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, January 20, 1976, 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. Partee
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. 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. Holmes, Manager, System Open Market Account
Mr. Pardee, Deputy Manager for Foreign Operations
Mr. Sternlight, Deputy Manager for Domestic Operations

Mr. Coyne, Assistant to the Board of Governors
Messrs. Kichline and Zeisel, Associate Directors, 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
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, Balbach, and Doll, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, St. Louis, and Kansas City, respectively
Messrs. Hocter, Brandt, and Keran, Vice Presidents, Federal Reserve Banks of Cleveland, Atlanta, and San Francisco, respectively
Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York

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

By unanimous vote, the memoranda of discussion for the meetings of the Federal Open Market Committee held on November 18 and December 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 December 16, 1975, through January 14, 1976, and a supplemental report covering the period January 15 through 19, 1976. Copies of these reports have been placed in the files of the Committee.

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

> Since the December meeting of the Committee the dollar has eased by roughly 1 per cent against major currencies. This easing has mainly reflected the recent decline of interest rates here and in the Euro-dollar market. In addition, renewed heavy buying of Swiss francs, partly speculative, has contributed to the strength of that currency and of other European currencies against the dollar. The Swiss National Bank intervened heavily, however, taking in some $650 million, and thereby helping to calm the market. We intervened in a very modest way on four occasions, selling a total of $47 million worth of marks out of our balances, which we have largely been able to recoup. On occasion, in addition to offering marks in New York, we have been able to intervene simultaneously in Swiss francs, using francs supplied by the Swiss National Bank for its own account.
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> In contrast with earlier periods of falling U.S. interest rates, the decline in the exchange rate for the dollar has been rather modest. In part this has reflected the market's recognition of the fundamental strength of the dollar, with

the U.S. trade account remaining in solid surplus. In addition, as compared with last year at this time, many market participants see the decline of U.S. interest rates as probably being temporary, rather than as a continuous slide. Finally, against the background of the various international agreements over the past year--in London last February, in Rambouillet in November, and in Jamaica most recently--the market has responded favorably to central bank intervention, which has been quite quick and forceful. In fact, traders in the market-place are beginning to complain that intervention has left exchange rates so stable that it has become hard to trade for profits.

Turning to operations, I have circulated to the Committee a report on the loss-sharing agreement that we reached in Basle with officials of the Swiss National Bank.[1/] The agreement is subject to the Committee's approval, which I recommend, and to approval by the Board of Directors of the Swiss National Bank. At current very high rates for the franc, some SF 2.60 to the dollar, neither we nor the Swiss are eager to go into the market. Nevertheless, there are opportunities to acquire francs in modest volume outside the market. At current exchange rates the System's share of losses would be 56 per cent to the Swiss National Bank's 44 per cent on any swap repayments that we might make. If the dollar should rise to SF 2.70 and beyond, the Swiss National Bank is prepared to sell dollars in the market, and the losses on any swap repayments would be shared equally. We have no illusions about an early repayment of the Swiss swap debt, but we can at least show some progress.

Turning to the Belgian franc, our program of modest daily purchases is about on schedule and we have repaid a further $30.1 million of debt. The Belgians hope, as do we, to accelerate the pace of repayment, but that largely depends on market developments.

Finally, at last week's Basle meeting, Governor Baffi and Deputy Governor Ossola of the Bank of Italy met with us to request a $500 million drawing under

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1/ A copy of this report, dated January 15, 1976, and entitled, "Loss-sharing agreement with the Swiss National Bank," has been placed in the Committee's files.

the Federal Reserve swap line. Italy has had an impressive turnaround in its current account--from a deficit of $7.5 billion in 1974 to flat last year--but the turnaround has been at the expense of a severe recession. More recently, with the resignation of the Italian cabinet, there have been heavy outflows of funds.

An added feature in the situation is market reaction to press reports suggesting that U.S. bank examination authorities are looking askance at loans to Italy, and the Bank of Italy believes this has been quite damaging to confidence in the lira at the present time. Governor Baffi argues that any further depreciation of the lira would only exacerbate domestic inflation, through escalators and other automatic mechanisms built into the Italian price and wage structure. Moreover, he feels that the lira is quite competitive in international markets at the present time. Consequently, he believes that the exchange rate should not be allowed to decline very far under pressure of speculative outflows. Nevertheless, Italy's usable cash reserves are low--under $500 million--and they need more resources in hand. At the time of the request to us, they also had rounded up $1 billion of additional credits from Germany, Switzerland, and the Bank for International Settlements. They are also applying for an SDR $450 million borrowing from the International Monetary Fund, which they have pledged to repay the System swap drawing, if that should prove necessary.

In response to questions by Mr. Coldwell about Italy's plans to borrow foreign currencies, Mr. Holmes indicated that the Italians were sending a delegation this week to the International Monetary Fund in Washington. No formal application for an IMF loan had been made thus far, but he understood that the Italians had some assurance of sympathetic consideration by the IMF. It might take some time for the loan arrangements

to be completed, however, and for that reason the Italians viewed the swap drawing on the System as a sort of bridge loan. Italy might also be able to borrow a substantial amount from the EEC oil facility, once that facility was put into place, but again such a loan was down the road a bit.

Mr. Holmes added that Italy's total foreign debt was around $14 billion, including that of the various governmental agencies, but fortunately the maturity structure of that debt was favorable in that only $300 million of the total would be up for renewal in 1976. The amount of foreign currencies that the Italians would need to borrow would therefore depend on the size of their intervention in support of the lira. The $1 billion in new credits, to which he had referred in his statement, included a $500 million loan from the Germans. As the Committee members would recall, the Italians had repaid a $500 million gold collateral loan from West Germany in 1975. In addition, the Swiss had agreed to make a $250 million gold collateral loan and the BIS had agreed to a $250 million direct swap. Accordingly, if the Italians drew $500 million on the System, they would have total new credits of $1.5 million plus whatever they might obtain from the IMF and the EEC oil facility.

In reply to questions by the Chairman about the EEC oil facility, Mr. Holmes said that it had been set up by the EEC countries some time ago, but it had not yet been put into operation. The total resources of the facility would be $1 billion, which--on the basis of tentative plans--would be borrowed in the market. Of the $1 billion total, he believed as much as $700 million might be available to Italy.

In response to a question by Mr. Holland, Mr. Holmes indicated that the Italians had exhausted their borrowing facilities at the IMF except for the additional leeway that was made available at the recent meeting in Jamaica. As a result of that meeting the Italians could now borrow a further $450 million in SDR's.

The Chairman inquired about the performance of the lira in recent days, and Mr. Holmes said that the lira was off about one-half per cent against the dollar and somewhat more against some of the European currencies. The Italian authorities were, therefore, letting the lira slide a bit, but they did not want the decline to go too far. He thought they were probably right in their view that substantial further deterioration in the lira would worsen wage and price problems in Italy.

In response to a further question by the Chairman, Mr. Holmes said the Italians had lost some $400 million in reserves since the fall of the Italian government on January 7, including about $180 million in the last 2 days. The lira had declined further today, but no information was available so far concerning any intervention by the Italians.

Mr. Holland asked Mr. Holmes whether he expected the Italians to make a stand at a level close to the current exchange rate and whether the drawing on the System might have to be followed by additional borrowings if Italian reserve drains proved to be heavier than anticipated.

Mr. Holmes said he thought the Italian authorities wanted to make a stand at a level close to the current rate in light of their concern about the inflationary impact of a further substantial depreciation of the lira. If a new inflationary spiral were triggered by such a depreciation, the competitive position of the lira could be seriously eroded. As he had noted in his statement, he thought the lira's position was quite good at the present time.

Mr. Solomon commented in reference to Italy's debtor position that so long as the OPEC countries continued to run a large surplus, other countries as a group would experience

a deficit in their current account. In these circumstances one could not judge the normal position of a country like Italy on the basis of whether or not its current account was close to zero or in surplus. Someone had to hold the "hot potato" and it happened to rest rather heavily now with Italy and the United Kingdom. On the other hand, the United States and Germany had current account surpluses that were really too large for the health of the world economy. This did not mean that the System rather than someone else should lend to the Italians. That was a separate, if related, question.

In reply to a question by Mr. Partee, Mr. Solomon noted that the improvement in Italy's current account position last year had been at the cost of a severe recession.

Mr. Pardee added that GNP in Italy had fallen 4-1/2 per cent in 1975 and industrial production about 12 per cent.

Mr. Wallich commented that, cyclically adjusted, the Italian balance of payments on current account was probably in deficit.

Mr. Mayo referred to the System's debt in Swiss francs and observed that the franc had appreciated considerably in recent months--indeed, it was now trading on a par with the

German mark. To an important extent, inflows of funds to Switzerland were induced by a desire for a haven that offered privacy, and he suspected that some of those inflows could prove to be temporary. He wondered, therefore, whether it might not be preferable for the System to try to minimize its losses by delaying repayment of its franc debt until the market was more favorable.

Mr. Holmes said he thought it would be highly desirable to reach agreement with the Swiss now on a rate at which loss-sharing would be 50-50, and he believed the proposed rate of 2.70 francs to the dollar was fair. The System would not incur any losses until swap drawings were actually repaid, and he did not envision the acquisition of very many Swiss francs at a rate less favorable than 2.70. However, he saw some advantages in making some small progress in reducing the Swiss debt through off-market transactions. As he had noted in his statement, the Federal Reserve would have to absorb 56 per cent of the losses at current exchange rates. Since the best that could be hoped for would be a 50-50 sharing of losses, it was his personal view that the System should be willing to take the extra losses--which would be quite small in light of the small size of the contemplated transactions--so as to show at least token progress in repaying the System's debt.

Mr. Mayo indicated that he had a somewhat different view. He was not raising any objection to going ahead with the loss-sharing agreement outlined by Mr. Holmes. However, he did question the desirability of incurring losses at current exchange rates. If the Swiss franc was indeed close to peaking--and he could be wrong in his assessment of where the franc was going--a delay would mean that the System would have to absorb only half the losses, and that was preferable to absorbing, say, 56 per cent of them. More importantly, the Swiss franc might weaken to a rate above 2.70 per dollar, so that the losses to be shared on a 50-50 basis would be smaller.

Mr. Holmes remarked that the Swiss had been very constructive in devising various ways for the System to acquire francs in off-market transactions. For example, the Swiss would be putting up dollars in connection with an upcoming drawing on the IMF oil facility by another country, and they were willing to share their lessened dollar exposure by selling some Swiss francs to the System. He thought such access to Swiss francs outside the market was very useful to the System, and he believed it was desirable for the System to help get this sort of mechanism well established.

Replying to a question by Mr. Holland, Mr. Holmes indicated that the Swiss authorities had been very cooperative.

They recognized that the Swiss franc was a special case and that it was strong against all currencies. In that connection, they apparently felt that they had some moral, if not legal, responsibility to be accommodating.

Mr. Pardee observed that the Belgians, unlike the Swiss, had been unwilling to accept any responsibility for the appreciation of their currency relative to the dollar.

In response to a question by Mr. Coldwell, Mr. Holmes said that losses on any new System drawings of Swiss francs would be shared on a 50-50 basis. In the unlikely event that the Swiss should draw on the System, they would absorb 100 per cent of any losses, but he believed that that part of the agreement might have to be renegotiated at a later date.

> By unanimous vote, the System open market transactions in foreign currencies during the period December 16, 1975, through January 19, 1976, were approved, ratified, and confirmed.

Mr. Holmes reported that $1,167.2 million of System drawings in Swiss francs would mature prior to the next meeting of the Committee and would be up for their eighteenth renewals. He recommended that the Committee approve the renewals. He added that $600 million of the maturing drawings were on the Bank for International Settlements. The Swiss National Bank,

which had originally advanced the francs, now wanted to have the drawings transferred to its account, apparently to avoid paying the BIS a commission for its services. He saw no objection to the transfer from the System's standpoint, since only a change in creditors was involved and no change in the amount or terms of the drawings was in question.

In reply to a question by the Chairman, Mr. Holmes said he saw no real alternative to renewing the drawings. It might prove feasible to repay $20 million or $30 million of the total, but that was about all that could be hoped for.

Replying to a question by Mr. Holland about the $600 million drawing on the BIS, Mr. Pardee recalled that the Swiss National Bank had found it desirable to minimize the extension of credit to the System in its own name. It had therefore made arrangements to extend credit through the BIS.

Mr. MacLaury said that was also his recollection. The decision to use the BIS was made by the Swiss National Bank and not by the System.

Mr. Holmes then noted that all of the System's drawings on the Belgian National Bank, totaling $277.5 million, would mature before the next Committee meeting. The Desk would pay

off any amounts that it could, but he recommended that the Committee approve renewal of the remaining balances.

> 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 January 30 through February 28, 1976, was authorized. It was understood that the System's outstanding drawing of $600 million on the Bank for International Settlements, maturing on February 13, 1976, would be transferred on that date to the Swiss National Bank under arrangements made between those two institutions.

Turning to the loss-sharing agreement with the Swiss, Mr. Holmes recommended approval of the proposal he had negotiated with the Swiss authorities, subject to final approval by Chairman Burns following favorable action by the Directors of the Swiss National Bank.

> By unanimous vote, the Committee approved an agreement with the Swiss National Bank for the sharing of losses incurred in the repayment of the System's swap liability to that Bank on the basis recommended by the Manager in his memorandum to the Committee dated January 15, 1976, subject to final approval by the Chairman

on receipt of advice that the agreement was acceptable to the Board of Directors of the Swiss National Bank.

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 December 16, 1975, through January 14, 1976, and a supplemental report covering the period January 15 through 19, 1976. 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:

The period since the last meeting of the Committee has been marked by gradually easing money market conditions and declining interest rates against a background of sluggish growth in money and credit aggregates. As the period began, the Account Management sought money market conditions about unchanged from those prevailing prior to mid-December--that is, a Federal funds rate around 5-1/4 per cent. Within a few days after the meeting, incoming evidence suggested a significantly weaker picture than was expected at mid-December and embodied in the Committee's indicated growth ranges.

Given the Committee's preference at the last meeting for a money-market-oriented directive, and in light of skepticism about the monetary growth data in the year-end period, the Desk responded quite cautiously to the weak aggregates. Thus, no change in stance was made until the final days of December, and then

in successive weeks the funds rate objective was edged down in steps of 1/8 per cent, to 4-7/8 per cent by January 9. By that time, with the market sensing the System's thrust, actual trading in funds was at 4-3/4 per cent, with some market participants anticipating that a continued decline was likely. Since the agreement by a majority of the Committee with the Chairman's recommendation of January 12, the Desk has aimed at a continuation of the 4-3/4 per cent funds rate until today's meeting.

Following the typical intra-monthly pattern, the Desk supplied reserves early in the period through outright purchases of $297 million of Treasury coupon issues and $675 million of bills in the market, and about $1.1 billion of bills from foreign accounts, along with sizable day-to-day repurchase agreements. Substantial repurchase agreements were required, particularly in the days surrounding the turn of the year, to avoid undesired firmness during this period of uncertainty and of sizable financial flows that were partly related to statement-date adjustments. Early in the new year, with Treasury balances dropping sharply, the Desk absorbed reserves through a market sale of $506 million in bills, sales of about $733 million of bills to foreign accounts, and a redemption of $600 million of maturing bills. There were also day-to-day matched sale-purchase transactions with foreign accounts and occasionally in the market. In the last few days, with market factors turning around again, the Desk has moved to provide reserves, including the purchase of $240 million of Federal agency securities to be delivered today.

Encouraged by the Desk's easier stance, weakness in the money supply, the December 24 reduction in reserve requirements, a decline in wholesale prices, and anticipation that credit demands would be moderate in the months ahead, interest rates have declined across the board in the past few weeks. Some short-term rates, in fact, have reached their lowest point since late 1972. In yesterday's auction, 3- and 6-month bills went

at 4.78 and 5.05 per cent, compared with 5.49 and 5.91 per cent just before the last meeting. Rates on commercial paper and bank CD's are down by roughly a full percentage point. On the day of the last meeting the Treasury sold a 2-year note to yield 7.28 per cent, while last Wednesday a similar issue was sold at a yield of 6.49 per cent. At the longer end, the yield decline was around 30 basis points.

