

Meeting of the Federal Open Market Committee

August 12, 1980

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, August 12, 1980, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman  
Mr. Gramley  
Mr. Morris  
Mr. Partee  
Mr. Rice  
Mr. Roos  
Mr. Schultz  
Mr. Solomon  
Mrs. Teeters  
Mr. Wallich  
Mr. Winn

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

Messrs. Black, Corrigan, and Ford, Presidents  
of the Federal Reserve Banks of Richmond,  
Minneapolis, and Atlanta, respectively

Mr. Altmann, Secretary  
Mr. Bernard, Assistant Secretary  
Mr. Petersen, General Counsel  
Mr. Holmes, Adviser for Market Operations

Messrs. Balbach, J. Davis, R. Davis, Ettin,  
Henry, Keir, Kichline, and Zeisel,  
Associate Economists

Mr. Pardee, Manager for Foreign Operations,  
System Open Market Account

Mr. Sternlight, Manager for Domestic  
Operations, System Open Market Account

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Mr. Coyne, Assistant to the Board of  
Governors

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

Messrs. Gemmill and Siegman, Associate  
Directors, Division of International  
Finance, Board of Governors

Mr. Beck, Senior Economist, Banking Section,  
Division of Research and Statistics,  
Board of Governors

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

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

Messrs. Czerwinski and Doyle, First Vice  
Presidents, Federal Reserve Banks of  
Kansas City and Chicago, respectively

Messrs. Boehne, Brandt, Burns, Eisenmenger,  
and Scheld, Senior Vice Presidents,  
Federal Reserve Banks of Philadelphia,  
Atlanta, Dallas, Boston, and Chicago,  
respectively

Messrs. Bisignano, Broaddus, Cacy, Danforth,  
and Ms. Nichols, Vice Presidents,  
Federal Reserve Banks of San Francisco,  
Richmond, Kansas City, Minneapolis, and  
Chicago, respectively

Mr. Ozog, Manager, Securities Department,  
Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of  
August 12, 1980

CHAIRMAN VOLCKER. Let's come to order. We have two new faces at the table today. Another way to put it is that we have one new face and one old face in a new guise. I want to welcome Mr. Ford and Mr. Corrigan. You have great privileges as new members. You may speak first, last, or in the middle when it comes to delivering some cogent comments on what we should be doing. I'll give you a little time to think about that. We do welcome you around the table.

I would like to mention and emphasize a matter on which I sent you a note. We had a leak about the aggregates [targets] for the year after our telephone consultation, which disturbed me. What disturbed me was not just the substance of it--though I don't think it would be considered the most damaging leak in the world in terms of the market [effect]--but that it could happen at all. I'm not suggesting at all that the only place a leak can come from is a Reserve Bank, but in this particular case the reporter identified [the information] as having come from a Reserve Bank or Reserve Banks. I suppose it might have come from Washington in other circumstances. Wherever it came from, there is nothing more corroding of the confidence with which we sit around the table or in a telephone conference and discuss [policy] than the fear that somehow there is going to be a leak of what is discussed. I just cannot operate in that way. I know of only one way to deal with this lack of confidence, which I don't want to have, and that is to diminish and diminish and diminish the [attendance at] meetings so nobody is here but the people who actually have to be. At least then we would have identified [the source of any leak] down to a smaller group. I don't think anybody wants to go in that direction, but that is one of the prices of having this kind of leak. I don't know where it came from, and I don't care where it come from in this particular incidence, but I do care about the matter in general. If you haven't already done so, I would urge you to take whatever [measures necessary to convey] the message in your own way within your own institutions to give us the best assurance we can have that this doesn't happen again. We are going to end up not talking very freely if it does. Enough of that.

