase later in '77, as the Chairman pointed out. I'm sorry, we'll have to look into this and I'll have to get back. We'll give you an answer on this.

MR. PARTEE. The first quarter could have had a lot of oil in it.

MR. WALLICH. Do you think it's oil?

MR. ZEISEL. It could have, I don't know. I'll have to look into it.

CHAIRMAN BURNS. You know, I have not studied these figures on profits, but I am surprised. Figures that I've seen indicate that, during the first and second quarters, the improvement in profits has been negligible.

MR. ZEISEL. Very small increase in the first quarter.

CHAIRMAN BURNS. And that surprises me, and I haven’t tried to analyze it. You have these very sharp increases in physical volume of business activity, accompanied by virtually stable profits.

MR. KICHLINE. Well, the first quarter is partly influenced by the winter weather, which presumably affected costs more than it did sales and profits. And on a quarterly average basis, the pickup that you are talking about really occurred later in the quarter. So I think there’s a lag phenomenon at work there that would affect the first-quarter performance.

In addition, we do have the minimum wage increase--and at an annual rate you get a shock effect in the first quarter, which presumably is also calculated in these figures. So some of that ought to show up later on in the second quarter, but the second quarter does look very strong to us, either, I guess, in terms of profits performance.

CHAIRMAN BURNS. Well, the figures I’ve seen for the second quarter look remarkably low.

MR. ZEISEL. We have a very moderate rate of increase in profits projected for the second quarter.

MR. WALLICH. That’s [why it seems so odd]. Even those profits that we see are deceptive, that is, the result of inventory and underdepreciation.

MR. ZEISEL. We’ll have to look at this a little more carefully, Governor, and report to you.

CHAIRMAN BURNS. I think that an interpretation of these profits figures is very important. That may help to explain the phenomenon that Mr. Eastburn described in his area. The acceleration in inflation that you commented on may possibly be reflected in these profits figures. And your estimates for profits later on in the year look remarkably high.

MR. KICHLINE. Well, it’s in part this lag effect, believing that the first half is an understatement of the underlying trend and that we have got special factors at work. We are not as high on corporate profits as we were several months ago, [and the change] reflects, in part I guess, the somewhat less optimistic view on corporate costs and, secondly, a somewhat weaker picture for real GNP.

MR. PARTEE. Of course, the level of ’76 was much higher than the level of ’75.

CHAIRMAN BURNS. Oh, yes.

MR. PARTEE. [Unintelligible] $40 billion in total profits [unintelligible].

CHAIRMAN BURNS. You have a very sharp increase in ’76, you know.

MR. WALLICH. My second question, Mr. Chairman--in the federal budget, I see that from the first to the third quarter, we have a massive swing in the high-employment surplus or deficit going from plus 10 in the first quarter to minus 10 in the third. And I wonder whether this plays a significant role in your evaluation of the stimulating effect of the budget.

MR. ZEISEL. We have a rapid increase in federal grants to states, which are coming into play in this period, so in a real sense this will underlie the increase in state and local spending that we anticipate in this period. You've got a number of pieces of legislation that relate to public service employment and other support programs, which move the federal grants to states and localities from about a $4 billion rate at the moment to about a $12 billion rate, I presume, in the first half of '78. And that's a big element in the swing in the budget and should be evident in terms of stimulus to real activity.

MR. KICHLINE. I might also note, early in the year we had a high-employment surplus of about $10 billion. And, in part, a transitory effect [is] reflected in that number, that is, gift taxes shot up to something like a $6 billion annual rate in the first quarter. And that particular number, of course, works into higher receipts. And so the first-quarter performance, I think, is the wrong base to measure from.

MR. JACKSON. Is that a consequence of returns filed in the first quarter for gifts made in the last quarter of the term?

MR. KICHLINE. It's a consequence of the change in the tax law last September, which in effect changed the rules on gift taxes. And apparently a lot of gifts were made in December to avoid the higher taxation implicit in January. And those were paid largely in the month of February. And [in] the first quarter, it's about a $5-1/2 billion to $6 billion annual rate, which in effect also shows up in our numbers in the first quarter as a reduction in the saving rate by about four-tenths. So that saving rate is a bit lower, as well, because of this effect.

CHAIRMAN BURNS. All right, thank you, Mr. Wallich. Mr. Black now.

MR. BLACK. Mr. Chairman, I have a question about the revision in your inventory projections for the balance of the year. You reduced these for the second, third, and fourth quarters relative to what you thought a month ago. Is this largely a result of the larger increase than anticipated in inventory building in the first quarter? Or do you have in mind some more fundamental factors? The reason I'm really intrigued by this more than anything else is that I've been playing around with some of the ratios put out by the Commerce Department in terms of '72 dollars, which should remove any downward bias from the switch to the LIFO method of accounting. These show inventory-sales ratios greater than we actually had when the recession began, and I've been thinking all along that inventories were in pretty good alignment. But they really don't look that good when you look at them in constant dollar terms.

MR. ZEISEL. Well, we haven't changed our view of the likely rates of inventory investment of this--what you note is a reflection of the fact that we got a larger inventory adjustment in the first quarter than we had been expecting. And rather than a moderate rate of growth sustaining through the year, we now tend to have a slower rate of growth later in the year. And basically the inventory-sales ratio at the end of the period remains about the same as we had had it earlier. But we get there a little earlier, in a sense.

MR. BLACK. I assumed [that's] what it was, but I didn't know. These constant-dollar ratios are very interesting, I think.

MR. ZEISEL. Yes, that's right. They do show a very different picture.

MR. BLACK. They sure do.

CHAIRMAN BURNS. All right, thank you, Mr. Black. Mr. Baughman now, please.

MR. BAUGHMAN. Mr. Chairman, I guess I feel obliged to report that in the Southwest we do continue to see a strong and growing demand for most everything, and the list of activities-- that is, types of labor that are in short supply--is growing. And we're seeing indications, of course, of a rather rapid rise in wage rates, in part related thereto, but it's probably not a dominant factor in the rise in wage rates. We've also had reports on two recent occasions of shortages of transportation, particularly trucks. A couple of months back, there were reports of fairly serious shortages of capacity to move sizable equipment and also cement. And recently there were reports of significant shortages of trucks to move produce.

CHAIRMAN BURNS. To move what?

MR. BAUGHMAN. Produce. Specifically, a lot of melons apparently being permitted to spoil in the fields because transportation could not be acquired to move them out to market. And it's reported, largely as a suspicion or an assertion rather than a fact, that there's been some lack of interest shown by the so-called independent trucker because of increased regulations, licensing, taxes, that sort of thing.

CHAIRMAN BURNS. Lack of interest in expanding their operations?

MR. BAUGHMAN. Well, not so much expanding, but even coming in, in the usual volume, into this area to move these products at this point in time. I don't have more on that. I've undertaken to learn more about just what's involved. It appears to be a fact that the produce has been permitted to spoil in the field in substantial volume and apparently for this reason--at least they have not cited as an additional reason, thus far, an inability to acquire the labor to harvest the product. Now, of course, in the labor force in that area there is a presumed substantial elasticity of supply of illegal labor. And there have been indications of substantial mobility of labor, particularly skilled labor, into the area.

With respect to energy, we hear all of the conversation about the uncertainty, and lack of program, and lack of specific goals and objectives which have been reported here. But even in the face of that, all of the available rigs for drilling on land are in use, and the lease rates are rising. The time lag to get a rig is lengthening--just to get on a list of a driller to drill. And here again, you get into an area where it's not reported as fact, not talked about openly, but there is a pretty generally accepted view that quite a bit of this drilling is being done for purposes of proving up supplies to be offered in the market at a later time, as compared with bringing [them] into the market immediately. Here, of course, is reflected in a meaningful sense some of the uncertainty as to the price [or] prospects for those products.

We continue to see announcements of sizable commercial construction projects in the major cities in the area. And it's interesting that a fair number of these are being announced for downtown.

CHAIRMAN BURNS. What kind of construction projects? Commercial--

MR. BAUGHMAN. I'm speaking primarily of office building structures, but also multi-unit residential and hotel.

CHAIRMAN BURNS. What about large industrial construction? Any of that?

MR. BAUGHMAN. There is some of it. Largely in the petrochemicals area. And that tends to be concentrated in a fairly small geographic area down along the coast. Aside from that, both indicated in the figures and just from observation as one travels around, it seems to be large numbers of fairly small developments, largely in suburban areas around the larger cities.

With respect to the pessimism, and it would seem unusual I guess, to find any of it in that kind of a general environment, but there is a good deal of pessimistic talk, and it seems to me that it traces both to the uncertainty of the application of regulations flowing from legislation that's already on the books as well as uncertainty as to prospective future legislation. The regulations flowing from legislation already on the books has greatly lengthened the developmental time or gestation time for bringing projects into being, into completion. And that, it seems to me, is a matter which is irritating businessmen as well as the bankers who finance businesses.

With respect to the general economic outlook, I guess the sector of it that interests me most, and in which I maybe feel less certain than other aspects, is this prospect for capital investment. And I don't have anything to add to the conversation that's taken place here. But it would seem to me that there is a very heavy dependence upon what develops there, as to just what the pace of progress from here will be over the next year or two. That's all I have, Mr. Chairman.

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

MR. PARTEE. Well, Mr. Chairman, I just wanted to set the record straight. Although I was a little critical of the comments on inflation that Jerry had, I think that the staff projection is very defensible; and in general terms, the 5-1/2 percent increase in real GNP looks to me quite supportable on the basis of the sector. The state and local spending outlook is vastly improved. Not only because of the federal transfers but also because of much better revenues as the recovery has proceeded.

I agree with you on plant and equipment. I think it looks pretty strong, and strengthening for the foreseeable future. And with that it seems to me would go increased inventory accumulation. So about the only black spot that the economy is likely to have, as I see in the forecast period, is in durable goods sales to consumers, in particular, automotive sales.

CHAIRMAN BURNS. Also foreign trade.

MR. PARTEE. Well, I think probably most of the deterioration is over in foreign trade. It may not be that there [will] be much improvement, but probably there won't be much [further] deterioration at this point. But we should expect to see car sales level off or even decline after this period of extremely strong demand, and that will be associated with the rise in the saving rate. But I think the other factors in the economy will overcome the phenomenon.

The difference between 5-1/2 percent in the forecast for the year ahead and 5 is not very great. I really don't know that I could choose between them. I guess I'm inclined to think that 5 is a little weak, but in any event, if it's 5 or 5-1/2, it's still in the range of continued expansion at a reasonable rate. And I think that's what we ought to keep our eye on.

Now, one other comment--although I'm not as critical of models as the Chairman--it is true that the models very often, for short periods, are quite wrong. And the fact that our model delivers lower business fixed investment doesn't surprise me. It [has done so] repeatedly, and it's delivered a high one repeatedly. It's just that it's [based on] an average experience, and it just doesn't seem to work too well in short-period forecasting. And the fact that the model has lower consumption than [does the] judgmental [forecast]--[that phenomenon] has occurred, as I remember, repeatedly over the last several years. So there's nothing terribly unusual about that. So I would not use the fact that it's a model to give it added importance or added weight; it needs to be taken into account, but I don't think it deserves added emphasis for that reason.

MR. WALLICH. You know, I think one needs to look at what goes into it and what are the factors that produce this result. That's why I say--when I spoke of a particular equation--see if it's the stock market, or excess capacity, or orders, or some other variable.

MR. PARTEE. The stock market, I think, is probably having quite an effect--

MR. BAUGHMAN. The survey results are not particularly encouraging, either.

MR. PARTEE. Pardon?

MR. BAUGHMAN. I say, the survey results are somewhat in the same direction, are they not?

MR. PARTEE. Yes, except that that looks so unreasonable, doesn't it, to see that the first half has been going on at a very substantial pace, and then all of a sudden you have this slump. It just doesn't seem very likely, you know, that it would be the way things would work out--especially since, as the Chairman said, none of the other figures you would look at support the idea of a marked, almost immediate slowing in the rate of increase in capital spending. Which is what you'd have to have for that Commerce survey to come off.

CHAIRMAN BURNS. Thank you, Mr. Partee. Mr. Guffey now.

MR. GUFFEY. A couple of comments with respect to the level of optimism in the High Plains area. It's been sort of divided, up to this point, in the sense that in the metropolitan areas there have been, for the early part of this year, fairly high levels of optimism. But there have been a couple of things that have occurred that are not readable yet but could very well dampen that somewhat. One is the fact that in the Colorado-Wyoming-New Mexico area, the drought has culminated in a limitation of any new [water] hookups, both commercial and residential. It's only a limitation--they still can hook up, but a very limited number over the rest of the year and projected into 1978, which is dampening considerably the construction of both residential and commercial.