Toward the close of the period, the rally was running out of steam, and it appeared that dealers felt uncomfortable with their sizable takings of 2- and 5-year notes last week. Over the whole interval, dealer holdings of over-1-year maturities increased by about $1.2 billion, to $1.6 billion. While Friday's discount rate reduction tended to bolster confidence, the market is also keenly aware of the approaching Treasury financing to be announced a week from today. With respect to that financing, the System holds $3.7 billion of the maturing issues, which we would plan to exchange for new issues in approximately the proportions that such issues are offered to the public.

Rates in the corporate bond market also declined in the past month, on the order of 10 to 25 basis points for seasoned issues. As with Treasury issues, the rally lost strength in the latter part of the period, partly because underwriters became too enthusiastic and priced new issues ahead of investor willingness to buy. Moreover, the strength of the market around the turn of the year has encouraged an increase in the calendar of offerings, including the rescheduling of issues postponed a month or two ago--in some cases with sizes enlarged.

The tax-exempt market also strengthened over the past several weeks, with yield declines on the order of 20 to 40 basis points. This market appears to be learning to live with more complete disclosure requirements for new issues--imposed both by law and by the increased wariness of investors after the events of the past year. Prospects for several major issuers, including New York

State and its agencies, remain clouded as regards any near-term return to normal marketing channels, although plans are under consideration to seek temporary off-market solutions.

Mr. Baughman said he thought the lag between incoming evidence on growth in the aggregates and the subsequent response of open market operations tended to be too long. He realized that the evidence concerning the aggregates was generally tenuous and that frequent changes in interest rates were regarded as costly. In the previous inter-meeting period, however, operations to move the Federal funds rate might have been initiated earlier, although he believed that the level reached toward the end of the interval was appropriate. If they had, the record--in retrospect--might look better.

Chairman Burns commented that the issue Mr. Baughman had raised was one on which more than one opinion could be, in some indefinable sense, correct. Certainly, differences of opinion on the subject were thoroughly understandable. With respect to the past month's operations, he had two observations to make. First, the Desk had followed--in his judgment, wisely--the rule that operations not be directed at moving the Federal funds rate in the period immediately following a meeting of the Committee, so as to avoid giving the market an immediate signal of the Committee's decision.

Second, the Committee had adopted a money market directive at its last meeting, and that factor alone would prompt the Desk to move more slowly than it otherwise would with regard to influencing the level of the Federal funds rate. He asked Mr. Sternlight and Mr. Holmes whether they had any additional comments.

Mr. Sternlight said he would add only that--as had been noted at the last meeting and in the Chairman's telegram of January 12--there was considerable uncertainty surrounding the data on the aggregates for the December-January period. That was another factor that had prompted caution in the timing of operations.

Mr. Holmes remarked that the Chairman and Mr. Sternlight had aptly described the circumstances that had caused the Desk to respond slowly to incoming data. He would note that, despite the cautious response, the decline in interest rates over the period had been fairly pronounced. While the decline might have begun a little later than some would have preferred, he was not sure that a week's difference in timing was crucial in terms of achieving the over-all objectives of the Committee. Moreover, he thought it was preferable to be relatively certain of the facts before acting rather than

to have to reverse an action shortly after taking it.

Mr. Baughman commented that, by the nature of the environment in which open market operations were carried out, one could never be very sure of the facts.

Chairman Burns agreed that there was always an element of uncertainty, but that the uncertainty was greater around the year-end than at other times. Moreover, recent innovations in the payments mechanism had further complicated the interpretation of money supply figures. He was not certain whether that had influenced operations at the Desk, but it had generated considerable staff study here at the Board. The staff also had done a great deal of new work in connection with the problems of seasonal adjustment and had arrived at results--which he had reviewed rather carefully--that provided some insight into the importance of seasonal adjustment and its implication for the Committee's decisions on policy. He planned to discuss the matter more fully in connection with the Committee's deliberations on the policy directive.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period December 16, 1975, through January 19, 1976, were approved, ratified, and confirmed.

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. Zeisel made the following statement:

Over this past month incoming evidence has indicated resumption of a faster pace of economic expansion, following a brief slowdown in the late autumn. In December industrial production, employment, and retail trade were all up strongly, and the economy seems to have sustained this momentum going into the new year.

Industrial production rose by 1 per cent last month, and the November index was revised up to show an increase of one-half per cent. Gains were widespread in December, with much of the acceleration in durable goods production, where the recovery has lagged. Output of consumer goods rose strongly, and so did production of business equipment. In this latter sector, however, the level of output remains only modestly above its early-summer low.

The rise in production in December was accompanied by a renewed growth in employment, but since the labor force increased strongly, the unemployment rate remained unchanged at 8.3 per cent. Nonfarm payroll jobs rose by nearly a quarter million, almost as much as the average increase during the initial cyclical rebound. In manufacturing, the length of the workweek jumped by four-tenths of an hour--although this rise in hours may be overstated somewhat as a result of seasonal adjustment problems.

A most heartening bit of news was the strength of Christmas sales. Increased consumer spending in December was particularly evident for autos, furniture and appliances, and general merchandise--the more discretionary goods. Fragmentary evidence suggests, moreover, that total retail sales are continuing strong into early January. There had been some concern earlier about the trend of consumer buying, as retail sales in constant dollars leveled out for a time after a strong rise last spring. This period of sluggishness in consumer markets probably reinforced the disposition of retailers to continue very cautious inventory policies. Excluding autos, inventory/sales ratios at retail are unusually low. Thus, the strong sales rise in December should be reflected in a further gain of industrial output in the months ahead and, even more important, may encourage some change in attitudes on the desired level of trade stocks.

Activity in the housing industry also continues to look better. Starts edged off slightly in December, but the level in the fourth quarter is still nearly one-tenth above the third-quarter average. Sales of new houses have resumed an upward course in recent months, and with flows of savings to thrift institutions continuing to be very ample and mortgage interest rates edging down, the outlook for housing in 1976 seems a good bit brighter now than it did several months ago.

The strength of the recovery later this year, however, will depend fundamentally on the rate of recovery in business capital spending. The past month has brought some disappointing news in this regard. New orders for nondefense capital goods in November now show a small decline, and in real terms, there has been very little increase in these orders since last spring. In addition, there was a sharp drop-back in November in contracts for commercial and industrial building; this series,

too, has shown no tendency yet to move much above its low point of last spring.

The most recent Commerce Department survey of anticipated business plant and equipment spending for 1976, moreover, indicates a year-to-year increase of only 5-1/2 per cent in nominal terms and a 9-1/2 per cent expected price rise for capital goods--in effect a year-to-year decline in real capital outlays of about 4 per cent. These results are weaker than indicated by either the earlier Commerce survey for the first half of this year or by most private survey results.

Our staff view is that these recent indicators of capital spending all point to the continuance of unusually cautious policies by business firms. But we believe the 5-1/2 per cent figure in the recent Commerce survey will prove to be too low. In a period of expanding activity, businessmen typically understate their planned capital outlays as the length of their forecasting horizon increases. And of course, since the survey was taken in late November and December there have been some encouraging developments--such as the renewed strength in consumer markets, the decline in interest rates, and the upward movement in the stock market--which should improve expectations. Investment spending tends to lag in the recovery, and spending is not at this time significantly out of line with the 1957-58 experience.

On balance, these recent developments have not caused the staff to alter materially its view on the strength of expansionary forces. With the acceleration of activity in December, real growth in the fourth quarter of last year was slightly stronger than we had expected last month--although, of course, it was substantially under the double-digit pace of last summer. Commerce Department figures for the fourth quarter will be available later today; we have estimated a rise in real GNP of about 6 per cent at an annual rate.

For the coming year, we have raised somewhat our projections of personal consumption expenditures, on the basis of the recent improvements in retail markets. Upward revisions were also made in our projections of net

exports--mainly reflecting larger expected sales of military hardware--and in residential construction--in response to the financial factors mentioned earlier. We have, however, cut our projected increase in business fixed investment spending by enough to outweigh these additional elements of strength, so that we are now projecting a slightly weaker over-all rate of expansion during 1976--an annual growth rate of about 4-1/4 per cent for the four quarters, about 0.3 percentage point less than last month. As a result, the unemployment rate is projected to edge off only slightly, to around an 8 per cent rate in the second half.

Our price projections have also been revised slightly, partly to reflect a small reduction in prices of fuel in the first half of 1976 as a consequence of the rollback called for in the Energy Policy and Conservation Act. A small increase in these prices later in the year is anticipated, however, reflecting provisions in the Act which permit gradual decontrol. The dominant new factor affecting our price projection is a further upward adjustment in projected wage rate increases. The rate of rise of compensation per manhour declined in late 1974 and early 1975, but there has been no further improvement such as we had been expecting. Given the continued rise in prices and the heavy schedule of bargaining this year, we are now projecting that the recent annual rate of increase in compensation--in excess of 8 per cent--will persist through 1976. With productivity gains likely to moderate to the 3 per cent range, in line with the slower growth of real output expected, and with no particular shocks anticipated from energy or food prices, we are projecting the over-all fixed-weighted price index to move about in line with unit labor costs--showing about a 5-1/2 per cent rate of rise during the four quarters of 1976, about 1 percentage point less than the price rise last year.

Chairman Burns remarked that before opening the discussion of the economic situation and outlook, he would again

call on Mr. Holmes, who now had some additional information for the Committee.

Mr. Holmes said he had just been advised that the Board of Directors of the Swiss National Bank had agreed in principle to the proposed loss-sharing arrangement, although it had yet taken no formal action. He had also been advised that the Bank of Italy was preparing to draw $250 million on the swap line, for value on Thursday, January 22.

Chairman Burns then called for the discussion of the domestic economic situation, suggesting that the members concentrate their remarks on any differences between their views and those of the staff.

Mr. Black commented that he continued to believe that the staff analysis underestimated the strength of the recovery. So far, the recovery had been similar to earlier postwar upswings. The staff projection for the period ahead, however, suggested weaker expansion than in the earlier upswings. In his view, there had been a marked and highly significant improvement in consumer and business confidence over the past month. The red book[1] and other sources of information on regional developments suggested that some involuntary liquidation of

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

inventories in the trade sector might have occurred toward the end of 1975, which might well lead to inventory investment early this year at a higher rate than that projected by the staff. In addition, the Bicentennial year was creating a completely new industry and new outlets for spending. Finally, 1976 was a Presidential election year, and it was not certain that the general population would assume that fiscal policy would be more prudent than it traditionally had been in election years.

In response, Mr. Gramley observed that at present he personally believed that expansion in activity in 1976 was more likely to exceed than to fall short of the rate projected by the staff. He too thought that over the past month the state of confidence had improved, and he felt reasonably sure that when the staff took account of recent sales and inventory developments in preparing its projections for the February meeting, it would raise the rate of growth for the first quarter. However, the cautious attitudes of businessmen in planning expenditures for fixed capital were still a source of concern. Revival of expenditures in that sector was essential if over-all activity were to grow in 1976 at a faster rate than that projected by the staff. In making its projection for today's meeting, the

staff had been faced with a set of bearish indicators of activity in that sector. Its projection of the 1975 to 1976 increase in business fixed investment--which was somewhat larger than the 5-1/2 per cent rise based on the Department of Commerce survey--was stronger than could be justified by the behavior of the indicators.

Mr. Black then noted that the president of a large construction company had said many building plans had been completed and could be activated quickly in the event that businessmen revised their spending plans upward, and he asked whether the staff saw any evidence of such an accumulation of plans on the shelf.

Mr. Gramley replied that the staff also had heard reports of an accumulation of building plans ready for activation and that such an accumulation was consistent with the widespread cancellation of industrial construction projects during 1974. As yet there were no signs that the plans were being taken off the shelf and activated. When that occurred, it would presumably be reflected in new orders for equipment and in other indicators of business capital expenditures.

Mr. MacLaury noted that, as shown in the green book,[1/] the staff projection of growth in real GNP over the period

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

from the fourth quarter of 1975 to the fourth quarter of 1976 had been reduced to 4.3 per cent from 4.7 per cent at the time of the December meeting--a reduction that was not consistent with his sense of the developing situation. While the staff had raised projected growth in consumption expenditures, it had substantially lowered projected expansion in business fixed investment. Even though the latter expansion exceeded that implied by the Commerce Department survey, the resurgence of confidence led him to think that the staff projection understated the rise that would occur. From the vantage point of the Minneapolis District, he had for some months viewed the outlook as stronger than indicated by the staff projection, and he felt now that his view was being confirmed.

Chairman Burns remarked that he agreed with the staff analysis and also with the views expressed by Messrs. Black and MacLaury. In explanation of that seeming inconsistency, he would say that it was good for the staff to follow the evidence very closely and not to place too much reliance on judgment. An element of judgment did and should enter into projections, but the staff had a laudable tendency not to give too much weight to the judgmental factor. Viewing the data that had recently become available regarding anticipations of business capital investment, new orders for capital equipment,

and contract awards, the staff had made a reasonable projection of business fixed investment. At the same time, his own judgment on the outlook for that sector of the economy was much the same as that expressed by Messrs. Black and MacLaury.

The Chairman added that recently he had had conversations concerning the Commerce Department survey of business capital expenditures with several individuals connected with a reputable economic counseling agency. From talks with people who had responded to the Commerce survey, they had concluded that responses to the latest survey had not been prepared so carefully as responses to the survey of 6 weeks earlier. In their view, businessmen had been too busy to consider the question carefully and to update their reports.

Mr. Kimbrel observed that the calendar of labor contracts up for renegotiation this year was large, so that interruptions to production for some significant periods of time were at least possible and could harm the recovery process. He asked whether the staff had taken account of that possibility in making its projections.

Mr. Zeisel replied that because of the substantial rise in prices that had occurred since contracts were last signed in the industries coming up for negotiations this year, the atmosphere was conducive to strikes. However, the staff did not feel

that strikes would be so severe as to affect economic activity significantly.

In response to questions, Mr. Zeisel observed that the greatest impact on wages was likely to come from developments in the trucking industry, where the contract expired in March. Since the current contract had taken effect, wage rates had fallen about 75 cents per hour below the level they would have reached had they kept pace with the rise in the consumer price index. In addition to their impact on the 400,000 workers covered, the terms of the new contract would have widespread effects throughout the economy. Wages had fallen badly behind in the rubber industry as well, and it was expected that the union would make a strong effort to win a substantial increase and a cost-of-living clause. In the electrical industry, where the contracts expired in June and July, the advance in wage rates had fallen behind the rise in prices by about 35 cents per hour. The automobile industry also would negotiate a new contract this year, but it was not likely to encounter severe problems. The present contract contained an effective cost-of-living clause, and the advance in wages had about kept up with the rise in the cost of living. The settlement was likely to be a traditional one for the industry, containing an over-all increase of about 3 per cent in addition to the cost-of-living adjustments.

Mr. Gramley remarked that the indicators suggested that the recovery was sufficiently strong to withstand a major labor dispute this year. Should there be an extended dispute in the trucking industry, for example, it probably would change the pattern of developments through the year without materially altering the over-all strength of the recovery.

Mr. Partee, referring to the earlier comments on the outlook for business fixed investment, said he believed that the current indicators of such investment were not indicative of what would develop. The recovery in economic activity had passed through a lull last autumn and early winter, and the current indicators of business investment might be reflecting that lull; the indicators, in effect, were lagging behind the improvement in final sales and the improvement in confidence that had occurred over the past month. He would guess that the 10 to 12 per cent rise in the stock market since the first of the year had added $100 billion to equity values. In the past such a rise had been regarded as a very good bull market. Altogether, he was inclined to the view that the rise in real GNP this year would be larger than that projected by the staff. It would not be a great deal larger, however, because some economic problems--such as those of State and local governments--persisted.

Chairman Burns remarked that recent forecasts of revenues of State and local governments looked much better than earlier ones and that over-all finances of those governments had improved greatly. He asked Mr. Gramley to comment.

Mr. Gramley observed that the position of State and local governments had been improving since the first quarter of 1975, when their over-all deficit had reached a high. In the fourth quarter of last year, on the basis of the newly revised GNP figures, those governments had a surplus at an annual rate of $13.6 billion. In its Annual Report, the Council of Economic Advisers projected substantial further improvement during 1976, on the basis that State and local governments would continue to follow cautious expenditure policies at the same time that their revenues would be raised by continued recovery in economic activity.