One other thing I would mention is the meeting schedule for 1981. I don't want your reactions at the moment but perhaps we can take that up at the next meeting and you can convey any reactions you have before that. You will recall that I raised the question some months ago--assuming we continue with the reserve targeting procedures--of whether the logic somehow suggested that we should have a meeting near the beginning of a quarter. We are compelled to do things according to the calendar: annually, quarterly, monthly, or whatever. Given that what we have been doing is setting the target for every quarter, the logic seems to suggest that it would be convenient to have a meeting near the beginning of the quarter or the end of the previous quarter. Then perhaps a reasonable checkpoint would be somewhere around the middle of the quarter. Doing that would mean intervals of six or seven weeks between meetings, typically, which is a little longer than what we have had in recent years. This year we are scheduled to have ten meetings. I would be perfectly happy to have more telephone updates between meetings if that seemed desirable--if it seems like a long time between meetings. But it still seems to me a rather attractive way of proceeding, assuming

we're on this kind of targeting. I'd like to get your reactions to it at or before the next meeting and then we can set some dates so people can get them on their calendars, however we're going to [proceed]. I can send out some tentative dates after this meeting, just so we have something concrete to look at. But the general concept is more important than the particular dates at this point. I think that covers all the extraneous business.

We need to approve more than one set of minutes. I take it there was a lapse in approving the minutes of a couple of telephone conferences, Mr. Secretary.

MR. ALTMANN. We need approval for the minutes of March 7 and May 6 and for the regular July 9 meeting.

CHAIRMAN VOLCKER. March 7th and May 6th got lost somehow. Were they telephone conferences?

MR. ALTMANN. Yes, they were telephone conferences.

CHAIRMAN VOLCKER. We need a motion.

SPEAKER(?). So moved.

CHAIRMAN VOLCKER. Without objection, we'll approve them. Mr. Pardee.

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

CHAIRMAN VOLCKER. Is the Treasury behind in covering Swiss francs and Carter bonds?

MR. PARDEE. They are fully covered on the Carter notes. The francs that we have accumulated recently have been put aside for payment of interest on those notes. They [have] discussed a little the issue of accumulating additional francs. [They are leaning to the view] that if we don't want any more they will acquire them. But we still have very modest balances for the System.

CHAIRMAN VOLCKER. Comments or questions? Governor Wallich.

MR. WALLICH. Scott, you said that these countries would be quick to support their currencies. Do you see any indications that that attitude might change if they go more deeply into recession?

MR. PARDEE. It could, but the question of financing their deficits is very important. And they want to maintain a strong currency so they can get the funds. There's a tremendous amount of competition among the authorities to get OPEC funds at this point. Any slippage on your currency means that the money just isn't going to come in your direction.

MR. WALLICH. Thank you.

CHAIRMAN VOLCKER. Everybody really wants fixed exchange rates?

MR. PARDEE. No they want strong exchange rates rather than fixed. In fact, a gently rising exchange rate is--

CHAIRMAN VOLCKER. Given that everybody can't have that. Governor Rice.

MR. RICE. You said that the market accepted the reduction of the discount rate as largely a technical adjustment. Does that indicate to you that the market is becoming more sophisticated or was it just a happy circumstance of timing?

MR. PARDEE. Well, on that particular occasion, I talked to several people who tried to interpret it. As you recall, on that Friday there were two other elements [involved]. One was that the federal funds rate did ride up and the other was that a large increase in the aggregates was published later in the afternoon.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. PARDEE. Several [market players] sent out letters or cables around the world from New York and other centers over the weekend trying to assess the implications. Those who said that the rising federal funds rate and the aggregates were important were right. And those who said that the Europeans were going to react negatively to the discount rate were wrong. They are very sophisticated but they can make mistakes, too. It's very hard to judge which way to read it. I raised the question with some of our senior people in the market as to whether the people who don't understand the Federal Reserve are making money at the expense of those who do. I think the [answer] is that it's more haphazard: That, in effect, handing the decision of determining interest rates over to the market on the domestic side is very much like the exchange market where we've turned to floating exchange rates. I had to scold some of the fellows a little in that they had been so pleased to have floating exchange rates and they should be able to take advantage of the freer market for money. But they're very nervous about it. So if sophistication is part of it, there's also a difference in the market now with these OPEC funds. The OPEC funds come right into the Eurodollar market in overnight money. It's sitting there. Where is it going to go? It's not going to stay necessarily in overnight money. And the sensitivity to interest rates is much greater than we have felt for some time. If the federal funds rate goes down, it means that the next day the Eurodollar rates will trail off in the Eurodollar market, which means that the fellows in OPEC and others who are moving money on that day will make a decision to put those funds that they are moving into marks or sterling or some [other currency] at that particular moment. If the federal funds rate is moving up at that point, giving signals to the Euromarkets to firm a bit, then the money will come our way. It's a very knife-edge sort of thing. There's much more volatility in the dollar exchange rate than we've had in other periods when not much was really going on.