The other event that had just occurred is a Federal Power Commission order that limits, as of January 1978, any new hookups--as far as gas is concerned--throughout an area of Kansas, Missouri, part of Oklahoma, and part of Nebraska, which means that if that order is in effect, there will be no new gas hookups as of January 1. Again, the comments coming from the business community, and particularly in the construction industry, are fairly [critical].

Lastly, with respect to the agricultural sector--which has been sort of depressed in terms of level of optimism up to this time because of the drought--[it] has all turned around in the crop areas, for example. What we are projecting now is a wheat crop that is larger by about 10 to 15 percent than in 1976, which was a very good crop year. The problem is now, not that they're not going to grow anything, but rather that they're adding to the carryover they already have, thus further depressing the price of grain, on top of which there is no clear capacity to store that grain. The price, as reflected by the futures, continues to deteriorate. On top of that, in the agricultural sector, what has been anticipated for meat prices, for example, particularly cattle, has been an increase, particularly in the latter part of this year. But the track record has been that cattle prices and red-meat prices [have] again turned down, so that there is a pessimism that's arising--not only [regarding] the cattle but the wheat--in the agricultural sector. So you put all those together, and what was kind of mixed before might turn out to be a fairly pessimistic outlook for that whole midsection of the country.

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

MR. MORRIS. Mr. Chairman, I have two comments. I think there's one measure of confidence that we shouldn't overlook, and that is the remarkable performance of the bond market in the last few weeks despite the fact that we pushed up short-term rates--and in fact probably because of it, because we showed the determination to move promptly. And despite the poor price index numbers coming out, we have seen a willingness in long-term investors to buy at declining yields, and the long-term market is significantly below where it was when the federal funds rate was at 4-3/4. So I think that is one area of confidence.

CHAIRMAN BURNS. How do you interpret that, Frank?

MR. MORRIS. I think there is an expectation that we are not going to have a sharply rising trend in interest rates. That also shows up in the Treasury bill futures markets. The Treasury bill futures yields are going down, reflecting an anticipation of that.

CHAIRMAN BURNS. You think this behavior of long-term interest rates reflects, in part, confidence in the Federal Reserve's policies?

MR. MORRIS. I think so, yes.

CHAIRMAN BURNS. Well, that's been my own judgment, but it's a hard thing to be sure of.

MR. MORRIS. I think if we had not moved in the face of that April bulge [in M1], we would not have had a decline in the long-term yield.

MR. JACKSON. How did you relate the stock market to that, considering that many of these long bonds are purchased by people that would normally have been in equities to a certain extent. And they obviously are not going to.

MR. MORRIS. Well, I think if we get this continued confidence in the bond market, it's going to spread to the stock market as well.

MR. PARTEE. But both could be consistent with not expecting a boom--

MR. MORRIS. That's right.

MR. PARTEE. --a willingness to invest in long-term instruments and holding away from the stock market.

MR. MORRIS. My other comment is less optimistic, Mr. Chairman. Getting back to the wages issue, which I think is going to be very critical in the next 18 months or so. I was talking recently with John Dunlop, and he is very pessimistic on wages. And his argument is that we've had a number of settlements recently in automobiles and other areas that have produced a maladjustment in the normal wage structure. And therefore, that is going to put pressure on union leaders in other areas this year and next to come up with settlements that will bring them back in line with the auto workers and steel workers and so on. I was wondering if the staff had looked into this--what Dunlop considers to be a really difficult structural wage problem?

MR. ZEISEL. I trust Dunlop puts a good deal of emphasis on that kind of analysis of the wage market, that is, the differentials, and in fact that proved to be a very important factor in areas like construction and raising wages.

CHAIRMAN BURNS. A little louder, please.

MR. ZEISEL. Excuse me, I think there's no question that that's going to have a significance. That's going to play some role in wage determination in the near future. My own feeling about wages, I think, has deteriorated slightly because I'm afraid of the feedback from the rapid increase in prices that we've had recently. And I think that's been the most significant factor in my own adjustment upward of the outlook for wages later on this year.

CHAIRMAN BURNS. You know, I think it would be a good idea for the staff to keep in touch with John Dunlop and one of our own [Reserve Bank] directors, Arnie Weber. They are probably the most astute students of the labor market that we have. And in judging wage trends, I think it would be a good idea for you to talk to each of these two men once every few weeks.

MR. MORRIS. He is pretty happy about the construction sector. But it's outside of construction that he thinks we're--

MR. PARTEE. He thinks steel and autos are well ahead of their [projected production] and so on.

MR. MORRIS. Yeah.

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

MR. FOSSUM. Mr. Chairman, I'd give the Committee a little sense of the sentiment from the Southeast based upon the expressions by our directors at their recent meeting. I'd say, almost to a person, our directors expressed, not pessimism, but very cautious optimism about the near-term economic future. And this is based in considerable part on the revived construction activity in our District, which is pretty general.

Real estate is moving actively again in all of the regions. We still have an overhang in central Florida. In south Florida, activity has picked up considerably, based in part on purchases being made by foreigners--mostly Latin American, I would say, although some Swiss money is coming in. One of our directors who is an industrial contractor reported that, despite the fact that it is not yet showing up in the figures, small, medium, and large companies are making commitments in a big way now for capital expenditures. And that they will be coming online, they've got all the business that can handle in the near-term future.

Supporting what Mr. Baughman reported, we are seeing shortages showing up now in oil drilling, rigs, and in labor. There is a shortage of oil barges in the Gulf area. Quite active activity on the Mississippi and Louisiana coast, but concern expressed for shortages that are impeding that. But generally, the outlook is one of cautious optimism.

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

MR. COLDWELL. Mr. Chairman, there are only three spots in the change, or in the projections, which raised some flags for me. First, the inventory change, shifting--from the first quarter to the second quarter--from 12.1 to 3.0. And secondly, the increase in final purchases jumped from 39 billion to a 57 billion rate. And then, finally, the net export picture, from a negative 13 to a positive 1. These are very large changes in these units as the forecast--

MR. PARTEE. Those are for the second quarter?

MR. COLDWELL. Between the first and the second quarters. I think, as I look over these figures and other matters, that the directions are right. I wonder if the magnitudes are quite that much in the way of change. I particularly question the degree of change in inventory because I think you're going to get more rather than so much less. The net export figure, I guess, was an oil figure more than anything else in the first quarter, and maybe that will swing that much. But a shift [in] consumer purchases by that large a change is truly a major shift. I guess all of this means to me that you've got negatives and positives on the side of the total change in the GNP. And I just wonder if maybe the second quarter isn't going to be stronger than what you're reflecting in this forecast.

MR. ZEISEL. As far as inventories are concerned, Governor, the first quarter was extremely strong in part because it was a substantial shift--a swing in inventories from the fourth [quarter] to the first. The actual rate of inventory accumulation in the second quarter is higher than the first at a reasonably--not a high rate, certainly relative to GNP, but certainly within a reasonable range relative to the growth in GNP.

The net export situation in the second quarter is reflecting a continued high import of fuels, a much larger import of fuels in the second quarter than we had anticipated, and this involved an upward revision of the import figure and of further weakness in the net export figure for the second quarter. Now, there is a bit of a long lag there, obviously, in getting figures on foreign trade, and those could be revised by the time the figures come out. But they look like they're moving in that direction.

We've revised upward our personal consumption figures for the second quarter and now have a very strong increase in that sector, so I think we have a pretty strong rate of increase in that sector. It's certainly possible that the second quarter may turn out to be even stronger.

The inventory figures we have are for April. They don't show any great acceleration from the earlier months, but they could move up rather swiftly.

CHAIRMAN BURNS. All right, thank you, Mr. Coldwell. Mr. Lilly now.

MR. LILLY. Well, I just wanted to point out that they would be unable to build 1978 models until the legislation that was in front of the Congress to reduce the emission standards was passed. I'm very much concerned about the 11-1/2 million annual rate of autos that you have projected, which includes the 25 percent decrease in imports, in view of the fact that legislation has not yet passed Congress, and the Ford Motor Company in the last couple of days announced they were going to put a '77 label on '78 models. I'm sure that General Motors is going through the same kind of problem as to what they're going to do, because the time for production is here. Now they can, as most of you know--the '78 models are mainly made in '77. So they have the balance of '77, they can build '77 models and they can call '78 models '77, but once they get to the first of January, they're in real trouble.

CHAIRMAN BURNS. What is the status of that legislation?

MR. LILLY. It's still in conference.

CHAIRMAN BURNS. Expected soon?

MR. LILLY. Well, you know, last May 25 it was expected almost daily, and nothing has happened, and we've all--

CHAIRMAN BURNS. Who's holding it up? Do you know? I haven't been told.

MR. LILLY. Well, I don't know.

MR. PARTEE. [Unintelligible]. It seems to me there's one last week--

MR. ZEISEL. We have kept in touch following your comments last month, Governor. We kept in touch with this legislation and, obviously, you are perfectly right. The producers are disturbed, quite worried--

MR. LILLY. Well, here's Ford, you know--now putting a label of '77 on a '78 model--incidentally that has an interesting effect because they're going to have to sell it at '77 prices, they think. So it's actually coming on the market a little cheaper.

CHAIRMAN BURNS. It might be a good idea to extend the thing.

MR. ZEISEL. They do anticipate--

MR. LILLY. I was afraid they might see that.

MR. ZEISEL. They do anticipate action very soon on this legislation. And on the basis of our discussions with Detroit, we have continued to assume that the legislation will get out very soon and that they will be able to move on to '78 production on schedule. And they are making that assumption.

MR. PARTEE. At higher prices.

MR. ZEISEL. At higher prices.

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

MR. WINN. Two brief comments, Mr. Chairman. First, in terms of our capacity measures. I'm quite impressed, on the one hand, with what industry has been able to do with some small retooling in terms of dramatically increasing the capacity of output for their plants. And so part of the new technology is just being factored [in] as the pickup occurs now in machinery orders and some of these things. So this is one thing to sort of take a look at, that we are getting tremendous output potential from very small increases in investment, a result of new technology.

On the other hand, the amount of real investment that has to come in our mining, coal, and other areas is just almost beyond imagination. And some of this is starting. The highly dramatized labor difficulties in coal haven't really led to an awful lot of inventory building up. Normally, you would think that would occur rather rapidly. Coal prices are firming, and their outlook is good. But the transportation investment is very real, it's resulting in changes in the location of coal. Instead of Duluth being a mining center, it may be a coaling center.

The third comment I'd like to make is, in Ohio the agricultural situation is not nearly as good as in other parts of the country. The drought this year, and the freeze, which affect the fruit crops and other things, added a little bit of pessimism into the air.

[Report on domestic open market operations]

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

CHAIRMAN BURNS. Thank you for a very interesting report. Any questions of Mr. Meek?

MR. WALLICH. I wonder to what extent open market operations in bills offset what the Treasury does by running off its bills? You mentioned one week where the numbers seemed to be not too dissimilar. But then you said that, over the quarter, the Treasury reduced bills, I believe, by $10 billion, which surely is much more than the Fed could have sold.

MR. MEEK. Well, our operations in the short run, of course, add to the available supply of market bills, and in this period they reduced the shortage in the market. Nonetheless, the shortage of bills in the market has been one of the reasons that the bill rates have been out of line with other short-term rates during this period.

CHAIRMAN BURNS. Any other questions? Well, thank you. And Mr. Kichline, could you introduce us to the Bluebook at present?

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

CHAIRMAN BURNS. Thank you. I overlooked an action that is required on the operations at the Domestic Desk that we need to approve if we are so inclined--what the Desk has done during the past month.

SPEAKER(?). So moved.

CHAIRMAN BURNS. Motion has been made and actually seconded.

MR. PARTEE. Do they have to buy them themselves if we don't approve?

CHAIRMAN BURNS. I hear no questions or objections. All right, any question to Mr. Kichline?

MR. COLDWELL. Jim, on alternative B, you are looking at an M1 [growth rate] rising from 1.9 [percent] in June to 8.2 in July. Would you tell me what the pattern of that was in 1976?

MR. KICHLINE. For the June-July period? We have it in one of these tables if I can locate it. M1 in June of last year declined 1.2 percent and in July rose 7.1 percent.

MR. COLDWELL. So your pattern isn't much different.

MR. KICHLINE. No.

