MEMORANDUM OF DISCUSSION

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, October 21, 1975, at 9:00 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Volcker, Vice Chairman
Mr. Baughman
Mr. Coldwell
Mr. Eastburn
Mr. Holland
Mr. Jackson
Mr. MacLaury
Mr. Mayo
Mr. Mitchell
Mr. Wallich

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

Messrs. Clay, Kimbrel, and Morris, Presidents of the Federal Reserve Banks of Kansas City, Atlanta, and Boston, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Gramley, Economist (Domestic Business)
Mr. Solomon, Economist (International Finance)
Messrs. Boehne, Davis, Green, Kareken, Reynolds, and Scheld, Associate Economists

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Zeisel,[1] Associate Director, Division of Research and Statistics, Board of Governors
Mr. Keir, Adviser, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Adviser, Division of International Finance, Board of Governors
Mr. Wendel,[1] Associate Adviser, Division of Research and Statistics, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Mr. Leonard, First Vice President, Federal Reserve Bank of St. Louis

Messrs. Eisenmenger, Parthemos, and Doll, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, and Kansas City, respectively
Messrs. Hocter, Brandt, and Balbach, Vice Presidents, Federal Reserve Banks of Cleveland, Atlanta, and St. Louis, respectively
Mr. Keran, Director of Research, Federal Reserve Bank of San Francisco
Ms. Tschinkel, Adviser, Open Market Operations, Federal Reserve Bank of New York

By unanimous vote, the Committee ratified the action taken by members on October 3, 1975, increasing from $3 billion to $4 billion the limit specified in paragraph 1(a) of the Authorization for Domestic Open Market Operations, on changes between meetings in System holdings of U.S. Government and Federal agency securities, effective October 3, 1975, through the close of business October 21, 1975.

1/ Joined the meeting at point indicated.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on September 16, 1975, were approved.

By unanimous vote, the memoranda of discussion for the meetings of the Federal Open Market Committee on August 19 and September 16, 1975, were accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period September 16 through October 15, 1975, and a supplemental report covering the period October 16 through 20, 1975. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Pardee made the following statement:

> Since the last meeting we have again passed through a sharp reversal of mood toward the dollar in the exchange market. After mid-September the mood was bullish, with the dollar rising nearly every day on occasionally heavy demand. Foreign central banks, in seeking to contain day-to-day exchange rate movements, were regular sellers of dollars and this intervention, amounting to nearly $750 million on September 22-23 alone, became about as forceful as intervention had been on the other side of the market earlier this year. Meanwhile, we took the opportunity to add to our mark balances without attempting to exert a market influence. We even bought $6 million equivalent of Belgian francs for balances when the dollar briefly reached levels at which we could do so without incurring a loss on our swap drawings beyond those reflected in the 1971 and 1973 devaluations of the dollar.
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> Since late September the bullishness has faded as the market has been gripped by several uncertainties. By far the dominant concern has been New York City's financial

difficulties and the broader implications thereof. Everyone I know in the financial area who has talked to Europeans over recent weeks has been questioned closely about the New York City situation. This concern has been reflected in a highly volatile market that is sensitive to any new development reported by the news services. In fact, when the City was seemingly on the brink of default last Friday (October 17), the New York exchange market ground virtually to a halt for several hours as traders awaited the outcome.

Not far beneath the surface has been the market's concern over the broader fiscal situation in the United States. The Treasury's suggestion in late September that this year's fiscal deficit might reach $90 billion was cited by market sources and foreign central banks as one of the trigger-mechanisms for the dollar's downturn. The President's tax-and-expenditure-cut proposals were received cautiously, with the fear expressed that only taxes would be reduced, leaving an even bigger deficit for next year. In such an atmosphere the continuing favorable news on our trade balance and on the general economic recovery in the United States so far has tended to give only brief buoyancy to the dollar.

The exchange market has also followed closely the recent downward movement of the Federal funds rate. The easing of interest rates here and in the Euro-dollar market has shaved a modest margin from the wide differentials favoring the dollar as against, for example, the German mark. Nevertheless, the easing of interest rates took many exchange traders by surprise which, in the context of the other concerns weighing on the dollar, led to an exaggerated exchange market reaction. Even so, there are scattered indications, and a few brave forecasts, of a pick-up of economic activity in Europe, which raises the possibility of a hardening of interest rates there. Finally, the German mark has been bid up on several occasions in reaction to the open discussion of possible borrowings abroad by the German government.

The dollar has declined by some 5 per cent from the late-September highs. With the exchange market becoming increasingly unsettled, European central banks have intervened just as forcefully as the dollar has fallen as they had when it rose. Some of the heavy dollar purchases, as by the French and the Swiss central banks, have been mainly to keep their respective

currencies in line with EC currencies. Even so, since the dollar has been declining generally, the thrust of this intervention has been to moderate that decline. Most of the pressures have emerged during the European trading hours--with the result that our operations have been relatively modest, and again, strictly to avoid disorderly conditions in the New York market. Since the last meeting we have intervened on four occasions, selling some $50 million worth of mark balances. As it happens, we bought about the same amount of mark balances at times of dollar buoyancy early in the period. Consequently, we have not as yet made recourse to the swap lines, but if the current unsettlement continues we may have to. Finally, as expected, during the period the Mexicans drew the full $360 million under the swap line.

Mr. MacLaury said he was not sure why the Europeans were so preoccupied with the financial problems of New York City. One possible line of reasoning involved the potential implications of a default for major financial institutions in the United States. Another involved an easing of short-term interest rates that would have an adverse impact on the exchange rate for the dollar. He wondered if there were other grounds for the Europeans' concern.

Mr. Pardee replied that a number of foreigners with whom he had spoken had referred to possibilities of the kind mentioned by Mr. MacLaury. It was his impression that their concern was heightened by their failure to understand the Federal principle of American government. They found it inconceivable that a national government would not virtually automatically come to the rescue of a major city experiencing severe financial difficulties. Explanations of the Federal principle seemed to have little impact on

their thinking. A few of his contacts had also expressed concern about the international market for municipal securities, noting that other major cities such as London, Rome, and Tokyo were struggling with financial problems.

In reply to a question by Mr. Mitchell, Mr. Pardee indicated that Europeans had little incentive to invest in U.S. municipal securities. Very few Europeans owned such securities and he did not know of any central bank that held them.

Mr. Mitchell asked whether the Europeans had any first-hand knowledge of the extent to which New York banks owned New York City securities. He assumed such information was not generally available, although it was in itself reassuring.

Mr. Pardee replied that the information was not generally available, but the Europeans read the financial press very carefully and the potential exposure of New York banks was one of the key points on which they were focusing.

Mr. Morris asked whether there was evidence of any real reluctance on the part of foreigners to purchase the CD's of New York City banks.

Mr. Sternlight said he had the impression that some foreign buyers of CD's were tending to diversify their holdings. Earlier they had displayed a distinct preference for the CD's of major New York banks, but now they were also buying those of other

major banks around the country. The premium on major New York bank CD's had virtually disappeared; indeed, the rates quoted on the CD's of one or two major banks outside New York had fallen below those on New York CD's for a brief period.

Mr. Pardee added that American banks seemed to have become more cautious in their Euro-dollar borrowing operations. Reportedly, they had begun to borrow on a somewhat longer-term basis and to borrow through Milan and other centers in addition to London. The rate differential in favor of American banks, particularly the New York banks, over major European banks appeared to have been squeezed out. American banks, especially after the Herstatt failure, had been able to quote rates that were 1/4 to 3/8 of a percentage point lower than those quoted by European banks but the quotations were now at about the same level.

Chairman Burns asked whether that development seemed to be related to the New York City financial crisis. It was his impression that the City's problems had little to do with the ability of U.S. banks to borrow in the Euro-dollar market.

Mr. Pardee said that while he was not sure about the role of the City's problems, he understood that all U.S. banks were affected, not just New York banks.

Mr. Wallich said he had observed a tendency among foreigners to allow the New York City situation to shape their

views about over-all financial conditions in the United States. Foreign observers did not understand the widespread feeling in the United States that New York City was a separable case. Such a thing was unheard of in their own countries.

Mr. Volcker commented that New York City's financial problems should not be viewed apart from other developments in U.S. financial markets, including obvious signs of weakness in existing credits elsewhere in the economy. The fact that the City's financial difficulties were superimposed on other indications of financial distress made the over-all financial situation more fragile than otherwise.

Mr. Mitchell said he wondered why foreigners had not reacted to the earlier SEC probings into problem areas that affected the quality of bank assets. Of course, those financial difficulties had not received the press coverage given to New York's problems.

Chairman Burns said he would question whether concern abroad about the New York situation had had much to do with the recent weakness of the dollar. He was inclined to attribute fluctuations in exchange rates for the dollar mainly to interest rate developments. In his view the sharp improvement in the dollar between March and September had reflected a favorable movement in interest rate differentials, and it was reasonable to anticipate at least minor repercussions from the recent decline of short-term

rates in the United States. To be sure, the New York City situation was a topic of great interest to the foreigners with whom System officials talked. The foreign officials read about New York in the newspapers and they would be expected to question Americans who were informed about current developments.

Mr. Pardee said he could not isolate the extent to which the recent weakening in the dollar might be attributed to foreign concern about New York City, but he thought the decline in domestic interest rates alone did not account for all of the recent adjustment in the dollar. His contacts abroad, even the central bankers whose primary interest usually was monetary policy, in their conversations now inquired first about the New York City situation. In his judgment the major concern affecting the market's atmosphere at the present time was New York City.

Mr. Volcker commented that domestic interest rates and the problems of New York City were not unrelated in the minds of foreign observers. As Mr. MacLaury had suggested, there was a feeling abroad that New York's problems would probably lead to an easier monetary policy, and the recent declines in interest rates were probably being read as confirming that expectation.

By unanimous vote, the System open market transactions in foreign currencies during the period September 16 through October 20, 1975, were approved, ratified, and confirmed.

Mr. Pardee then reported on developments relating to System drawings on the Swiss and Belgian swap lines that had been outstanding since 1971. All of the drawings in Swiss francs and the bulk of those in Belgian francs would mature for the seventeenth time during the next few weeks. With respect to Swiss francs, the Manager had hoped to get started on a program of market purchases and direct acquisitions from the Swiss National Bank in order to reduce the System's indebtedness. Unfortunately, the dollar's relapse in the foreign exchange market had forced a delay in the implementation of such a program. In the Belgian case, the Desk had taken advantage of firmness in the dollar to purchase $6 million equivalent of Belgian francs in the market. Mr. Holmes had also traveled to Belgium to press for a settlement of the issues that were still unresolved. Upon his return he had provided the Committee with a memorandum on his negotiations and his recommendations.[1/] The present market atmosphere was not conducive to further market purchases and in any event the System was waiting for a response from the Belgian authorities following Mr. Holmes' visit. He therefore recommended renewal of the drawings in question, which matured on various dates from November 5 through 14.

1/ Mr. Holmes' memorandum, dated September 30, 1975, and entitled "Belgian swap developments," was distributed to the Committee on October 3. A copy has been placed in the Committee's files.

In reply to a question by the Chairman, Mr. Pardee said that a decision by the Committee not to approve the renewals would create the need for a quick resolution of all the issues that were still unresolved, including those between the System and the Treasury.

Chairman Burns observed that if there were no other consequences, he for one would be prepared to recommend at some stage that further renewals not be approved and that the matter be resolved once and for all. He was not ready to make such a recommendation today.

Mr. Mitchell said he thought Treasury officials should be informed of the Chairman's views in the near future and Chairman Burns indicated that they would be.

Mr. Holland commented that it was time for the System to escalate the pressure on the Treasury to resolve the matter. He noted that there might be an opportunity for the System to acquire some Belgian francs in conjunction with a British drawing on the International Monetary Fund. The System would probably incur some losses in the process, but he thought a strong statement should be made to the Treasury regarding the System's willingness to absorb some losses in order to repay its long outstanding drawings.

By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium, the Swiss National Bank, and the Bank for International Settlements, maturing in the period November 5 through 14, 1975, was authorized.

Secretary's note: Notes by Governor Wallich on the October Basle meeting, which were distributed at this meeting, are appended to this memorandum as Attachment A.

Messrs. Zeisel and Wendel entered the meeting at this point.

Chairman Burns then called for the staff report on the domestic economic and financial situation, supplementing the written reports that had been distributed prior to the meeting. Copies of the written reports have been placed in the files of the Committee.

Mr. Partee remarked that the presentation this morning would be in two parts: Mr. Zeisel would review recent developments and the staff's base projection, and then he (Mr. Partee) would comment on the base projection and on alternative projections that had different monetary policy assumptions.

Mr. Zeisel made the following statement:

Economic data available in recent weeks have confirmed the strength of the rebound of production and employment in the third quarter. Commerce Department preliminary figures indicate that gross national product in real terms increased at an 11.2 per cent annual rate--though problems of deflation may have exaggerated the reported rise. The rebound reflected not only the sharp slowdown in inventory liquidation, but also a strong gain in consumer outlays. Some

further improvement in residential construction outlays and an upturn in current-dollar fixed-capital outlays by business also played a part.

The progressively greater strength of the recovery in industrial production over recent months has been particularly impressive. We now estimate that industrial output increased by almost 2 per cent in September. In addition, the figures for July and August were revised up and now show increases of 1 per cent and 1.6 per cent, respectively. For the third quarter as a whole, the index is 14-1/2 per cent above the second-quarter average--at a compound annual rate. Production advances have been widespread, with particularly large gains in materials, consumer durables, and, significantly, in business equipment, which showed its second monthly increase in September after almost a year of decline.

Reduced inventories of nondurables and continued strength in durable goods orders--which rose 2 per cent further in August--suggest a further expansion in industrial activity, but the pace of the advance seems likely to slow, for several reasons. First, steel output was stimulated temporarily in September by user efforts to beat an October 1 price hike; second, auto production is scheduled to level off in October since assemblies slightly exceeded sales last month and inventories were already high; third, and more fundamentally, the rebound in industrial production was obviously generated in large measure by the slowing in the pace of inventory liquidation, and this source of added strength seems likely to be reduced. In fact, the inventory adjustment appears to have been completed in nondurable manufacturing, and the book value of these stocks edged up in August. Stocks also increased in trade, and August saw the first month of over-all accumulation of business inventories in book-value terms since last January. Stock-shipment ratios remain high in durable goods manufacturing, however, and further liquidation appears quite likely in this sector.

One element of the recent economic picture that had caused us some concern was the failure of retail sales to expand further after July. But things look a bit better now, following some upward revision of the August figures, and the advance report shows a small further rise in September. This recent plateau in consumer outlays follows an upsurge in the spring and early

summer, which reflected in part the effect of the tax rebates; some pause in growth as that stimulus wore off was not too surprising. With production and payrolls having moved up sharply in the meantime--nonfarm payroll jobs last month were 900,000 above June--we would expect a resumption soon of the upward trend in consumer outlays.