Mr. Partee remarked that his main point was that the State and local governments would remain cautious in planning expenditures. New York State continued to face serious problems; he hoped that Mr. Volcker would comment on that situation. The commercial and multi-family sectors of the construction industry still had problems that would limit the recovery in building. On the other hand, as he had indicated, he believed that business fixed investment would be stronger than suggested by the latest survey of the Commerce Department.

Chairman Burns remarked that the view had become widespread among businessmen, bankers, economists, and others that the world had entered a new era--that economists had learned how to fine-tune the economy and that the business cycle was dead. Given the belief that we would have mild recessions, at worst, the depth of this recession must have come as a shock. The effects of that shock had been underestimated, but now there were signs that confidence was being restored to a significant degree.

The Chairman then asked Mr. Volcker if he would comment on the financial situation of New York State.

Mr. Volcker said New York State and its agencies still had great financial difficulties. Earlier this month a financing by a small agency had been handled fairly well, with the help of some banks that rolled over their holdings. From here on, however, financings would become larger and would be more difficult to manage. Under consideration was an effort to put together a comprehensive program to deal with agency financing needs--which totaled more than $2 billion. The program would rely on public funds for about two-thirds or three-fourths of the required amount. However, there were grave doubts that even the remainder would be forthcoming from private sources.

At about the time of the agency financing during the spring, Mr. Volcker continued, the State would need to borrow $4 billion. It was thought that the State's financing could not be accomplished in the market, and some kind of nationwide syndicate of banks was being considered. More detailed discussion to determine the plan's feasibility would be premature, however, because the budget program had not yet been presented. Altogether, the very large financing problem ahead for both the State and its agencies was unresolved.

Mr. Eastburn remarked that he would comment first on the state of confidence. Because it had often been said that consumer spending would be the key to developments in 1976, he had talked with a number of retailers in his District during the past week. One retailer had pointed out that the current behavior of consumers, which was preventing the recovery from being aborted, could be viewed--using an old analogy--as a half-full glass; on the other hand, projections of a rate of unemployment as high as 8 per cent at the end of this year could be viewed as the half-empty glass. Retailers were being encouraged by strong Christmas sales and by continuation of strength into January, with sales considerably above year-earlier levels. Moreover, there was a feeling that psychology had changed--that consumers had abandoned the excessive caution

that had been evident earlier; they were spending not only for quality goods but also for such frivolous items as "pet rocks," which had been a popular item this Christmas season.

Continuing, Mr. Eastburn observed that when pressed further, retailers seemed more realistic in their optimism; they anticipated a slow, unexciting uptrend over the next 6 to 9 months. Consequently, their inventory policies remained relatively cautious. One expressed the view that inventories would be kept in line even if that resulted in some loss of sales. Such a prospect, along with other aspects of the outlook, was consistent with an 8 per cent unemployment rate at the end of the year and led him to emphasize the empty rather than the full half of the glass.

With respect to the position of State and local governments, Mr. Eastburn said the Mayor and the Finance Director of Philadelphia were now indicating that the city faced a deficit of $80 million in the fiscal year ending July 1. Apparently, that prospect had not been evident to the public earlier because projected revenues had been based on unrealistic assumptions. As a result, substantial emergency increases in property and other taxes now were required. And reflecting the school budget, the over-all budget probably would still be in deficit in the next fiscal year. In his view, the situation in

Philadelphia was illustrative of the problems facing many local governments outside of New York.

Chairman Burns commented that for some time the bond market had been sensitive to the financial problems of Philadelphia.

Mr. Morris remarked that even from the vantage point of Boston the staff projection of 4.3 per cent growth in real GNP from the fourth quarter of 1975 to the fourth quarter of 1976 appeared conservative. He had been thinking in terms of growth in a range of 5 to 5-1/2 per cent. During the past few weeks, evidence of a basic change in the psychology of consumers and investors had been impressive, and the outlook was stronger now than it had been 5 weeks ago. He was surprised that the staff had revised downward its projection of growth in real GNP.

Chairman Burns asked Mr. Morris if he would comment on the unemployment situation in New England.

Mr. Morris remarked that actual unemployment rates in New England, although above the national average, were not so high as the reported figures, which were based on a faulty formula. In Massachusetts, for example, the reported rate was 13 to 14 per cent, but he believed that the actual rate was 10 or 11 per cent. In the BLS formula for calculating State unemployment rates, a number of adjustments were made

to the figures for insured unemployment. Consequently, the more generous a State's unemployment compensation program and the more people collecting benefits, the higher that State's unemployment rate. New Hampshire, for example, followed a tighter policy with respect to unemployment benefits, and the State's reported unemployment rate typically was below the national average. In January Massachusetts tightened up the eligibility requirements for unemployment compensation by making ineligible anyone who had voluntarily left a job, with the results that insured unemployment would be reduced and the reported unemployment rate would decline dramatically. Actually, the Governor had been urged to publish figures based on an alternative formula, because the figures that had been published gave a faulty image of the State.

Chairman Burns remarked that the problem had political implications, because certain special benefits--such as extended unemployment compensation--were related to a State's unemployment rate.

Mr. Zeisel commented that recently the Labor Department had changed the formula for estimating State unemployment rates and had provoked considerable controversy. In fact, the State of New Jersey had sued the Department in an effort to block the change, because it would result in a reduction in Federal grants to the State.

In response to questions, Mr. Morris observed that in the 1960's the unemployment rate in Massachusetts had been close to the national average. In the recession of 1969-70, however, the State's economy had been hit hard by cutbacks in military research and development and by curtailments in the electronics industry, from which it had not fully recovered by the onset of the more recent recession. Even before that recession, therefore, the State's unemployment rate had been higher than the national average.

Mr. Morris then reported that Massachusetts faced a potential problem in turning over its short-term debt, even though it had a balanced budget. The scale of the problem was small, involving $300 million in the March-April period and $200 million in June. Over the past few months, the State had been buying its own obligations by mobilizing and drawing down cash balances; because of inefficient financial management, various agencies had had scattered bank balances. But the State could not obtain another $500 million in that way, and at present there was no public market for its obligations. The State's problems in raising funds in the spring could well be compounded if, as seemed likely, New York State faced a severe problem at the same time. In

his opinion, Massachusetts had no hope of selling securities in the public market until New York's problem was resolved. A plan to sell $500 million of securities to the mutual savings banks was under consideration.

Mr. Mayo remarked that unemployment rates in New York, California, Illinois, and Michigan--as well as those in New England States--exceeded the national average, and staff investigation of the causes would be worthwhile.

Mr. Winn observed that industrialists in his District had a strong preference for paying overtime rather than increasing employment.

Chairman Burns commented that the preference Mr. Winn had noted was a general phenomenon. When sales first began to improve, producers tended to react cautiously because the improvement could prove transitory. As the improvement continued, however, their confidence grew. In time, a boundary line was crossed, and employment had to be increased. That was one of the hopeful factors in the present situation.

Mr. Winn said industrialists preferred not to increase employment because of the possibility that subsequent layoffs would have an adverse effect on their tax rating for purposes of the unemployment insurance fund. Moreover, the cost of fringe benefits had become quite high. However, he agreed

that the process of increasing hours without increasing employment could not go on for long.

With respect to the situation of local governments, Mr. Winn remarked that labor in the public sector was more militant than he had ever seen it before. He believed that more public employees were on strike at present in the Fourth District than in any other, and upward pressures on the cost of public services were strong.

Mr. Winn observed that he was concerned about a number of other elements in the situation. First, the current indicators of business fixed investment, as compared with the past, overstated capacity-raising expenditures because of the importance now of outlays for environmental purposes. In his District, the major part of the rise in investment expenditures so far appeared to be of the latter sort. Second, General Motors was planning large investment expenditures and a major model change-over for next autumn. Other auto manufacturers were not doing so, however, and he wondered about the implications for the industry's future. Third, speculation in options might cause problems among dealers in options; a speculative blow-off would be unfortunate. Finally, he was concerned that events abroad--involving, in particular, Syria and Angola--might develop in a way that would have a significant impact on the course of the

U.S. economy this year, but such possibilities were not taken into account in the projections.

Mr. Jackson noted that near the end of December, he and Mr. Partee had met with leaders of the real estate investment trust industry, and he thought that it would be useful to summarize the latters' views. Last autumn people in the industry had thought that their situation was improving, but now they were less optimistic. Legal and accounting problems had arisen in connection with swaps of assets with commercial banks, and prospects for more of them had deteriorated. Although such swaps had attracted considerable attention, they had amounted to only about $450 million--of which $160 million had been accounted for by a single transaction.

Continuing, Mr. Jackson observed that some of the industry's assets had begun to be self-sustaining. Shopping centers were probably the strongest investments, despite the adverse impact of the bankruptcy of the W.T. Grant Company. In garden-type apartments, occupancy rates had stabilized. However, net rents had continued to decline because of the sustained surge in costs of operation, and the representatives felt that nothing should be done to encourage the building of more apartment units. The condominium situation seemed to be mixed; some units had been converted into rental apartments and were encountering a better

market. Altogether, he would characterize as modest, if not poor, the industry members' view of prospects for construction of commercial buildings and of multi-family residential units.

Mr. Jackson reported that the industry people were not optimistic about vacant land ventures, which he believed accounted for about 20 per cent of the loans that were on a non-accrual basis. More defaults were expected, and at present there was no market for the land. In addition, the representatives remained apprehensive that some major REIT's would go into bankruptcy, bringing on a new crisis.

Mr. Partee said he would add only that the industry people felt there was a glut of office buildings. Houston and Kansas City were the only centers mentioned that might not have a surplus.

Mr. Clay remarked that several office buildings were under construction in Kansas City, including a large one downtown and a large one just north of the city.

Mr. Winn asked whether it was true that the moratorium on delinquent loans had ended and that foreclosures were forcing many builders into bankruptcy.

Mr. Jackson replied that he did not have any recent reports. The situation had improved somewhat in September and October, but the lull in the economic recovery in the autumn might have brought on some additional failures.

In response to a question by Chairman Burns, Mr. Gramley reported that the rate of failures in the construction industry had been quite high through the first 6 or 7 months of last year but had declined appreciably since then.

Mr. Mayo observed that he supported the staff analysis of the economic outlook, although he agreed that one might have reservations about the validity of the latest Commerce Department survey of business capital spending. In his view, the optimism expressed by some participants in today's meeting was not inconsistent with the outlook suggested by the staff projections of the past couple of months.

Continuing, Mr. Mayo commented that State and local governments would contribute less to recovery this time than they typically had before. Apart from the effects of the financial problems of some units, voters had been reluctant to approve new projects, and retrenchment programs were being implemented in some areas and contemplated in others. The housing industry also was not making its customary contribution to the recovery. With respect to the REIT's, the overhang of uncompleted projects was serious, and in the Chicago District one also heard the warning that construction of more apartments should not be encouraged. With respect to fixed investment, businessmen in his District appeared to remain very cautious, despite the

strength in retail sales and other bullish elements in the situation. Altogether, he thought there was more than an even chance that the staff projection would prove to be an overestimate rather than an underestimate of the course of economic activity this year.

Mr. Wallich observed that the slack in the expansion of business fixed investment had two possible explanations. One was that the high level of excess capacity at present did not justify a higher rate of investment; in effect, the existing capital stock was consistent with the desired capital stock. Alternatively, fixed investment was being limited by business efforts to improve liquidity. Should the latter be the case, business investment at some point in the future might be higher for a time than under the first premise, as businesses tried to get back on track with respect to the level of the capital stock. Which of the alternative explanations one thought was correct depended upon one's estimate of the desired capital stock. He asked whether the staff had a view concerning the question.

In response, Mr. Gramley said it was very difficult to determine the factors affecting business fixed investment at any particular time. He would note that the staff's judgmental projection for such investment did not differ a great deal from the econometric model's projection. In the model, a heavy weight was

given to the relationship between estimates of the desired and the actual capital stock. The model also gave substantial weight to real interest rates, but uncertainties about the actual level of real interest rates were great enough to limit one's confidence in that source of influence on the model's projection of business fixed investment.

Mr. Gramley added that in his opinion businessmen's attitudes toward fixed investment at present were influenced by a deep concern about the state of profits. That concern was evident also in the cautious inventory policies being followed and in the preference for lengthening the workweek rather than adding to employment. He believed--as had been suggested by Mr. Partee earlier--that the recent upturn in retail sales might provide the business community with convincing evidence that a really good recovery was under way and thereby lead to a marked improvement in business capital investment in the near future.

Chairman Burns commented that the Board's index of capacity utilization for major materials provided impressive evidence of a good recovery in activity. The rate of utilization had risen from 70 per cent in the first quarter of 1975 to just over 80 per cent in the fourth quarter, and only a small further rise could bring on shortages of particular materials.

Mr. Gramley remarked that there was considerable dispersion in the capacity utilization rates by industry. Production of nondurable materials had recovered rapidly, and utilization rates for broadwoven fabrics had almost returned to the quarterly peaks reached in the 1972-74 period. However, considerable slack existed in a number of industries--particularly metals.

Mr. Wallich then asked how the staff projection of real GNP compared with the many published forecasts.

In reply, Mr. Gramley noted that the average forecast suggested growth of 5 to 5-1/2 per cent over the four quarters of 1976 and an increase of about 6 per cent from 1975 to 1976; the staff projections of the past 4 or 5 months had been at the low end of the range of the forecasts. As he had suggested earlier, the staff projection might well be raised by the time of the next meeting of the Committee, in light of the latest developments in sales and inventories. Nevertheless, he would stress that forecasters should not give a great deal of weight to the statistics for a single month. The figures for the latest month looked fairly good, but he would remind the Committee that only a month ago the statistical evidence had suggested that the recovery in activity had slowed.

Mr. Volcker remarked that, like Mr. Gramley, he would not be quick to change his view of the outlook, but he also agreed with those who felt that the atmosphere had improved over the past month or two. So far, the recovery had been confined largely to consumption expenditures, and that sector--along with inventory investment--could continue to stimulate over-all activity for a while. He was concerned, however, about other sectors of the economy.

With reference to earlier comments on the condition of the REIT's and prospects for the construction industry, Mr. Volcker observed that a tremendous volume of construction activity in New York was directly or indirectly sponsored by the State, and he was sure that was true in other States as well, if on a smaller scale. In New York no new State-sponsored projects were being started, and while a lot of activity remained in the pipeline, nothing would be left by the end of the year. That had great significance for the construction industry.

Mr. Volcker said he was concerned about the behavior of business fixed investment. The lag in recovery in that sector was real, and he did not expect the situation to change quickly. Like Mr. Mayo, he believed that businessmen remained very cautious; they were concerned about the state of profits in relation to the high cost of new capital equipment. And as Mr. Winn had suggested,

a significant part of capital expenditures was to meet environmental requirements rather than to modernize or to increase capacity. Consequently, there was some danger that a fairly good recovery--an even better one, perhaps, than projected by the staff--would continue to be based largely on consumption expenditures, provoking shortages of certain types of capacity before expansion in business fixed investment had gained much momentum. Such developments would aggravate the problem of inflation and would tend to shorten the recovery.

While he did not now see an early end to the recovery, Mr. Volcker said the sort of developments he had outlined posed a policy problem. The question, to which he did not have an answer at present, was whether monetary policy--or more appropriately, perhaps, tax policy--could stimulate a more vigorous expansion in investment outlays. If that could be done, he would feel more optimistic about the longer-term prospects for the recovery in activity and for reduction in the rate of inflation.

Mr. Balles commented that at the January meeting of the directors of his Bank, the only major disagreement that the business directors had had with the Bank's research staff had been over the latter's forecast for the rate of increase in prices this year--which was close to that in the projection of the

Board's staff. The views of the business directors seemed to be based mainly on strong expressions of intent by company after company to take the earliest possible opportunity to raise prices in order to restore profit margins that had been reduced during the recession. Their minimum expectations for price increases in particular industries were on the order of 7, 8, and 9 per cent, compared with the staff's projected over-all rate of about 5-1/2 per cent during 1976. Against that background, he asked Mr. Gramley whether the staff's current projection--if it was in fact underestimating growth in real GNP--was likely to be underestimating the rate of inflation as well.