MR. COLDWELL. One point higher.

MR. KICHLINE. No, that is right. We are starting clearly at a June base that's roughly a bit higher. But essentially the same sort of thing in terms of, after two months or so, we assume that resumption of growth will occur. That's what we've built into our patterns this time. This is two months after this massive bulge--

MR. COLDWELL. Yet, your economic situation is sharply different.

MR. KICHLINE. That's right, if our forecast is right, it will be stronger this time around than last.

MR. COLDWELL. Which ought to then build a higher rate for M1, shouldn't it?

MR. KICHLINE. Well, since we have a little bit higher rate on average for that period, we have a higher rate.

MR. COLDWELL. I know, but starting at the lower base you still are moving roughly the same--

MR. KICHLINE. We, by the way, are just about on track now in terms of [the second] quarter. We had an 8.2 percent annual rate of growth, and we have about the same this time. So, on average in the second quarter this year and last, there's not much change.

CHAIRMAN BURNS. All right, thank you, Mr. Coldwell and Mr. Kichline. Mr. Morris please.

MR. MORRIS. Mr. Chairman, I'm very much disturbed by this prospect of an early July artificial bulge in the money supply. It seems to me that our response ought to be to adjust the seasonal adjustment factors to reflect the fact that our present seasonals are wrong. To do otherwise is to give a market which is very sensitive to these numbers a misleading impression as to what is going on. We now have in the marketplace a feeling of confidence that we have got the money supply under control. I don't think we ought to mislead the market, but on the other hand, for us to publish numbers where we know the seasonal adjustment factor is wrong, I think doesn't make any sense. I hope I can find some support around the table [for] that possibility.

CHAIRMAN BURNS. You have me as a supporter, at least tentatively. What is the answer to Mr. Morris?

MR. KICHLINE. Well, this is the first July that we had this. [Previously there were two instances] of this sort of experience--the third time around [will be] this July. In April, there were clearly a number of things going on. We had three special factors, I remember, plus sort of underlying transactions demands. So one of the issues is, how much do you allow for seasonal impact of this Social Security check? And, quite frankly, the reason I brought it up is to call it to your attention, but also I'd like to put a little tone of uncertainty on it. I know the New York Federal Reserve Bank has a somewhat smaller allowance--at least in our staff discussions early on they have allowed something smaller than we have. So I think there is a good deal of uncertainty as to how much one ought to put into this special factor.

MR. MORRIS. Well, I think seasonally adjusting weekly data involves a lot of uncertainty anyway. But it seems to me that we do have some historical basis for making an adjustment we ought to use.

MR. PARTEE. Well, is this seasonal? You've had two occasions--two different weeks and two different months, and the third one is coming up. Now, the two seem to go the same direction, so do you already bet and change the seasonal? What if the third one doesn't happen?

CHAIRMAN BURNS. Suppose you didn't call it a seasonal? Suppose you called it an identifiable special factor that you are correcting for?

VICE CHAIRMAN VOLCKER. It's not very identifiable, is the trouble.

CHAIRMAN BURNS. What's that? Well, not the amount, no.

VICE CHAIRMAN VOLCKER. One way of handling it is, when you announce the figure, emphasize that this happened.

MR. MAYO. It seems to me that's the better course to go, Mr. Chairman. I don't visualize this, just by reading the explanation correctly, as a seasonal at all. It's an increase in the money supply that is on the books of the private sector for a longer period of time during a month, during the year.

MR. MORRIS. If it happened every year, then the seasonal would take [it] into account, and we would not be showing a big bulge. It's [because of] the fact that it doesn't happen every year that we've got a problem.

MR. KICHLINE. But that's my point, I think, Frank, that this isn't a seasonal. If it happened every year, it would be up every year because you have a larger volume of money in the hands of the Social Security recipients for a longer period during that year. But I don't think it is a seasonal at all.

MR. PARTEE. It won't happen, of course, in the same month. It only happens when, as I understand it, the first of the month is a weekend.

MR. KICHLINE. Well, the third of the month is on Saturday or Sunday or holiday. I might say there's a chance--

CHAIRMAN BURNS. Isn't this analogous to the kinds of adjustments our statisticians have learned how to make in retail trade because of the shifting date of Easter?

MR. PARTEE. Exactly, or the number of trade days in a month.

CHAIRMAN BURNS. I have sympathy for what Mr. Morris has suggested, having worked on problems of that sort, not recently, but over many years in the past. What I could say in defense of the staff is that what they are allowing for, this exceptional factor, is not very large. And when you make your seasonal correction, the elements of uncertainty are parallel--[it] is much larger than the allowance which they make; therefore, practically, I don't know that it makes too much difference.

VICE CHAIRMAN VOLCKER. How much are we talking about?

MR. KICHLINE. In dollar terms, a billion and a half. But let me just say for that particular week, July 6, our weekly pattern consistent with alternative B has a not-seasonally adjusted increase of $10 billion and a seasonally adjusted increase of $3 billion. So there's a $7 billion seasonal adjustment there in that week already, so out of the three we assume that 1-1/2 is associated with this Social Security affect.

MR. COLDWELL. Will you translate that into percentage change, too, Jim? A third of your 8.2 would be--

MR. KICHLINE. Yeah. Without it we would be down to a 5.8 percent annual rate of growth in July.

CHAIRMAN BURNS. 5.8 without this special Social Security factor. What is it with that factor?

MR. KICHLINE. 8.2.

CHAIRMAN BURNS. Gentlemen, I think you've heard me say time and again at this table that 4 equals 8, and now we have 6 equaling 8. And I still would go with Mr. Morris, I think, but it's not a factor of much consequence, really, practically, because of uncertainty in measurements that surrounds our entire operation here.

VICE CHAIRMAN VOLCKER. Conceptually, I don't see why this affects more than one week. Why isn't it all washed out the next week?

CHAIRMAN BURNS. Well, but it's spread out. The average effect on the month.

VICE CHAIRMAN VOLCKER. I understand that, but you get a higher month because one week is higher.

CHAIRMAN BURNS. And therefore the rate of change is--

MR. KICHLINE. It's that the change from [the week of] July 6 to [that of] July 13 is different with the higher level in the first week. We have it all washing out in the first 15 days of July. And that's indeed what happened, if our interpretation is correct, in both October and April--that it's a first-half phenomenon, and it occurs largely in the first week, and a little bit in the second week, and in the third week it's all gone.

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

MR. MAYO. Well, I was on the same track as Frank--I think this is an absurdity in the [sense that] it causes people to suggest, when they hear the explanation, that we are all nuts down here. It isn't even clear--even if we say it's washed out, well, we are saying it really isn't washed out because it makes a difference in the way the rates go. And if it is not washed out--if we are saying that, well, the Social Security recipient actually has on average more money in the month of July than he would before, [then] I think there is a real increase over the entire year. Maybe it's tiny here; maybe it's only 1/10 of 1 percent in the overall, but isn't that what we are saying, that it isn't strictly a seasonal?

MR. KICHLINE. You're quite correct. I meant that the level of the money stock is not higher after mid-July, but on average you are talking about--

MR. MAYO. But on average it is, and so that enters in--to put this absurdly, perhaps--this enters in to maybe 1/10 or 2/10 of 1 percent higher money supply growth for the entire year , or an annual rate of 2-1/2 for the month of July. And so we should theoretically set our long-term target ranges one-tenth or two-tenths higher for what is an absurd factor. And I think this does make us look rather foolish. So I would vote very strongly for an adjustment to wash the thing up.

MR. MORRIS. I don't think it makes the average figure for the year higher, because the rate of change in August would be lower because of this.

MR. MAYO. Not necessarily. If you are a Social Security recipient and you have that money two days earlier, you have an average balance of cash for the month of July that's higher than it would otherwise be, right? It hasn't anything to do with August, September, or any other month. But it's an absurd economic practice.

VICE CHAIRMAN VOLCKER. A billion and a half dollars for two days can't affect the annual average by even 1/10 of 1 percent.

MR. MAYO. It affects the monthly average by 2-1/2 percent, Paul. Now, what I'm concerned about is the expectation in the marketplace that, by God, the money supply is exploding on us again.

CHAIRMAN BURNS. Let's be careful; we are not talking about the explosion, we are talking about--

MR. MORRIS. We are talking about very big increases in the first week of July, Mr. Chairman--about $3 billion.

CHAIRMAN BURNS. We are talking about a difference between 5.8 and 8.2, and that is well within the normal margin of error of the seasonal calculation.

MR. PARTEE. That's for the month. I think Frank's talking about the first week.

CHAIRMAN BURNS. Well, that's true, for the first week it will be very much bigger.

MR. PARTEE. Well, I think Paul's got the right idea; you just emphasize it in the statement. If you start to adjust your statistics ad hoc, there is a question of credibility: "Why are you doing that? Because you didn't want to show a large increase?"

MR. MORRIS. We do this for the industrial production index when we have a special factor.

MR. PARTEE. Well, I know, but I have always been a little nervous about that.

CHAIRMAN BURNS. The difference there is that it's been done for years, and therefore it's a respectable procedure by now.

MR. WALLICH. Well, the other special factors from time to time--when we have to do the same for each of them, in the end, then we find that the money supply throughout the year grows at 5.5 percent.

MR. GARDNER. Seems to me [that] protestations about people who have watched our money supply figures and immediately translate them into market actions are contradictory in the sense of the subject we are now discussing. If we are really going to tell the world to stop worrying about weekly fluctuations, we ought to think a long time about making adjustments in those weekly fluctuations. I wouldn't mind commenting on them. If we don't want people to do what they are already doing, and I suppose that's a vain hope--

MR. MORRIS. All I'm suggesting, Steve, is that we have a good seasonal adjustment instead of a lousy one.

MR. PARTEE. Well, I would suggest that we might discontinue the seasonally adjusted weekly figure as of the first week of July and give this as a reason. There are so many odd things affecting that seasonal pattern, that we are going to stop seasonal adjustment.

CHAIRMAN BURNS. I think we have to be very careful about that. A campaign is being waged against the Federal Reserve now by some economic and statistical quacks. And for us to discontinue the seasonal calculations would, I think, be a concession on our part, which I am not ready to make at all--that the quacks who make a living out of quackery have suddenly become prophets and valid interpreters of statistical procedures. I don't think we ought to do that. I think we ought to follow Mr. Morris's suggestion, or do what the staff is now doing, or something in between. After all, there is some leeway here.

If we follow staff procedures, some explanation of the numbers ought to be indicated in the news release. I would not suspend the seasonal calculation. What we ought to take up--and this is not the day to do it--is the question of publication of these weekly figures. I will finally argue, I think, that we ought to discontinue. These are sheer noise. We would have to take some heat from the journalists and congressional people, but there has been enough discussion of that--the unreliability over those figures--to justify our doing that. [But] let me not debate that issue today.

MR. BALLES. You have my vote, if you are going to vote today.

MR. MAYO. I'll second it.

CHAIRMAN BURNS. This is discontinuance permanently. I thought you were suggesting for the one week.

MR. PARTEE. No, for permanently, of the seasonally adjusted weekly figures.

CHAIRMAN BURNS. Well, no, I would--

MR. PARTEE. You can't discontinue the unadjusted figures. Freedom of information requires--

CHAIRMAN BURNS. I don't see why you can't. After all, we don't publish daily figures, thank God. We could do it, we've got them.

MR. PARTEE. You'd get a court case.

CHAIRMAN BURNS. Look, whether we win or lose a court test, you do the right thing in this shop. But let's not debate that issue today. Mr. Balles, you had a question on the Bluebook.

MR. BALLES. I wanted to ask Mr. Kichline a question, not on Bluebook per se, but on related matters in financial markets. Just a comment. In the first place, I find it rather strange, this dichotomy in the trend of business loans since the first of the year--New York versus the rest of the country, among the big banks. Total business loans are up about 600 million in the aggregate among the big banks, but New York's gone down 2-1/2 billion, and the other banks have gone up 3.1. I wonder if that's got something to do with the recent downward adjustment in the prime rate in New York. I am particularly interested in [whether] the staff has a view on the dichotomy in the behavior of business loans--New York versus the other large banks. And whether you had a view, secondly, on whether there might be a further narrowing in the present differential between the prime rate and the commercial paper rate.

MR. KICHLINE. With regard to New York, the only information that we have that seems quite consistent--we've checked reasonably thoroughly on this--deals with the performance of the commercial paper market. Many of the prime customers apparently were in the paper market. We tracked down the names of some of those issuers who were large borrowers earlier in April and May, particularly, and they seemed to have been candidates for New York City banks. And perhaps the borrowing that would normally have gone to the New York banks showed up in the paper market.