Up to now, capital spending and residential construction have provided only modest support to the recovery. New orders for nondefense capital goods dropped 3 per cent in August, continuing to see-saw around the same level since April. Housing starts edged off by 2 per cent in September, but the third-quarter average was a fourth above the first-quarter low. There has been some tightening of mortgage market conditions recently, but permits advanced further in September, and the volume of new mortgage commitments has remained at a high level, suggesting further gains in residential building activity this quarter.

The developments of the past 5 weeks have led us to make a number of changes in our projections, although the over-all contour remains similar to that of last month. We continue to project a relatively sizable advance in real GNP in the current quarter, though less than in the third quarter, with a further slowing during 1976 to about a 4 per cent rate of gain in the second half of the year.

Our oil price assumptions have been altered significantly in this projection. We now assume a gradual--rather than an immediate--decontrol, with the result that the level of domestic oil prices would be expected to rise only moderately further until late 1976. The result is to reduce our projection of the increase in the general price level by almost one percentage point over the next several quarters. With the main source of intensified pressures on the price level, nominal GNP, and interest rates removed, we also returned to the assumption of M_1 growth at about the 6-1/4 per cent midpoint of the Committee's 5 to 7-1/2 per cent range. Since the downward revision in nominal GNP growth is about matched by the slower assumed expansion in the money supply, the impact on projected interest rates is relatively small. We continued to expect a considerable increase in short-term rates over the next year.

We have also reduced somewhat our projections of real growth in GNP over the quarters ahead. In the State and local sector, we believe that financing difficulties are likely to be affecting attitudes and expenditure plans adversely, and we have thus cut back the growth in such spending over the next several quarters. Some recovery is expected late in 1976 as financial market problems presumably are resolved and as tax revenues improve cyclically.

Projected increases in business fixed investment have also been trimmed slightly, reflecting the recent lack of vigor in new orders and the disappointing results of the confidential Edie survey, where the final tabulations show only a 3 per cent rise in planned capital outlays for next year. We are projecting a substantially larger gain--10 per cent on a comparable basis--but the difference about matches the average understatement of this particular survey in the first year of recovery in earlier postwar cyclical upturns.

Finally, we have made some small cuts in projected consumer outlays, reflecting mainly the somewhat less vigorous growth of personal income produced by the current projection.

We still expect price pressures to moderate over the next year, with the increase in the fixed-weighted index for gross private product reduced to an annual rate of about 5 per cent by the end of 1976. Also, the bulge in the next few quarters due to projected oil price increases has been removed. Unemployment still is projected to decline gradually, but with somewhat less vigorous real growth in the economy, we would now expect the unemployment rate to average around 7-3/4 per cent--rather than 7-1/2 per cent--in the closing months of 1976.

Mr. Partee made the following statement:

Despite the fact that our economic projection basically is little changed, I must admit that I and other members of the staff are a good deal more apprehensive about the outlook than was the case a month ago. We have trimmed back somewhat the projected rate of expansion beyond the upward-revised third quarter of 1975, and this is the direction in which all of us

would lean. But whether the downard adjustment is sufficient, and whether a reasonable rate of real growth will in fact be sustained throughout 1976, is most difficult to judge, for three reasons.

First, we are still quite uncertain about the appropriate assumption that should be made as to decontrol of domestic oil prices. We have incorporated a program of gradual decontrol in our projection this time, since that seems to be the direction in which thinking has moved, but there has in fact been very little progress to date in reaching an agreed compromise between Congress and the Administration. If the move to decontrol is more rapid than we have assumed in incorporating something like the Administration's earlier 39-month program, the effects on price performance and on the strength of real demands in the economy would be correspondingly more adverse.

Second, the behavior of the State and local securities market has worsened markedly in the past month, reflecting the widening impact of the New York City financial crisis on investor attitudes. As Mr. Zeisel has indicated, we have marked down our earlier projections of State and local spending in the quarters immediately ahead, but there is no basis whatever for judging whether the cutback we have incorporated is enough or, for that matter, too much. Also, we have made no allowance for effects that the crisis could have on the psychology of businessmen, consumers, and lenders--particularly if it persists and deepens. The negative effects on the economy thus could be larger than we have projected.

Third, there have been many indications that bank managements, especially in the larger institutions, are holding thus far to unusually conservative lending policies, despite the protracted decline in business loans. This situation may well change as the effects of the economic recovery on business sales and earnings become more apparent. But it seems quite possible that the cautious attitude of the bankers reflects widespread concern about the quality of existing portfolios, in which case lending policies may remain very selective as to risk until some of the current problems are resolved. If so, credit availability for other than the best names could remain quite limited, at the banks as well as in

the securities markets. This probably would not serve to abort the recovery in its early stages, when the momentum generated by the turnaround is strong, but it could become a serious retardant to continued economic expansion later on.

Despite these qualms about the underpinnings of our basic projection, we have attempted to estimate the effects on that projection of different policy assumptions, since the Committee will be reviewing its long-term monetary targets today. The alternative projections are presented in the set of tables that has been distributed.[1]

The first table outlines our monetary and fiscal policy assumptions. Alternatives A, B, and C are keyed to the monetary growth paths of the blue book,[2] as indexed by growth rates in M_1 centered on 7-1/2 per cent, 6-1/4 per cent, and 5 per cent, respectively, over the projection period. Each of these alternatives incorporates the fiscal policy assumption stated in the middle of the page--that is, that the 1975 tax cuts are extended to calendar 1976 and include a continuation of the current personal income tax withholding rates. We have also attempted an initial evaluation of the incremental effects that the President's recent revenue and expenditure proposals might have on the economy during 1976. This proposal would result in an additional tax reduction of about $12 billion for the calendar year, but with expenditures cut by about $25 billion below what we otherwise would have projected in the fiscal year beginning in October 1976.

The possible effects of these different policy assumptions over the next five quarters are shown in the second table. As might be expected, the predicted growth in nominal and real GNP is somewhat larger with the faster monetary growth path (line A) and somewhat lower with the slower 5 per cent money growth assumption (line C) than with the 6-1/4 per cent money growth assumption of the base projection in the green book.[3]

1/ The set of tables is appended to this memorandum as Attachment B.

2/ The report, "Monetary Aggregates and Money Market Conditions," prepared for the Committee by the Board's staff.

3/ The report, "Current Economic and Financial Conditions," prepared for the Committee by the Board's staff.

(line B). By the final quarter of 1976, the unemployment rate is projected to be four-tenths of a point lower or higher than in the base forecast, depending on the monetary growth assumption used. As is usual in our model runs, differences in the monetary growth rate of this magnitude do not have appreciable effects on the pace of inflation during the projection period; by the end of 1977, however, an extension of the projection suggests that the price level would be about 2 percentage points higher under A--and a little lower under C--than in the green book projection.

The incremental effects of the fiscal program shown here are surprisingly small. In part, this results from the fact that an income tax reduction takes some time to be fully reflected in spending levels in the private sector. By the time these effects would be having a material impact on private spending, the beginnings of the cutback in Government expenditures would inject a more than offsetting influence on nominal and real GNP. A second reason for the weakness of the fiscal impact is that, in the absence of an adjustment in monetary policy, the larger Federal deficit associated with the program in calendar 1976 results in higher market interest rates.

We would estimate the rate effect of the additional fiscal assumptions to be on the order of one-half of a percentage point in short-term markets during 1976, as is shown in the final table. Of course, an interest rate effect of this size could be offset by an upward adjustment in monetary growth rates. Thus, the Treasury bill rate in line A, with the fiscal increment added, is no higher than the rates shown for next year in line B, which assumes monetary growth continuing at the midpoint of the current 5 to 7-1/2 per cent M_1 target path. Even apart from the extra fiscal increment, it is still our belief that short-term rates will be moving upward over much of the projection period under any of the monetary alternatives presented. The rise would likely be greater the lower the monetary growth path shown, at least within these ranges of difference. But the long-term rate pattern would probably not be so sensitive to the monetary assumption. Long-term rates will be reacting to the projected moderation in both the pace of inflation and real growth, so that, under the monetary growth path of A, we believe that there would be a good chance that long-term yields would show little, if any, further increase from current levels.

Chairman Burns remarked that it would be desirable if Committee members' comments on the economic situation and outlook emphasized any points on which they differed significantly from the staff analysis and avoided technical issues.

Mr. Baughman commented that he was unsure why Mr. Partee and other members of the staff viewed the outlook with more apprehension now than they had a month ago. It seemed to him that the evidence suggested a gradual improvement in the economic situation and, therefore, was encouraging. The projected slowdown in the expansion in activity was from a rate that was clearly unsustainable. Moreover, the prospect that State and local governments might not be able to borrow so freely as in the past should tend to drive them toward a more sound financial condition. The major disturbing element in the outlook was a diminishing prospect for a substantial slowing in the pace of inflation.

Mr. Partee agreed that the statistical evidence suggested that the recovery had developed very well in recent months and that there seemed to be little cause for concern. In viewing the statistics, it was only the pause in the expansion in retail sales--following a very large rise--and the slow rate of monetary growth--which was not yet understood--

that were sources of concern. However, he felt that some problems might be developing that were not yet reflected in the statistics. Specifically, the New York financial situation was having an effect on expenditures of State and local governments, and it was difficult to judge how large the cutbacks would be. Decisions were being influenced by budget constrictions, resulting from shortfalls in revenues, and by a reluctance to go into the capital market in the current circumstances. When financial market constraints had developed in 1969, they had contributed to a decided slowing in the growth of State and local government expenditures.

Another development that was a source of concern, Mr. Partee continued, was the apparent unwillingness of major banks to assume additional risk. Their current attitude was more characteristic of depression than of recovery. By this stage of the previous recovery, banks had been scrambling to make loans; they had been making "bullet-loans" and "cap-loans" and taking other steps in an effort to improve their loan volume. In this recovery, there was no indication of that sort of behavior. On the contrary, reports suggested that the large banks were being very cautious. It was difficult to assess the effects that such an attitude--if it persisted--would have on the course of economic activity as time passed.

Finally, Mr. Partee observed, there was the problem posed by the decontrol of oil prices. The existing freeze was scheduled to expire on November 15, and over the next few weeks the Congress would be considering legislation. His own guess was that decontrol of prices would be gradual rather than abrupt, but the outcome was uncertain.

Mr. Baughman remarked that if supervisory authorities had any influence on banks' policies, they would have to accept some of the responsibility for the banks' current attitudes toward taking risk. The System had encouraged the banks to pursue more cautious policies, and they had come to do so at the wrong time in the business cycle; he agreed that it was a phenomenon characteristic of depression. It seemed to him that the System now could take steps to induce a reversal of banks' attitudes. With respect to the depression of the 1930's, he recalled that the low interest rates of the time applied mainly to money market instruments; they did not apply to bank borrowings by small businesses.

Chairman Burns commented that one had to bear in mind a prominent difference between this period and the 1930's: the public market for securities recently had been strong and active, in contrast with the 1930's, and many companies were borrowing through the public markets rather than through banks.

Mr. Partee remarked that it was primarily the best-rated companies that were borrowing in the public markets.

Mr. Baughman then observed that wages and salaries comprised a large part of the expenditures of State and local governments, and labor contract negotiations in that sector had resulted in very large increases in wage rates. A limitation on the borrowing ability of State and local governments might be the only way to reduce the rate of increase in wages to one consistent with over-all economic stability. In the industrial sector as well, the wage-negotiating process had tended to price labor out of the market; that development was inconsistent with significant progress toward the twin goals of full employment and stable prices.

Mr. Eastburn said he would add to Mr. Partee's list of concerns the discouraging prospects for reducing the rate of unemployment. Even under the most expansive monetary policy assumption of alternative A, the unemployment rate was still as high as 7.3 per cent in the fourth quarter of 1976, and estimates through 1977 made at the Philadelphia Bank were not encouraging. It seemed unlikely that high rates of unemployment would be tolerated for so long a period of time. It seemed more likely that pressures would build up

for System action and for all kinds of *ad hoc* improvisations to reduce unemployment, which could be dangerous.

Mr. Morris said he was more concerned than Mr. Partee about the behavior of the statistics. For example, there had been a pronounced loss of upward momentum in the leading indicators for August and also in those available so far for September. Moreover, the difficulty in generating monetary growth in an economy that was supposed to be expanding rapidly might be providing some information. It might be, of course, that the latest money supply figures were just a short-run aberration in the data that would be offset by figures for later months. Nevertheless, the figures reduced one's confidence in the strength of the expansion and generated concern that the expansion might be aborted prematurely.

Mr. Holland observed that an additional element in the current situation that needed to be watched carefully was the flow of funds through the banks and the nonbank thrift institutions into real estate markets. Those flows were a key determinant of residential construction and would have a bearing on the progress made in cleaning up the unsound loans scattered through the financial system that were contributing

to the cautious attitudes of lenders. He asked what the flows into the thrift institutions were projected to be under the alternative policy assumptions.

Mr. Axilrod replied that under the base projection, deposit growth at nonbank thrift institutions was at annual rates between 6 and 8 per cent over the projection period, through the fourth quarter of 1976. The growth rates were between 8 and 10 per cent under the more expansive policy assumptions of alternative A, and between 4 and 6 per cent under the less expansive assumptions of alternative C.

Mr. Partee observed that under all three alternatives, the inflows were projected to moderate from the rates in the first half of this year, even though a 50 basis-point increase had been assumed in the Regulation Q ceilings on long-term certificates. Almost all of the increase in real estate loans recently had been accounted for by the savings and loan associations and GNMA and FNMA. Banks appeared to be avoiding mortgage loans. It was not clear whether that was because of yield relationships--which were not especially favorable for a diversified lender--or because of concern about the quality of such loans. Banks had begun to acquire title to some real estate projects in financial difficulty, which was quite unusual.

Mr. Wallich observed that the prospects for continued recovery in economic activity depended to an important degree on whether the expansion in consumer buying and the turnaround in inventory investment were followed by increases in residential construction and business fixed investment. In the early stages of this recovery, residential construction had not provided the usual support, and it was uncertain whether the momentum of the upswing would have a greater positive than negative impact on that sector. With respect to business investment, no accelerator effect had yet been set in motion--even though economic activity so far had recovered about as rapidly as one could have expected--perhaps because of low rates of capacity utilization. He asked how the staff viewed prospects for those major sectors of activity.