Mr. Gramley replied that, in his view, it was more likely that the staff projection underestimated than overestimated the rate of price increase in 1976. However, the rate of increase in prices in the short-run--as in the past--would not be affected very much if real GNP expanded at a faster rate than projected. The principal effect on prices would occur after 1976. In those circumstances, increases in wage rates could be somewhat larger, but productivity gains also would be greater. Barring unforeseen developments--having to do, for example, with the cost of energy--he felt that a rise in the general price level in a range of 5-1/2 to 7 per cent was a reasonable expectation.

Chairman Burns observed that over time the staff projection of the rate of increase in prices in 1976 had undergone considerable change. Earlier, the projection had been for a significant reduction in the rate during the course of the year. According to the latest projection, however, the rate throughout the year--at about 5-1/2 per cent--would remain close to that in the fourth quarter of last year. And Mr. Gramley's expectation was for a still higher rate--one between 5-1/2 and 7 per cent. Personally, he had felt all along that the staff had been underestimating the pace of inflation; he would guess that it would be between 6-1/2 and 8 per cent.

The Chairman added that the Department of Commerce GNP figures, on the revised basis, indicated that inflation was at an annual rate of just over 7 per cent in the third quarter of last year, and no figure was yet available for the fourth quarter. In his judgment, the current rate was in a 7 to 7-1/2 per cent range, and although he hoped events would prove him wrong, he did not expect significant improvement this year.

Mr. Baughman noted that by historical standards the projected rise in unit labor costs was large, given the amount of unemployment. He asked whether the staff felt that the actual increase was more likely to exceed than to fall short of the projected increase and whether the rise was likely to have an

adverse effect on businessmen's decisions concerning fixed investment and exert a drag on the recovery during the course of this year.

In response, Mr. Gramley observed that in developing its projection the staff had struggled more with compensation per manhour, and its implications for unit labor costs, than with any other element. In the projection, hourly compensation in the nonfarm economy rose about 8-1/2 per cent from the fourth quarter of 1975 to the fourth quarter of 1976; and productivity advanced about 3 per cent, resulting in a rise in unit labor costs of about 5-1/2 per cent. The argument could be made--and, in fact, had been made by the Board's labor economists--that the reduction in the rate of increase in consumer prices in 1975 would have an important impact this year on the course of wage rates in many activities, even if it had little effect on the major settlements, and that the staff projection for compensation per manhour was too high. However, he had been reluctant to reduce the projected rate of increase in the face of evidence that the rise in wage rates had not slowed over recent months.

With respect to Mr. Baughman's second question, Mr. Gramley commented that businessmen appeared to anticipate faster rates of increase in wages and unit labor costs--and also in prices--than those projected by the staff, and they were not likely to find it

discouraging if events more or less conformed to the staff projections. Moreover, the outlook for profits was quite favorable. In the staff projection, corporate profits rose 21 per cent from the fourth quarter of 1975 to the fourth quarter of 1976, even though profit margins changed little.

Mr. Baughman then observed, first, that the geophysical work preparatory to exploration for oil and gas in his District was reported to be at a low level, and presumably, some change in expectations would be required to raise it. Second, activity of architectural firms also seemed to be down. Third, prospective employees for both farm and household work reportedly pressed vigorously to be paid in cash and without deductions for social security and income taxes.

In response to questions by the Chairman, Mr. Baughman added that it was difficult to judge whether the recently enacted Energy Policy and Conservation Act was having a discouraging effect on exploration for oil and gas, but he thought that it probably was. Most comments on the Act had a critical tone, and while it was said that no drilling rigs were idle, it was also said that use of a rig could be obtained at a considerably lower price than earlier. In explanation of the attitude attributed to prospective household workers, he suspected that they generally had another wage-earner in the family, who was

covered under social security and they were attempting to evade taxes. In the case of farm workers, he would guess that the attitude reflected a preference for income now rather than later.

Finally, Mr. Baughman remarked that during the past week he had encountered a banker who had said if money market interest rates fell any lower, he would have to begin to seek new loans.

Mr. Mayo observed that the Committee was about to begin a discussion of its longer-run targets for growth in the monetary aggregates during 1976, and although the first month of the year was almost over, no staff projections of economic activity beyond the fourth quarter were available. Despite all the qualifications concerning projections for so far into the future, he would find it useful to have some staff impression concerning, at least, the first half of 1977.

Mr. Gramley remarked that the staff had not carried its projections into 1977 for two reasons. First, data just now becoming available for the fiscal 1977 Federal budget suggested that fiscal stimulus would be substantially less than the staff had been assuming would be the case. Having anticipated that possibility, the staff had wanted to have an opportunity to appraise the budget more fully before developing projections for the first half of 1977. Second, business and consumer confidence

appeared to have been undergoing a change over recent weeks, and he wanted to see another month's data before attempting to judge the implications that the confidence factor might have for 1977. The staff planned to present projections for the first half of 1977 in the next green book.

The Chairman said the Committee now needed to consider and extend its longer-run targets for the monetary aggregates. He was scheduled to testify on this subject at a hearing on February 3 before the House Committee on Banking, Currency, and Housing. In keeping with the usual practice, he planned to announce at that hearing the growth ranges for the monetary aggregates that the Committee anticipated over the updated period from the fourth quarter of 1975 to the fourth quarter of 1976. Before turning to the discussion of those targets, he would ask Mr. Gramley to report on some staff studies that had a bearing on the general question before the Committee.

Mr. Gramley made the following statement.

> I will be referring in my remarks to some charts and a table that are entitled "Policy Alternatives."[1/] Our staff projection of real GNP growth in 1976 has not changed a great deal over the past several months, but the risks associated with it have, in my judgment, changed significantly. In particular, I am less worried now than I was last fall that financial constraints

1/ Copies of these materials are appended to this memorandum as Attachment A.

will interfere seriously with the course of recovery during 1976. Something of fundamental importance has been happening, I believe, to reduce the amount of money needed to finance economic expansion. Obviously, this is a critical issue for the Committee's consideration in setting its longer-range monetary targets.

The first chart shows the income velocity of M_1 in this and past cycles. M_1 velocity usually is relatively flat, or declines somewhat, during a recession--and its behavior during the recent recession differed only a little from historical experience. In the past two quarters, however, income velocity of M_1 has risen twice as fast as the average for the previous 4 recoveries--actually, as fast as in the 1949-50 upswing, when the economy was awash with liquidity.

This behavior of velocity is all the more puzzling when account is taken of short-term interest rates, which usually rise rather sharply in the early stages of a business expansion. We are presently in the ninth month of recovery in industrial output, and yields on most short-term market instruments are below their cyclical lows of last June.

This behavior of interest rates in a strongly expanding economy argues convincingly that the recent weakness of money growth does not result from a restriction of supply relative to demand. Instead, it appears to reflect a failure of the demand for M_1--given income and interest rates--to grow along the path indicated by historical relationships.

The quarterly econometric model used by the Board's staff has in it a money demand equation that can be used to estimate how much the growth of money demand has fallen behind expectations. In the past the model's money-demand function has been reasonably reliable--in the sense that errors of prediction did not tend to cumulate. Since the third quarter of 1974, however, the model's predictions have gotten progressively worse, as is indicated in chart II.

All of the shortfall has been in the demand deposit component of M_1. By the fourth quarter of

1975, the error had grown to $18.7 billion--about 6-1/4 per cent of the actual stock of money. Translated to growth rate terms, this means that if past relationships had held, growth of M_1 at an annual rate of around 8-1/2 per cent would have been required since mid-1974 to finance the expansion of GNP that has occurred--while still keeping interest rates where they are. The actual growth rate of M_1 over those 6 quarters was only 4-1/4 per cent.

If money is defined more broadly, the discrepancy between recent and past experience diminishes, but it does not vanish. For example, the income velocity of M_2, which is shown in chart III, has also risen quite rapidly relative to past experience. This is true for M_3 velocity as well. I should note, in this connection, that growth rates of the time and savings deposit components of M_2 and M_3 do not seem materially out of line with recent cyclical experience.

As you are well aware, there are numerous financial innovations under way that may have contributed to increased efficiency of money use. The shift of funds to corporate savings accounts since mid-November has been a significant factor recently. As for the trend since mid-1974, the Board staff has been seeking intensively--but so far with only limited success--to find the explanation for the weakness of money demand. We believe the shock effect of record-high interest rates in 1974 may have awakened many individuals and small businesses to the benefits of economizing on cash. And a number of other developments--such as the growth of NOW accounts, increased use of telephonic transfers of funds from savings accounts to demand balances, the spread of overdraft privileges in the banking system, and the increase of third-party payments from savings accounts--have probably each played a small but significant role. Yet, all of these developments taken together do not seem to explain adequately the ability of the economy to get along with the recent modest increases in money balances.

The staff is therefore in a quandary. Since we are not sure why demand for money has been so weak, we cannot be sure when the period of weakness will end. In our current GNP projection, as in earlier

ones, we have assumed that there will soon be a reversion to historical relationships between growth rates of nominal GNP and growth rates of M_1, taking interest rates into account. But we also assume that the level of money demand has been permanently lowered, relative to the level of GNP, by the increased efficiencies of money use adopted to date.

These are the assumptions that underlie the figures in the table showing the effects of alternative monetary policies on key economic and financial variables. If the long-run course of policy provides for a 6-1/4 per cent rate of increase in M_1, as the green book projection assumes, we would expect pressures to begin developing in financial markets later this quarter and to continue throughout 1976. With Treasury bill rates under this alternative projected to rise to a little above 7 per cent by year-end, savings flows to thrift institutions would taper off as the year progressed. But the effects of financial restraint on housing and on other sectors would be relatively modest--much less than we expected 6 months ago, when we first extended our projection through all of 1976.

Given this base projection, raising or lowering the target growth rate of M_1 by 1 percentage point would, we believe, have the effects on key economic and financial variables shown in the table. Thus, we estimate that an additional 1 per cent added to M_1 growth would, by the close of 1976, raise the level of real GNP by about a half a percentage point, reduce the unemployment rate by a couple of of tenths, and add a couple of tenths to the rate of inflation--with larger effects on prices later on. We estimate that 1 percentage point less in M_1 growth would, under present circumstances, have effects of roughly equal magnitude, but of opposite sign.

The principal thought I would like to leave with the Committee, however, is that there are much greater uncertainties now than is usually the case about the economic and financial effects likely to be associated with any given growth rate of narrowly defined money. Therefore, a wider range of evidence than just the behavior of M_1 needs to be weighed in

> assessing the degree of monetary stimulus or restraint. Assigning greater importance to broader monetary aggregates will be of some help. However, careful attention will also have to be given, for a while at least, to movements of interest rates and other indicators of financial market conditions to judge the thrust of monetary policy on real economic activity and prices.

The Chairman then called on Mr. Axilrod to comment on the longer-run targets.

Mr. Axilrod observed that in anticipation of today's discussion the staff had followed its usual practice in the blue book[1/] of presenting alternative longer-run growth ranges for the monetary aggregates and moving the 1-year period for the proposed ranges ahead by one quarter. Three alternative sets of ranges were shown in the blue book and, of course, retention of the current ranges would represent a fourth alternative. The alternative B ranges included a range of 5 to 7-1/2 per cent for M_1, the same as that adopted by the Committee at its October meeting for the period ending with the third quarter of 1976. Alternative A contained an M_1 range that was 1 percentage point higher, and alternative C an M_1 range that was 1 percentage point lower, than the alternative B range. As it had in other recent blue books, the staff was projecting somewhat slower rates of growth in time and savings deposits relative to M_1

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

than were implicit in the Committee's current ranges, and that projection was reflected in each of the three alternatives. He would add, however, that the early January experience pointed to very strong growth in time and savings deposits. That experience had not been given full weight in the projections because of its limited duration and its occurrence in a period when short-term interest rates had fallen to new cyclical lows.

Continuing, Mr. Axilrod said that alternative A made up in an arithmetic sense for the shortfall in M_1 growth in the fourth quarter. More specifically, alternative A incorporated a level for M_1 in the third quarter of 1976 that was the same as the level implied in the Committee's current growth target for that quarter. However, that arithmetic relationship did not take into account the economic implications of shifts of funds into savings accounts by business firms nor the implications of other factors that could be changing the demand for money. By way of brief background, he would note that in the 2 months since businesses were first authorized to hold savings accounts, the staff estimated that roughly $1-1/2 billion of the increase in such accounts represented business funds that were substitutable for demand deposits. According to staff projections, such substitutable funds might grow by an additional $1 billion or so over the next 9 months. Thus, over the period from the fourth quarter of 1975 to the third quarter of 1976, the increase would

be on the order of $2-1/2 billion. Taking such deposit shifts into account, alternative B appeared on economic grounds to be more nearly consistent with the Committee's current longer-run growth range for M_1. More specifically, if the shifts in question were deducted from the level implied by the current target range for the third quarter of 1976, the result was a level for M_1 that was virtually the same as the third-quarter level shown under alternative B.

Mr. Axilrod added that the Committee might also wish to consider where the aggregates were currently in relation to the bases adopted by the Committee at various times during 1975. As the members would recall, the growth range for M_1 had remained unchanged at 5 to 7-1/2 per cent, but the base was raised in effect each time the Committee extended the 1-year period for its target range following the selection of March 1975 as the original base. In other words, each new base was set a bit above the one implied by the underlying 6-1/4 per cent midpoint of the growth range extended from the previous base. This in effect allowed some scope for a fourth-quarter shortfall in growth relative to the longer-run range. Thus, growth in M_1 from the March base to the fourth-quarter average, or from the second-quarter average to the fourth-quarter average, was still within the Committee's longer-run range, although it was at the lower end of it. Over the same periods, growth in M-2 was close to the midpoint of its range and growth in M_3 came out at the higher end of its range.

In the context of the shifts of funds by corporations that he had just reviewed, Mr. Axilrod continued, a 6-1/4 per cent growth rate for M_1 from a fourth quarter base would tend to overstate the degree of monetary stimulus in relation to that provided by the same growth rate in earlier periods. The staff estimated that such shifts would require--to achieve a neutral result, so to speak--a reduction on the order of 1/4 to 1/2 percentage point in the 6-1/4 per cent growth rate. Accordingly, an alternative somewhere between B and C would have the same economic meaning as the Committee's current longer-run range for M_1 with its 6-1/4 per cent midpoint.

Chairman Burns observed that the Committee had a choice at this point. It could devote some time to a discussion of technical issues or it could move directly to the policy questions involved in reaching a decision on the longer-run growth ranges.

A majority of the Committee members indicated a preference for proceeding immediately to the policy issues.

The Chairman said he would be governed by the majority's preference, but he would make special provision for a systematic discussion of technical matters at a later meeting. He thought such a discussion should include a review of seasonal adjustment

techniques, which he felt were of great importance for the proper conduct of open market operations. Indeed, he had reached the conclusion that the Committee's short-run instructions to the Manager often caused the Desk to chase shadows. In his judgment those instructions needed to be reformed.

Turning to the policy issues relating to the longer-run growth ranges, the Chairman said he wanted to make a few comments before the Committee began its discussion. As he judged the outlook for economic activity, and indeed as the majority of the members appeared to view that outlook and the prospects for continued inflation, he thought there was little reason for the Committee to raise the growth ranges from their current levels. He therefore wanted to make the case, first, for lowering the ranges, and next, the case against lowering them. He would then put forward a suggestion for Committee consideration.

Several arguments could reasonably be advanced for lowering the growth ranges at the present time, the Chairman said. First, the money-demand function appeared to have shifted downward in relation to GNP; currency and demand deposits were doing more work than in the past. That development definitely

argued for lowering the growth ranges. Second, the current business recovery had been under way since around April 1975, and a reduction in monetary stimulation would be consistent with the moderately advanced age of the economic upturn. Third, one could argue that the adoption of lower growth ranges now would be a timely step toward what had been, and should remain, the Committee's longer-run goal of reattaining a stable general price level.

The Chairman added that those arguments were by no means conclusive, and indeed there were powerful arguments against lowering the growth ranges. First, while there had been a downward shift in the demand function for money over the past 1-1/2 years or so, the staff's studies were inconclusive on the question of whether that trend was likely to continue, and the possibility that it might not continue had to be respected. Second, while most Committee members appeared to believe that the recovery had developed a certain momentum, some members questioned the strength of the recovery. Moreover, their view was shared by many businessmen and economists outside the Committee. Third, the shortfall in the growth of the monetary aggregates during the fourth quarter could not be ignored completely. While it could be argued that the ranges need not

be raised, or should not be raised, to compensate for the shortfall, one could also argue that they should not be lowered, considering that there had been a shortfall.