With regard to the prime rate spread, it clearly has narrowed. I don't know about further narrowing. I think that the pressure would be there, given the New York banks' performance on business loans, and the Redbook clearly reports qualitative comments that business loan demand at New York banks is relatively weak. And so I think that there would be some continued pressure because of the preference of many of the borrowers to seek alternative sources of funds. And so I think that the pressures are in that direction for a narrowing of the spread.

MR. JACKSON. In that connection, John, I happen to have been at the New York board meeting, and I don't think Paul was; Alan was, some others. But there was some indication that this was not an unusual phenomenon, that typically loan demand growth in New York lagged the rest of the country in a business cycle, and that this was not abnormal in any sense of the word--

VICE CHAIRMAN VOLCKER. Well, it is true that New York normally lags, but this has been an exceptionally long and pronounced lag. And I think the normal, usual explanation for it in the Treasury market is that the biggest companies in the country are relatively liquid, and most of the loan demands must be coming from smaller ones, which is reflected in the fact that outside the weekly reporting banks, it's stronger than in [larger] weekly reporting banks outside of New York.

And this is an exceptionally wide discrepancy by historical standards, although, in [its] general direction it's not unusual. I think the banks are in a conflict about the pricing of their loans. They don't want to reduce the prime rate. They feel it loses profit margin all around. On the other hand, they have this problem--if they could reduce the prime rate without reducing it on so many secondary loans, I think they would do it. They are unhappy with the pricing structure--there are too many people with the prime rate; they haven't been able to correct it.

CHAIRMAN BURNS. All right, thank you. Mr. Willes, please.

MR. WILLES. I have just one question, Mr. Chairman, following along essentially the same line that Governor Coldwell was on earlier. I assume, given the robustness of the economy, that if your forecast for M1 turns out to be in error, and you are surprised by the number that you see, [would you] expect to be surprised with higher, stronger numbers?

MR. KICHLINE. I wouldn't be surprised to see anything, frankly, on a monthly basis, but I think one of the factors tending to hold down July growth in our view is still some continuing lag impact of the higher interest rates--that we ought to be having some marginal trending down of what would otherwise be the underlying rate of growth of money demands holding interest rates constant. So I think our guess at this juncture is quite good. But if I put all the special factors together and what would likely come out, I think that we could very well be in for somewhat higher rather than somewhat lower numbers.

CHAIRMAN BURNS. All right, we will hear from Mr. Jackson and then break for coffee.

MR. JACKSON. I have already said what I was going to say.

CHAIRMAN BURNS. Very good. We'll take a break now, a brief break.

[Coffee break]

CHAIRMAN BURNS. Gentlemen, we have to resume our deliberations, and we want to turn now to the policy directive, and let me just say a word about that--give my own views. We embarked on some tightening; what we sought to achieve, I think we have achieved. There has been a marked slowing down in the monetary aggregates. Also, while short-term interest rates have risen, the long-term interest rates not only have not increased, they have actually declined.

To a degree, I think, we have been lucky. To a degree, however, I think our action has been very reassuring to the business and financial community. We have indicated that we do have a firm policy for dealing with inflation and that we at least are discharging that responsibility. And we are not going to let the monetary aggregates explode, and we'll do our job. And I think this has been comforting to the market and is perhaps partly responsible, to say the least, for the behavior of long-term interest rates during the past three weeks.

I would recommend to the Committee that we stand still. And alternative B looks good to me. As far as the federal funds rate is concerned, I think I'd stay where we are, with a range of 5-1/4 to 5-3/4, and with an asymmetrical midpoint at 5-3/8. Now, I've had a discussion with the staff about the Social Security factor. As I think you all know, the New York Bank holds a weekly [press] conference on the meaning of the figures they put out. And this time, at the New York Bank's press conference, the point will be made quite sharply and very clearly that the weekly figure is affected by the Social Security factor, and therefore we will not be misleading the market.

As far as the figures are concerned, under alternative B, if, let us say, we did follow Mr. Morris's suggestion, instead of having 3 to 7 for M1, the figures would be 2 to 6, you see. And it's a difference almost without much meaning. While I lean in favor, logically, to Mr. Morris's suggestion, I think that it would be a mistake to dictate to the staff on a matter of this sort, and Mr. Kichline has indicated to me that, in addition to the Social Security factor, there are other factors, technical factors, at play that have not been properly evaluated. And, therefore, I would stay with the staff adjustment as it stands and not interfere with it but make a full explanation of the uncertainty and the special character of the figure at the New York Bank press meeting.

Well, to repeat, my best suggestion to the Committee is to adopt alternative B as far as the monetary aggregates are concerned and to stay with the present federal funds rate range. I see no good reason for changing.

MR. BLACK. Would you use the money market directive, Mr. Chairman, or the aggregates directive?

CHAIRMAN BURNS. Well, logic is a stern master, and if one respected it, really, one would have to use a money market directive--but I have found it desirable at times to throw logic to the winds, and I see some advantage in the monetary aggregates directive because, basically, that is what we ought to be doing. Who would like to speak first? Mr. Volcker, please.

VICE CHAIRMAN VOLCKER. I have the same feeling about the federal funds rate range that you do. I think, basically, we are talking about B. I am, anyway, and you are. I think I feel a little more cautious about the business outlook than the staff does at this point. But also the aggregates are going up higher, and I think that this is a little above our target. This is the right compromise, and I wouldn't like to see the federal funds rate declining [to] 5 percent here, so I'd like that lower base, the one we have been working on. And the aggregates are also all right with me. I'd be perhaps a little happier by lowering the lower end of the range of M1, just in case it did come in low, because we could stand it coming in low again--make it 2 to 7--but 3 to 7 is also acceptable to me. I think the important thing is, if the aggregates come in a little low, we can take that and not go below the 5-1/4 on the funds rate.

CHAIRMAN BURNS. All right, thank you, Mr. Volcker. Mr. Roos now, please.

MR. ROOS. Mr. Chairman, I would like to speak in behalf of the alternative C pattern, for a couple of reasons. It is obvious that our aggregates are at the upper portion, the upper limits, even beyond the upper limits, [of the] long-term ranges. If we are going to get these down, we are going to have to, somewhere along the line, make a correction, unless we determine in July to again raise the base from which we project these ranges. And if we do that, if the ball game is similar to where it is today, I think we will find ourselves at a dangerously high range for the aggregates.

If we are going to have to make a correction, it seems to me that, if we do it at a time when businesses are relatively strong, we create less of a reaction in the business community and less of a potential reaction psychologically. If, for example, in the latter half of the year, due to capacity constraints, there is a turndown in the economy--if we move at that time to make such an adjustment downward in our aggregate targets, I think it will be a much more difficult time to bite the bullet than if we do it now. And even though we see a great deal of confidence today, we do see the possibility of a significant turndown in the last half of the year. We think it would be awfully difficult to make this adjustment later on, and I'd just like to, for whatever my opinion is worth, express a preference for C.

CHAIRMAN BURNS. Let me make this observation. It's not that I want to be argumentative. I'm trying to be factual. If the economy should turn down, you can rest assured that the monetary aggregates will come in at a very subdued rate no matter what our target's going to be. And therefore, the monetary aggregates will slow down even if we left them unchanged, no matter what we do, pretty nearly. That certainly has been the experience over many, many years. Mr. Mayo now, please.

MR. MAYO. Mr. Chairman, I feel quite strongly that the federal funds rate range should remain exactly where it is. I feel also, though, that I would rather adopt the monetary aggregates specs of C, because I am concerned--I don't want to see us move as much as the fed funds range would indicate if, indeed, we only get a 2 percent or 1-1/2 percent increase in M1 and, correspondingly, with M2. So, I would prefer to see the lower ranges adopted by this Committee for both M1 and M2 as being quite consistent with the 5 to 5-3/4 range. I also prefer the money market directive, but I don't feel strongly about it. But I think it is the preferred course this time.

CHAIRMAN BURNS. Mr. Black now, please.

MR. BLACK. Mr. Chairman, I feel that M1 in the second quarter is still going to be moving a little faster than we'd like to see it. In view of the likelihood that the economy will continue on upward, the demand for transactions balances is likely to lead to some rise in the demand for money. But fortunately, it looks like M2, which I consider a lot more important, is coming in better now, and the prospects for holding that within the target range seem pretty good to me, so I come out almost where you did in saying we ought to stay about where we are.

I was leaning toward the money market directive, which I don't like to do, either, and if you are prepared to throw logic to the winds, I'll go along with you and go with the aggregates [directive], which I really prefer for philosophical reasons. Like Mr. Mayo, I would prefer the ranges on M1 and M2 embodied in C because our projection suggests, quite surprisingly, that we may have a little less growth than staff suggests.

CHAIRMAN BURNS. Okay, Mr. Black. Mr. Coldwell, please.

MR. COLDWELL. Mr. Chairman, I'd be perfectly satisfied with the steady policy directive this time, but that, to me, implies use of the money market directive rather than the monetary aggregates directive. I would prefer that we use the full specs of alternative B, 5 to 5-3/4 on the funds rate range. If things turned out to the point where you had a very large shortfall of the aggregates, I wouldn't want to be limited to only 1/8 of 1 percent change in the funds rate. It seems to me that, looking further on down the road, we've got ourselves built into a very high velocity estimate, and I'd like to maybe soften my bet a little bit on that, so I'm perfectly willing to stay in the 3 to 7 range for alternative B right now. But I'd like a little flexibility in the funds rate and use the money market directive.

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

MR. BALLES. Mr. Chairman, in spite of some jawboning that we have gotten from certain quarters, I feel personally pretty good about what we did in calming down the monetary aggregates. I think that has worked quite well. We have reassured markets, as you've mentioned and as Frank Morris alluded to earlier. In terms of the decline in long-term rates, and in terms of the decline in the T-bill futures market, I would stay just about where we are and see what happens for another month, when we get a peek at the August estimates.

I'm basically fairly bullish on the economy. I recall somewhere here [at] the table last month, maybe it was Mr. Guffey--I know now to call this Guffey's law--saying that the better the economy, the more time we spend looking for problems. Despite the fact that you can always find certain areas of risk, I think the economic outlook is quite bullish, and therefore I'd be prepared to stay with alternative B on the federal funds rate. Like several others, including Mr. Mayo and Mr. Black, I would prefer the alternative C specifications on the monetary aggregates, and I would go for the aggregates directive. I'd be prepared to rise above principle in this case.

CHAIRMAN BURNS. Thank you, Mr. Balles. Mr. Eastburn now.

MR. EASTBURN. Mr. Chairman, I like your suggestion of alternative B. I think, also, that it is consistent with the uncertainty that I was talking about earlier. And one of the things we also hear when we talk of businessmen is that they do look to the Fed for some source of stability. And in that connection, I was interested to read in the Redbook a comment by Professor Samuelson--zigzagging around the desirable range as new information cumulates is the optimal policy posture in a changing world filled with uncertainty. I am not about to take on Professor Samuelson, but I understand that that position, even in technical terms of optimal control theory and rational expectations, is questionable, and certainly [it is] in terms of the intuitive feeling that I have about uncertainty. It seems to me that whatever we can convey to the business community that we're going to move gradually, I think would be for the good. In that context, it seems to me that it would be well for us to go with alternative B.

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

MR. WILLES. Thank you, Mr. Chairman. We've talked a lot today about uncertainty, about businessmen's feelings, and so on. It seems to me that one element of consistency between what businessmen tell us and what we've heard around the table today is an increasing concern for inflation. And I guess, in the comments that you made earlier about the salutary effect that monetary policy has had on businessmen's expectations--I find that very compelling, and I would take that same argument, that same logic, and apply that in a context today of suggesting that we ought to continue to give fairly overt signals that we are sensitive to that concern and we are going to continue to press gradually and modestly in that direction, even at the risk of some increase in short-term rates. That has the added advantage--if the Bluebook is correct, and I find the argument fairly sound--that an increase in rates now would imply a smaller increase in short-term rates 9 to 12 months down the road, and that would have some obvious advantages as well. So I would prefer to see the Committee move in the direction of alternative C.