In response, Mr. Partee commented that the staff's judgmental projection suggested that plant and equipment expenditures would rise at an accelerating pace during 1976, and such expenditures in nominal dollars would be up 10 per cent from this year. The comparable increase for the business fixed investment component of GNP was about 11-1/2 per cent. With respect to housing, single-family starts were projected to increase somewhat through the early part of next year and then to stabilize. The projected expansion in multi-family starts

was small, in contrast with the last couple of business upswings, not only because of financing problems but because of the weakened state of the industry. For example, new rental projects could not be cost-justified on the basis of current rents and building costs. Reflecting developments in these areas, recovery was projected to continue throughout next year. He would note, however, that the econometric model portrayed a weaker economic situation than did the staff's judgmental projection.

Mr. Balles remarked that he agreed with Mr. Partee's observations concerning the attitude of major banks toward risk. Many banks had been burned on REIT, international, and other types of loans made during the period of over-exuberance in 1972, 1973, and early 1974, and they were not even certain yet about the extent of their losses. However, that attitude did not seem to be shared by medium-sized and smaller banks, at least not on the West Coast. They had not been burned, were not being conservative, and were looking for business. That behavior was encouraging, because the smaller regional or local banks accounted for a good part of the financing of small businesses.

Mr. Partee said he agreed that the conservative attitude toward risk was confined primarily to the major banks. A

tabulation of data for the weekly reporting member banks--which were the larger banks--and the rest of the banks indicated that the loan experience of the latter group was not so weak. However, the major banks accounted for a large share of total business loans.

Mr. Balles remarked that the large customers of the major banks had alternative sources of funds.

Mr. Partee commented that the large customers rated Aaa or Aa could borrow in the commercial paper market or in the capital market. However, he did not believe that the commercial paper market could readily absorb an issue of a lesser-rated company, and risk selectivity in the capital market had developed to the point where it was difficult to market a bond with a rating of A or lower. His inquiries indicated, moreover, that at least some insurance companies had raised their standards on private placements; they would no longer accept issues of lesser-rated companies.

In response to questions from Chairman Burns and Mr. Volcker, Mr. Axilrod observed that the risk differential between Baa and Aaa bonds had fluctuated between 140 and 150 basis points during the summer and was at the upper end of that range in most recent weeks. The premium had been about

90 basis points a year ago and had averaged about 95 basis points over the past 5 years.

Mr. Morris remarked that the figures cited by Mr. Axilrod applied to the secondary market. At present no Baa securities were being issued because there was no market for them.

Mr. Axilrod commented that comparison of A and Aaa issues presented a similar picture, although the differential was not so wide. The picture was also similar for a comparison of A and Aaa utilities, but in that case, the differential had narrowed to about 120 basis points from a peak of 140 points last summer.

Mr. Kimbrel observed that insurance companies in the Atlanta District appeared to be uninterested in making commitments for residential or other real estate related loans. He asked whether that seemed to be the case in other parts of the country as well.

Mr. Partee replied that insurance companies in general appeared to have little interest in income-property mortgages. He was not informed about their current activity in the area of single-family units, but in any case, their importance in that area had declined in recent years.

Mr. Morris remarked that the behavior of insurance companies in the Boston area was similar to that described by Mr. Kimbrel.

Mr. Jackson commented that several mortgage companies he had visited recently had reported some pickup in activity. However, they were still highly selective in their operations, because the economics of apartment projects were quite adverse and because the net rents of commercial projects were not high enough to support the costs of construction and capital.

Chairman Burns remarked that it would be useful to give attention to the investment policies of the insurance companies on a continuing basis. He asked Mr. Partee to arrange for a report to the Committee on that subject in the near future.

Mr. Mayo observed that, like Mr. Partee, he felt that the statistics might be suggesting a stronger economic situation than in fact had been developing. Among the directors of the Chicago Bank and more generally in his District, there was a little less optimism now than 4 to 6 weeks ago. Businessmen felt that the national statistics were not consistent with the evidence from their own operations and from those of their customers. That feeling might result from a tendency for activity in the Seventh District to lag because of the importance of capital goods in the District's economy. But comments in this month's red book[1/] suggested that the phenomenon was much

1/ The report, "Current Economic Comment by District," prepared for the Committee by the staff.

more widespread. Consequently, he would question whether business confidence had improved to a point that would support a pace of economic recovery as strong as that suggested in the green book, much less any stronger. He recognized, however, that it was difficult to interpret and quantify the effect of such attitudes.

With respect to banker attitudes toward the quality of loans, Mr. Mayo continued, managements and loan officers appeared to be responding with a lag to warnings that had been issued by the System in 1973 and 1974. The major banks had become quite cautious, and they dominated the over-all statistics. At the same time, however, bankers in his District had indicated that loan demand was weak. He was uncertain whether that was true in other Districts as well.

Chairman Burns commented that it was natural for business loan demand to be weak in view of the enormous liquidation of business inventories, some improvement in profits, and--until recently--heavy corporate borrowing in the capital market. With respect to the over-all business situation, the view had been widespread--and it still existed to a significant degree--that the recovery was inadequate and also that it was negligible relative to comparable periods of recovery in the past. However, measured by employment, unemployment, industrial production, or

real GNP, the pace of recovery this time had been above average. Recently, some signs of hesitation had appeared. In particular, the expansion in retail sales had slowed down, after having been the recovery's driving force since early in the year. It was too soon to tell whether it would persist, but a slowdown surely was to be expected after the sharp spurt in sales associated with tax rebates and special social security payments. Every recovery proceeded unevenly--at least in terms of the evidence of the statistical reports. The index of leading indicators--which Mr. Morris had referred to--had moved unevenly over the years.

In his view, the Chairman continued, some doubt about the outlook stemmed primarily from the behavior of retail sales and from growing concern about the repercussions of the New York City crisis. The oil price situation--which had been confused for many months and was not a new element--was not a significant factor. Concern about the New York crisis had become nation-wide; there was a vague feeling that the difficulties would spread, and the channels for transmitting the adverse influence across the economy were not difficult to identify. If the Congress decided not to do anything and New York City defaulted, it would clear the atmosphere. It would not be a good development for the economy, but prolonging the crisis would be worse. Markets did not thrive on uncertainty.

Chairman Burns observed that the cautious attitude of bankers was perfectly natural and even right. As a result of their earlier extreme optimism, they had gone through a period of extravagant boom and reckless lending, both domestically and abroad. The consequence was that they had many dubious loans and substantial loan losses. Their experience with real estate loans was the worst since the 1930's; their problems in that area were not confined to loans to the REIT's. In addition, banks were affected by the failure of W. T. Grant, and they had outstanding loans to other weak retail establishments and to weak airlines. Many banks held securities issued by New York City, and bankers in general were worried about the deterioration in the market for municipal securities. Commercial banks held over $100 billion of municipal securities--47 per cent of the total outstanding.

The psychology of bankers tended to fluctuate, the Chairman continued, and it was natural for them now to be conservative and cautious. Some time would be required for those attitudes to change. The System could do little to change them; if it pumped out massive reserves, banks would add to their holdings of Government securities to a much greater extent than they would expand their loans. As he said, the recovery--with its ups and downs and variations--appeared to be proceeding satisfactorily,

but the potentially large consequences of the New York City financial crisis were a new development.

Mr. MacLaury commented that Mr. Partee's expression of greater apprehension about the economic outlook had surprised him, and he agreed with the points that had just been made by the Chairman. In his view, the oil price situation was not an important factor in the outlook, but the New York City problem was a major source of concern. With reference to Mr. Eastburn's concern about reactions to persistence of a high rate of unemployment, he noted that he and others would have argued earlier that the country would not prove to be so tolerant of the rates that had already been experienced. No one was satisfied with high unemployment, but he felt there should be less emphasis on the unemployment rate and more on achieving growth in employment. The Chairman's publicly stated proposals for dealing with unemployment--unsalable as they might be--needed to be taken into consideration in Committee members' thinking about the subject. Altogether, he felt that the staff projection of economic growth in 1976 was too weak. He did expect growth to moderate from the pace of the second half of this year, but it was likely to be 6 per cent through 1976.

Mr. Mitchell observed that, in his opinion, the main problem in the current business upswing was neither the plight

of New York City nor the conservative attitude of major banks but rather the state of the markets for housing and autos. The expansion in consumer buying earlier this year and the turnaround in inventory investment had sparked a sharp upturn in activity in the second half of this year, but given the outlook for sales of autos in 1976 and the prospects for housing starts--particularly with the levels of interest rates in view--the recovery soon would lose its momentum. Those prospects for next year contributed toward pessimism. The survey of attitudes of mortgage lenders suggested that they would not be very active. The savings and loan associations were worried about their flows of funds. The levels of interest rates that were being talked about for next year would shut off the inflows of funds to those institutions, and an increase in the Regulation Q ceilings like that assumed by the staff would not help at all.

Those concerns, Mr. Mitchell continued, led him to wonder whether the mix of fiscal and monetary policies was correct. It appeared that the Federal deficit, after having been large in 1975, would still be too large in 1976, and he wondered whether sizable deficits would continue indefinitely. It would be better to have less fiscal stimulus and more monetary stimulus in order to improve prospects for the investment sectors

of the economy. However, one might wonder where the cuts in Federal spending would come; the green book analysis of the President's recent budgetary proposals speculated that a substantial portion of the spending cuts would be in transfer payments. In his opinion, the outcome for 1975 was more or less assured, but economic performance next year appeared to be in serious trouble.

Mr. Winn remarked that there was an additional influence on the activity of banks that needed to be considered: the national auditing firms had been badly burned, and as a result, they were requiring greater write-offs of loans than the examiners were. With respect to the ramifications of the New York City situation, it seemed to him that the interest rates being paid on securities of both the City and the State were not viable and would have to be written down either by default or by negotiation. Either way, there would be a shock effect.

Chairman Burns commented that there might not be a shock effect. One problem at the moment was that no good bankruptcy law existed to handle the New York City situation. The Congress ought to focus on that problem, among others. In his opinion, there was a serious question whether the City was a viable financial entity, and when a financial entity was no

longer viable, the only thing to do was to reorganize it and restructure its debts. Because the City had bearer obligations outstanding and did not know who all the holders were, some new machinery had to be devised for the purpose of restructuring.

Mr. Jackson observed, with reference to earlier remarks of Mr. Holland, that banks and other lenders were not likely to be relieved of the burden and the threat of bad real estate loans. In his opinion, moreover, such a development would not be desirable because it would produce more of the kind of speculation that had created the problem in the first place.

Mr. Jackson then asked, in view of the outlook for the Federal budget, whether additional increments of fiscal stimulus would be likely to have a proportional--or more or less than proportional--impact on economic activity and whether they would be likely to add to upward pressures on interest rates.

Mr. Partee replied that, in his judgment, increments of fiscal stimulus had less and less net positive effects on economic activity because they tended to raise interest rates and, thus, to induce cutbacks in private spending plans. Concerning next year, the staff's base projection assumed a high employment deficit of $17 billion. The still larger deficit that would be associated with greater fiscal

stimulus would add to strains in financial markets. Interest rates might not be much higher than otherwise, but private investment would be affected.

Mr. Coldwell asked whether attitudes toward the size of the Federal deficit--and perhaps toward the monetary aggregates as well--should be adjusted to some extent for the very large increase that had occurred in the dollar value of GNP over the past few years.

Chairman Burns remarked that the Federal deficit in relation to nominal GNP was larger this year than at any time since the second world war.

Mr. Partee commented that the monetary aggregates generally were measured in terms of rates of change rather than absolute amounts.

Mr. Volcker observed that in the past he had expressed doubts about the continued strength of the recovery into next year, and so he was in substantial agreement with Mr. Partee's apprehensive view of the situation. In particular, he was concerned about the outlook for business fixed investment and for home building. With respect to investment, he thought there was a fundamental problem involved in profits and profit margins. Businessmen's answer to the problem was to raise prices, but

that solution obviously posed problems for monetary policy and also raised additional questions about the sustainability of the business expansion. Moreover, businessmen, like bankers, were cautious because of the erosion of their assets. In cases where their companies did not have a prime rating, they were reluctant to borrow or to attempt to raise equity funds, even though they might see an expanding market for their products. Such attitudes were an additional drag on investment.

With respect to the New York problem, Mr. Volcker asked Chairman Burns whether his view that the City was not a viable financial entity implied that the City was not a viable economic entity as well and would have to reorganize more than just its debt.

Chairman Burns replied that he would not say the City was not a viable economic entity, although clearly its financial situation would be easier to deal with if its economic situation were stronger. As was generally known he had, at present, grave doubts about the desirability of Congressional action with respect to the City's problem other than action to amend the bankruptcy law. In his view, legislation of some form of loan, guarantee, or insurance program in behalf of the City would result in a MAC-type operation, although it would take a year or two rather than a month or two before the City ran into trouble once again.

New York City had assumed enormous interest charges, and the interest rates on MAC obligations were very high. Under a guarantee program, substantial fees would be required. And then should New York again be able to borrow on its own in a few years--which did not seem very likely--it probably would have to pay extremely high interest rates. Given the enormous debt that had to be rolled over, it was not at all clear that the City would be able to bear the burden of the high interest rates. For that reason, he believed the chances were high that sooner or later a financial reorganization would have to take place: the maturity dates of the debt would have to be extended a few years and the interest rates would have to be scaled down to some degree. He thought that aspect of the problem was being neglected. Thinking seemed to run in terms of new borrowing, which probably would be at higher rates of interest than the City could bear, and would only postpone the necessary reorganization.

Mr. Winn said he had felt that bankruptcy was the only way out for New York City, but the experience of the Penn Central bankruptcy did not offer encouragement about that solution.

Chairman Burns said he agreed. In the Penn Central case, the shareholders had lost their investment, and then wages

had continued to rise for the bankrupt organization at exactly the same rate as for profitable railroads.

Mr. Winn commented that, in addition, the railroad's services had deteriorated, so that the worst of all possible worlds had resulted. He felt that procedures had been established to begin the correction in New York. Because of its possible repercussions, a bankruptcy at this point was unthinkable. The effort to renegotiate pensions and otherwise to cut costs--as well as to deal with the debt problem--was under way. In his opinion, that effort should be supported, with the necessary restrictions. It would be desirable now to shift the country's attention away from the New York City problem.

Chairman Burns remarked that, while he had spoken earlier about restructuring the City's interest obligations, he also had in mind restructuring its pension arrangements.