After taking these various arguments into account, the Chairman continued, he was inclined to the view that it would be desirable for the Committee to reduce the lower limit of its range for M_1 by 1/2 percentage point. That would mean moving from the current range of 5 to 7-1/2 per cent to 4-1/2 to 7-1/2 per cent. A wider range was indicated in his judgment by the increased uncertainty about M_1 that had emerged from the Committee's experience over the past year and especially in recent months. Moreover, a small reduction in the lower limit of the M_1 range was certainly suggested by the evidence--which could no longer be neglected--that the money-demand function had shifted downward. On the other hand, he would be inclined to leave the ranges for M_2 and M_3 unchanged. In part, he had in mind the fact that those aggregates had compensated in a sense for the weakness in M_1; in addition, the Committee had reduced the lower limits of the ranges for M_2 and M_3 by one percentage point at its meeting in October 1975 when it last considered the longer-run ranges.

The Chairman remarked that he would not make any suggestion with respect to the credit proxy beyond recommending that for now it be retained among the aggregates specified by the Committee. The Committee would have an opportunity to decide whether it wanted to continue using the credit proxy when it turned its attention to technical issues at a later meeting. The credit proxy had been a source of some inconvenience and embarrassment, but it would take the Committee a good deal of time to unravel the factors that were involved.

Mr. Coldwell said he came out close to the Chairman in his preferences for the longer-run ranges, but he arrived at his position by a somewhat different route. It seemed to him that the Committee's many problems with M_1--including problems of definition, seasonal adjustment, shifts to time deposits, and inadequacies in the data--argued strongly for downgrading that aggregate in the Committee's forecasts and in its testimony to Congressional committees. In the latter connection, he recognized that the Congress would continue to demand some accounting for M_1. He hoped that the Committee would devote more attention to M_3 while paying less to M_1. For him that meant specification of a wider range for M_1 in order to accommodate the uncertainties concerning the figures. And perhaps increased attention might be given to market

conditions and other factors in the Chairman's testimony before the Senate and House Banking Committees. Therefore, he agreed with the Chairman's proposal for widening the M_1 range to 4-1/2 to 7-1/2 per cent. He differed on the ranges for M_2 and M_3, however; for M_2 his preference would be a range of 7 to 10 per cent and for M_3 a range of 8 to 11 per cent. Those preferences would imply reductions of 1/2 percentage point and 1 percentage point, respectively, from the Committee's current ranges.

Mr. Coldwell added that, while he was a little unsure about the economic outlook, he sensed that the economy would continue to strengthen, and he believed that lower growth ranges were called for in light of that outlook. On the other hand, if the Committee decided to maintain its current ranges, he believed that, in effect, it would be telling the Congress that it was going to adhere to previously set ranges despite changes in economic conditions. He doubted that such a position was a good one for the Committee to take.

Mr. Mitchell indicated that his preference would be to retain the current ranges for the monetary aggregates, but he would not be disturbed by a reduction in the lower limit of the M_1 growth range to 4-1/2 per cent. In his view the

weakness in M_1 was related in part to real structural changes in the financial system, but it was also accounted for in large measure by weakness in business loan demand. As business loans were repaid, compensating balances were reduced. In its GNP projection, the staff was assuming that historical relationships between growth rates of nominal GNP and growth rates of M_1 would be reestablished. He agreed that such a development would occur, and in his judgment, it would be associated with a pick-up in business loan demand. In these circumstances he would not want to lower the growth range for M_1 to any significant extent.

Mr. Mitchell observed that the Committee's current range for M_2 appeared to be realistic, judging by the recent performance of time and savings accounts at banks and nonbank thrift institutions. As for the credit proxy, he hoped the Committee would not discontinue its use, because it was the only aggregate that was really understood and subject to relatively direct control by the Committee. For that aggregate, he thought a growth range of 6 to 9 per cent was about right for the year ahead. The bank credit proxy had been weak because of weakness in business loan demand; when a loan was repaid, the compensating balance disappeared. As he had suggested, however, he expected business loan demand to strengthen considerably, possibly by the end of the first quarter.

The Chairman inquired whether the staff was aware of any change in practices affecting compensating balances.

Mr. Gramley said that the staff was not aware of any major changes. In reference to Mr. Mitchell's hypothesis, the staff had done one study that might have a bearing on the issue. The staff had tried to determine the influence that changes in expenditure components of GNP might have on the rate of growth in the quantity of money. The results suggested that inventory liquidation--which led to declines in bank loans and, therefore, in compensating balances--did have some effect on the rate of growth in the money stock. However, the contribution that inventory liquidation made to an explanation of the recent weakness in the demand for money was minor.

Mr. MacLaury remarked that he could accept the Chairman's suggested ranges for longer-run rates of growth in the aggregates. A technical case could be made for lowering the range for M_1 at this time, and also, it would be desirable to make some change to avoid giving the impression that the Committee would retain the original range forever. His preference was for an M_1 range of 4-1/2 to 7 per cent. He recognized, however, that some unexplained change in the demand for money had occurred, and he could accept the 4-1/2 to 7-1/2 per cent range even though he ordinarily favored either narrow ranges or point targets.

He would not change the ranges for M_2 and M_3. Rates of growth within the existing ranges appeared consistent with some further drop in longer-term interest rates, which he would like to see as an incentive to investment outlays. While his confidence in the strength of the recovery had increased, he believed that there was still a long way to go.

Mr. Balles said the question of whether or not there had been a downward shift in the demand for money was crucial. If such a shift had occurred, the Committee should provide for less monetary growth, but if it had not, the System ran the risk of under-financing the economic recovery. He was as perplexed as the Board's staff in trying to explain the weakness in monetary growth, and his staff had been investigating the hypothesis that the money-demand equation was now misspecified and that the demand for money possibly had not decreased. Underlying this line of reasoning was the fact that banker attitudes toward risk had undergone a major shift and had turned definitely more conservative. To illustrate that point, he had been surprised to hear the head of a major West Coast bank give an extremely gloomy report on the outlook for bank profits in 1976. Indeed, the banker in question thought 1976 would be the worst year

for bank profits since the depression, and he expected a wave of dividend cuts. In fact, one major bank in California would be announcing a dividend reduction later today. What this gloomy outlook added up to was the lagged impact of inflation and the recession on the quality of bank assets and on bank earnings. The banker expected that many more loan losses would be reported this year and that they could be even larger than those reported in 1975.

It remained to be seen, Mr. Balles continued, whether this dire forecast would be realized, but it underscored the proposition that banks, especially the larger ones, were now stressing the quality of assets and earnings; they were much more in the mood to emphasize the rate of return on investments and were paying much less attention to growth or to maintenance of a market share for their own sake. A result of that attitude had been a significant widening in the spread between the prime rate and both the CD and the commercial paper rates since late 1974. With the prime rate so much above the other rates, the demand for business loans at banks had lessened and banks were less interested in selling CD's. Reduced market interest rates, therefore, had not triggered the money-demand response that would have been anticipated on the basis of the present money-demand equation.

Chairman Burns observed that Mr. Balles' alternative hypothesis might provide an explanation of the weakness in bank credit and a partial explanation of the weakness in M_4 and M_5, which were defined to include large-denomination CD's. However, he did not see how it could be an alternative explanation of the weakness in M_1 or even in M_2 or M_3.

Mr. Gramley commented that, unless the money-demand function had been mis-specified over the years, the hypothesis outlined by Mr. Balles would explain the weakness in bank credit but it would not account for that in M_1 in a period of rising income and declining interest rates. He added that the Board's staff had devoted a great deal of effort to investigating whether anything on the supply side might help to explain the behavior of M_1, and the staff could not find any significant evidence to support the supply hypothesis.

Mr. Balles remarked that if the alternative explanation he was advancing was correct--and he recognized that it was as yet unproven--it suggested that the roughly parallel movement in the demand for money and the demand for bank credit had been broken by the recent behavior of banks. It would seem to follow that the demand for money by households and firms had not necessarily shifted downward. If it was true that banker attitudes

toward risk had contributed to the fall in interest rates--as reflected in greater selectivity in bank lending activities and smaller bank sales of CD's--market interest rates might well decline without inducing the enlarged demand for money that would otherwise be expected from the money-demand equation.

Mr. Balles said he had another reason for being cautious about accepting the hypothesis of a decline in the demand for money. His staff had done research on earlier periods when the question had been raised about a possible shift in money demand. It had been argued, for example, that the demand for money had shifted upward in 1966 and 1971. However, his staff was of the opinion--on the basis of subsequent evidence--that no shifts had occurred in those periods. He was, therefore, led to approach this question very cautiously, and his preference was not to form a firm opinion until he saw more evidence. In terms of the Committee's long-term ranges, that preference led him to the conclusion that some consideration should be given to making up for the short-fall in the fourth quarter. One way of accomplishing that objective would be to retain the Committee's current ranges, but to use the third rather than the fourth quarter as the base for the ranges.

Chairman Burns said he had serious reservations about that procedure because of the communications problem that would be created. He believed that if the Committee started to vary its procedures--if it did not stay with moving 1-year periods based on quarterly averages--it would have great difficulty in attaining even a modicum of understanding from members of Congress and from the business and financial communitie He did not mean to imply that the current procedure was ideal, and he was not addressing the intrinsic merits of Mr. Balles' proposal

Mr. Balles commented that in view of the problem of communications, the Committee might be well advised to go one step beyond its present practice and publish not only the ranges of growth rates it decided upon for the monetary aggregates, but also the dollar levels implied by the upper and lower limits of the range. The Federal Reserve had been the object of a good deal of sharp--in his view, unjustified--criticism to the effect that it was playing games by maintaining its growth ranges while shifting the base for those ranges. If the Committee decided to retain the current ranges, he believed such criticism could be defused by indicating clearly any differences in levels that given growth rates might produce by the end of 1976 due to a

shift in the base from the third to the fourth quarter of 1975. And if the Committee decided to reduce its growth ranges because it accepted the hypothesis of a downward shift in the demand for money, the problem of possible public misunderstanding might be attenuated by the explanation that the Committee did not think the economy needed as much monetary growth because of the shift.

Chairman Burns recalled that the Committee had previously rejected a recommendation to publish levels because doing so would tend to complicate communications with Congress and the public. Perhaps the matter needed to be reconsidered. A separate question was the desirability of taking levels into account in the Committee's internal deliberations, and Committee members seemed to be agreed on the usefulness of levels for that purpose.

Mr. Balles observed that if the Committee did not publish the levels associated with its longer-run growth ranges, analysts would be quick to calculate them and make their own interpretations.

The Chairman commented that all sorts of interpretations could be anticipated in any event, and he suspected that the Committee's problems of communications would not be

eased as the year progressed. He thought the Committee had been handling those problems reasonably well, but he respected Mr. Balles' opinion and agreed that a good case could be made for publishing levels. It was a matter the Committee would need to return to at a later meeting.

Mr. Holland said that the Committee now had about as good a set of reasons for changing the longer-run growth ranges as it was likely to encounter. As a matter of personal philosophy he believed it was desirable for the Committee to alter those ranges from time to time. There had been significant changes in economic and financial conditions, and he thought it made sense to let those changes be reflected in the longer-run ranges.

Mr. Holland added that there was a reasonable amount of evidence to support the view that the demand for money had fallen. He understood the staff's quandary in not being able to explain that decline, and its decision to project some snapback. The Committee itself had to be more adventuresome. He agreed with the Chairman's recommendation for reducing the lower end of the M_1 range by 1/2 percentage point. Indeed, his first preference would be to reduce the entire M_1 range by that amount. If later in the year the staff assumption

of a snapback in the demand for money should prove to be correct, the Committee could decide then whether or not to make an adjustment. An upward shift in the demand for money would not necessarily argue, of course, for raising the range at that time since the economy would be further into the business recovery.

Mr. Holland said he would also lower the ranges for M_2, M_3, and the credit proxy by 1/2 or 1 percentage point. With one exception, the reductions would be less than those the staff had proposed for the alternative B ranges, but they would be consistent with his view that the demand for M_1 was likely to continue weaker than the staff anticipated. He also believed that the ranges he had in mind would be consistent with a generous availability of funds during the business recovery.

Chairman Burns then asked Mr. Gramley to summarize information on fourth-quarter GNP developments that had just been received.

Mr. Gramley commented that the newly available figures from the Department of Commerce did not deviate greatly from the estimates in the green book. The new data indicated that real GNP had increased at a 5.4 per cent annual rate in

the fourth quarter; the staff had estimated a 6.2 per cent rate of growth. The rise in the deflator of around 6-1/2 per cent was about the same as the staff had anticipated. The major deviation was in the inventory investment figures, which were considerably lower than Board staff estimates; actually, the Department of Commerce figures were slightly negative. Final sales were stronger, and that strength showed up partly in residential construction, partly in business fixed investment, and partly in net exports. To him, the data suggested that there would be room for inventory investment to provide more thrust in the first quarter than the staff had incorporated in its projection.

The Chairman then called for a resumption of the discussion of the longer-run ranges.

Mr. Wallich commented that at a time of unusual uncertainty with regard to the monetary aggregates one rule of thumb for policy was to make no change. A second rule was to take into account in choosing among operating targets a disturbance that had the effect of unsettling the demand for money; that would lead him to lean more on interest rates than on the monetary aggregates. The implications of those

two rules of thumb, as he reviewed them, was that the Committee should aim at very little change in interest rates for now. That conclusion led him logically to favor a widening of the longer-run ranges for the aggregates, so that operations would not be likely to interfere with a reasonable degree of stability in interest rates. In stating his policy preference, he realized that real interest rates might well have undergone an unobservable change in recent days. Expectations of inflation appeared to have diminished, and although nominal interest rates had declined recently, real rates quite possibly had remained constant or might even have increased somewhat. One could not tell for sure.

Mr. Wallich added that he shared Mr. Balles' concern with regard to the Committee's problems of communications. He too found troublesome the fact that the published ranges, which had not changed for M_1, were related to shifting bases. Fortunately, the rate of growth in M_1 from the March base that had originally been set at the April 1975 meeting was still within the 5 to 7-1/2 per cent range. The same was not true, however, when the growth rate was related to the latest base used by the

Committee--the third quarter of 1975. An attenuating consideration was, of course, that only a relatively brief period had elapsed since the latest base had been established.

Mr. Wallich noted that the ranges were acquiring a certain strategic--or perhaps tactical--property, particularly in light of the prevailing uncertainties about the demand for money. He agreed with Mr. Holland's view that it was desirable to introduce some flexibility in setting those ranges. His own preference would be to change one side of the ranges at a time, thereby introducing a degree of flexibility while permitting the change either to be reversed or to be confirmed by a similar change on the other side of the ranges at a subsequent meeting. In keeping with this approach and with his current preference for widening the ranges, he would reduce the lower limit of the range for M_1 by 1/2 percentage point and the lower limits of the ranges for M_2 and M_3 by 1 percentage point. For M_3, he would argue that the 8 to 12 per cent range was not unreasonable. However, a 12 per cent rate of growth might seem rather high, and he was not wedded to that range for M_3.

The Chairman said he would add two footnotes to Mr. Wallich's comments. First, there had been an undershoot

in the fourth quarter and that undershoot had a bearing on the range to be set for the year ahead, since the latter would have a fourth-quarter base. Nevertheless, the Committee should not lose sight of the fact that there had been overshoots in the two previous quarters. Second, the Committee had never committed itself to staying within the ranges that it specified. On the contrary, the Concurrent Resolution itself recognized that the Committee had considerable freedom to change its views with regard to appropriate rates of growth.

Mr. Black remarked that he agreed with the Chairman's views on the proper range for M_1. He believed that the demand for money had probably shifted downward, as evidenced by the fairly good pickup in economic activity despite a shortfall in M_1. He saw no reason to try to compensate for that shortfall. It was also his view that M_2 and M_3 had assumed relatively more importance. He would lower the ranges for those aggregates in light of the fact that the economic recovery had now been under way for some 9 months and in view of the desirability of moving toward noninflationary growth rates in the aggregates over the longer run. The ranges for M_2 and M_3 associated with alternative B seemed about right to him.