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

MR. PARTEE. Well, I am in agreement with your proposal, Mr. Chairman. I think it would be a good time to stand still because it isn't altogether clear to me which way we are going to be going from this point. There are a few signals in the economy that are a bit bothersome. On the other hand, it seems to me the bulk of the evidence is that we'll have continued substantial expansion. Also, I think if you look at alternative B's ranges--M1, 3 to 7--well, assuming June is right, at about 2 percent, that means M1 below 4 in July would get you below the lower limit. Now 4 is not such a disturbingly low figure. And so I think it's set about right. And on the other side, to get 7, you would need to have quite a large increase in the month of July. Now it is possible, so I think that these are very good outer bounds of the tolerability we ought to have for what might seem to be developing as we go into the early summer.

I'm inclined to think it ought to be a money market directive because of the very narrow band on funds, and also because of this uncertainty we have about the month of July with the technical factor that was discussed before, and with the question of how much rebound there will be. And that would leave open the possibility of a special meeting or a special wire if, in fact, July developed very unusually in terms of the aggregates. So I would take exactly the specs you suggested, but I would prefer a money market directive.

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

MR. MORRIS. Well, Mr. Chairman, I think we are very fortunate that the staff projections for May and June turned out to be pretty close to reality and that we didn't need the insurance on the funds rate that I feared we might need a month ago. I like alternative B. I would hope that we could stay, as Dave Eastburn suggested, at 5-3/8 for the month. But on the other hand, I would expect the Manager to use a full range in the event that we get a radically different performance in the aggregates than we're now expecting.

CHAIRMAN BURNS. Who would like to speak next? Yes, Mr. Jackson.

MR. JACKSON. I prefer alternative B, but I would prefer a money market directive. If you look at the calendar and the distortion to take place July 1, and we meet on the 19th, and the projections are that it'll take two weeks for this to be worked out, we will really hardly know what's going on for July or most of the period ahead of us. So I think a money market directive would be preferable.

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

MR. WALLICH. Well, we've worked off most of the bulge of April and the two following months, but not all of it is for M1. So to be going again at 8 percent in July is something of a concern. However, this is a special situation, and so I would not take issue with the alternative B range of 3 to 7 [for M1]. As far as the funds rate is concerned, I hope we can stay at the present level and take our subsequent moves in discrete steps. So again, I would go with 5 and 5-3/4, although ordinarily I would prefer a wider range. As far as the directive is concerned, I have preferred on general principles an aggregates directive.

CHAIRMAN BURNS. Thank you, Mr. Wallich. Who'd like to speak next? Yes, Mr. Guffey.

MR. GUFFEY. I'd like to join those--I guess Paul Volcker, Bob Mayo, and others--that have suggested that we adopt the aggregate ranges of C but rather the federal funds that you have suggested, 5-1/4 to 5-3/4, and staying at the 5-3/8 as long as possible. That seems to me and our staff a little more consistent with staying where we are and avoiding a drop in the federal funds rate that might possibly occur. The other point that I'd like to make, whether it's a money market directive or an aggregates directive, I guess it's not of great importance to me. So long as we have that lower range of the fed funds of 5-1/4, it will not go below 5-1/4 under any of those, and I could accept either a money market or an aggregates [directive].

CHAIRMAN BURNS. All right, thank you, Mr. Guffey. Now, Mr. Baughman.

MR. BAUGHMAN. I get the feeling that we are once again gradually building a procyclical record of monetary policy. Granting the great uncertainty of the numbers--as we attempt to peer a few weeks ahead, it seems this moves me into the direction of those who have suggested a little firming, or at least posturing for some possible firming. And I find myself in a position of substantial indifference as to whether that be done by raising the bottom or the top of the funds range and riding with the aggregates shown in alternative B, or standing with the present fund range and adopting the aggregates in C.

My preference would be to ride with the aggregates in B and raise the ceiling a little for the top end of the range on the federal funds rate. With respect to the form of the directive, it seems to me the probability still is [that it is] desirable to ride with the aggregates rather than the money market conditions directive.

CHAIRMAN BURNS. All right, thank you, Mr. Baughman. Mr. Winn, please.

MR. WINN. Mr. Chairman, these are mighty small difference we are talking about. I think [if] our posture could be steady as you go, we probably are in the best position. I think I would prefer the B, money market directive.

CHAIRMAN BURNS. Thank you, Mr. Winn. Who would like to speak now? We have a few silent members of the Committee still. Mr. Gardner, please.

MR. GARDNER. My experience with this recovery--the only one I've had the opportunity to live with in the introspective halls of the Federal Reserve System--is that we are never quite sure of it. It is certainly protracted, it certainly has not spawned an enormous number of pressures. It has not been traditional. I can understand all of those uncertainties because of the world's present environment--the energy problem and the like.

I think our posture, standing firm or standing where we are now, is entirely appropriate. We had a long discussion this morning about pessimism or unease in the business community. These are quite different, I would suspect, than any discussion which might have occurred prior to the oil embargo and other events that have taken place in our historical perspective. Therefore, I'm pretty sure that the recovery is still going to drag out. I think that's a logical presumption to make.

And I've been told that the federal funds rate is going to be at 7 and 7-1/2 or 8 percent six or eight months from now ever since I arrived. Therefore, I want to stay where we are, and I think it would be wise to adopt a caution in the sense of the sensitivity to the economy by keeping that 5-1/4 to 5-3/4 federal funds rate. And I think there has been a lot of wisdom expressed for having either an aggregates or a money market directive. I'm not going to invert logic further; I'll accept whatever direction the Committee agrees on.

CHAIRMAN BURNS. I'd like to second that, that's my view. Thank you, Mr. Gardner. Mr. Lilly now, please.

MR. LILLY. Well, we are talking about such a small difference between B and C that I find it difficult to have an opinion. But I must make a bow toward the longer range, and this is what we have to do over the coming years. It would seem to me that any slight tightening possible should be undertaken, so I would be in favor of C on that basis and the funds rate--the range that you suggested--5-1/4 to 5-3/4, with a 5-3/8 midpoint.

CHAIRMAN BURNS. All right, thank you. Anyone else would like to speak?

MR. FOSSUM. Mr. Chairman, we would support the alternative B. One possibility that occurs to us is that [for] the M1, which has been excessive in the second quarter, the alternative C ranges might be more appropriate. M2 has been performing much better, and perhaps the 6 to 10 range is more appropriate there.

CHAIRMAN BURNS. Thank you, Mr. Fossum. Mr. Winn, are you in a mood to speak? Oh, yes, of course you did. Are you in the mood to speak again?

MR. WINN. No.

CHAIRMAN BURNS. I think we have heard now from every member of the Committee. As far as the language of the directive goes--I haven't kept a record--I am a little uncertain what the rest of the Committee's thinking is. I have the impression that as many are in favor of the monetary aggregates directive as the money market directive. Let's have a show of hands on the part of the Committee, those who favor a monetary aggregates directive.

MR. ALTMANN. Four, Mr. Chairman.

CHAIRMAN BURNS. Now we'll just check that--those who favor a money market directive.

SPEAKER(?). I was going to vote for the majority.

MR. ALTMANN. Six, Mr. Chairman.

CHAIRMAN BURNS. All right, I will vote with the money market directive. Let me just take a--well, my Secretary has given me somewhat incomplete information, I am sorry to say, and I don't trust my memory. There is, as I read the record, a majority in favor of 3 to 7 for M1; there is a majority in favor of a federal funds rate of 5-1/4 to 5-3/4.

I'm uncertain about the attitude of the Committee toward the range for M2. Let's have a show of hands on the range indicated in alternative B, 6 to 10. Those who find it more or less acceptable will kindly raise their hands.

MR. ALTMANN. Ten, Mr. Chairman

CHAIRMAN BURNS. Well, gentlemen, any further indication of the Committee's thinking?

VICE CHAIRMAN VOLCKER. I think there is some logic, as Mr. Fossum suggested, in just reducing the M1 a little bit. It is M1 that's above our ranges, not M2--one way to compromise it for me.

MR. PARTEE. Yes, I thought it was a reasonable suggestion.

CHAIRMAN BURNS. I see no difficulty in having the range 2-1/2 to 6-1/2. Let's have a show of hands on preference. We're going to be comparing 3 to 7 for M1 over against 2-1/2 to 6-1/2. Those who prefer 3 to 7 will raise their hands.

MR. ALTMANN. Two, Mr. Chairman.

CHAIRMAN BURNS. All right, those who prefer 2-1/2 to 6-1/2 will raise their hands. Very well, that's helpful. Any other comment? Well, I hear none; therefore, I think we ought to vote now on a money market directive and an M1 range of 2-1/2 to 6-1/2 percent, an M2 range of 6 to 10--I don't want to push logic--and a federal funds rate range of 5-1/4 to 5-3/4 with an asymmetrical midpoint that is 5-3/8. Are we ready for the vote?

MR. COLDWELL. I think I'd be constrained on that last one, Mr. Chairman. I think we need more room on the bottom side.

CHAIRMAN BURNS. Well, I respect that. There is a very clear majority favoring the lower limit of 5-1/4. I don't think the difference is really very large. If and when we get to 5-1/4, depending on how events in the economy, and the money market, and the financial markets more broadly are developing, we can take another look at it, if we are not rigidly bound by the decision reached. We can communicate with one another between meetings. I think we ought to have the vote now.

MR. ALTMANN.

Chairman Burns	Yes
Vice Chairman Volcker	Yes
Governor Coldwell	No
Governor Gardner	Yes
President Guffey	Yes
Governor Jackson	Yes
Governor Lilly	Yes
President Mayo	Yes
President Morris	Yes
Governor Partee	Yes
President Roos	Yes
Governor Wallich	Yes

Eleven to one, Mr. Chairman

CHAIRMAN BURNS. All right, thank you. Now, we concluded what I wanted to conclude a little sooner than I thought, I am glad to say, but if the Committee consents to my doing so, I'd like to leave now and turn the meeting over to Mr. Volcker.

The subjects to consider are, first, the foreign currency activities that we have been engaged in, and second, the special problem with regard to repurchase agreements on accounts of foreign institutions. And, of course, we have to confirm the date for the next meeting. And any other subjects the Committee considers appropriate, Mr. Volcker will deal with.

We'll reconvene, Mr. O'Connell, at 2:15, and we are not subject to any Sunshine limitations, considering what we intend to talk about. And you know the subject.

MR. O'CONNELL. I do, and in my judgment you are not [subject to Sunshine Act limitations at that session], Mr. Chairman. And with your permission, if, in the course of that discussion, it appears to be otherwise, I will hasten to remind you.

CHAIRMAN BURNS. Well, you'll be there as our moral as well as our legal conscience.

MR. PARTEE. Will we reconvene as the FOMC?

CHAIRMAN BURNS. No. We are reconvening as a--

VICE CHAIRMAN VOLCKER. I think that we need a report on foreign currency operations from Mr. Holmes.

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

VICE CHAIRMAN VOLCKER. Mr. Morris, please.

MR. MORRIS. Alan, what's been the reaction to the comments in the BIS [Bank for International Settlements] report about the place of the American dollar?

MR. HOLMES. Hasn't been much visible market reaction to that. I know it has caused a great many people inside government to think about how long we can sustain this without some pressure developing on the dollar. But I think more important is how well we do on the inflation front compared with Germany, Switzerland, and some of the others. Right now we're sort of average and not doing as well as they. But with our interest rates a bit higher, the dollar has been extremely steady in the exchanges.

VICE CHAIRMAN VOLCKER. I have a feeling we have been pretty fortunate that the dollar has been as steady as it has been in view of the trade balance and our inflation performance. And the key, I suspect, in the last month or so was this rise in interest rates that came along at a fortuitous time from that standpoint.

MR. HOLMES. We had no appreciation of the dollar, but it did offset these other movements attempting to weaken it.

MR. PARTEE. Well, one wonders whether the dollar shouldn't appreciate.

VICE CHAIRMAN VOLCKER. Well, we've had some discussions on that recently with foreigners, and what they point out is that there's no indication that our trade with other industrialized countries is really suffering. It's oil, and LDCs [less-developed countries] for various reasons, and Japan--Japan [as an industrialized country] is the one exception to that.

MR. PARTEE. Yes, if you take out the OPEC countries, I think you still find the deterioration.

VICE CHAIRMAN VOLCKER. That's right. But it's in the LDCs and in Japan. It's not vis à vis Europe--well it is Canada, too; [trade with] Canada has been [deteriorating].

MR. PARTEE. Well, if you break up the world into enough separate spots, you're going to find some place you're in balance with.

VICE CHAIRMAN VOLCKER. Well, this is the European argument you hear back, though. There is no need for any depreciation of the dollar vis à vis Europe. Which is basically what you are talking about here.

MR. PARTEE. Did you say, Alan, that money market conditions were easing in Germany?