Mr. Volcker observed that the City had many problems in addition to the serious one of its debt burden, and the magnitude of the task of restructuring the City's obligations should not be underestimated. In addition to the often-cited deficit of $800 million in the current expense budget, an additional $400 million to $500 million of current expenses had been concealed in the capital budget; and some capital

expenditures had to be made. The City's total budget was about $12 billion, but a very substantial part of it was financed by the State and the Federal Government in connection with mandated programs. The part of the budget that was under the control of the City amounted to about $4 billion. When one spoke of cutting expenditures by as much as $1 billion, it was clearly a very difficult challenge that extended beyond interest payments. In the case of New York City, compared with Penn Central, at least some progress had been made in the discussions to impose a freeze on wages, which were already too high. But still, the financial gap to be filled relative to the expenditures under the City's control was very large. If the authorities were to attempt to eliminate the deficit by raising taxes, it probably would have to raise them across the board by 20 to 25 per cent. However, a tax increase made no sense in New York. The City had experienced a persistent decline in employment in recent years--30 to 40 per cent in manufacturing over the past 5 years, for example--and there was no natural buoyancy in its revenues.

Chairman Burns remarked that a tax increase would make sense only if it were State-wide.

Mr. Coldwell remarked that New York did not get very much sympathy.

Chairman Burns said he thought that situation was changing. While legislation to assist New York probably would not pass in Congress if the vote were taken today, the number voting for assistance would be larger than a month ago and very much larger than 3 months ago.

Mr. Black commented, with respect to the business situation and outlook, that the Chairman had made most of the points he had had in mind. He would add only that in the beginning of a business upswing, the strength of the expansion often was underestimated. He asked Mr. Partee what he thought of the chances that this time the automobile market might prove to be a source of unexpected strength in view of the impressive improvements in gas mileage in the new models.

In response, Mr. Partee noted that auto sales in the staff projection were at an annual rate of 10.2 million units in the first three quarters of next year, compared with annual rates of about 8 million and 9.2 million units in the second and third quarters of this year, respectively. The staff had taken an optimistic view because sales seemed to have been responsive to the merchandising campaigns and because fuel economy seemed to be a salable feature. But so far as he knew, the auto companies themselves were not projecting a sales rate as high as the staff was. Therefore, he did

not think the probabilities were high that sales would exceed the staff projection. However, there was some chance that expansion in over-all consumer spending would exceed the projected growth. For several years real consumption had increased little, and unfulfilled desires might well have accumulated that would now be translated into effective demands. Against that, however, he would note that the judgmental projection already included an appreciably higher level of consumer spending than was suggested by the econometric model.

Messrs. Zeisel and Wendel left the meeting at this point.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period September 16 through October 15, 1975, and a supplemental report covering the period October 16 through 20, 1975. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Sternlight made the following statement:

> Open market operations for most of the past month have been directed at fostering a somewhat more accommodative availability of reserves, against a background of unexpected weakness in the monetary aggregates and market uncertainty about the New York financial situation. As the period began, the Desk was aiming for a slightly

firmer condition of reserve availability--edging the Federal funds rate up from around 6-1/4 per cent at the time of the last meeting to about 6-1/4 to 6-1/2 per cent, which approached the midpoint of the 6 to 7 per cent range adopted last month. By late September, the data on aggregates were coming in toward the weak side, however, and the Desk retreated back to a 6-1/4 per cent objective--though it took a few extra days to achieve this because of some pressure around the quarter-end statement date.

In early October, the aggregates looked significantly weaker--well under the desired ranges--and in response to this and to the Committee's concurrence in the Chairman's recommendations of October 2, the Desk aimed for progressively lower funds rates. In recent days, the rate has been around the 5-3/4 per cent lower bound of the Committee's revised range.

Actual operations during the period included purchases of about $760 million of coupon and Federal agency issues and net purchases of about $1,050 million of bills. Again, very extensive use was made of short-term repurchase agreements and matched sale-purchase transactions to cope with day-to-day swings in reserve availability. About midway through the period, we had used all but about $300 million of the normal $3 billion leeway for the net increase in System Account holdings between Committee meetings, and to provide for possible contingencies, the Committee temporarily enlarged the leeway to $4 billion through today's meeting. As it turned out, we did not have to use the enlarged authority. Looking ahead, very large reserve needs are projected as Treasury balances accumulate until early November, but we would expect to meet part of the need through repurchase agreements and at this point we do not recommend continuation of the enlarged leeway.

Yields on most types of Government securities have declined significantly since the last meeting of the Committee, largely reflecting market perceptions of a more accommodative monetary policy in sharp contrast with the widespread anticipation of greater firmness and rising rates a month ago. To some degree, the decline in Treasury rates was augmented by demand of the flight-to-quality type

as some investors reportedly shied away from municipal issues and bank CD's. Yesterday, 3- and 6-month bills were auctioned at about 5.89 and 6.16 per cent, respectively, down 56 and 75 basis points from the rates just before the last meeting. A 2-year note was auctioned last Thursday at an average yield of 7.55 per cent, while a similar maturity went at 8.44 per cent on the day of the last meeting. Heavy demand from individuals helped absorb large supplies of notes when rates lingered above 8 per cent, while strong bank demand has been evident recently in the wake of more accommodative monetary moves.

For long-term Treasury issues, yields are down as much as 40-50 basis points. The yield declines in both bills and coupon issues have occurred despite a steady and abundant stream of new issues; issues auctioned during the inter-meeting period will raise $3.6 billion in bills and $8.8 billion in coupon issues. The Treasury is expected to announce tomorrow its offerings to refund $2.4 billion of November 15 notes and possibly to raise $1 billion or so of new money. The System Account holds $474 million of the maturing notes and we plan to exchange these for the new issues in roughly the proportions offered to the public.

In the corporate bond market, yields came down only modestly, even though the calendar was relatively light. Yields on highest grade municipal issues also declined during the month, particularly on issues of States and cities well distant from the North East. But lesser-grade issues, especially in and around New York, did less well. For New York issues, the public market has nearly closed. New York City issues trade in only an extremely limited way, reportedly at yields in the 10 to 15 per cent area for intermediate- and longer-term issues and over 20 per cent on very short-term issues. The small volume of trading in MAC issues has been at rates in the 11 to 12 per cent area, with price quotes often fluctuating up and down 2 or 3 points from day to day in reaction to current news items. Trading in New York State issues has thinned out drastically in the past month, following the barely successful placement of $755 million of short-term notes. Originally placed at yields of around 7 to 8 per cent, these State notes later were quoted, in limited trading, at rates in the 10 to

12 per cent area, while longer-term issues of the State are quoted around 8 or 9 per cent. New York State agencies, which must do some financing in the next couple of months, are also unwelcome in the markets, and their outstanding issues trade very little and at steep discounts.

The complex financial package put together in the New York State legislature in early September to take care of City needs into early December was threatened several times during the month with severe dislocations. It very nearly came apart Friday, and the City's default on a $450 million note issue was only narrowly averted when the Teacher's Retirement Fund reluctantly agreed to purchase MAC bonds. For several hours on Friday, the markets waited anxiously for word on whether a default would occur. The market atmosphere was poorer in those few hours than the quoted price changes might suggest. Prices of municipal issues retreated, although not very drastically, as sales were not pressed aggressively--perhaps because holders felt there would be a last minute resolution, or because they realized the futility of pressing sales, or perhaps because they were just too numb to act. Nor was there a great rally when the 11th-hour reprieve came--since participants were well aware that the current package only carries the City into early December.

Mr. Holland asked whether the Desk had detected a falling off recently of demands for bills and other Treasury securities on the part of individuals as interest rates had declined.

In response, Mr. Sternlight observed that in past auctions of Treasury notes, interest on the part of the general public became substantial when it appeared that the yield would be above 8 per cent and it slackened off when it appeared that the yield would be below 8 per cent. He had not detected a similar critical

point for public interest in Treasury bills. In the case of bills, public interest appeared to have been influenced more by the flight to issues of high quality. He had heard that funds from maturing CD's held by some small investors had moved into Treasury bills, and also that part of the proceeds from maturing New York City obligations was being placed in bills.

Mr. Black asked Mr. Sternlight if he foresaw as much strength in M_1 over the next 2 months as the Board's staff did.

Mr. Sternlight replied that the New York Bank's projection of M_1 was somewhat lower than the Board's. On the assumption of prevailing money market conditions, the Bank staff projected growth at an annual rate of 1 per cent over the October-November period, whereas the Board staff projected a rate of about 4 per cent. For November alone, the former projected a rate of 7 per cent and the latter a rate of 10 per cent.

Mr. Axilrod remarked that so far this year the average absolute errors in the M_1 projections of the two staffs had been quite similar. Thus, the error had averaged 3.3 percentage points for the Board's staff and 3.5 points for the Bank's staff. The difference between the actual growth rates and the midpoints of the ranges adopted by the Committee had been 3.2 percentage points.

Mr. Volcker commented that both staffs projected rather rapid growth in M_1 over the months ahead.

Chairman Burns observed that the correlation analysis underlying the staff projections was about as misleading with respect to growth in the money supply as such analysis was with respect to growth in real economic activity and to other economic developments. Econometric studies had their virtues, but they averaged past experienced and, therefore, were of limited assistance in the present circumstances, which were unique in many respects.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period September 16 through October 20, 1975, were approved, ratified, and confirmed.

Chairman Burns then noted that the Committee had planned to reexamine its longer-run target ranges for the monetary aggregates at today's meeting. He would be reporting the targets agreed upon in testimony before the Senate Banking Committee scheduled for October 30, pursuant to the Concurrent Resolution adopted last March. The Committee also had planned to consider whether it should continue to formulate its targets in terms of percentage rates of change over an annual period or shift to the use of dollar levels to be attained at the end of the period.

The Chairman observed that those questions were difficult from the technical viewpoint as well as from the economic and financial viewpoints, and if the time were available the Committee could advantageously spend a day or two discussing them. In the interest of saving time, he might set forth the conclusions he had reached after pondering the questions closely over a considerable period. He had taken account in his thinking not only of the substantive issues but also of the System's public posture--a matter the Committee had to consider seriously because monetary growth rates were now a subject of continuing debate in the Congress and among the public, just as the unemployment rate and the appropriate definition of full employment had been in an earlier era.

As the members knew, Chairman Burns remarked, the target ranges were merely expressions of the Committee's best judgment at a given time, and the Committee was free to change those ranges as circumstances or its own judgment changed. Nevertheless, it might be useful for him to take a moment to review the recent performance of the monetary aggregates against the background of the ranges the Committee had set earlier.

At its April meeting, the Chairman observed, the Committee had agreed upon target ranges for the aggregates for the period from March 1975 to March 1976 which he had

reported during his initial testimony under the Concurrent Resolution, before the Senate Banking Committee on May 1. Data on the aggregates were now available through September 1975, so that the annual rates of growth for the first 6 months of the period could be compared with the 12-month target ranges set in April. For M_1 the 6-month growth rate was 6.8 per cent, well within the target range of 5 to 7-1/2 per cent. For M_2 the growth rate was 10.0 per cent, near the upper end of the 8-1/2 to 10-1/2 per cent range. For M_3 the growth rate--12.9 per cent--was slightly above the upper limit of the 10 to 12 per cent range.

At its July meeting, Chairman Burns continued, the Committee had retained the previous numerical ranges for the various aggregates, but had adopted the second quarter of 1975 as a new base--as he had reported in hearings before the House Banking Committee in late July. Measuring from the average levels in the second quarter to the levels in September, M_1 and M_2 had grown at rates of 5.8 and 9.1 per cent--both well within the ranges--and M_3 had grown at an 11.9 per cent rate, close to the upper end of its range.

Today, the Chairman remarked, the Committee would be deciding on target ranges for the period from the third quarter of 1975 to the third quarter of 1976. The basic question was,

of course, what those ranges should be. But because the Committee did not operate in a cloister, it had also to consider how best to present its targets to the public--provided always that its basic objectives were not compromised.

Considering M_1 first, the Chairman remarked, the Committee's ultimate objective--as stated repeatedly in its meetings and in Congressional hearings--was to reduce growth to a substantially lower rate, so that it would be consistent with general price stability. That process might perhaps take 3 to 5 years, although the length of the period had never been definitely specified and probably could not be. In his judgment, the appropriate ultimate growth rate would be somewhere between 1 and 2 per cent, far below recent longer-run rates. If the members intended to reduce M_1 growth to such a rate within 3 to 5 years, one could argue that the present was not too early to begin tapering off the Committee's targets. One might also note that the new target period would end about 16 months after the start of the current recovery, by which time some restraint on continued economic expansion would normally be appropriate. On that basis also one might favor some reduction, however slight, from the present target range for M_1.

However, Chairman Burns observed, the analysis of the problem obviously could not stop there. In his judgment there were powerful reasons for favoring no change from the present target range for M_1. First, because the recovery had been under way for only 4 or 5 months, this might well seem much too early to reduce the range. Secondly, although the end of the new target period would be about 16 months after the beginning of the current recovery, it was probable that there would still be slack in the economy at that time--including a high rate of unemployment and considerable underutilization of physical capital resources. Finally, a reduction in the target ranges now would be widely noticed and widely criticized, and a good deal of misunderstanding in the Congress and among the public would be fostered in the process.

The Chairman said he realized that some Committee members might favor a faster rate of growth in M_1 than had been experienced during the past 6 months. It should be borne in mind, however, that because the present 5 to 7-1/2 per cent range was fairly wide the Committee had ample scope, if it wished to use it, to work toward a higher rate of monetary growth within that range.

All in all, Chairman Burns remarked, he would recommend to the Committee that it leave the target range for M_1 unchanged. He recognized that the annual rate of growth from the second to the third quarter of 1975, at 6.9 per cent, was above the mid-point of the 5 to 7-1/2 per cent range, so that the application of the range to a third quarter base would result in slightly higher figures for the third quarter of 1976 than would the application of the same range to a 15-month interval beginning with the second quarter of 1975. There had been a similar implicit increase in the target when the base for the one-year range had been shifted forward from March 1975 to the second quarter. However, because those technical changes in targets were small both in absolute terms and relative to the usual range of error, they should not be a source of much concern.

With respect to M_2 and M_3, the Chairman continued, on strictly economic grounds it would be hard to argue that the present ranges should be retained if the Committee agreed that no change should be made in the range for M_1. In that event, the staff suggested that the ranges for M_2 and M_3 be reduced because, according to the blue book, "slower growth in time and savings deposits is now anticipated, given recent experience and the expectation that market interest rates will again be under upward pressure late this year and early next year." But a reduction in

the target ranges for M_2 and M_3 could present difficulties as far as public understanding was concerned. While Congress and the general public now focused almost exclusively on M_1, if the ranges for M_2 and M_3 were reduced those magnitudes would be seized upon for discussion and comment and would suddenly achieve some prominence. It would be argued that the Committee was moving toward a more restrictive posture, and in some quarters that argument might take a somewhat demagogic form, along the following lines: the Committee had the power to set any level of interest rates it desired, and it anticipated disintermediation because its objective was to bring about a rise in interest rates. He thought it would be desirable, if possible, to avoid inviting such criticism at this time.