MR. ROOS. How is our national interest adversely affected if that night the OPEC people shift some of their money into sterling? Whom does this hurt?

MR. PARDEE. It's not a question of hurting or helping at this stage; it's just that there's more volatility.

MR. ROOS. Is that bad?

MR. PARDEE. [It is] if all of a sudden we have a cumulative movement that is triggered by it.

MR. ROOS. Have we had such a--

MR. PARDEE. No we haven't. We haven't had it this month and we've been rather quick to operate. Of course, we're basically interested in acquiring as many marks as we can to clear the decks for the next problem.

VICE CHAIRMAN SOLOMON. I think to some extent we can take some cheer from the fact that there is this much sensitivity to interest rates. It really reflects a neutral view about the likely movement of the dollar. The fact that we're running virtually in equilibrium this year and Germany and Japan have such large deficits offsets a traditional pessimism about the dollar. There is a neutral view and, therefore, we get very large movements of money in response to very tiny differences in interest rates. If [market participants] still had the same pessimistic view of the dollar that they had over most of the period in the last three years, then I don't think we'd see this much sensitivity to interest rates. We'd see consistent pressure on the dollar.

MR. PARTEE. The interest rate differential as reported yesterday supports [that view]. It is 400 basis points more adverse to the United States than it was at the beginning and the exchange rate is the same. There is obviously a stronger undertone of confidence in the dollar than before, as you say.

MS. TEETERS. There must have been surplus OPEC funds floating around in 1974-75. How long did it take for them to settle down or disappear from the market?

MR. PARDEE. In that case the surplus did disappear over the course of the next two or three years. By 1977-78 there wasn't much surplus left.

MS. TEETERS. Yes, but they must have had some investible funds that they didn't put some place permanently.

MR. PARDEE. Yes, a lot of that came in directly into U.S. Treasury bills and so forth. At that time there wasn't quite so much diversification as there is now. Also, the other central banks and authorities were not bidding so eagerly for the funds. Now the German finance ministry is working very hard to get as many marks in as possible. The Swiss have been very active, as have the Japanese. It has not been very open, but a lot of work is being done. And, of course, the French have quietly opened all the doors and windows for people to invest in francs. In some ways that's healthy since they are deficit countries and the money has to go some place, so it's better to go in places where it's in strong hands. But there is a difference this time. The OPEC countries are not so automatically putting their funds in dollars and holding them there, particularly in open ways such as in Treasury bills. And the others are pressing hard for funds to come to their way.

CHAIRMAN VOLCKER. Do you have some recommendations?

MR. PARDEE. Simply some renewals. With the Bank of France we have one swap drawing for \$26 million. We've been repaying our mark swap debt but we have coming up in the next period some seven swap drawings in the amount of \$382 million. All of these are first renewals.

CHAIRMAN VOLCKER. We do have to ratify transactions since the last meeting. If there are no objections to renewing the swaps, we will renew them if necessary.

MR. PARDEE. If necessary.

CHAIRMAN VOLCKER. Can I have a motion to ratify?

MR. SCHULTZ. So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection, they are ratified. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Questions or comments?

VICE CHAIRMAN SOLOMON. Peter, to what extent have these dealers who are under water hedged in the futures market when they met their underwriting responsibilities? Is it now fairly prevalent among all of them to hedge their positions?

MR. STERNLIGHT. It's more prevalent than it was. I don't have fully up-to-date figures on that. I expect that they are really long and really hurting to some degree.

VICE CHAIRMAN SOLOMON. What lag is there on their reporting their positions in the futures market?

MR. STERNLIGHT. It's about a week or two. We're only getting those futures positions twice a month now, so we're not quite up-to-date on that.

CHAIRMAN VOLCKER. Are we changing that or--?