MR. HOLMES. They had been except around the tax date.

MR. PARTEE. Do you think it was a special thing?

MR. HOLMES. No, I think they deliberately tended to keep interest rates on the low side.

VICE CHAIRMAN VOLCKER. The Italians are a bit worried about their economy turning down; mass production figures showed a decline. Any other comment?

MR. WALLICH. When you observe that some pressures are being brought on the Japanese with respect to the upcreep in their reserves as a result of nonmarket acquisitions, [do] you see a tendency there to also try to accumulate, to some extent, high reserves at commercial banks?

MR. HOLMES. No, I think the Japanese have really abstained. And I suspect, of all the central banks, we have a larger share of their total dollar holdings than any other. In fact, they have used us to keep all those visitors from pounding on their doors. They say, "No, the Fed wants us to stay with them," which we have not said. But it's a good way to keep that steady stream of commercial and investment bankers away.

VICE CHAIRMAN VOLCKER. That doesn't say whether they are hiding it?

MR. WALLICH. Well, I meant by commercial banks, banks of the Japanese--

VICE CHAIRMAN VOLCKER. Japanese commercial bank holdings.

MR. HOLMES. I have no evidence of this.

MR. WALLICH. The opposite of what the Italians are doing.

MR. HOLMES. I have no evidence.

VICE CHAIRMAN VOLCKER. Any other comment? I take it that we have to approve, ratify, and confirm.

MR. PARTEE. One transaction.

VICE CHAIRMAN VOLCKER. Without objection, that is done. The only other thing we have is this foreign RP [repurchase agreement] business. I don't know whether I can assume you have all read these memoranda--there is one from me and one from the Board's staff analyzing some of the pros and cons.

If I can, let me just put the issue as simply as I can. If we continue providing this facility for foreign central banks, it appears, under our current understanding of IRS [Internal Revenue Service] regulations, we need to inject some arm of Federal Reserve System as principal. Which means it would be an obligation or instrumentality of the U.S. government and therefore free us from withholding tax. And the legal situation is such that, even if we just inject the New York [Federal Reserve] Bank as principal of the [Federal] Open Market Committee, it then becomes an open market operation, which the [Federal] Open Market Committee must approve. So that's why we have an issue for the Committee.

I think there are a couple of underlying questions that have been raised: whether in principle it's a good idea for the Federal Reserve to have such a facility for foreign central banks or governments; and second, whether it helps, harms, or is neutral in terms of affecting the conduct of our own domestic open market operations. Mr. Holmes might offer a comment on that at the beginning.

Just to review the general background, we fell into, if that's the right word, this practice fairly heavily after the oil crisis, [when] a lot of short-term money was moving around. There had been some isolated examples of doing RPs before. But after the oil crisis, there was a lot of foreign central bank money that wanted a very short term investment vehicle. When they came to us, it seemed logical to do RPs in a pattern of what had been done for the System account. And this has become a regular thing, averaging about a billion and a half dollars a day, these days.

We were operating under the presumption that foreign central banks are subject to exemption from withholding tax so long as they are in government securities. What has changed is [that] the IRS recently had a rather definitive-sounding ruling in a very different context. It concerned a REIT [real estate investment trust] that wanted to count RPs that had been made [in] government securities [under] certain other IRS regulations. And the IRS, for the first time [with regard to] government securities--they said it before in municipal securities to avoid the tax-exempt pass-through--they said an RP was a loan for tax purposes and not a security.

So the technical problem was, once they became a loan instead of the security--and the loan in this case presumably from the government securities dealer, and we were acting as an agent in between--there is a clear, definite threat that withholding is necessary, to the point where I thought we could no longer proceed in this knowledge, so we stopped it. And since then all transactions have been done with the System account, which was the pattern of 70 percent of the transactions earlier. The general practice has been, if the System account is operating anyway, they are done with the System account. The System account, as Mr. Meek reviewed, has had a lot of ups and downs recently, so we have been able to do them all with the System account.

But the question now is, how the Committee wants to regularize this, if at all. I should say, if they are cut off, there is, I think, a justified feeling, although the magnitude of it can't be identified, that the RP facility has become enough of a part of our investment services and other services to central banks generally that what would be affected is not just the RP facility but some of the other investment transactions in some unknown dimension.

Technically there is another route that could be [taken]. Foreign governments are also exempt from withholding tax, and whatever they hold there, with some exceptions. But in general they are exempt. Foreign central banks, if they are wholly owned by governments, which is a big if, would presumably be exempt under that provision, but they can only get exempt by making individual application for a ruling to the IRS. And it appears very doubtful that they would want to do that because it raises other complications. There is one central bank--I guess I am a little doubtful whether it was a central bank, because of its name, the Saudi Arabia Monetary Authority--that has made such an application and is deemed exempt, but that is the only central bank that is in that category. As a practical matter, I think if you relied upon that exemption, the foreign central banks would not apply, by and large, and it would certainly introduce a discontinuity.

There have been conversations between us and the Treasury and between the Treasury and the IRS, and where this stands at the moment is, the Treasury has gone to the IRS on our behalf, so to speak, and discussed the problem and asked essentially whether the IRS agreed with the theory that as a government instrumentality, if we're injected as principal, there would be no withholding tax. They got a favorable sound in response to that, but they also got the response that we should ask for a ruling precisely to confirm that. The Treasury suggests that we apply for the ruling, and technically we would apply for it as [the] New York [Federal Reserve] Bank with the full support of the Treasury. The Treasury would attach a memorandum, and so forth, saying they think it's appropriate and proper.

And in view of this apparent necessity to ask for a ruling, I personally think it is appropriate today for the Committee to decide basically what it wants to do, but not to take any formal action. Authorize us in effect to apply [for] the ruling. Assuming the ruling is favorable, then adopt a formal action that regularizes the whole procedure. Otherwise, it is at least theoretically possible that we would formally approve an approach here and then find that the IRS didn't act, and we might look a little silly--after we have to reverse the action. So you can do what you want to do--I guess the basic question is whether you want to do anything. I don't think there's any necessity for taking action today. But before we [go] to the IRS for a ruling, I want to know whether you are prepared to take the action following presumably the favorable ruling.

We've proposed three alternatives here. I think the Board's staff is in general agreement here that these are the appropriate alternatives. If I understand it correctly--although you are the man, Tom; you can [speak] to it--they prefer what we cited as the third alternative, which is permitting the Federal Reserve Bank of New York to act as principal on these transactions. And we would then act as principal when we were conducting it in the market. If it was convenient for the [Federal] Open Market Committee, for the [System] Open Market Account, as in the past, if [the System account] wanted to take the transactions, [it] could be principal.

A variant of that is to put the New York Bank as principal whether or not the System account is also principal. That is the course of action that I favor myself because it seems to me closest to past practice and does not involve any question of whether the System account is being involved in anything that's special for foreign accounts. But I think the other alternatives are technically feasible. The first alternative would not require any explicit action at all, just an understanding that the present directive covered it. In effect that's the way we are operating at the moment. But in regularizing it, as I say, I have some preference for what's presented as the third alternative. I don't know whether you want to say anything about the effect on the System account, Alan and Tom, and the different alternatives, or any other aspect of it.

MR. PARTEE. Would you start off by saying what we are doing at the moment, Alan?

MR. HOLMES. What we are doing at the moment. At the moment, if the foreign account wants to make a repurchase agreement, we do a matched-sale agreement with them. With the System account.

MR. PARTEE. Whether or not the account needs to have that reserve [drain]?

MR. HOLMES. If we need to absorb reserves, that helps us to absorb. And then go into the market and do it for the System, matched in the market. So that in that case it helps. If we are not supplying reserves at all, our practice up until now had been to do it in the market. Now [if] we did [it] with the System account [when we do not need to absorb reserves], [we] offset that by a corresponding reversing--in other words, we [treat] it like a market factor that [is] absorbing reserves, and we offset it.

Now, when we were supplying reserves, we would also go to the market. We would do the matched-sale purchase with a foreign account but do correspondingly more in the market on the reserve supplying side. Again, treating it like a market factor, which we have been doing. If it helps us, fine; if it doesn't, we offset it.

MR. WALLICH. Well now, what will happen when you get to [a] lower [volume of] operations if the legislation concerning Treasury interest on balances passes? Wouldn't you then find yourself sometimes in the position, and perhaps quite often, that you are acting in the markets simply in order to offset something that you've done with the foreign accounts? You then tell the market, don't you, that this is a foreign account, you don't--

MR. HOLMES. We would say it's in connection with a customer transaction.

MR. WALLICH. So there's no danger of misleading the market that you're actually trying to achieve an objective that isn't the case.

MR. HOLMES. No.

MR. WALLICH. But it could still appear after a while that a very substantial part of total transactions reflected these customer transactions in the foreign accounts.

MR. HOLMES. Yes, but this is very common in the bill market when we buy outright. As you know, we buy and sell for foreign accounts, over three or four times as much as we do for the System account outright. And we identify those as customer transactions when we do them in the market. And that's caused us no trouble.

VICE CHAIRMAN VOLCKER. Under the alternative proposal, anyway, these transactions would be for the New York Bank as very brief principal to a foreign account, and not to the System account. They're all done as a trading [unintelligible].

MR. PARTEE. But that would have a reserve impact, Paul. It's no different than dealing for the System Open Market Account.

VICE CHAIRMAN VOLCKER. Well, it depends upon where you begin this process. A foreigner brings money in--of course, he wouldn't bring money in if we didn't have the facility--but if that was not offset, it would be a drain. When the Bank acts for its own account, there is no reserve impact. That's one way of looking at it. It's just monies passed through to the market. There's only a reserve impact when the System account gets in on the other side. Depends upon how you look at it.

MR. PARTEE. [Unintelligible] right away, like you would if you bought bills for it.

VICE CHAIRMAN VOLCKER. That's right. It's just like using bills for the foreign account. Except the only difference is a technical one. We buy bills as agent. Here we would just inject our name as principal on both sides of the transaction. That's the only change that would take place. Where we're not acting as agent, we would act as principal, technically.

MR. GARDNER. Paul, you are suggesting, really, that we continue under the first approach and consider, after the IRS ruling, whether to adopt the second or the third approach.

VICE CHAIRMAN VOLCKER. Right.

MR. GARDNER. Now, you've already had a meeting of the FOMC to discuss this by telephone.

VICE CHAIRMAN VOLCKER. It was not a meeting. It was an informal discussion.

MR. GARDNER. Informal discussion, all right. I have a strong preference for the second approach, but I will deal with that as you find it in order to be dealt with. Because we are not going to make, according to your specifications, a final decision.

VICE CHAIRMAN VOLCKER. I think that's right, and I don't think we need to know specifically which approach will be adopted in the end. I think we need to know that one of the three will be adopted. That decision, I think, should be made today.

MR. MAYO. So the decision is basically whether the facility is worthwhile or not?

VICE CHAIRMAN VOLCKER. Although, I guess in applying for the ruling, [we] will have to apply either in our [Federal Reserve Bank of New York] name or the System name, won't we.

MR. O'CONNELL. Yes, I think that, too, can be a matter to await a decision. I agree with President Mayo that, at this time--or, may I suggest, Mr. Chairman, the [discussion], first, as to whether or not you will continue this operation, is appropriate; and then, whatever sense of the Committee [is] in terms of the alternative, to follow that.

VICE CHAIRMAN VOLCKER. I think that is right. The basic issue is whether we have this facility at all, at least on the present scale. And you may still do it in a very limping way. You can certainly do it with the Saudis.

MR. MAYO. Do you want a motion to that effect or would you just rather have a--

MR. COLDWELL. Before we start that, may I ask a couple of questions about the issues. First, Alan, to what extent are we dealing with others rather than central banks?

MR. HOLMES. It's been entirely, well, if you include some of the monetary authorities as a central [bank], it's strictly central banks.

VICE CHAIRMAN VOLCKER. Some central banks acting as agency for their government.

MR. HOLMES. But that's because they do it anyway.

MR. COLDWELL. We are dealing only with central banks.

MR. HOLMES. Asian Development Bank is also a customer.

MR. COLDWELL. Asian Development Bank is a customer.

MR. HOLMES. Yes, some of the international--

VICE CHAIRMAN VOLCKER. Ficio, in Italy, has been one; that's probably one we have to stop anyway. It is not clear what its status is.

SPEAKER(?). That's finished.

MR. PARTEE. That's finished?

MR. HOLMES. But it's only with people that are authorized to have an account with us. It's mainly central banks; it would be one or two international institutions that from time to time might have just raised a bond issue, have plans to invest that money or use it within a week, and they might ask us to do an RP.