Chairman Burns observed that there were three possible means of dealing with the ranges for M_2 and M_3 that seemed reasonable to him. One was to retain the present ranges, despite the economic arguments against doing so, without any special comment. Another was to retain the present ranges, but to inform the Congress in the course of his forthcoming testimony that the Committee expected more difficulty in attaining those ranges than that for M_1. The third, which he would recommend to the Committee, was to retain the present upper limits of the M_2 and M_3 ranges, but to reduce the lower limits somewhat in view of the economic considerations noted by the staff.

Finally, Chairman Burns said, he came to the question of whether the Committee should continue to formulate its longer-run targets in terms of rates of change or whether it should shift instead to the use of levels. A staff memorandum on the subject[1/] arrived at the conclusion that it would be best, on balance, to continue to express the longer-run targets in terms of growth rates. He accepted the staff's conclusion and recommended it to the Committee. If any members had doubts about that conclusion, he would suggest that the Subcommittee on the Directive, of which Mr. Holland was chairman, be asked to review the question and give the Committee the benefit of its advice in the near future.

To summarize, the Chairman remarked, he recommended that the Committee retain the present range for the longer-run growth rate in M_1; that it retain the present upper limits of the ranges for M_2 and M_3, but reduce the lower limits somewhat--perhaps by one percentage point; and that--for the time being, at any rate--it continue to express its longer-run objectives for the aggregates in terms of percentage growth rates.

Mr. Mitchell noted that the Chairman had not commented on the bank credit proxy, which was among the aggregates for which the Committee had formulated target ranges in the past.

1/ The memorandum referred to, by Mr. Axilrod, was dated October 15, 1975, and entitled "Levels and growth rates." It was distributed to the Committee on October 16. A copy has been placed in the Committee's files.

Chairman Burns replied that in his judgment it would be best not to mention growth ranges for the bank credit proxy in his testimony before the Senate Banking Committee. He then called for general discussion of the longer-run targets.

Mr. Mayo said he had struggled a good deal with the question of the appropriate longer-run targets. On the one hand, he thought there were strong reasons for retaining the 5 to 7-1/2 per cent range for M_1; on the other hand, he was concerned about the staff's conclusion that that would call for reducing the ranges for M_2 and M_3. The Chairman had mentioned the desirability of working to reduce the rate of growth in M_1 substantially within a 3-to-5 year period. However, relative to a period of that length, a one-year target period could be considered short term; and because of his concern about M_2 and M_3, he had given some thought to the possibility of raising the one-year target range for M_1.

On balance, Mr. Mayo continued, he had concluded that it would be desirable to retain the 5 to 7-1/2 per cent target range for M_1. One consideration affecting his thinking was that the staff's expectations for the associated growth rates in M_2 and M_3 depended on a judgment about the interest rates that would prove consistent with M_1 growth in a 5 to 7-1/2 per cent range, and he had difficulty in accepting the staff's judgment on that score.

He also had concluded that it would be desirable to retain the lower, as well as the upper, limits of the ranges for M_2 and M_3, for some of the same reasons that had led the Chairman to recommend retaining the upper limits of those ranges and both limits of the M_1 range. Specifically, he was concerned that many observers--having in mind the frequent observation of System officials that it was not desirable to focus exclusively on M_1--would miscontrue a reduction in the lower limits of M_2 and M_3 as a move toward a more restrictive policy at a time when the economic recovery was still in a sensitive state. The Committee would not be bound indefinitely to whatever longer-run ranges it agreed upon today; it would have another opportunity within 3 months to reconsider the ranges, and it could then modify those for M_2 and M_3 if in fact they proved inconsistent with that for M_1. To retain the ranges now would not amount to postponing trouble, since the record demonstrated the high degree of fallibility of the best available forecasts of the relationship between growth rates in the aggregates and interest rates. He, for one, was hopeful that the present ranges for the three aggregates would prove consistent.

Chairman Burns remarked that, as he had indicated earlier, he would consider a decision to retain the present ranges for all three aggregates to be reasonable. He had recommended a reduction in the lower limits for M_2 and M_3 because of his feeling that the

economic considerations leading to the staff's proposal should not be ignored entirely. But the choice had been a close one, and he could readily accept Mr. Mayo's suggestion.

Mr. Mayo went on to note that he concurred in the Chairman's recommendation that the longer-run targets continue to be formulated in terms of growth rates rather than levels. While he was among those who thought that more attention should be paid to levels, that judgment related to the Committee's own deliberations and analyses, not to the manner in which the targets were expressed publicly. Congress and the public were accustomed to thinking in terms of growth rates; if the targets were announced in terms of levels, questions would immediately be raised about the growth rates such levels implied. Even to mention levels in the course of Congressional testimony, much less to give them prominence, would involve greater detail than necessary. If an outside observer was interested in the levels implied by particular growth rate targets, he could, of course, calculate them readily from the growth rates and figures for the base period. As he had remarked at the previous meeting, the Committee's decision to specify growth targets in terms of percentage ranges rather than single figures had been a wise one. To begin now to use levels rather than growth rates would simply complicate matters. Growth rates were to be preferred not only in order to avoid confusion; they were also

the proper focus of understanding. At the same time, he thought the Committee itself would benefit from greater stress on levels in its own discussions.

Chairman Burns observed that Mr. Mayo's concluding observation was entirely consistent with his own thinking. His recommendation related to the manner in which the targets were expressed publicly, and he agreed that more attention should be given to levels in the Committee's deliberations.

Mr. Volcker said he had no difficulty in accepting any of the Chairman's recommendations. He had not found it necessary to consider the questions involved as extensively as the Chairman and Mr. Mayo had, perhaps because--in light of the uncertainties about the underlying economic relationships--he did not take an overly serious view of the specific numerical targets.

He might make a few points in order to illustrate his thinking, Mr. Volcker continued. He liked the notion of setting an upper limit for the longer-run growth rate in M_1--in effect, agreeing upon a boundary beyond which growth would be considered to be too rapid, against the background of long-range factors of the sort the Chairman had mentioned. He would become progressively more worried if higher and higher numbers were considered, and while there was no particular magic in 7-1/2 per cent, he agreed that that was a reasonable upper limit for M_1.

However, Mr. Volcker remarked, he had a somewhat different attitude toward the lower limit. So long as all other conditions appeared satisfactory, relatively low rates of growth in M_1 would not disturb him, and they would have the advantage of helping the Committee approach the long-range objective the Chairman had cited. In short, if other things were equal, he would be inclined to widen the range for M_1 by reducing the lower limit. But in light of the likely public reaction to such a change, he would be quite willing to retain the present 5 to 7-1/2 per cent range. He assumed there was general acceptance of the Chairman's position that the Committee was always free to change its targets.

Chairman Burns observed that he had been troubled ever since the Committee began announcing its longer-run targets by the possibility that the members might feel obligated to do what they could to hit those targets, regardless of other considerations. To repeat a point he had made often before, the Committee's objective was not to achieve particular growth rates in monetary aggregates but to accomplish its objectives with respect to the behavior of the economy.

Mr. Volcker remarked that it was because he agreed completely with that view that he had made his initial comment about not taking the numerical targets too seriously. To carry the point one step further, he would not feel bound by the longer-run ranges

in connection with the Committee's month-to-month decisions on short-run targets--although, obviously, the Committee could not permit the short-run and the longer-run targets to deviate over an extended period without changing one or the other. Also, given the difference in his attitudes toward the upper and lower limits of the longer-run range, the average of those two numbers--that is, the midpoint of the range--had virtually no significance for him. At the minimum, the Committee should be willing to use the whole range; and, as he had suggested earlier, it should always be prepared to change any range it had previously agreed upon. With respect to M_2 and M_3, he liked the idea of making some adjustment in the ranges at this time, since an objective analysis suggested that those ranges were no longer consistent with that for M_1.

Mr. Eastburn observed that he would take exception to Mr. Volcker's view that the longer-run target ranges should not be taken too seriously. He thought those ranges should be taken quite seriously, because in the past the Committee had tended to err in the direction of being unduly flexible with respect to its longer-run goals. The ranges in question were useful in providing fixed points of reference for the members to keep in mind in reaching their short-run decisions.

Mr. Volcker said he might comment briefly in an effort to clarify his position. He had not meant to imply that setting longer-run targets was a useless exercise; he agreed that the ranges--and particularly the upper limits--were useful in helping to avoid undesirable cumulative effects of successive short-run decisions. What worried him was the implication that could be drawn from the specificity of numerical ranges of greater precision than he thought was warranted.

Mr. Eastburn remarked that he agreed with Mr. Volcker on the latter point. Turning to the Chairman's recommendations, Mr. Eastburn observed that, while cyclical considerations would ordinarily call for reducing the target ranges as the recovery proceeded, he shared the view that that would not be appropriate at this time--particularly because the aggregates had been undershooting target levels during the past several months. He would suggest that the Chairman indicate in his testimony that the Committee would attempt to achieve growth rates at the upper ends of the ranges over the coming months. He had a general inclination toward narrower ranges than the Committee was now using, and he thought it was desirable, when feasible, to be specific about the Committee's preferences within the announced ranges. At the present time, moreover, an indication that the Committee was aiming at growth rates near the upper ends of the ranges would be helpful in avoiding the kind of

public reaction to the target ranges themselves about which some concern had been expressed today.

Chairman Burns said he presumed Mr. Eastburn favored aiming at growth rates near the upper ends of the one-year ranges because of the low rates recorded in the past 2 or 3 months. However, the rates of growth over the past 6 months were well within the ranges; indeed, they were near the upper ends for some aggregates. It was important for the public to recognize that the flood of new money created in May and June had not been extinguished, and that it had been doing its work in subsequent months when the growth rates were low. While he appreciated Mr. Eastburn's point, he would not want the public to lose sight of that fact. The task of exposition was a delicate one, at best.

Mr. Eastburn commented that the point he had mentioned was likely to be brought up in the course of the hearings, whether or not the Chairman offered any observations on it in his prepared testimony. With respect to M_2 and M_3, he would favor retaining the present ranges rather than reducing the lower limits, partly because he did not like the idea of widening the ranges still further. If the ranges were kept unchanged, the Chairman could note in his testimony that the actual growth rates might very well fall short of the lower limits.

On the subject of growth rates versus levels, Mr. Eastburn continued, while he appreciated the complications that levels involved, he thought they did impose a useful discipline. One possible resolution of the problem would be for the Committee to use levels for internal purposes over the coming quarter and then decide whether it would be feasible to employ them in a broader context.

Chairman Burns referred to his earlier suggestion that the Subcommittee on the Directive be asked to consider the question of levels versus growth rates. He asked whether Mr. Holland thought the Subcommittee would be able to complete a report before the next meeting of the Committee.

Mr. Holland replied that the Subcommittee should be able to complete a preliminary report based mainly on a review of the work already done by the staff. If that did not meet the needs of the Committee, the Subcommittee could undertake a more fundamental examination of the matter.

The Chairman asked whether that approach was agreeable to the members, and a majority indicated that it was.

Mr. MacLaury said that, like others, he would refer to the one-year objectives as "targets," but only for lack of a better word. Because they could be changed in mid-course, those objectives were not targets in the meaningful sense that one could ask

later whether or not they had been achieved. That the figures were always subject to change was a point which needed to be reiterated often, and he was pleased that the Chairman did so.

In his judgment, Mr. MacLaury observed, an important distinction had been drawn today between the manner in which the targets were presented to the public and the way in which the Committee approached them in its internal deliberations. While he was now persuaded that it was preferable to formulate the announced targets in terms of ranges, for internal purposes he would favor using point targets, perhaps with an associated confidence interval. The Committee's purpose in making such a distinction would not be to mislead the public but rather to avoid misleading itself.

He favored using a point target in internal deliberations, Mr. MacLaury continued, because he found such a formulation more satisfying intellectually than a range. He would not be indifferent at any particular time to growth in M_1 at rates of, say, 5 and 7-1/2 per cent. Earlier in the year, for example, he had expressed a preference for M_1 growth at a rate near the upper end of the range--7 or 7-1/2 per cent; now, given his view that the outlook for the economy had recently improved--a view which, he had been surprised to discover, was not shared by other members--he would be prepared to move the point target towards 6 per cent.

If the range was so wide that it could be retained even though the change in the degree of confidence about the economic outlook was as great as it had been since March, it was wide enough to encompass almost anything that one might wish to include in it.

With respect to levels and growth rates, Mr. MacLaury remarked, he for one would have difficulty in interpreting figures on levels except in terms of the growth rates they implied. His only reason for wanting to stress levels in the Committee's deliberations was to deal adequately with revisions in the base-period figures. He thought it might be useful to experiment for a few months with a procedure under which the Committee would initially agree upon a growth rate and an associated level, but subsequently--if there were revisions in the base-period figures--it would consider the level rather than the growth rate to have embodied its target. The advantage of such a procedure would be primarily psychological; in effect, the burden of proof would be on those who wanted to retain the earlier growth rate rather than the earlier level whenever one no longer implied the other. Similarly, if the staff recommended retention of a growth rate rather than a level, it would be expected to offer an explanation.

In conclusion, Mr. MacLaury said he did not feel strongly about the ranges for M_2 and M_3. On balance, he had a mild preference for reducing the lower ends of those ranges a bit.

Mr. Coldwell said he would be inclined to widen the longer-run range for M_1 by a half of a percentage point in both directions. On the one hand, current circumstances suggested the desirability of aiming in the near term for a somewhat higher figure than recently. On the other hand, a lower target would probably be in order at some time in the future and there would be some advantage in having the range encompass somewhat lower figures now, even though the need for them might still be rather distant. Mr. Volcker had already covered most of the other points he had planned to make.

Mr. Jackson remarked that he would favor reducing both the upper and the lower limits for M_2 and M_3 and stressing the change in the forthcoming hearings. It was important for Congress to recognize that, while the Committee's fundamental policy had not changed, the expected growth rates in the broader measures of money had been reduced as a consequence of fiscal actions taken by Congress itself.

Mr. Jackson added that thus far in his admittedly brief service on the Committee he had heard relatively little mention of the bank credit proxy. He wondered about the propriety of including the proxy among the targets if little or no attention was paid to it in the Committee's deliberations.

Chairman Burns observed that, as he had indicated earlier, he thought it would be best to omit reference to the proxy in his

forthcoming testimony. The Committee could decide later whether or not it wanted to retain the proxy among the aggregates for which it set targets.

Mr. Mitchell remarked that the credit proxy was the aggregate over which the Committee had closest control.

Mr. Jackson commented that it might well be desirable for the Committee to continue to set targets for the proxy. If so, however, it should pay more attention to that measure.