Mr. Leonard indicated that his personal preference would be to change the longer-run growth ranges only infrequently, and he also favored relatively narrow ranges for the aggregates. It seemed to him that such an approach would tend to validate the concept of longer-run targets. However, he could also appreciate the points made by the Chairman, and in any event, he regarded the change in the M_1 range proposed by the Chairman as relatively minor in view of the uncertainties that were associated with that aggregate. Moreover, while he had not done the arithmetic, the proposed 4-1/2 to 7-1/2 per cent range on a new fourth-quarter base might well be encompassed later this year by the current 5 to 7-1/2 per cent range on a third-quarter base; what he had in mind was the megaphone-shaped or expanding range of levels that was traced by extending a given set of growth rates out over time.

Mr. Leonard added that the green book projections assumed a 6-1/4 per cent growth path for M_1. Since the alternative B ranges appeared to be consistent with such a path, they would be his preference.

Mr. Mayo said he supported the Chairman's recommendations for the growth ranges. Broadening the M_1 range would provide an opportunity to call attention publicly to the Committee's uncertainty about a possible

shift in the demand for money. The announcement of the new M_1 range could also furnish the occasion to explain that M_2 and M_3 were now felt to be more relevant aggregates than they used to be. Moreover, it could be argued that the new range for M_1 was not meant to indicate that the Committee had lowered its target, but that it had made a technical adjustment in recognition of the changing relationship between M_1 and the other aggregates. In that connection, he would retain the current ranges for the other aggregates, since to reduce them would destroy the basic argument that no real change had been made in the ranges. Finally, the wider range for M_1 would give the Committee a little more flexibility in meeting the needs of the economy as the recovery unfolded.

Mr. Eastburn commented that his preference would be to retain the current ranges for the monetary aggregates. His view was based on three considerations. First, he felt that the recovery projected by the staff was inadequate, and he was especially concerned about the unemployment rate associated with the staff projection. Second, the fourth-quarter shortfall in monetary growth was also a matter of concern to him. And third, he regarded the evidence of a downward shift in the demand for money as inconclusive.

Mr. Eastburn added that these considerations led him to prefer the current ranges, but he could accept the modified M_1 range proposed by Chairman Burns. The Committee--as the Chairman had emphasized at a number of meetings--was not wedded to particular growth rates, and he agreed that some flexibility in setting those rates was desirable. Nonetheless, he foresaw a major problem of communications for the Committee if it did adopt the Chairman's proposed change. It would be difficult to explain the technical basis for the change, and many observers in Congress and elsewhere were likely to conclude that the Committee had made a restrictive move.

Mr. Mayo observed that the proposed retention of the 7-1/2 per cent upper limit of the M_1 range would tend to mitigate the expected criticism.

The Chairman said he had intended to mention earlier that Mr. Partee was attending his first meeting as a member of the Committee. He was sure he spoke on behalf of all the members in expressing a warm welcome to Mr. Partee and in wishing him well in his new duties. He asked Mr. Partee to comment on the growth ranges.

Mr. Partee said he saw no basis in the economic outlook for reducing the rate of monetary expansion. Indeed, if he

were to accept the staff projection of economic growth over the next four quarters, he would have to urge an increase in the growth ranges. However, as he had already observed, he thought the recovery was likely to be more vigorous, perhaps appreciably so, than the staff anticipated. A rate of economic expansion from the fourth quarter of last year to the fourth quarter of this year in the 5 to 6 per cent range--rather than the 4.3 per cent rate projected by the staff--would not surprise him. In light of the recovery that he foresaw, he would retain the current growth ranges for the monetary aggregates.

Mr. Partee added that he could accept the reduction to 4-1/2 per cent in the lower limit of the M_1 range proposed by the Chairman. In his judgment there was a sound technical reason for such a reduction. In particular, he found quite persuasive the argument relating to a shift of funds by corporations to passbook accounts. The one-time stock adjustment was still occurring and was expected to continue for some time, thereby permitting a lower growth rate for M_1. The move to a fourth-quarter base also made sense, because the shift of corporate funds had had its first effects on M_1 during that quarter and had helped to account for much of the shortfall in M_1 occurring at that time.

Mr. Partee said the technical argument did not extend to M_2 or M_3, and since he expected the economy to meet only the minimum standards of a recovery, he would not be able to participate in a decision to reduce growth ranges for those aggregates. Also, he did not regard M_2 and M_3 as cosmetic-type objectives, but wanted to pay a good deal of attention to them. Since growth in those aggregates would depend importantly on the level of market interest rates in relation to Regulation Q ceilings, it followed that movements in interest rates would require close attention, especially when market rates reached so-called threshold levels. Market rates were currently below such levels, but he suspected that the question of threshold levels would come to the fore by the spring.

The meeting then recessed. It reconvened at 3:05 p.m. with the same attendance as at the morning session.

Mr. Kimbrel said he appreciated the difficulty of communicating the technical reasons for a reduction in the Committee's longer-run growth ranges. However, possibly because he was not a technician, he had always felt that the Committee should focus upon total economic behavior and not necessarily upon some particular monetary behavior. He was concerned about the possibility of an escalation in the rate

of inflation, especially in light of the major wage negotiations that were scheduled during 1976. For that reason, and in recognition of the technical considerations outlined in the blue book, his preference would be to reduce the current M_1 and M_2 ranges by perhaps 1/2 percentage point and the M_3 range by 1 percentage point. He realized that such reductions could be misinterpreted, but unless there were risks that had not been brought to his attention, he would favor such reduced ranges.

Mr. Volcker commented that current Committee procedures in setting longer-run growth ranges gave rise to all sorts of technical problems. He was glad that the Committee would have an opportunity to examine such problems at a later meeting since he did not think the Committee's present procedures always had the most felicitous results. Fortunately, the technical problems were not fully exposed because the performance of the aggregates had been reasonably within the ranges specified by the Committee, at least with respect to the base periods established in the spring of last year.

Turning to the substance of the Committee's decision today, Mr. Volcker said he was delighted to see some sentiment in favor of reducing the lower limit of the M_1 range, and he himself would have no concern about lowering the upper limit

as well. However, he could tolerate a growth rate as high as 7-1/2 per cent for now in light of the recent shortfall in M_1 growth. On the other hand, the proposed reduction in the lower limit to 4-1/2 per cent was a step in the right direction and he would be prepared to approve an even larger reduction.

Mr. Volcker said that some reduction in the M_2 and M_3 ranges seemed to be called for on grounds of technical consistency. The staff had reached a similar conclusion. He did not think that the Committee had to lower those ranges as much as the staff had suggested under alternative B in the blue book, and he rather liked the ranges that Mr. Coldwell had proposed.

Mr. Volcker added that Mr. Partee's remarks seemed to imply a somewhat easier monetary policy than the one the staff suggested would be consistent with its view of the business outlook. He himself was reasonably satisfied with recent developments. Finally, he agreed with Mr. Wallich's views regarding the desirability of specifying somewhat wider ranges for the aggregates and not making interest rates overly sensitive to movements of the aggregates within those ranges.

Mr. Winn said he was more concerned about the problem of communications than some of his colleagues. He appreciated

the argument that could be made regarding a downward shift in the demand for money, but he had strong reservations about lowering the growth ranges following a period of shortfalls. Under the circumstances, a reduction was almost sure to be interpreted as an adjustment in the range to accommodate actual results rather than an adjustment made on policy grounds. In short, the problem of public understanding troubled him considerably.

The Chairman remarked that growth of the aggregates had been within the target ranges in relation to the original March and second-quarter bases that had been specified by the Committee. It was true that a shortfall had occurred in growth from the third-quarter base, but an interval of only 3 months was involved and that was not sufficient for judging a 12-month growth target. Mr. Winn might well be right with regard to the problem of communications. He himself was especially sensitive to that problem since he had to live with it from day to day. There would be criticism and misinterpretations regardless of what the Committee did. The subject of monetary policy was inherently difficult and poorly understood. However, he did not think there would be any great problem of communications if the

Committee adopted his recommendations to leave the ranges for M_2 and M_3 unchanged and to reduce only the lower limit of the M_1 range. The case for doing the latter was clear in terms of measurable factors that could be cited, to say nothing of additional factors whose quantitative magnitude could not be appraised. Moreover, questions of communications alone could never be decisive; facts had to be respected insofar as they were known. The recent shortfall in M_1 growth could be explained in large measure by technological changes, including the Board's new regulation permitting corporate savings accounts. In these circumstances he would not feel uneasy about reducing the lower limit of the M_1 range.

Mr. Winn observed that his main concern was to assure somewhat greater growth in the monetary aggregates during the current stage of the business recovery. More moderate growth might be appropriate later during the year. In a word, he regarded the timing of the monetary stimulus as critical.

The Chairman remarked that the Committee's ability to control short-run movements in the monetary aggregates was very limited, and problems with seasonal factors further complicated the Committee's task. The difficulty of seasonal adjustments

was highlighted by a staff finding that a monthly growth rate of 4 per cent might well be equivalent to a growth rate of 8 or 9 per cent on the basis of reasonable alternative seasonal factors. The evidence for such a statement would be presented to the Committee--and, he believed, in decisive fashion--at a future meeting when consideration was to be given to technical problems.

Mr. Jackson observed that the Committee's efforts to control the monetary aggregates sometimes seemed like a game of basketball played on a skateboard with the opposing team having the right to move the basket. Where communications were concerned, the world unfortunately thought of the Committee's growth ranges as straight lines, when very often they were curved lines to which adjustments had to be made. He shared Mr. Partee's interest in trying to focus on M_2 and M_3, although he found it very difficult to concentrate on measures that were subject to such effects as those produced by the Regulation Q ceilings. In some circumstances, those ceilings could completely distort the performance of the broader measures of money in relation to the Committee's objectives. From an operational point of view, moreover, it was extremely difficult

to focus on a measure like M_3, because estimates were available only once each month and were subject to a sizable margin of error. His conclusion would be to widen the growth ranges. Specifically, he would adopt a 4-1/2 to 7-1/2 per cent range for M_1 and drop the lower limit of the ranges for M_2 and M_3 slightly.

Mr. Baughman said he would advise the Committee not to set in concrete any conclusions about a downward shift in the demand for money. In his judgment, the evidence was still sufficiently uncertain that any reference to such a shift should not imply that it was permanent.

Chairman Burns indicated his agreement and noted that his Congressional testimony would have to be along the lines recommended by Mr. Baughman. He would be able to speak with some definiteness about what had happened over the past four to six quarters, but he would have to be very cautious in his testimony about what might happen in the future.

Mr. Baughman added that despite his uncertainty about the future performance of M_1, he still felt there was sufficient evidence to justify reducing the M_1 range at this

time. However, he found himself in the same corner as Mr. Partee with regard to a reduction in the M_2 range. It seemed to him that the technical arguments relating to M_1 did not carry through to the broader measure, unless one was prepared to take a fairly unequivocable position with respect to a change in the demand for money. On the issue of broadening the ranges, it was his view that the present ranges were already rather wide, and apart from reducing the lower limit of the M_1 range, he would be inclined to make no changes.

Mr. Morris said that he would subscribe to the views stated by Mr. Partee.

Mr. Clay observed that the Committee's job was one of encouraging a sustainable economic expansion and a concurrent reduction in the rate of inflation. To accomplish the first objective, he thought the Committee should foster somewhat faster growth over the period immediately ahead than had occurred recently in the monetary aggregates. However, to promote a deceleration in the rate of inflation, he believed the aggregates should not grow as rapidly in 1976 as would be permitted by the Committee's current ranges. Accordingly, he would set ranges of 4-1/2 to 7 per cent for

M_1, 6-1/2 to 9-1/2 per cent for M_2, and 7-1/2 to 10-1/2 per cent for M_3; the latter two ranges were those associated with alternative B in the blue book.

The Chairman remarked that it was clear that the Committee accepted his recommendation to reduce the lower limit of the M_1 range to 4-1/2 per cent. It was equally clear that the Committee wished to retain the 7-1/2 per cent upper limit of that range. A majority of the Committee members, but only a thin majority, was in favor of leaving the M_2 and M_3 ranges unchanged. He inquired whether the Committee wanted to discuss the latter ranges further.

Mr. Coldwell commented that according to data in the blue book the growth rates of M_2 and M_3 had exceeded 10 per cent in only a few quarters over the 1973-1975 period. That evidence supported his preference for reducing the M_2 and M_3 ranges.

Mr. Partee suggested that the years 1971-1972 would be a better period to use for comparative purposes, since the economy was then also coming out of a recession. As he recalled, growth in M_2 and M_3 during that period had generally been much higher than the current ranges.

Mr. Coldwell said he was not sure the two recovery periods were comparable. In any event, he believed the present outlook called for a slight reduction in the M_2 and M_3 ranges.

Mr. Volcker said he shared Mr. Coldwell's view; a possible compromise would be to reduce only the lower limits of the M_2 and M_3 ranges.

Mr. Mayo observed that such a reduction would destroy the argument that the proposed change in the M_1 range was based on technical considerations. The latter related in part to shifts of funds by corporations into savings accounts and also to other changes in the demand for money. To the extent that corporate deposit shifts were involved, M_2 would not be affected; to the extent that a reduced demand for M_1 balances was caused by other factors, growth in M_2 would be affected much less than growth in M_1. Moreover, the retention of the upper limit for M_1 and of the current ranges for M_2 and M_3 could be justified as an opportunity to make up for the recent shortfall in monetary growth, although the Committee might not want to make use of that opportunity. That course could also be justified as a

relatively modest contribution to the current economic recovery. In his view it would be preferable to hold off signaling a more restrictive policy until later.

The Chairman noted that the Committee had not been standing still: When the longer-run ranges had last been reviewed at the October meeting, the lower limits of the ranges for M_2 and M_3 had been reduced by 1 percentage point.

The Chairman added that according to the notes he had taken during the discussion, seven members of the Committee had indicated a preference for not changing the current M_2 and M_3 ranges. He asked whether any member had altered his views during the discussion, and no member indicated a change in his thinking.

The Chairman observed that the majority favored reducing the lower limit of the range for M_1 by one-half of a percentage point and retaining the present ranges for M_2 and M_3. He then recommended that the Committee accept a growth range calculated by the staff for the credit proxy, the procedure it had also followed at the October meeting. It would not be desirable to continue such a procedure indefinitely, and the Committee would need to discuss this matter at a later meeting.

No objection to the Chairman's recommendation was heard.

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

In the blue book for this meeting, we have presented for your consideration short-run ranges for the monetary aggregates that are wider than usual. There are three reasons for this:

First, it follows recent Committee practice.

Second, we are quite uncertain about the demand for money, particularly for M_1, in this transitional period.

Third, in view of the growing dissatisfaction with money supply seasonal adjustments, we have undertaken a very careful review of the implications of applying alternative techniques. We have not changed our basic methodology as a result, but it is clear that alternative, reasonable methods of seasonal adjustment will produce noticeably different seasonal factors for any individual month. A wider band for the aggregates would recognize that uncertainty as to the seasonal factors limits the significance that can be attributed to short-run variations in monetary growth.

Apart from these somewhat technical considerations, the basic outlook in the blue book once again reflects a lowering of expected interest rate levels for any particular rate of monetary growth, given the staff's GNP projection. As noted in the blue book, our expectation of resumed growth in the monetary aggregates is based essentially on the view that such large increases in velocity as occurred in the third and fourth quarters simply cannot persist, given past historical experience. It is difficult to find special factors that held growth in money down in the fourth quarter at the interest rates then prevailing, apart from business savings accounts. But it is possible that exceptionally large loan repayments in December provided banks with considerable liquidity that was in effect mopped up by the System.

If the liquidity had not been absorbed, bank placement of the proceeds of loan repayments would have lowered the Federal funds rate and other short-term rates by more than actually occurred. Such an

> absorption of bank liquidity by the Federal Reserve may have caused the stock of money in the hands of the public temporarily to fall below the demand for money, given GNP. But if the demand is there, such a shortfall cannot long persist, and M_1 growth is likely to be resumed as the reserves are supplied to accommodate the public's efforts to obtain additional cash in the months ahead, whether these efforts take the form of increased borrowing or of asset sales.