VICE CHAIRMAN VOLCKER. In all respects, it's the same people for which we have always had investment accounts, which is--

MR. PARTEE. How do you distinguish doing it for the foreigner and not for a U.S. government agency? Let's say the Home Loan Bank Board would like you to start investing its money.

MR. HOLMES. I think they would much rather do it themselves. As far as RPs are concerned, I know that for a fact. That's a big operation they have, and I wouldn't want that operation; that's a big operation. I'd much rather see them be part of the market.

MR. PARTEE. Though, of course, you are talking about a billion and a half, if I understand, and that's a very large operation.

MR. HOLMES. Yeah, but the Home Loan Banks are doing more than that themselves each day.

VICE CHAIRMAN VOLCKER. Has this question ever risen, of a U.S. governmental agency wanting us to--any kind of government agency.

MR. HOLMES. No.

MR. PARTEE. We haven't sent them a circular offering--

SPEAKER(?). But I think we did make some for the postal--

VICE CHAIRMAN VOLCKER. Well, we do.

SPEAKER(?). At one point, I think before they took it over themselves. I think the Treasury--

VICE CHAIRMAN VOLCKER. Well, regularly these transactions, they just go through the Treasury. I am certain the FDIC [Federal Deposit Insurance Corporation] was always investing through the New York Bank, but they did it through the Treasury.

MR. WALLICH. Well, government operations are one thing you do with a government institution, but here we are taking business away, it seems to me, from the market. Now is this analogous to operating in bills on behalf of customers? If commercial banks did this for a foreign central bank, would that commercial bank be making a profit or getting maybe some kind of a collateral advantage out of the operation?

MR. HOLMES. Oh, yes, I believe it would.

MR. WALLICH. So we are already, by virtue of having all of these securities, taking something away from the market.

MR. HOLMES. We have always had the attitude, Governor Wallich, that if central banks would prefer to deal directly in the market, go ahead and do it. We have interposed no objection to that. But we feel that ever since we started operations--we have done operations before in central banks--they like it, it's part of our close working relationships with the foreign central banks. And I think they are considerably useful to us, first, in watching these flows into and out of the dollar, and also in getting subsidiary information from the central banks because we have close daily contact with them on these operations.

MR. WALLICH. Well, I can see there are advantages, but I can also see that the general principle that one should let the private sector do what it can is in danger of being violated here. There may be many things that we could do better, or at least we could take away from the private sector, if we were so minded. And I think, unless we can demonstrate that this is very important to us or that we do it substantially more to the liking of the foreign central bank, there is a presumption of letting the private sector do it.

MR. COLDWELL. Especially because we make no charge for doing it.

VICE CHAIRMAN VOLCKER. Well, the charge is a separable issue. I think we ought to charge, myself. And we are preparing some plans to that effect, and the charge would be--

MR. BAUGHMAN. Mr. Chairman, on that point, it is observed in the report that the operation in the aggregate is a bit on the profitable side. What is the source of the earnings at present?

VICE CHAIRMAN VOLCKER. Well, the whole foreign department in New York is a very profitable operation. If you take all the balances which foreign central banks hold with us and assume some earnings made on those balances, yes, just demand deposits. It is now, however, very unevenly skewed. Some accounts have a sizable balance that we don't do much for, some we do quite a lot for and have very minimal kind of balances. There is no explicit charge, although the total operation is quite a profitable one by commercial standards.

MR. BAUGHMAN. What is the nature of the earnings on the foreign balances?

VICE CHAIRMAN VOLCKER. Well, it's just that we assume the earnings rate on the portfolio--

MR. BAUGHMAN. An assumed income?

MR. HOLMES. No, it's an actual income because the fact that the central banks brought money in and left it has absorbed reserves. In offsetting that, we've bought securities.

VICE CHAIRMAN VOLCKER. For every dollar they have in an account balance, it's a drain on reserves which we have offset through enlarging the System Open Market Account.

MR. LILLY. Are any of those balances in the funds markets?

MR. HOLMES. I think this would be one alternative, if we gave up the facility.

MR. PARTEE. The RP market's not much different.

VICE CHAIRMAN VOLCKER. Well, the question--

MR. HOLMES. The RP market is not quite as high a rate.

VICE CHAIRMAN VOLCKER. The RP market itself, I think, is going to be difficult--the federal funds market--for many of them to operate in. But they will make other arrangements, and the question arises, what happens to the money? My own sense of it is that probably most of it will go into the Eurodollar market. That's the big competitor. They will have tax problems, among other things, if they put it in the federal funds market here. But many American banks would try to take it and put it offshore, which is where the bulk of this money is now. There's a hell of a lot more there than there is in our billion and a half.

Now some of them will reevaluate their position, and you can theoretically, or in practice, I suppose, have some of it moving in the foreign currency markets. I don't think that would be the largest part of it by a long shot. I think that would be a small part. But they've got to put the money someplace else, and those are their choices: elsewhere in the U.S. market; the Eurocurrency markets one way or another, which I think is where most of it would go; [and] to some limited extent, perhaps, in foreign currencies.

MR. WALLICH. So there would be some slight pressure on the dollar from possible movements into other currencies.

MR. HOLMES. I think it would be slight, but there would be some.

VICE CHAIRMAN VOLCKER. And you're putting a little more in the Eurodollar market. I think that's quantitatively more important. You are promoting the growth of the Eurodollar market as opposed to domestic markets.

MR. MAYO. Isn't this function quite well justified, Paul, as part of, in effect, the execution of monetary policy, in that we know instantly what's going on? If it were through commercial bank channels, we would know, but it wouldn't be that perfect information.

VICE CHAIRMAN VOLCKER. It's been my strong impression that our record has not been good in getting information elsewhere. We have always taken the position--and quite often they will ask, "Do you have any objection if we operate in the private market?" And our answer is basically, "No, but we would like to keep informed about what you're doing." Any reports about what they are doing are extremely scarce.

MR. HOLMES. I think that's quite right; we are not well informed about what they're doing in the market. We can make a big issue of this, and maybe we should make an issue--I have in one or two cases, but--

MR. PARTEE. And yet, you see, I'm concerned about the domestic operations effect. First of all, within the last five weeks, I testified on behalf of the Board's support on this Treasury investment process, emphasizing the fact that it was very difficult for us to have to deal with all these Treasury balances moving in and out and the offsetting open market operations. Superficially, I fail to see the distinction between that and the difficulty that the foreigners could cause for us by our having to engage, in effect, [in] open market operations.

Secondly, I recall, Alan, that you were having trouble with Venezuela some years back. That it was hard to lay out that money that they wanted to invest. That was before the Treasury had decided to bring all its money into the Fed, and so you didn't have that scale of operations. Now if the Treasury moves back to its previous situation--and apparently this Venezuelan thing has spread, so that it's now quite general that people are doing the RPs--first of all, what's the defense? Isn't that just the opposite of what you said you wanted to avoid in the case of the Treasury? Secondly, couldn't it cause us some days when [we would have] considerable difficulty laying all that out.

MR. HOLMES. To your first question, at least these operations are all in one direction. They don't go up by 9 billion and down 9 billion; they're fairly steady in size, and they are predictable.

MR. PARTEE. And they're just repetitive.

MR. HOLMES. And they're repetitive, right. Secondly, we retain the right--if it interferes with open market operations, I'll be the first one to come to this Committee and say that we're going to stop all of this. Because we can't allow that to interfere with open market operations any more than we could let these big swings in the Treasury balance [interfere]. I think since it's predictable and not too large, we can approach some people and say, "Look, you're putting too much in the RP market, get some of it out." We can do that, and we have done that--on one of those occasions where we did have a one-day difficulty doing what we wanted to do for the System because this was interfering.

VICE CHAIRMAN VOLCKER. They'll still go ahead and do it in some form or another, whether or not we're the intermediaries.

MR. HOLMES. At least that will get the money out of our accounts.

MR. PARTEE. Yeah, get the money out of the account, that's all.

MR. COLDWELL. Alan, operationally, do you have any advantages other than the knowledge of flows?

MR. HOLMES. Well, I can recall--remember, go back to the time when we had those huge currency inflows from Germany and the rest of the continent in 1971. Instead of going into the market--well, you know what would have happened, the bill rate would have gone to zero. But the fact that it was coming to us and we could see the dimensions of it, we could go to the Treasury and work out a system by which it could be accommodated without any impact on our reserves, or much impact--certainly there was some on interest rates.

VICE CHAIRMAN VOLCKER. In general terms, the background of this whole operation in dealing as agent for foreign central banks, whether it's RPs or anything else, I think this grows out of a tradition--and stronger than the tradition in most central banks--the policy that they want this money funneled through central banks, and this is a service that's expected to be provided, and I think virtually all central banks would provide this service. The difference is that most of them would say, "You've got to go through us--we think it's discourteous to put it in the market." We don't say that.

MR. WALLICH. This kind of operation doesn't happen in very many countries--

VICE CHAIRMAN VOLCKER. It's [in] relatively few countries--sterling, the French franc to some extent. It occasionally happens in other countries, but for isolated situations. Of course, we don't have much occasion because we don't keep foreign balances. But when we do, we do use the facilities through the foreign central banks.

MR. WALLICH. What sorts of comments do you get from the market? Is there a sense that they're being done out of a little business?

MR. HOLMES. Well, as you probably know, we have tremendous competition. There are teams from all of the investment banks and all of the large commercial banks that spend all of their time in seminars and going around trying to sell central banks their services. And in recent years there has been a drift away from us. I think we have a smaller proportion now of the total dollar holding. In fact, I know we have smaller proportions than we did, let's say, three or four years [ago]. There is a big selling campaign going on.

MR. WALLICH. Is it important to the private sector?

VICE CHAIRMAN VOLCKER. Well, there is some sense of competition, I think that is fair to say. It's not hugely important. Obviously these are not very profitable operations, and turning over short-term money of this sort, you make a little commission on it. It's not--

MR. MAYO. If I were a central bank, Paul, and I went into the New York market, I wouldn't be content, would I, to just deal with one bank. I would split it up.

VICE CHAIRMAN VOLCKER. I think most of them do.

MR. MAYO. And then these things get magnified out of all proportion in terms of what you might call market turmoil. Now, theoretically, we are not concerned with market turmoil; it always settles through. But as a practical matter, aren't we? Isn't this what would happen?

VICE CHAIRMAN VOLCKER. Well, I think it would depend upon the individual banks. Some of them would pick out an agent; some of the ones that aren't too big, I suspect, do it--tend to concentrate in one agent. Some others would scatter it around. I think most of them, even the ones that don't use us much, like to feel that they could use us in particular circumstances when they didn't want to operate through the private market for some reason, or [as a] kind of backstop to their arrangements in the private market. I think part of it is basically that some of them are uneasy about keeping so much in the Eurodollar market. And for this very short-term money, there isn't all that much alternative to an RP in the American market. And anybody is going to run into this tax problem on RPs.

MR. HOLMES. One thing that has concerned me a bit, it hasn't developed, but it is something that I think we ought to keep our eye out for. And that is, some of these people who are selling these services sell them on the basis that they can arbitrage that account very heavily. And that could be bad for our market if it got too large.

VICE CHAIRMAN VOLCKER. We have told the market in writing a couple of times that we have no objection to them competing for this business, no objection to a central bank using them. We didn't like the idea of very heavy arbitrage operations, so they are in and out every day for billions of dollars in order to try to get next to three basis points.

MR. MAYO. And I think this is an appropriate central bank function and we ought to enthusiastically support it.

MR. EASTBURN. Could I ask you a question on that? You mentioned consideration of charging. I think we have a potentially explosive issue. It involves a whole group of services to central banks. It involves some benefits to both parties. Is it possible to cost out--

VICE CHAIRMAN VOLCKER. Yes, I think we can. We do have a charge for handling gold, for example, which we've just revised to reflect current costs. We do charge for a few things, a very few things.

MR. EASTBURN. I am assuming that in addition to the courtesy that's involved in this kind of service, that there must be some advantage to the foreign central bank in dealing with the

Fed rather than with the market. And the market may stay quiet about this forever, but then may not.

VICE CHAIRMAN VOLCKER. I personally think it's very legitimate to make a charge. I don't know just what that charge should be, but I--

MR. WALLICH. Balance or actual cash?

VICE CHAIRMAN VOLCKER. Well, I was thinking earlier in terms of balance. Before this issue ever arose, I thought the most straightforward way to do it may be a minimum balance. That may still be true, but now, it's come up in terms of this particular issue, I think you could inject a little commission for RPs.