Mr. Kimbrel expressed the view that a reduction in the lower limits of the ranges for M_2 and M_3 would be subject to misinterpretation. Accordingly, he would favor retaining the present ranges for those aggregates and indicating in Congressional testimony that there might be difficulty in attaining them.

Mr. Holland said he liked the ranges the Chairman had suggested and would advance some additional reasons in their favor. Those ranges had the merit of implying a somewhat different performance of GNP than that indicated by the base projection presented by the staff this morning. The staff's projection implied a considerable reduction in the rate of growth of M_2 and M_3, and he was happy to associate himself with aspirations for faster growth in those aggregates. In his judgment it would be important to provide somewhat more credit to the real estate sector in order to get a bit more economic recovery--although not a big recovery.

Unduly tight credit conditions could significantly worsen the difficult long-term work-out situations at many lending institutions; unless the financial system was given the chance to continue to work out its present problems gradually, it would be in no condition to face the problems that would descend on it further down the road.

Mr. Holland observed that there was a second reason for setting ranges for M_2 and M_3 higher relative to that for M_1 than suggested by the staff's analysis. The staff was a prisoner of a logic that denied the possibility that recent shortfalls in M_1 were of lasting or continuing significance. That logic led them to anticipate strong money demands, and thus rising interest rates, and thus slow growth in M_2 and M_3. From time to time Committee members held views of the likely behavior of M_1 that differed from those of the staff, and at present he thought it would be wise for the members to allow for the possibility that money demands would not be quite as strong as the staff suggested, that interest rates would rise somewhat less, and that M_2 and M_3 would be a little stronger. In his view, such a position made good economic sense.

Mr. Holland remarked that the Chairman's proposal to reduce the lower but not the upper limits of the ranges for M_2 and M_3 was particularly appealing, since he would not want to offset a tendency, should it develop, for those aggregates to grow somewhat faster than

expected. It also was logical to reduce the lower limits of M_2 and M_3 now, however, because those variables had been given special stimulus by the fiscal actions taken last spring. More generally, it was important that the Committee stand ready to adjust the ranges whenever the need arose, if only to avoid suggesting that its approach was more monetarist than it in fact was.

Finally, Mr. Holland said, he would favor retaining the bank credit proxy among the aggregates for which the Committee specified longer-run ranges, for reasons he would not take the time to explain at this point. Earlier, the range had been 6-1/2 to 9-1/2 per cent; he thought 5 to 9 per cent would be appropriate for the coming one-year period.

Mr. Coldwell remarked that he would prefer a range of 6 to 10 per cent, and Mr. Mitchell suggested 5-3/4 to 6-3/4 per cent.

Mr. Leonard observed that he conceived of a target as a bull's-eye, surrounded by rings with progressively declining point-values. While the Committee should aim at the bull's-eye, it should recognize that, given the imperfect state of the art, it might have to be content with hitting some other part of the target. He could endorse the ranges suggested by the Chairman for the reasons the latter had advanced. As to the mode of expression, he had a slight preference for levels over growth rates. He did not feel strongly about the matter, however, and would be happy to have it reviewed by the Subcommittee on the Directive.

Mr. Balles remarked that developments since the Chairman first testified regarding the 12-month targets demonstrated that the Committee had been well-advised to use relatively broad ranges. While the ranges suggested by the Chairman today had a good deal of merit, the real test was whether they would permit the Committee to achieve the deceleration in the aggregates that would be necessary at some point as business conditions continued to improve. A fundamental dilemma involved in the practice of announcing one-year targets, which had been recognized at the outset, was that changes in the targets would have announcement effects. Related to that was the great difficulty of educating the Congress and the public generally regarding the lag with which changes in monetary policy affected the economy.

Mr. Balles said he was convinced that it would be a mistake not to reduce the lower limits of the ranges for M_2 and M_3 at this time, partly because an undershoot would be hard to justify. Such a reduction would also offer a useful test of the likely reactions in Congress and among the public to changes in the target growth rates which could not be maintained indefinitely unchanged throughout an upward cyclical movement. While he was not sure whether a lower limit of 5 per cent for the M_1 range would provide enough flexibility for slowing the growth in that aggregate as the economy continued to improve, he favored retaining the present range for M_1 at this time.

Mr. Balles expressed the view that it was appropriate for the Committee to use ranges of growth rates for external purposes. However, he felt fairly strongly that it should make greater use of both levels and point targets in its internal deliberations. Otherwise, there was likely to be uncertainty about the implications for the future of any changes in base-period levels.

Mr. Wallich said he had expected that by this time the monetary aggregates would be strong and interest rates would be under upward pressure. Indeed, he had thought all along that, given the high rate of inflation, it would be difficult to finance the current expansion with monetary growth rates of the magnitude the Committee envisioned, and he had expected the Committee to find it necessary to tolerate overshoots in monetary growth in order to avoid excessively high interest rates. Instead, the opposite was happening; the money supply was growing slowly and interest rates were declining.

One possible inference, Mr. Wallich continued, was that velocity was extremely variable, and that it might continue to increase sharply over the months ahead. He was not prepared at this point to assess the likelihood of such a development. However, he had not changed his general view that the recovery was unlikely to proceed satisfactorily unless the growth rate in M_1 was somewhat above the 6-1/4 per cent midpoint of the present

12-month range. If anything, that view had been confirmed by the recent changes in the economic outlook, even though the changes had been rather marginal.

Accordingly, Mr. Wallich observed, he would favor raising the range for M_1 to 6 to 8-1/2 per cent. He would also accept the judgment that M_2, and particularly M_3, would grow less relative to M_1 than had been previously thought. For both of those aggregates he would favor ranges of 8 to 10 per cent--the ranges shown in the blue book, along with 6 to 8-1/2 per cent for M_1, under alternative A in the discussion of longer-run objectives.

As for other matters, Mr. Wallich remarked, it was his impression that the bank credit proxy added little to the Committee's thinking. However, he would not want to act casually to eliminate that aggregate from the list for which the Committee set longer-run targets; some thought should be given to the question and a deliberate decision made. With respect to the use of levels and growth rates, he definitely shared the view that it was feasible to communicate with the public only in terms of growth rates. Internally, however, the Committee would often be better off to think in terms of levels, in order not to be deceived about the implications of holding a growth rate constant when the base had been revised.

Mr. Baughman said he found entirely acceptable the Chairman's suggestions for longer-term targets, including the slight reductions proposed in the lower limits of the ranges for M_2 and M_3. As the Chairman had noted, the rate of growth in M_1 from the second to the third quarter had been above the midpoint of the 5 to 7-1/2 per cent range. As a consequence, to shift the base forward by a quarter without changing the range would imply a change in policy. While the matter was not of great moment in this instance because the amount involved was small, it would be desirable in general to recognize explicitly the policy changes implicit in any such shifts of base. It would be particularly desirable to avoid falling into a pattern in which policy changes of greater or lesser magnitude were regularly made by such means without explicit notice.

Mr. Baughman expressed the view that the considerations involved in formulating targets should be studied by a subcommittee and their report reviewed by the full Committee. He personally was inclined toward point targets and dollar levels, on the grounds that they involved less of a communications problem than did the alternatives. He recognized, however, that revisions in data posed difficult problems under all formulations.

Mr. Mitchell said he would reject the idea of changing the Committee's longer-run objectives by the calendar or the clock; the

objectives should be changed only when justified by changes in the environment. At the moment visibility was the poorest it had been in a long time, and he would want to wait 2 or 3 months before deciding whether the objectives should be modified. He did not agree with those who seemed to favor change for its own sake, or with those who argued that the logic of the situation required some modification of the targets. In sum, he shared Mr. Mayo's view that the previous target ranges should be retained at this time.

Because M_2 and M_3 included M_1, Mr. Mitchell continued, to change the targets for the former and not the latter would imply a sharper change in the target for the added quantities--in the case of M_2, time and savings deposits at commercial banks, and in the case of M_3, those deposits plus deposits at thrift institutions. Thus, the ranges suggested by the Chairman, which included some reduction in the lower limits for M_2 and M_3, could be interpreted to indicate that the Committee contemplated disintermediation. He would not want to expose the Committee to such a charge.

Mr. Morris expressed the view that it would be wise to widen the ranges for M_2 and M_3. Once the rate of growth in M_1 was given, growth in the broader aggregates would depend on short-term interest rates, and the System's ability to foresee short-term rates in this period was extremely limited. As of 3 or 4 months ago, the

staff would have advised the Committee that a 2 per cent growth rate in M_1 over the intervening months would be associated with short-term rates much higher than those actually prevailing. Moreover, the spread between growth rates in M_1 and M_2 had been much wider than the staff would have forecast. In view of the problems of prediction, wider ranges were needed for M_2 and M_3.

Mr. Winn remarked that an outside observer listening to the Committee's discussion today might well ask whether the subject was the economics or the politics of goal-setting. He thought his own response would have to be the latter.

Chairman Burns said he did not agree with that view. In his judgment the economic justification for targets of the magnitudes under discussion was quite clear. To illustrate, he would assume that the recovery would prove satisfactory in the sense that it would be quite strong but not extraordinarily so--specifically, that real GNP would grow by 7 or 8 per cent over a 12-month period--and that prices would rise by 6 per cent. Those figures would yield an expansion in the dollar value of real GNP of 13 or 14 per cent. If one recognized that historically velocity had tended to rise faster than the money supply in the first year of expansion, it would be clear that growth in money at a rate of, say, 6-1/2 per cent would be quite enough to finance a recovery of the magnitude he had assumed. He could not be certain that real

GNP would actually grow at a 7 or 8 per cent rate, but the proposed target for money seemed reasonable to him on economic grounds.

Mr. Winn asked whether the Chairman would have used similar figures in discussing the question last January.

Chairman Burns replied that he would have defined a satisfactory recovery in essentially the same way. The difference was that such a recovery now appeared to be a reasonable prospect--a statement he could not have made in January.

Mr. Black said he could summarize his position by noting that he agreed with the Chairman's suggestions for targets for the reasons advanced by both the Chairman and Mr. Holland. He would also like to emphasize Mr. Balles' comments about the desirability of beginning to think about the need to reduce the target growth rates for the aggregates at some point in the future, since growth at the current target rates would not be appropriate over the longer run. In his judgment, however, the time to actually reduce the target rates had not yet arrived.

The Chairman then suggested that the members indicate their preferences with respect to one-year ranges for the several monetary aggregates. He asked first whether the members favored retaining the present 5 to 7-1/2 per cent range for M_1.

A majority of the members responded affirmatively.

The Chairman then asked for expressions of preference among three alternatives for M_2 and M_3--retaining the present ranges without special comment; retaining those ranges but indicating in the forthcoming testimony that, for economic reasons, there was great uncertainty about them; and retaining the upper limits but reducing the lower limits by one percentage point.

Initially, an equal number of members expressed a preference for each of the three alternatives described. After some further discussion, however, a majority expressed a preference for the third alternative.

Chairman Burns observed that a question remained regarding the treatment of the bank credit proxy. He proposed that no mention of that aggregate be made in his formal testimony, but that a staff estimate of the range that would be consistent with the one-year ranges agreed upon for the other aggregates be included in the list of longer-run objectives reported in the policy record for this meeting. If the members agreed with that procedure, the Committee could plan on discussing the appropriate role of the proxy at a later time.

In response to the Chairman's question, a majority indicated that such a procedure would be acceptable.

Mr. Axilrod then made the following statement on prospective financial relationships:

As the Committee members know, the staff still expects a rebound in M_1 growth in the weeks immediately ahead. I would like to take just a few minutes to place that expectation in perspective.

I personally find little difficulty in explaining the low rates of growth of money supply for July and August and into September. Those low rates of growth each month still imply growth in the money supply at an annual rate of 6.9 per cent from the second quarter to the third quarter. That rate of growth implies an increase in the income velocity of money from the second quarter to the third quarter at about an 8.2 per cent annual rate, and this was accompanied by an increase in Treasury bill rates of close to 1 percentage point.

The behavior of velocity and interest rates was very similar to that in the first quarter after recovery in the 1958 period, when velocity increased at a 7.8 per cent annual rate and Treasury bill rates increased by 3/4 of a percentage point. The behavior of velocity was also very similar to that in the first quarter of recovery in the 1970-71 period, when velocity rose at an 8 per cent annual rate. In three other cyclical periods, the change in velocity in the first quarter of recovery varied between 1 and 13-1/2 per cent.

Thus, I find no problem in explaining money supply behavior during the summer. It reflected the fact that in May and June enormous sums of money were supplied and were therefore available for use throughout the course of the summer; they were indeed used when you look at the velocity figures.

What is somewhat surprising is the falling away of money in the last 3 weeks or so, when we have seen a reduction in the outstanding level of M_1 on the order of $2 billion. There are two developments that may help to explain this. One does not relate immediately to that 3-week period, but it bears closely on it. In September as a whole--in contrast to July and August--there was a very sharp decline in short-term credit raised by businesses, both at banks and in the commercial paper market. In both markets, businesses repaid debt on balance; in July and August they had increased their outstanding indebtedness slightly. As a result, in September banks did not need to bid actively in the funds market in order to provide the funds to lend

to business or to commercial paper dealers. Because of weak loan demands, there was little pressure exerted by banks to expand the supply of reserves--less pressure than we probably anticipated.

Secondly, in the last half of September and early October the clearly developing New York City crisis seemed to change in a very marked way the behavior of New York City banks. In that period the New York City banks raised $1.6 billion of money in the CD market; before that they had been raising more modest sums. Those funds were raised, I believe, largely for cautionary reasons--to provide banks with liquidity against contingencies looking ahead 2, 3, or 4 months. The funds were not raised because banks saw any substantial loan demand or any substantial need to increase investments in Treasury bills. What they did with that money in part was to reduce borrowing from the Federal funds market. Their net Federal funds borrowings dropped on the order of $1 billion over the period. This put less pressure on the Federal funds rate than otherwise would have occurred. As a result, because the Federal funds market was not beckoning, the System supplied less reserves than it otherwise would have through open market operations.

In general, in late September and early October there was an increase in the demand for liquidity, in large part by the New York City banks. This was reflected in reduced demands for Federal funds, and reduced willingness to extend credit at existing interest rates, although loan demands were weak in any event. As a result, the Federal Reserve supplied less nonborrowed reserves than otherwise, contributing to the weakness in the money stock that we have observed.

While it seems likely that bank behavior as it affects the supply of reserves constrained money growth, given the Federal funds rate, I doubt that such constrained growth is sustainable over a very long run unless the public's attitude toward, and willingness to hold, money has changed. We don't have convincing evidence yet that the public is willing to hold considerably less money than normal in relation to a growing volume of transactions, after taking the level of interest rates into account. Perhaps there's been some downward shift in the demand for money recently, but probably not an extremely substantial one. In that

case, it would be expected that as we progress through late October and November, business corporations and the public generally will have to step up their borrowing and begin selling liquid assets in an effort to increase their cash. This will tend to put upward pressure on interest rates and on the Federal funds rate.