Chairman Burns then called for a discussion of current monetary policy and the directive. He believed that agreement on ranges of tolerance for the monetary aggregates could be achieved quickly and that the basic issues to be decided were the range for the Federal funds rate and the form of the directive.[1/] In order to expedite the proceedings, he would begin by proposing that the Committee adopt a money market directive again this time. He asked the members to indicate informally whether they preferred that to the monetary aggregates formulation of the directive.

The poll indicated that the members were evenly divided on the question.

Mr. Holland observed that, in his view, the present was one of those occasions when it was reasonable to adopt a money market directive and to specify relatively wide ranges of tolerance for the aggregates. However, he had not indicated

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1/ The alternative draft directives submitted by the staff for Committee consideration are appended to this memorandum as Attachment B.

a preference for the money market directive because he was concerned that the Committee might be sliding away from the practice of formulating its directive in terms of the monetary aggregates. He would be able to accept a money market directive this time if he felt that the Committee would soon return to a monetary aggregates formulation for the directive.

Chairman Burns remarked that he intended to advocate a return to a monetary aggregates directive. At present, however, the meaning of the money supply figures was quite uncertain. As he had indicated earlier, he planned to call for a thorough discussion at the next meeting of the Committee.

Mr. Holland commented that under the circumstances he could accept a money market directive and its implicit policy stance that the Federal funds rate be maintained at about its current level unless growth in the aggregates appeared to be deviating substantially from current expectations.

In another informal poll, a majority of the members indicated that a money market directive was acceptable.

Turning to the question of the Federal funds rate range, Chairman Burns said he had serious reservations about the desirability of any further significant decline in the funds rate. Given the decline in that rate and in the whole interest rate structure in recent weeks and given the economic

outlook, it seemed likely that any further decline in the funds rate would have to be reversed rather soon. At times such a reversal was not easy to accomplish. Accordingly, he would not like to see the funds rate drop below 4-1/2 per cent during the coming inter-meeting interval unless new developments suggested that such a decline was desirable.

Mr. Mitchell remarked that he would like to see the funds rate drift down to the 4-1/2 per cent area--not in the current week but as soon afterward as feasible. At the moment he saw no need for subsequent reductions in the rate. Believing, however, that it would be incongruous to plan to move the rate down to the bottom of its range, he favored a range of 4 to 5-1/4 per cent. He had no great objection to the 4-1/4 to 5-1/4 per cent range shown under alternative B in the blue book, but he would like to see the rate move down a little from its current level of about 4-3/4 per cent.

Mr. Coldwell observed that he would not want the Federal funds rate to go above 5 per cent. With a money market directive he would be willing to accept a 4-1/4 to 5 per cent range for the funds rate.

Mr. Mitchell remarked that he would not mind that range. His objective for policy at this time had been largely met by the reduction in the discount rate to 5-1/2 per cent,

announced 4 days earlier. In his opinion, that was inducing a change in psychology with respect to long-term interest rates. It was important to reinforce that change, and consequently he favored the further downward drift in the funds rate.

Mr. Mitchell said the past year had been an extremely difficult one--particularly for the Chairman, who had carried the responsibility for publicly explaining the Federal Reserve's goals and the reasons for its various policy actions. In the process, however, he seemed to have convinced most people that the Federal Reserve was dead set against an inflationary monetary policy. Reflecting the persistence of that conviction, long-term interest rates had begun to decline, and he viewed the reinforcement of that trend as a vitally important objective of policy. In his judgment, the economy could not recover if long-term interest rates remained as high as 10 per cent. And such a level would not put an end to inflation.

Mr. Partee remarked that he had initially preferred a funds rate range of 4 to 5 per cent, but he recognized that a rate of 4 per cent might have an undesired signal effect. Accordingly, he could accept a range of 4-1/4 to 5 per cent.

Mr. Eastburn commented that even under a money market directive the behavior of the monetary aggregates was taken

into account. Therefore, he thought the Committee ought to allow enough leeway for some decline in the funds rate in case growth in the aggregates fell short of rates currently expected.

Chairman Burns asked the Committee members to indicate whether the 4-1/4 to 5 per cent funds rate range suggested by Mr. Coldwell would be acceptable.

A majority of the Committee responded affirmatively.

In response to questions, Chairman Burns observed that he would address himself to the issue of the way in which the Desk's objective for the Federal funds rate should be adjusted in light of the behavior of the monetary aggregates. Bearing in mind that in recent months many members of the Committee had expressed a preference for attaching more importance to the broader measures of the money supply than had been the case in the past, he would focus on M_1 as symbolic of the entire family of monetary aggregates. Quite some time ago the Committee had interpreted the range it set for M_1 as a zone of tolerance or of indifference; in fact, the language used to describe the short-run constraints was "range of tolerance." The Committee's interpretation of that language had changed gradually, almost imperceptibly, and--in his view--largely inadvertently. Over time, however, the result was an

interpretation entirely different from the original one. Adjustments in the funds rate objective were now made in response to projections of the 2-month growth rates in M_1 within the range specified as well as to movements that carried the projections to or beyond the limits of the range. The Committee had drifted into a procedure which was, in his judgment, an exercise in fine tuning that had involved the Desk and the Committee in chasing shadows.

Therefore, the Chairman said, he would recommend that operations be conducted in the manner originally intended--that the ranges be viewed as zones of indifference and that operations not be directed at moving the funds rate unless the projections of the aggregates were virtually at or outside the upper or lower limits of their specified ranges. For example, if the Committee agreed upon the 4 to 8 per cent M_1 range shown under alternative B, which was associated with prevailing money market conditions, a 4 per cent rate of growth would be viewed as about equal to an 8 per cent rate; on the basis of uncertainties regarding the accuracy of seasonal measures alone, that would be reasonable. The funds rate would be maintained near its current 4-3/4 per cent level unless the aggregates approached or went outside the limits of their ranges. The one change from earlier practice that

he would recommend to the Committee was the specification of slightly wider short-run ranges for the aggregates--as shown under all three alternatives in the blue book--which was justified on the basis of the seasonal problems alone. If that was acceptable to the Committee he would suggest adoption of the specifications for the aggregates shown under alternative B.

In response to questions on the specifics of operations contemplated in his recommendation, the Chairman said he had in mind maintaining the current funds rate level--not moving to the midpoint of the 4-1/4 to 5 per cent range--as long as estimates indicated that the aggregates were growing at rates within their specified ranges. He would deviate from that only if the growth rates were close to their limits; in that case he would want to allow the Desk some discretion as to the timing of operations directed at moving the funds rate. He would suggest that the full width of the Federal funds rate range be available for use should the aggregates appear to be growing at rates outside their specified ranges.

Mr. Coldwell remarked that he was not sure whether the procedure the Chairman had suggested was a return to one previously employed by the Committee or was a shift to an entirely new one. It was his understanding that, in the past, open market operations

had been guided by the Committee's desire to effect changes in the Federal funds rate in an orderly and gradual fashion within its specified range. If the Desk saw growth in the aggregates moving toward the bottom of their ranges, it would begin gently to move the funds rate down within its range.

Chairman Burns agreed that that had been the standard procedure for some time. However, that practice represented a departure from the interpretation originally attached to the ranges of tolerance adopted by the Committee, which were regarded as zones of indifference. He remembered vividly a discussion that had taken place in which he had interpreted the ranges as such zones, and Mr. Holmes had asked if the Desk should not begin to move the Federal funds rate as growth in the aggregates approached the limits of their ranges. He had agreed, and that had been the sentiment of the Committee at that time.

Mr. Wallich commented that in the present situation pursuit of the procedure advocated by the Chairman would result in a lag of 2 weeks after obtaining an estimate that M_1 was growing at a rate below its range before the Desk aimed for a Federal funds rate at the lower limit of its range. That would be quite a long time between the recognition of weakness in the aggregates, however indefinite, and the full response to that weakness.

Chairman Burns remarked that by late Wednesday of this week the Desk would have a new estimate of money supply growth in the January-February period, and it would be able to take that data into account in operations beginning on Thursday. If the estimate indicated that M_1 was growing at about a 4 per cent annual rate or less--and the Committee had adopted a 4 to 8 per cent range of tolerance for M_1--the Desk would begin immediately to direct operations toward reducing the funds rate gradually. If a shortfall first began to appear a week or two later, Desk operations to reduce the funds rate would begin then. However, there could be a problem of sorts if the shortfall began to appear as late as 3 weeks from this Wednesday. In that case the Desk would not have quite enough time before the next meeting to achieve the desired result of a gradual reduction in the funds rate to the lower limit of its range.

Mr. Wallich commented that--for the coming period--he would not object to the procedure the Chairman had described, because he viewed interest rates as a key factor at this time. However, he thought such a procedure would result in more rigidity in the funds rate than he would ordinarily find acceptable.

Chairman Burns agreed that the funds rate would tend to be more stable under the proposed procedure. In his judgment,

however, the procedure that the Committee was using resulted in fluctuations in the funds rate that were not justified on economic or financial grounds. Small variations in the rates of growth of the money supply had been viewed as having significance when, in fact, they did not. Such variations were random rather than systematic.

Mr. Wallich remarked that while the level of the money stock figures might be uncertain due to seasonal adjustment problems, the estimated rate of growth relative to the expected rate was probably meaningful.

Chairman Burns observed that the procedure he had proposed was a change from recent practice, as Mr. Coldwell had noted. It was, however, a return to an operating rule that the Committee had followed previously. The Committee might decide today to continue its recent practice pending a more thorough discussion of operating techniques at the next meeting, but in his judgment a change in operating techniques was inevitable.

Mr. MacLaury said he would not describe the Committee's procedures as shadow-chasing. To his mind, the Federal funds rate had moved in a rather systematic--not erratic--fashion over recent months. He did not believe that the Committee had drifted into the practice of attaching significance to the

midpoints--and not just to the limits--of the tolerance ranges it set for the aggregates. On his part, at least, that had been a conscious decision, and he would not want to revert to the procedure the Chairman had described as the Committee's method of operation a few years ago.

Continuing, Mr. MacLaury remarked that, while he was not opposed to allowing the Desk some discretion in its operations, he would argue that such discretion should be exercised along the following lines. First, the Desk should take a movement in the projections of the aggregates as an indication of the direction in which the funds rate ought to be moved. If the Desk--in its discretion--felt that sufficient reasons existed for not following the direction indicated by the behavior of the aggregates--which admittedly was erratic-- he would be prepared to abide by its view. It was his feeling that at times--especially under a money market directive--the possibility of a change in the funds rate in response to movements in the aggregates had been too severely limited by the Committee. For example, the Committee had ruled out the possibility of a funds rate response in the first and last weeks of the previous inter-meeting interval, leaving only 2 weeks in which the funds rate could be moved in response to the behavior of the aggregates. He found that unsatisfactory.

Chairman Burns said he did not think the characterization of the Committee's targets as "zones of indifference" or "ranges of tolerance" could be dismissed lightly. The Board staff had done a great deal of research on seasonal adjustment procedures, which he had followed very closely. The staff's investigation of nine alternative seasonal adjustment procedures for M_1--all judged to be more or less equally valid--suggested that the annual rate of growth for any particular month might vary within a range of about 7 percentage points depending on the procedure used. For a 2-month period the range of variation would be less, but still on the order of 4-1/2 percentage points.

Mr. Mitchell said the Committee was debating an issue that he thought it could not resolve and that, in any case, probably was not very important. At times, either because of past behavior of the aggregates or for other reasons, the Committee had directed the Desk to move the funds rate at some specific time.

With respect to the behavior of the aggregates, Mr. Mitchell said one needed to bear in mind that judgments during the inter-meeting periods were made on the basis of preliminary and uncertain weekly figures. He would agree, therefore, that there was some zone in which differences in growth rates were not significant. In considering a 4 to 8 per cent range for M_1, for example,

he saw no difference between rates of 4 and 5 per cent or between rates of 3 and 4 per cent. However, he did see some difference between rates of 4 and 8 per cent. In his judgment, if the data becoming available week by week during the inter-meeting interval cumulated toward the lower or upper limit of the range, operations should be directed toward moving the funds rate in the appropriate direction. But if the weekly figures suggested that the growth rate was not far from the midpoint--5, 6, or 7 per cent--he would not be inclined to move the funds rate.

Chairman Burns commented that Mr. Mitchell's observations added force to his own views. The tests of seasonal adjustment techniques that he had referred to were based on monthly statistics. However, open market operations were guided by the much more wobbly weekly figures.

Mr. Holland said he agreed with the Chairman's reading of history concerning interpretation of the specifications, and he also agreed that the earlier approach was preferable. However, it had one shortcoming, which Committee members might bear in mind in the more extended discussion of operating procedures at the next meeting. At times, for example, the data becoming available during an inter-meeting period had suggested that growth in the aggregates would be in the lower part of the range but not low

enough to trigger a reduction in the funds rate. Then for the next meeting, growth rates had been projected from levels that were somewhat lower than those the Committee had contemplated earlier. In that manner, cumulative shortfalls sometimes had occurred. As Mr. Mitchell had suggested, the Committee had dealt with those situations by instructing the Desk to move the funds rate down. However, it should be possible to devise a better means of dealing with such developments.

Mr. Partee said he agreed that there should be zones of indifference within the ranges of tolerance specified for the aggregates. Like Mr. Holland, however, he was concerned about the potential for cumulative deviations from the midpoints that did not trigger changes in the funds rate. For that reason, he believed that ordinarily, in due course, the funds rate should be moved to the midpoint of its specified range, unless the behavior of the aggregates or developments in financial markets indicated otherwise. In the present case, however, the difference between the midpoint of the 4-1/4 to 5 per cent range and the current level--that is, 4-5/8 versus 4-3/4 per cent--was almost insignificant.

Chairman Burns commented that he could accept the interpretation of operating techniques suggested by Messrs. Mitchell and Holland; it was close to his own view and, in his opinion,

represented an improvement over recent practice. As he understood it, no distinction would be made among growth rates of 5, 6, and 7 per cent within the 4 to 8 per cent short-run range of tolerance for M_1.

Mr. Volcker observed that he fully supported the Chairman's view on operating procedures, and he could accept the specific prescription just indicated. But in light of his objectives for the long-term securities market, he would be reluctant to move the funds rate up from its current 4-3/4 per cent level even if growth in M_1 appeared to be near the 8 per cent upper limit of the proposed range. Accordingly, he would prefer a somewhat higher upper limit for M_1 in order to avoid the possibility of disturbing the market atmosphere the Committee was seeking to achieve.

Mr. Mitchell remarked that it was important to keep that market atmosphere in mind and not let basic objectives be disturbed because of short-run behavior of the aggregates.

Mr. Coldwell remarked that, as he had stated earlier, he would not like to see the funds rate move up to 5 per cent. He suggested that the Committee consider an M_1 range of 4 to 9 per cent, with a zone of indifference around the midpoint.

Chairman Burns remarked that, in view of the position he had emphasized today, a range of 4 to 9 per cent might be

preferable. He asked the members to indicate informally whether that range and the mode of operation that had been outlined would be acceptable.

A majority of the members indicated acceptance.

The Chairman then suggested that the Committee ask the staff to determine the consistent ranges of tolerance for the remaining aggregates.

Mr. Coldwell remarked that, because of the importance of M_2 in the current environment, the Committee might wish to comment on the staff judgment concerning the range that was consistent.

Mr. Holland said he thought an M_2 range of 7 to 12 per cent would be appropriate.

In response to a question by the Chairman, Mr. Axilrod remarked that the demand deposits were the most volatile component of M_2. He would assume that the Committee had raised the upper limit of the M_1 range in order to accommodate an erratic movement in demand deposits on the high side, should that develop, but that it was not necessarily contemplating faster growth in time deposits as well. Consequently, he would adjust the M_2 range to 7 to 11-1/2 per cent.

The Chairman then proposed that the Committee vote on a directive consisting of the general paragraphs as drafted

by the staff and the money market proposal 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 January-February period would be 4 to 9 per cent for M_1, 7 to 11-1/2 per cent for M_2, and whatever the staff determined would be consistent for RPD's. The range of tolerance for the weekly-average Federal funds rate in the inter-meeting period would be 4-1/4 to 5 per cent. It would be further understood that Desk operations would be conducted in the manner described earlier--namely, that the ranges for the aggregates be interpreted as including zones of indifference and that the Desk maintain the Federal funds rate at about its current level unless incoming data suggested that the monetary aggregates were growing at rates approaching the limits of their specified ranges.