MR. WALLICH. I'd feel better about it if there were some specified charge so that we couldn't be accused of competing on the basis of no charge, no profit.

MR. COLDWELL. Alan, to what extent have you been able to move some of the people out of RPs into regular transactions in bills?

MR. HOLMES. Well, we really haven't made much of an effort except when it was building up to be a problem. But that was quite successful.

MR. COLDWELL. It was successful.

MR. HOLMES. Some of the money disappeared, and I don't know where it went, and some of it went into short Treasury bills--through us. I suspect the other went into Europe.

MR. WILLES. Change of focus for just a moment. As I understand, we've changed our practice so that we are accommodating these RPs currently.

VICE CHAIRMAN VOLCKER. Well, changed in the sense that we have stopped doing any of them in the market.

MR. WILLES. We are offset through the open market.

SPEAKER(?). If we were to continue to do that, is there a compelling need to go to the IRS for the ruling itself, or can we just let it ride and continue to accommodate these types of transactions?

VICE CHAIRMAN VOLCKER. Well, we could, but the issue having been raised, and raised in very plain form by this IRS ruling--and in the light of the consultations with the Treasury, and then in turn the Treasury with the IRS, and the IRS saying it looks okay but we really want you to have a ruling--I think we ought to have a ruling. And that, you know, [it] would have been nicer not to, but given where we are, given the question that has arisen, I really think we have to clarify it.

MR. HOLMES. The Treasury has promised very strong support on this.

MR. COLDWELL. Would the ruling block out the idea of the central bank applying for exemption?

VICE CHAIRMAN VOLCKER. No. Well, I don't think any of them would without the ruling. With the ruling they wouldn't have any incentive. But if they had another reason to apply, for other types of transactions, for instance--if they wanted to do an RP in the market, where you don't have this governmental instrumentality interjected, they'd have to get a ruling.

MR. COLDWELL. Well, if they did, then we could still work through the market.

VICE CHAIRMAN VOLCKER. If they got a ruling, we wouldn't need the ruling for that particular central bank.

MR. HOLMES. One hundred and four central banks going to the IRS for a ruling.

VICE CHAIRMAN VOLCKER. There are some central banks we know will fail in getting the ruling because they have some element of private ownership in them.

MR. COLDWELL. [Unintelligible] does, doesn't it?

VICE CHAIRMAN VOLCKER. No. Venezuela did--Venezuela is our big problem, historically. Venezuela passed a law to eliminate their private holding, but during most of this period they had some private holding. So they do not have available to them the defense that they are a government institution. We don't know about all the [central] banks--it's hard to tell whether some of them are privately owned or not. There are maybe a dozen that we suspect have some private ownership in them.

MR. COLDWELL. The major [central] banks would be government owned, I am sure.

VICE CHAIRMAN VOLCKER. Well, some major banks do have private ownership. The Bank of Belgium just comes to mind. But they are exempt by treaty. And there are several things that cut across here. The Swiss have private ownership and are exempt by treaty; fully exempt, too.

MR. GARDNER. The Federal Reserve could not get a ruling.

VICE CHAIRMAN VOLCKER. The Federal Reserve could not get a ruling, that is right. We are a governmental instrumentality under the IRS, but we are not a government.

MR. COLDWELL. I was thinking in terms of the volume you do. Your volume would be largely with government-owned central banks.

VICE CHAIRMAN VOLCKER. Except Venezuela is big, and I'm not sure--we think they are government owned now, [or] they will shortly become, but they may still be in some transition state. The deadline of the law saying that they are [completely] government owned is past, but we understand that not all the private owners have coughed up their stocks. So their status is a little ambiguous at the moment.

MR. GUFFEY. Paul, carry this one step further. If we do, indeed, get a satisfactory ruling, that essentially forces all central banks to move through us.

VICE CHAIRMAN VOLCKER. No, well, no more than they are now. Well, I just don't know the extent to which they are now doing RPs in the market, assuming they're exempt. There is probably some of that. But we don't know how much. Certainly when this [recent IRS] ruling comes to their attention and is fully analyzed, to the extent they are doing it they must be stopping.

MR. GUFFEY. That's right, they will come to us, so we will essentially force them all into the Federal Reserve because the uncertainty--

VICE CHAIRMAN VOLCKER. Our impression is, and I think it is mostly an impression, that they do a lot of this with American banks, but the American banks book it in the Bahamas, basically. I mean they move it offshore, for this reason.

MR. PARTEE. And that could still go ahead.

VICE CHAIRMAN VOLCKER. And that still goes ahead. And that's what they have to do with all of it--they have to get out of the RP vehicle. There may be other vehicles for doing it in the domestic market. But that's why I think the bulk of it will go into the Eurodollar market.

MR. HOLMES. Paul, I might add that a great deal of the countries, the smaller LDCs who have money, come in for a very short time, and they don't add much to the size of the operation--but [it's] extremely useful for them in trying to manage a fairly small portfolio of dollar assets.

MR. WALLICH. If we are very useful to them, then wouldn't they be willing to go and seek certification?

VICE CHAIRMAN VOLCKER. Some of them might. I can't predict that. I would just suspect that it's not going to be important to most of them to want to horse around with the IRS in the United States, which raises a question about their other income from the United States if they didn't get the ruling.

Somebody more legally informed than I can pick this up, but we can now certify under the present exemption for central banks that they are a central bank and therefore exempt on their government securities holdings. We can't certify that they are a government; we can certify that they are a central bank. Now if, for instance, they applied for a ruling that they were part of the government and somehow failed, they might worry about jeopardizing the exemption they might already have as a central bank. I would just guess that, you know, going to the IRS is a kind of a horrendous decision for a foreigner, and they are not going to be eager to do it. But some of them, I'm sure, would.

MR. WALLICH. I'm looking at this as a measure, you know, of the eagerness of the central banks to have this facility and the importance of it to them. And the result of the test is that it's not all that important; they are not willing to run that risk.

VICE CHAIRMAN VOLCKER. I don't think that anybody could argue that this is absolutely crucial to a central bank's operation--it's a convenience for them.

MR. COLDWELL. [Unintelligible] cover RPs in governments.

VICE CHAIRMAN VOLCKER. Pardon me?

MR. COLDWELL. Your exemption covers RPs in government [securities].

VICE CHAIRMAN VOLCKER. The exemption that we are looking for says it doesn't make any difference what obligation we are giving them because all obligations of a governmental instrumentality are exempt.

MR. COLDWELL. Yes, but your present [unintelligible] this exemption covers government[s] only.

VICE CHAIRMAN VOLCKER. No, anybody's--

MR. PARTEE. Any secured government loan. That's the issue isn't it?

VICE CHAIRMAN VOLCKER. The way you say our present exemption--let me make sure.

MR. COLDWELL. You have the authority to provide certification.

VICE CHAIRMAN VOLCKER. Yes, that's just for government securities, or deposits, I think.

MR. COLDWELL. Well, my question is, how much of these RPs are covered on the government--

VICE CHAIRMAN VOLCKER. None, no. Because that is what the ruling was. They said these are not government securities, these are loans. That's the problem.

MR. HOLMES. The whole legal situation rather confuses me, I must confess. Because for open market operations these are purchase and sales of securities, and that's the legal interpretation. It's the IRS interpretation, I think, that could be challenged, but I am not a lawyer. Because when we buy securities on RPs, we take delivery of them. If there were a failure on the other end of the RP, we would have the right to sell those securities on behalf of the foreign central bank. So you know, not being a lawyer, I stick with the idea that this is a purchase and sale.

VICE CHAIRMAN VOLCKER. Under the Federal Reserve Act these are still purchases and sales as far as we are concerned. Under the Internal Revenue Code they say they are loans.

MR. COLDWELL. The exemption you seek, then, is just the RP exemption.

VICE CHAIRMAN VOLCKER. That's all. Well, the exemption we seek is just to say that we are a governmental instrumentality. I think a ruling that we are a government instrumentality, which then permits us to make what we call RPs and what the IRS calls loans. We want a declaration that we are a governmental instrumentality. Because then the law is quite clear. It says obligations of governmental instrumentalities are exempt.

MR. PARTEE. And that would have to be the Fed of New York.

SPEAKER(?). No, the System Open Market [Account].

VICE CHAIRMAN VOLCKER. No. That depends on which alternative you take. Whether it's the Fed in New York or the System Open Market Account.

MR. PARTEE. It's clearer, I think, for the System Open Market Account, but then I am bothered at doing things in the System Open Market Account that aren't called for as a monetary policy action.

VICE CHAIRMAN VOLCKER. I defer to the lawyers. My understanding is that it doesn't make any difference to the lawyers whether it's the Federal Reserve Bank in New York or the System Open Market Account. So I don't think legally it makes any difference whether it's New York or the System account.

MR. GARDNER. Well, I expressed earlier a preference for alternative 2 if you want to debate that, but I didn't think you wanted to debate all these alternatives. Incidentally, SAMA [Saudi Arabia Monetary Authority] didn't apply for the exemption for any reason connected with this transaction at all. It applied for an exemption some years ago for other investment purposes. They got a declaration that they were in effect an instrumentality of the Saudi Arabian government. Which is all they got. So whatever they do in our marketplace would be an investment in private or government securities, they're not subject to the withholding tax that's applied to foreign investors.

VICE CHAIRMAN VOLCKER. One of the reasons, I think, [other central banks] will be cautious about getting a ruling is there will still be some question about [whether] certain operations are a business in the United States, in which case they wouldn't be exempt. Or whether it's a passive investment of some sort, so there are all these complications around the edge. I think what we really need here, and all we need, is a clear expression of sentiment by the Committee--I don't think we need a formal vote--that alternative 1, 2, or 3 is okay. One of those three at least will be all right. And in effect, authorizing either the Bank or the System Open Market Account--presumably do it in the form of both. So that we could go either direction. Go to the IRS for the ruling.

MR. WALLICH. It's understood that if we do this, you'll impose a charge of some for--

VICE CHAIRMAN VOLCKER. Well, that's an additional question. I'm happy to do it under that arrangement. Because I think we should anyway. If the Committee wants to issue that sentiment, I think that's appropriate, too.

MR. COLDWELL. I think we ought to have a report back to the Committee on the pros and cons and the way in which changes are going to be implemented. We have had enough problems with this pricing business.

VICE CHAIRMAN VOLCKER. Let me propose specifically, and maybe we can have a showing of hands. The Committee is in agreement that we go to the IRS for a ruling in contemplation that one of the three approaches will be adopted assuming a favorable ruling, and that we will come back to the Committee with a proposal on changes and an analysis thereof.

MR. HOLMES. And selection of which of the three.

VICE CHAIRMAN VOLCKER. And selection of which of the three, right.

MR. GARDNER. In essence, this is the same subject that was discussed at the conference call, but that was not a meeting, and this is a meeting of the FOMC.

VICE CHAIRMAN VOLCKER. Are we ready for a showing of hands?

MR. PARTEE. This is not--we wouldn't be indicating a preference for one of the three. I have trouble with your dealing as principal with the Committee.

VICE CHAIRMAN VOLCKER. But you're indicating that one of the three is going to be acceptable to the Committee.

MR. COLDWELL. That means in effect that New York will continue its provision of the service of RPs to all customers.

VICE CHAIRMAN VOLCKER. But through the System account.

MR. COLDWELL. But no matter how it's done, you will continue to provide that service.

MR. PARTEE. May I also understand, Mr. Chairman, that the proviso that Alan added, which is that if there is ever any difficulty, interference with open market operations, he will immediately bring it to our attention?

VICE CHAIRMAN VOLCKER. Beyond that, if there is a real difficulty with System operations during this interim period , we won't do it on that day.

MR. WALLICH. Because you have been able to do it only due to a large movement.

VICE CHAIRMAN VOLCKER. We would only be able to do it in conformance with past practices during these fortuitous large movements in the System.

MR. ROOS. You want a showing of hands, Mr. Chairman?

VICE CHAIRMAN VOLCKER. Yes, I would. This is in favor of a suggestion that I had made. Do you have any expression of opposition? Okay, well, we will proceed and ask for a ruling in conjunction with the Board legal staff and in conjunction with the Treasury.

MR. COLDWELL. Does that mean that you will ask the IRS for a ruling either way, for [the System] account or New York?

VICE CHAIRMAN VOLCKER. Yes. I guess we are just left with the date of the next meeting, which is July 19.

END OF MEETING