To keep interest rates from rising substantially, the System will need to provide the reserves through open market operations that will support a greater expansion in money. This is the essential reason why we expect money growth to revive over the near term at around current interest rate levels. If, however, the precautionary behavior of banks continues, and if this spills over and adversely affects the spending of the public, then it is probable that a sizable rebound in money growth would not be forthcoming at today's interest rates.

Mr. Baughman remarked that Mr. Axilrod's analysis of the recent decline in the money supply was in fact an excellent statement of the reasons for placing greater emphasis on the monetary aggregates and less on market interest rates in the conduct of open market operations.

Mr. Volcker commented that he admired the ingenuity of Mr. Axilrod's effort to explain the perplexing developments of recent weeks. However, it seemed to him that if the explanation were correct, upward pressures should have been evident in markets for both CD's and Treasury bills, and he did not believe such pressures had existed. The explanation seemed to underestimate substantially the linkage between the markets for those instruments and the market for Federal funds.

In response, Mr. Axilrod observed that actual rates on CD's of the major New York banks had been subject to upward pressure in the recent period, although that was not reflected in the statistical series on posted rates. In the Federal funds market, some downward pressure would have been evident, but the System reacted to the easing tendency by draining reserves and, consequently, by forcing banks to borrow somewhat more from the System than they would have otherwise. The Treasury bill rate was not involved in a significant way, because the major banks were using the proceeds of sales of CD's to reduce their borrowings of Federal funds and not to buy bills; given the existing CD rates, bills were not a good buy.

Mr. Morris remarked that a major bank in Boston also had issued CD's and used the proceeds to reduce its borrowings of Federal funds.

In response to a question by Mr. Mayo, Mr. Axilrod said that under alternative B the staff had projected a 9.3 per cent rate of growth for M_1 in December.

Chairman Burns then suggested that the Committee turn to its discussion of current monetary policy and the directive. To help focus the discussion, he would suggest, without elaboration,

the following short-run specifications for the Committee's consideration: for growth rates in the October-November period, ranges of 3 to 7 per cent for M_1, 5-1/2 to 8-1/2 per cent for M_2, and 0 to 4 per cent for RPD's; and for the Federal funds rate range in the inter-meeting period, an upper limit of 6-1/4 per cent and a lower limit of either 5-1/4 or 5-1/2 per cent--although he had a slight preference for the latter.

Mr. Black observed that he agreed completely with the Chairman's suggestions except that he would lean toward a 5-1/4 per cent lower limit for the funds rate in the expectation that growth in the monetary aggregates would be weaker than presently anticipated by the staff.

Mr. Morris remarked that he was somewhat disturbed by the Chairman's proposal for the funds rate range, first because it implied that the rate would be maintained at the present level of 5-3/4 per cent until further data on the aggregates became available, and secondly because in the event of a further shortfall, it would provide relatively little leeway--only 1/4 of a percentage point if a 5-1/2 per cent lower limit were adopted--for a reduction in the funds rate. In his judgment, the Committee had erred last month in deciding to seek somewhat

firmer money market conditions on the basis of projections, not firm evidence, of strength in the aggregates. Fortunately, present procedures providing for inter-meeting consultations were sufficiently flexible to have permitted the Committee to correct its course 2 weeks later, thus averting the more serious consequences that might otherwise have resulted. He cited last month's experience because he feared that the Committee might be complacent about recent shortfalls in light of the staff's current projection that, with no change in the funds rate, M_1 would grow at a 10 per cent annual rate in November. He was skeptical about that projection partly because of his observation that errors in staff projections tended to be serially correlated; when monetary growth had been consistently overestimated or underestimated for several months the probability was high that the projection for the next month would err in the same direction.

Mr. Morris said he considered it imperative to achieve adequate growth in the money supply soon. While he found the slow third-quarter growth in the aggregates defensible, he would have difficulty explaining continued slow growth in the fourth quarter--an outcome that would be inappropriate for the economy and damaging to the image of the Federal Reserve as well. It was important to recognize that the economy was still in the early stages of

recovery, that indicators of economic activity had been less than buoyant in the past 4 weeks, and that current capital market conditions were more typical of the final stage of a boom period than the early stage of a recovery.

Mr. Morris observed that those considerations led him to favor the specifications of alternative A, including a 5 to 6 per cent range for the funds rate. Those specifications would require the Manager to seek a 5-1/2 per cent funds rate immediately and would provide additional leeway for further moves should that prove necessary.

Mr. Morris added that his preference for the alternative A specifications did not imply that he would support an increase in the Committee's longer-run targets; he agreed with the statement in the blue book that the short-run and longer-run objectives were only loosely related. But he could not be complacent about the low rates of growth of the money supply and of bank credit in recent months. Accordingly, he supported a flexible posture aimed at probing toward lower interest rate levels in order to achieve adequate growth in the aggregates in the coming inter-meeting interval.

Mr. Mitchell remarked that while he was inclined to agree with Mr. Morris' prescription for policy, he would be satisfied with the ranges suggested by the Chairman; specifically, ranges

of 3 to 7 per cent for M_1 and 5-1/4 to 6-1/4 per cent for the funds rate. He was willing to accept that funds rate range--which was 1/4 of a percentage point higher than the alternative A range--because he attached more importance to setting the upper limit on the 2-month range for M_1 at 7 per cent, as the Chairman had proposed, rather than at 5-1/2 per cent, as called for under alternative A.

Mr. MacLaury said that he did not interpret the recent slowdown in M_1 growth as a sign of economic weakness and therefore did not agree that it was imperative to bolster M_1 growth in the coming period. The Chairman's prescription for policy was agreeable to him; in particular, he liked the widened M_1 range, and he favored a 5-1/4 to 6-1/4 per cent range for the funds rate.

Mr. Mayo observed that he favored the specifications of alternative A, primarily on the basis of money market considerations. To his mind, the current environment provided an opportunity for the Committee to demonstrate that monetary policy was flexible in the short run. He felt the Committee's concern about the markets and about M_1 could be conveyed by a monetary policy which allowed the Federal funds rate to, in effect, seek its own level. Despite the market's tendency to overreact to any move by the Federal Reserve, he thought it would be receptive to a 5-1/2 per cent Federal funds rate, and he would recommend that the Manager

be instructed to move toward that midpoint of the 5 to 6 per cent range. Taking a broad perspective, such a move could be viewed as quite small.

For M_1, Mr. Mayo continued, he preferred the range of 3-1/2 to 5-1/2 per cent shown under alternative A. With respect to the range recommended by the Chairman, he would be less concerned about an upper bound of 7 per cent than about a lower limit of 3 per cent. If that lower limit were adopted, he would favor Committee consultation if the rate of growth in M_1 dropped below 3-1/2 per cent. While he did not share Mr. Morris' view of the likely direction of error in the staff's projections, he did share the latter's concern about the growth of the money supply over the next few weeks.

In sum, Mr. Mayo said, he would like to see money supply growth in the fourth quarter a little stronger than projected under the unchanged money market conditions of alternative B. Even under alternative A, the fourth-quarter rate of growth in M_1 was projected to be only 3.7 per cent on a quarterly average basis, and he did not view that as too strong. Moreover, he considered the alternative A path to be consistent with the Committee's longer-run targets. While the blue book table on longer-run targets showed under alternative A a 7-1/2 per cent rate of growth for M_1 over the one-year period through the third quarter of 1976,

that would not be inconsistent with a target range of 5 to 7-1/2 per cent. Moreover, the Committee would remain free to seek slower M_1 growth at a later time, if it should desire to do so.

Mr. Coldwell remarked that he liked the Chairman's proposals for the ranges for M_1, M_2, and RPD's. For the Federal funds rate, however, he preferred a range centered on 5-1/2 per cent; if the upper bound was set above 6 per cent, he would reduce the lower limit enough to achieve a midpoint of 5-1/2 per cent.

Mr. Eastburn said he preferred the specifications of alternative A to those suggested by Chairman Burns; he was somewhat concerned about the lower limits involved in the latter. Whether or not he could accept the Chairman's proposals would depend importantly on the way the Desk would interpret them. He asked Mr. Sternlight to comment.

Mr. Sternlight remarked that the Desk would seek Committee guidance on the appropriate interpretation.

Chairman Burns said he might comment on the specifications he had suggested. He would not want to set the lower limit of the funds rate range as low as 5 per cent--and therefore had recommended a lower limit of 5-1/4 or 5-1/2 per cent, with some preference for the latter--because of the likelihood that it would prove necessary somewhat later to reverse course and raise the funds rate. However, if the Committee chose a range of, say, 5-1/4 to 6-1/4

per cent, he would see no difficulty in moving toward a 5-1/2 per cent rate within the next week. Indeed, a rather prompt move toward the 5-1/2 per cent area would seem quite reasonable in light of the recent behavior of the monetary aggregates and the market uncertainties generated by New York City's difficulties. The Desk would then still have some leeway to reduce the funds rate further if necessary. Of course, if inconsistencies among the specifications appeared to be emerging he would consult with the Committee on any further changes that might seem appropriate.

Mr. Mayo asked how Mr. Sternlight thought the market would perceive a 5-1/2 per cent funds rate.

Mr. Sternlight said the market's present view seemed to be that the System was in process of edging slightly in an easing direction, and that the Committee's current funds rate objective was in the 5-1/2 to 5-3/4 per cent area--even though the Desk had not yet aimed for a rate below 5-3/4 per cent. Accordingly, he thought that operations along the lines the Chairman had suggested would be consistent with current market expectations.

Mr. Volcker remarked that today's discussion perplexed him. During the two preceding Committee meetings many participants had expressed deep concern about the difficulties likely to be encountered, as the recovery proceeded, in restraining money supply growth sufficiently to meet che Committee's longer-term targets. There had

been a great deal of sentiment at those meetings for allowing the funds rate to move up--a course he had found himself resisting. Now, as a result of a few weeks of weakness in the money supply, the sentiment seemed to have reversed. He personally was not concerned at this juncture about the recent weakness in the aggregates; indeed, he viewed it as a welcome development, given the likelihood of excessive monetary growth later.

More generally, Mr. Volcker continued, he saw little sense in attempts to affect the short-run path of the monetary aggregates through changes in the Federal funds rate. The relationship between the two variables was limited; the degree of responsiveness of the aggregates to changes in the funds rate was quite small and the margin of error extremely large. Consequently, he would again urge the Committee not to be too quick to change the funds rate for the sake of achieving some presumed short-term effect on the money supply.

In sum, Mr. Volcker observed, he would favor a directive that called for maintaining fairly steady money market conditions at this time. He would be reluctant to see the funds rate drop appreciably because he believed the earlier concerns about future excessive monetary growth were still legitimate, and therefore--as the Chairman had suggested--that such a course might have to be reversed rather quickly. However, he would want to remain

alert to the possibility that market uncertainties generated by the New York City situation might call for some easing of policy.

Turning to the specifications, Mr. Volcker said he shared the Chairman's original preference for a 5-1/2 per cent lower limit on the funds rate range. He would be agreeable to a high upper bound on the M_1 range of tolerance since he saw no need to limit M_1 growth at this time. However, to reflect his general view that the funds rate should not be reduced appreciably, he would set the lower limit of the M_1 range at 2 per cent.

Mr. Holland said he thought Mr. Volcker's prescription for policy applied better to the period just past than to the one ahead. While he agreed that the funds rate was an imperfect instrument and its relationship to M_1 was loose, he thought the proper perspective on recent developments had been aptly conveyed by Mr. Axilrod. There was sufficient evidence to indicate that increased caution among banks was responsible, in large part, for the unusual behavior of the funds market in recent weeks. In effect, there had been a reduction in the level of the funds rate associated with an adequate flow of reserves to banks, and the Desk had not supplied an adequate volume of reserves because of the funds rate constraint under which it was operating. It seemed to him, therefore, that the Committee should adjust its short-term operating targets to take account of that apparent change in banker

attitudes, particularly since the present attitudes were likely to persist for some weeks, and perhaps months.

At the same time, Mr. Holland continued, the Committee had to take account of the effects of changes in the funds rate on market expectations. He suspected that if the funds rate were allowed to move back up to the 6-1/4 per cent area--the level it had reached before the weakness in the monetary aggregates had set in--the reaction would be sizable, but that it would remain manageable so long as the rate did not reach new high ground. He would recommend that the Committee deliberate further before allowing the funds rate to move above 6-1/4 per cent, even if growth in the monetary aggregates was quite strong. In the same manner, he would be wary of allowing the funds rate to drop below 5-1/4 or 5 per cent because that also would constitute a signal of a sharply new policy. In his judgment, the Committee should carefully weigh the evidence before sending out signals of such policy shifts in either direction.

Accordingly, Mr. Holland said, he favored a funds rate range of 5-1/4 to 6-1/4 per cent, with Desk operations to be handled as the Chairman had suggested. He would recommend a quarter-point reduction in the rate within the next week, and he would urge a prompt additional reduction of a quarter point if the data available a week later indicated that the aggregates were continuing

to fall below their ranges of tolerance. The objective would be to reach a funds rate level at which the deposit-creating machinery of commercial banks was again functioning properly.

Chairman Burns remarked that there had been a glaring omission in the discussion so far--hardly anyone had mentioned the very real danger of continuing inflation and the need for caution on that score. The persistence of inflationary pressure should not be overlooked, particularly in light of the recent price increase in OPEC oil and of the rise in the private GNP fixed-weight deflator from an annual rate of 5.5 per cent in the second quarter to 7.7 per cent in the third quarter.

Mr. Wallich observed that, although previously he had shared the view that the Committee should welcome current shortfalls in money supply growth in light of the longer-run risk of excessive growth, he was beginning to become concerned about the failure of the money supply to behave in the expected manner. Accordingly, he favored alternative A for the coming period. He would like to see more flexibility in the funds rate as a general matter; at present he would favor some reduction in the rate immediately and a further decline to as low as 5 per cent later in the period if necessary.

Mr. Wallich said he recognized that such a policy would have costs--in particular, that it would put downward pressure on

the dollar. But among its advantages was the fact that it would help the rest of the world--which, in turn, would help the United States. While that was not a dominant consideration for policy, it was not altogether irrelevant.

Mr. Kimbrel remarked that businessmen with whom he had spoken recently appeared to share the Chairman's concern about inflation. They had expressed concern not about shortages--except perhaps of heavy manufacturing equipment--but about increased costs of meeting environmental standards and, surprisingly, the burdensome proportions of sharply higher insurance premiums.