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 increased very sharply in the third quarter of 1975--expanded more moderately in the fourth quarter. In December retail sales rose sharply, but the increase in the fourth quarter as a whole was

less than that in the third quarter. After having slowed over the preceding 2 months, the rise in industrial production and in non-farm payroll employment accelerated in December. However, the unemployment rate remained at 8.3 per cent, as the civilian labor force grew about as much as total employment. The increase in average wholesale prices of industrial commodities was again relatively large, but average prices of farm products and foods declined sharply further. The index of average wage rates was unchanged in December, following 2 months of large increases.

The exchange value of the dollar against leading foreign currencies held steady in December but eased somewhat in early January. Another sizable foreign trade surplus was registered in November.

M_1 declined in December, and growth in M_2 and M_3 slowed considerably. At commercial banks, inflows of time and savings deposits other than large-denomination CD's slowed, despite a continuing build-up of business savings accounts, while inflows of deposits to nonbank thrift institutions were relatively well maintained. In terms of quarterly averages, growth in M_1 from the third to the fourth quarter was modest, while growth in M_2 and M_3 was more substantial. In recent weeks interest rates on both short- and long-term securities have declined appreciably. In mid-January Federal Reserve discount rates were reduced from 6 to 5-1/2 per cent.

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 maintain prevailing bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates appear to be growing at about the rates currently expected.

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

It was agreed that the next meeting of the Committee would be held on February 18, 1976.

Thereupon the meeting adjourned.

Secretary

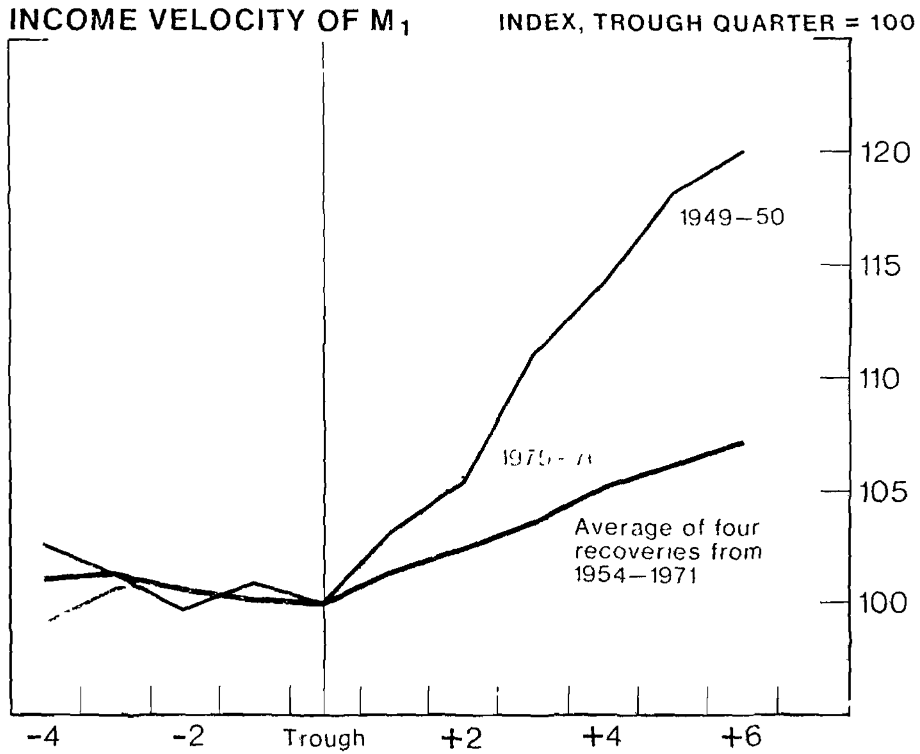
ATTACHMENT A

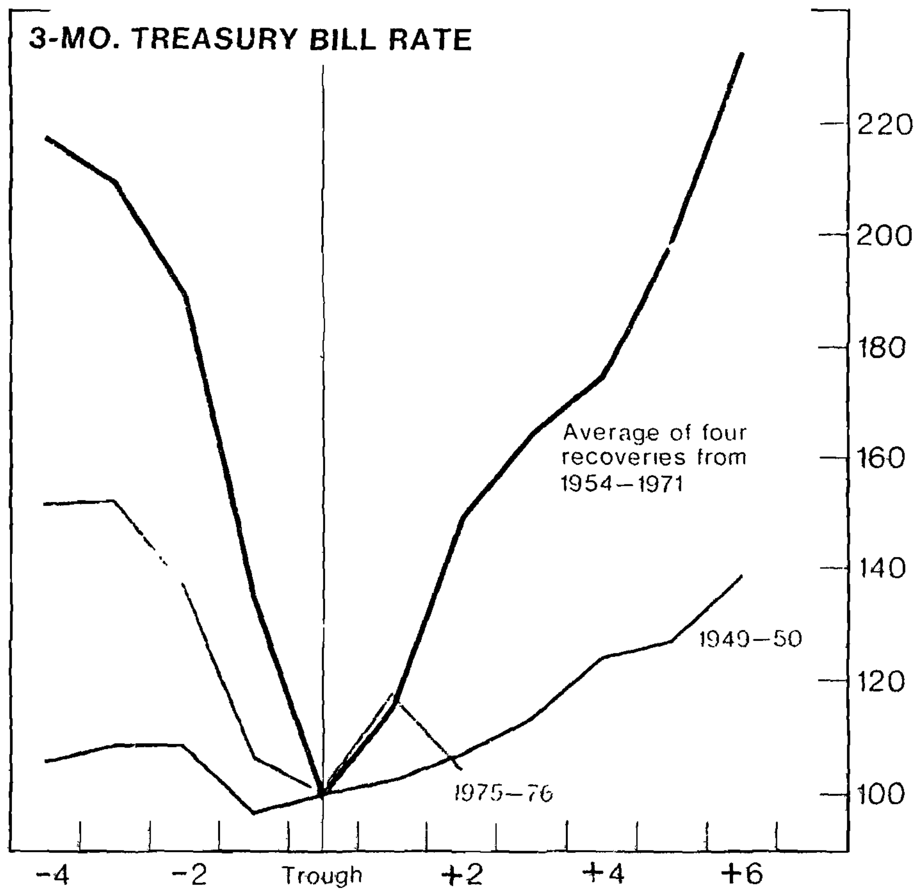
POLICY ALTERNATIVES

January 20, 1976

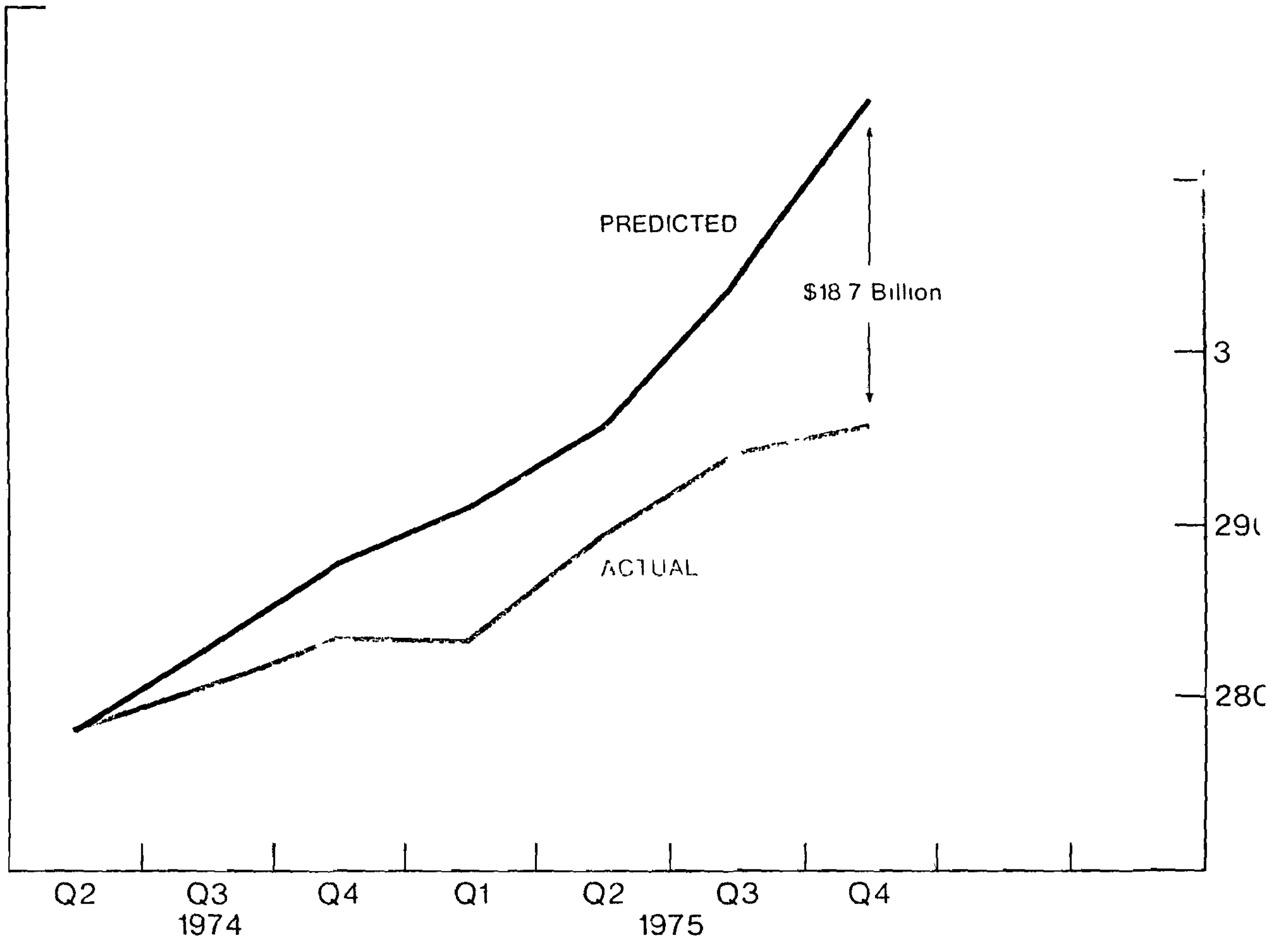
STRICTLY CONFIDENTIAL (FR)

CLASS II FOMC

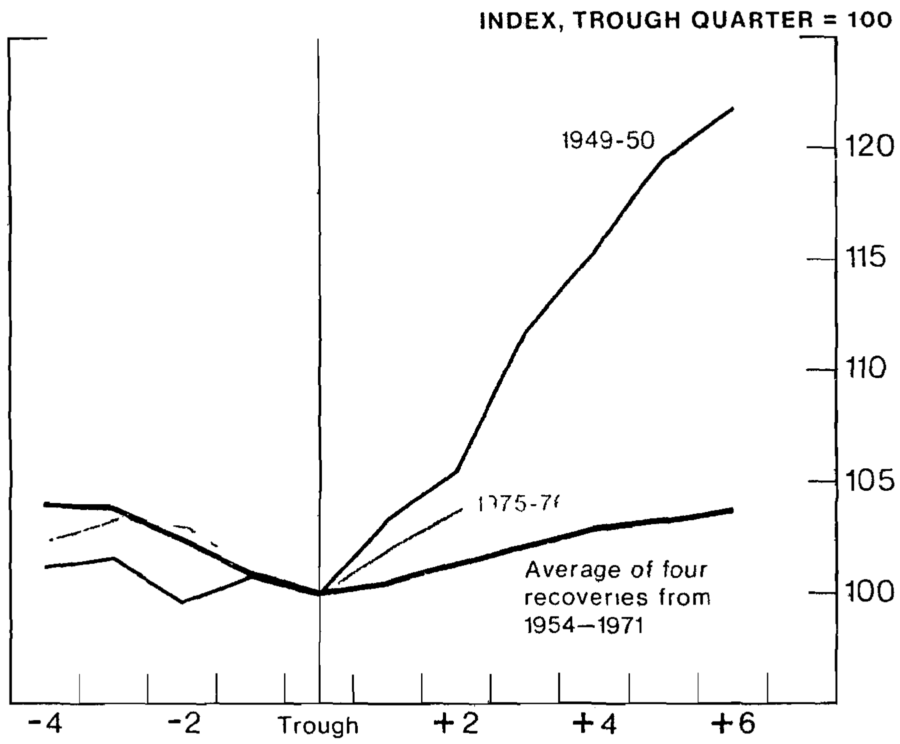

INCOME VELOCITY OF M_1
INDEX, TROUGH QUARTER = 100
120
115
110
105
100
1949–50
Average of four recoveries from 1954–1971
-4
-2
Trough
+2
+4
+6


3-MO. TREASURY BILL RATE
220
200
180
160
140
120
100
Average of four recoveries from 1954–1971
1949–50
1975–76
-4
-2
Trough
+2
+4
+6

ACTUAL & PREDICTED LEVELS OF M_1



INCOME VELOCITY OF M_2



Monetary Policy Alternatives
Effects on Key Economic and Financial Variables

	1976			
	I	II	III	IV
Treasury Bill Rate, Per Cent				
1. 6-1/4% M_1 Growth*		6-7/8		7-1/4
2. 7-1/4% M_1 Growth*		4-3/4		6-3/4
3. 5-1/4% M_1 Growth*		7-1/8		8
Real GNP, Per cent Increase at Annual Rates				
1. 6-1/4% M_1 Growth*	4.5	4.5	4.3	4.0
2. 7-1/4% M_1 Growth*	4.5	4.7	4.9	5.0
3. 5-1/4% M_1 Growth*	4.5	4.3	3.7	3.0
Real GNP Level, Billions of 1972 Dollars				
1. 6-1/4% M_1 Growth*	1232.8	1246.6	1259.9	1272.2
2. 7-1/4% M_1 Growth*	1232.8	1247.3	1262.6	1278.4
3. 5-1/4% M_1 Growth*	1232.8	1246.0	1257.5	1266.9
Unemployment Rate, Per Cent				
1. 6-1/4% M_1 Growth*	8.2	8.1	7.9	7.9
2. 7-1/4% M_1 Growth*	8.2	8.1	7.9	7.7
3. 5-1/4% M_1 Growth*	8.2	8.1	8.0	8.1
Fixed Weight Price Index for Gross Private Product				
1. 6-1/4% M_1 Growth*	5.6	5.6	5.6	5.5
2. 7-1/4% M_1 Growth*	5.6	5.6	5.7	5.7
3. 5-1/4% M_1 Growth*	5.6	5.6	5.5	5.3

* QIII 1975 through QIII 1976, extended through the fourth quarter of 1976; no account is taken of shifts of funds to savings accounts by corporations.

ATTACHMENT B

January 19, 1976

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on January 20, 1976

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that output of goods and services--which had increased very sharply in the third quarter of 1975--expanded more moderately in the fourth quarter. In December retail sales rose sharply, but the increase in the fourth quarter as a whole was less than that in the third quarter. After having slowed over the preceding 2 months, the rise in industrial production and in nonfarm payroll employment accelerated in December. However, the unemployment rate remained at 8.3 per cent, as the civilian labor force grew about as much as total employment. The increase in average wholesale prices of industrial commodities was again relatively large, but average prices of farm products and foods declined sharply further. The index of average wage rates was unchanged in December, following 2 months of large increases.

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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 "Monetary Aggregate" Proposals

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.

"Money Market" Proposal

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to maintain prevailing bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates appear to be growing at about the rates currently expected.

ATTACHMENT C

January 20, 1976

Points for FOMC guidance to Manager in implementation of directive		Specifications
A. Desired longer-run growth rate ranges (as agreed 1/20/76):		
(QIV '75 to QIV '76)	M_1	4-1/2 to 7-1/2%
	M_2	7-1/2 to 10-1/2%
	M_3	9 to 12%
	Proxy	6 to 9%
B. Short-run operating constraints (as agreed 1/20/76):		
1. Range of tolerance for RPD growth rate (January-February average):		-7 to -2%
2. Ranges of tolerance for monetary aggregates (January-February average):	M_1	4 to 9%
	M_2	7 to 11-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		4-1/4 to 5%
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 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 instructions