Turning to policy considerations, Mr. Kimbrel said it was his judgment that the demand for money and credit would strengthen if the recovery in economic activity continued. For the specifications he could accept either those of alternative B or the ranges suggested by the Chairman.

Mr. Baughman expressed agreement with Mr. Kimbrel's remarks. In addition, he thought the Desk should operate with respect to the funds rate in the manner described by the Chairman.

Mr. Balles observed that it was the consensus of the San Francisco Bank's directors that inflation continued to be the number one danger to the economy. At a recent meeting the

directors had been nearly unanimous in the hope that the Federal Reserve would keep that danger in mind now that recovery was clearly under way. While he fully shared that view, he was still concerned about another danger--that the Federal Reserve would not create enough money to sustain the recovery. Because he was not yet convinced that the monetary aggregates would rebound as the staff projected, he would favor any set of specifications that would result in some reduction of the funds rate in order to stimulate monetary growth. However, if the Desk was to be instructed to reduce the funds rate to 5-1/2 per cent rather promptly, he thought it would be consistent with the Committee's customary procedure to use a range with a 5-1/2 per cent midpoint--such as 5 to 6 per cent, or perhaps 4-3/4 to 6-1/4 per cent.

Mr. Jackson remarked that the relationship between the funds rate and the rate of growth in M_2 and M_3 evidently was closer than he had thought earlier. That consideration led him to support the Chairman's recommendation for a near-term reduction in the funds rate to about 5-1/2 per cent, with the intent to move it lower within a 5-1/4 to 6-1/4 per cent range if necessary.

Mr. Leonard said he shared the Chairman's concern about the long-run problem of inflation. For the coming period, however, he strongly favored a directive along the lines of alternative A,

which called for seeking conditions consistent with substantial growth in monetary aggregates over the months ahead. While he could not be certain about the appropriate lower limit for the Federal funds rate range, he would allow the Manager enough leeway to support substantial growth in bank reserves.

Chairman Burns remarked that, while there were differences in the Committee members' views, they did not seem large. For the Federal funds rate, a majority appeared to favor a range of 5-1/4 to 6-1/4 per cent. He asked the members to indicate informally whether they would find that range acceptable, on the understanding that the Desk would seek a 5-1/2 per cent funds rate within the next week unless new data on the aggregates available on Wednesday or Thursday should indicate that that would be inappropriate; and that the Desk's subsequent operations would depend on the behavior of the aggregates, according to the usual procedures.

A majority of the members indicated that the proposal was acceptable.

In response to further questions by the Chairman, a majority indicated that they would find acceptable ranges of 3 to 7 per cent for M_1, 5-1/2 to 8-1/2 per cent for M_2, and 0 to 4 per cent for RPD's for the October-November period; and the language of alternative B for the operational paragraph of the directive.

Mr. Volcker said it seemed to him that by adopting such a course the Committee would be implicitly saying that certain developments--including the New York City situation and perhaps the W.T. Grant bankruptcy--had had rather profound effects on market psychology and liquidity preferences which had to be taken into account. He could think of no other developments that could account for the change in liquidity preferences about which so much concern had been expressed today.

Chairman Burns remarked that he would not interpret the Committee's posture in that manner. He might note, however, that the apparent change in liquidity preferences was a complex phenomenon that was not easy to explain.

Chairman Burns then proposed that the Committee vote on a directive consisting of the general paragraphs as drafted by the staff and alternative B of the drafts for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following short-run specifications. The ranges of tolerance for growth rates in the October-November period would be 3 to 7 per cent for M_1, 5-1/2 to 8-1/2 per cent for M_2, and 0 to 4 per cent for RPD's. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 5-1/4 to 6-1/4 per cent, with the under-standing regarding Desk objectives that he had proposed earlier

and with the customary further understanding that the Chairman might find it necessary to consult with the Committee if inconsistencies in the specifications should develop.

Mr. Volcker said he planned to cast an affirmative vote, but would do so reluctantly.

> By unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions for the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that output of goods and services--which had turned up in the second quarter--increased sharply further in the third quarter. In recent months retail sales have been maintained at the higher levels reached in early summer, and industrial production has strengthened progressively. Nonfarm payroll employment continued to expand in September, and the unemployment rate edged down from 8.4 to 8.3 per cent. In September, as in August, average wholesale prices of industrial commodities rose somewhat faster than earlier in the year, in part because of increases in prices of energy products; prices of farm and food products rose sharply in September. The advance in average wage rates in recent months has remained somewhat less rapid than in 1974 and early 1975.

After rising further in late September, the exchange value of the dollar against leading foreign currencies has declined to about its mid-September level. In August the U.S. foreign trade surplus increased as agricultural exports rose. Bank-reported private capital movements showed a further net inflow, while U.S. liabilities to foreign official agencies declined again.

M_1 rose slightly on the average in September but declined in the latter part of the month and in early October. From the second to the third quarter, however,

M_1 grew at a 6.9 per cent annual rate. Inflows of consumer-type time and savings deposits to banks and to nonbank thrift institutions continued to moderate in September, reflecting in part the attractiveness of alternative investments, and growth in M_2 and M_3 slowed further. Although conditions in markets for State and local government securities continued to be adversely affected by New York's financial problems, most short- and long-term interest rates have declined in recent weeks. On October 15 the Board of Governors announced a reduction of member bank reserve requirements on long-term time deposits.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions that will encourage continued economic recovery, while resisting inflationary pressures and contributing to a sustainable pattern of international transactions.

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Secretary's note: The specifications agreed upon by the Committee, in the form distributed after the meeting, are appended to this memorandum as Attachment D.

It was agreed that the next meeting of the Committee would be held on November 18, 1975, at 9:00 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

Henry C. Wallich
October 21, 1975

Report on BIS Meeting - October 13, 1975

In meetings and bilateral discussions, concern was expressed about the continued weakness of European economies. Some skepticism was voiced also concerning the strength of the American recovery, combined with concern about a rise in U.S. interest rates relative to European rates. The German representative defended his government's plans for financing a small part of the German budget deficit abroad, while the British representative expressed doubt about the need for throwing this burden on the international capital market, to the possible detriment of other potential borrowers. Questions were asked repeatedly about New York City.

In the discussion of the Interim Committee's gold agreement, which had left the working out of certain matters to the central banks, Zijlstra stated that he planned to render a report to the Committee at its next meeting in January. There was, in his opinion, two views. According to the first, central banks could deal in gold subject to the twofold constraint imposed by the Interim Committee -- no increase in official gold holdings and no pegging of the price of gold. The other view was that central bank dealing in gold would become possible only after amendment of the IMF agreement, which might take 18 months or more. The first view received some degree of support from almost all

except the U.S. and the IMF representative. The German, French, Italian, and Netherlands representatives spoke with particular vigor. The IMF representative argued that inter-central bank operations would not be legal prior to amendment, but suggested that the BIS could act for the central banks by buying gold and reselling it to them later, a suggestion that was not accepted by Zijlstra. I argued for delaying gold dealings until after amendment but recognized that the alternative view might have some merit, and I suggested further discussion of the matter at the next BIS meeting.

A BIS representative expressed the view that, unless central banks bought the gold sold by the IMF for the benefit of developing countries, the IMF would be virtually unable to sell any gold at all. Even a few tons, in the present state of the market, would cause the price to collapse.

The IMF representative presented two alternative plans for the sale of one-sixth of the Fund's gold holdings over periods of alternatively three and eight years, the proceeds to be used principally to subsidize concessionary interest rates on loans from the IMF trust fund. Annual sales in case of the eight-year alternative, he pointed out, would amount to only 10 per cent of annual South African sales.

All in all, the discussion revealed very little support for the U.S. position, and even the IMF representative's support was predicated on a device for avoiding its consequences that was not acceptable. The desire for immediate implementation -- after the

January Interim Committee meeting -- does not imply that many or perhaps any central banks would buy. But there is a belief that the gold market would be stronger if it were known that central banks could buy. The ability of central banks to deal in gold seems to be regarded as a political decision rather than a legal matter. Some countries regard all parts of the gold agreement -- sales for the LDC's, restitution, and constraints on central banks' trading -- as a package. Some even say it would be useless to debate any of this if implentation had to await amendment of the IMF articles.

There was virtually no discussion of the many technical problems arising out of the IMF proposed sales. A meeting to deal with these is to be held during or immediately preceding the November BIS meeting.

ATTACHMENT B

Alternative Economic Projections

October 20, 1975

Prepared by the staff
Board of Governors Federal Reserve System

MONETARY AND FISCAL ASSUMPTIONS

MONETARY

Correspond to Blue Book Alternatives -

Indexed by M_1 growth:

Path A - 7-1/2 per cent
Path B - 6-1/4 per cent
Path C - 5 per cent

FISCAL

Correspond to base Greenbook projection -

Continuation of 1975 tax reductions:

Individual taxes down by $12 billion in 1976
Corporate taxes down by $4 billion

Budget outlays in FY 1976 - $370 billion

ADDED FISCAL

Correspond to the President's program -

Net further tax reductions

$12 billion in calendar 1976, and thereafter

Expenditures cut by $25 billion in FY 1977 to a level of $395 billion. We assume a gradual phase in, beginning in QIV 1976.

ALTERNATIVE PROJECTIONS OF MAJOR ECONOMIC VARIABLES

Based on Different Monetary and Fiscal Assumptions
(Per cent change at seasonally adjusted annual rates)

Blue Book Alternatives	1975 III	1975 IV	1976 I	1976 II	1976 III	1976 IV	Annual rate of Increase over six quarters: 1975II--1976IV
			NOMINAL GNP				
A	16.2	15.5	11.8	11.7	11.9	12.1	13.2
B	16.2	15.4	11.2	10.5	9.9	9.5	12.2
C	16.2	15.3	10.6	9.5	8.3	7.2	11.2
Fiscal Increment			0.9	0.8	0.2	-0.9	0.3
			REAL GNP				
A	10.8	7.7	5.8	6.2	6.3	6.0	7.1
B	10.8	7.6	5.3	5.1	4.5	3.8	6.2
C	10.8	7.5	4.8	4.2	3.1	1.9	5.4
Fiscal Increment			0.8	0.7	0.1	-0.9	0.2
			PRICE INDEX 1/				
A	8.1	6.6	6.2	5.5	5.6	5.5	6.2
B	8.1	6.6	6.1	5.3	5.2	4.9	6.0
C	8.1	6.6	6.0	5.1	4.9	4.4	5.8
Fiscal Increment			0.4	0.3	0.2	0.0	0.2
			UNEMPLOYMENT RATE 2/				Decline in percentage points 1975II--1976IV
A	8.4	8.1	8.0	7.8	7.5	7.3	-1.6
B	8.4	8.1	8.0	7.9	7.7	7.7	-1.2
C	8.4	8.1	8.0	8.0	7.9	8.1	-0.8
Fiscal Increment			-0.1	-0.2	-0.2	-0.1	

Fiscal Increment - Additional effect of Administration's proposed fiscal package. Last column for fiscal increment shows additional per cent increase during calendar year 1976.

1/ Fixed weighted price index for gross private product.

2/ Level of rate.

INTEREST RATE PROJECTIONS
(Levels, in per cent)

Blue Book Alternatives	1975		1976			
	III	IV	I	II	III	IV
	3-MONTH TREASURY BILL RATE					
A	6-3/8	6-1/4	7	7-1/4	7-1/2	7-1/4
B	6-3/8	6-3/4	8	8-1/2	8-3/4	8-3/4
C	6-3/8	7-1/4	8-3/4	9-1/4	9-1/2	9-1/4
Fiscal Increment	--	--	1/4	1/2	3/4	1/2
	Aaa CORPORATE BONDS					
A	9-1/2	9-1/2	9-1/2	9-1/2	9-1/2	9-1/2
B	9-1/2	9-1/2	9-1/2	9-3/4	10	10
C	9-1/2	9-1/2	9-3/4	10	10-1/4	10-1/4
Fiscal Increment	--	--	1/8	1/8	1/4	1/8

NOTE:

Fiscal Increment - Additional effect of Administration's proposed fiscal package.

Attachment C

October 20, 1975

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 21, 1975

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that output of goods and services--which had turned up in the second quarter--increased sharply further in the third quarter. In recent months retail sales have been maintained at the higher levels reached in early summer, and industrial production has strengthened progressively. Nonfarm payroll employment continued to expand in September, and the unemployment rate edged down from 8.4 to 8.3 per cent. In September, as in August, average wholesale prices of industrial commodities rose somewhat faster than earlier in the year, in part because of increases in prices of energy products; prices of farm and food products rose sharply in September. The advance in average wage rates in recent months has remained somewhat less rapid than in 1974 and early 1975.

After rising further in late September, the exchange value of the dollar against leading foreign currencies has declined to about its mid-September level. In August the U.S. foreign trade surplus increased as agricultural exports rose. Bank-reported private capital movements showed a further net inflow, while U.S. liabilities to foreign official agencies declined again.

M_1 rose slightly on the average in September but declined in the latter part of the month and in early October. From the second to the third quarter, however, M_1 grew at a 6.9 per cent annual rate. Inflows of consumer-type time and savings deposits to banks and to nonbank thrift institutions continued to moderate in September, reflecting in part the attractiveness of alternative investments, and growth in M_2 and M_3 slowed further. Although conditions in markets for State and local government securities continued to be adversely affected by New York's financial problems, most short- and long-term interest rates have declined in recent weeks. On October 15 the Board of Governors announced a reduction of member bank reserve requirements on long-term time deposits.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions that will encourage continued economic recovery, while resisting inflationary pressures and contributing to a sustainable pattern of international transactions.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with substantial growth in monetary aggregates over the months ahead.

Alternative B

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Alternative C

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with modest growth in monetary aggregates over the months ahead.

ATTACHMENT D

October 21, 1975

Points for FOMC guidance to Manager in implementation of directive		Specifications
A. Desired longer-run growth rate ranges (as agreed, 10/21/75): (QIII'75 to QIII'76)	M_1	5 to 7-1/2%
	M_2	7-1/2 to 10-1/2%
	M_3	9 to 12%
	Proxy	6 to 9%[1/]
B. Short-run operating constraints (as agreed, 10/21/75):		
1. Range of tolerance for RPD growth rate (October-November average):		0 to 4%
2. Ranges of tolerance for monetary aggregates (October-November average):	M_1	3 to 7%
	M_2	5-1/2 to 8-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		5-1/4 to 6-1/4%
4. Federal funds rate to be moved in an orderly way within range of toleration.		

5. Other considerations: account to be taken of developments in domestic and international financial markets.

C. If it appears that the Committee's various operating constraints are proving t be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instruction

1/ Range estimated by staff as consistent with ranges for other aggregates.