MR. STERNLIGHT. We're implementing a whole new set of dealer reports. We began one schedule, which we've been getting for just a month. Within the next few months we'll be getting a report that will have the futures position daily, but we don't have that phased in yet.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Mr. Chairman, I was wondering if we shouldn't talk a little about the way we respond to changes in the demand for excess reserves in terms of the implementation of open market policy. It isn't just a matter of letting interest rates move up in response to an increase in demand for excess reserves. If we do not treat that as though it were a change in the multiplier and adjust the target for

nonborrowed reserves accordingly, then we're implicitly changing both our targets for growth of the monetary aggregates as well as the level of interest rates we consider acceptable. We wouldn't do that if we thought this was going to be a change of [some] duration for, say, a six-month period. We'd obviously make some adjustments. And I wonder if we ought to think about the possibility of doing that in the short run, recognizing of course that we'll have to reverse that once it goes the other way. I'm curious what your comments would be.

MR. STERNLIGHT. Well, there is some adjustment. In fact, we make modest technical adjustments in the path, which are worked out mostly by Ed Ettin and Steve Axilrod in consultation with the Desk. There was a modest adjustment allowing for the higher level of excess reserves, although it went up only a small extent of the way, in the review that was conducted a few days ago. I think your point is certainly a valid one. Nevertheless, I would note that in a sense that [bulge] in excess reserves is not causing us to aim for significantly higher levels of borrowed reserves currently because at the same time the banks have been wanting to hold a lot of excess reserves they also--irrationally, perhaps--have come in [to the discount window] and done a fair amount of borrowing. So one could argue that we should also have allowed for the reserves they got via the borrowing route. But in the forward-looking part of our path we were not deliberately forcing the banks to borrow much more than that roughly \$100 million level that had been the starting point for borrowings when the path was set up for this recent period.

CHAIRMAN VOLCKER. The trouble is that we can't do what you are suggesting, I don't think, in any particular week, and then the next week assume [the relationship] is going to go back to normal. That has more or less been the behavior.

MR. STERNLIGHT. Yes, usually we have assumed that a high excess reserve week would be followed by a week in which excess reserves would be subnormal. But this time we figured that there may have been something unusual in the demand for excess, so our assumption was that excess reserves would come back more or less to normal rather than to subnormal.

CHAIRMAN VOLCKER. We can make some kind of guess, whichever way, in the following week. But we can't do anything in the actual week when that big excess arises, I don't think.

MR. GRAMLEY. Well, we know what required reserves are because required reserves depend upon deposits for a prior period. We know what actual reserves are on a day-to-day basis. So, as operations are going on, we know what level of excess reserves is building up and we would have to interpret this as an increase in demand for excess reserves. Then the question would be: Couldn't we respond to this with a recognition that we don't want to have changes in the demand for excess reserves affect either the growth rates for the monetary aggregates or the level of interest rates? There would be no real reason for doing so.

MR. STERNLIGHT. Well, at some other level, I could say that in a way we did respond to that. In that last full week that had the \$1 billion plus of excess reserves we were trying to take out the excess, but we had no expectation that we were going to be able to



wring out all of it. To have wrung it all out probably would have sent the funds rate soaring. As it was, when we were taking out as much of the excess as we could, the funds rate was fairly easy at around the 7 percent level.

MR. PARTEE. I would emphasize that we do have the safety valve of the discount window. If something began to tighten the market, we'd automatically tend to get an increase in borrowing. That's the reason why it's important to have the discount rate well in tune with money rates. Fortunately it was changed just before [this situation occurred], or I suppose the funds rate would have gone above 11 percent.

MR. GRAMLEY. I agree, but we wouldn't use that approach for leaving our target for nonborrowed reserves the same irrespective of what happened to other factors affecting the multiplier. That's the safety valve we always want there for any basic changes in demand for money that come about.

MR. PARTEE. I guess we'll let a week occur, Lyle, before we change it.

CHAIRMAN VOLCKER. If we could forecast that, I think you are right. But every week is different. In that particular week, the banks went out and borrowed a large amount of money at the beginning of the week, which gave them the excess. But they had already borrowed it and that's the point at which the federal funds rate went up. And then it was too late.

MR. GRAMLEY. My thought would be that we really don't have to forecast excess reserves. What we want to do is to deal with the change in demand for excess reserves as it occurs. And as it occurs, we can measure it.

MR. BALLEES. How would you do it, Lyle?

MR. STERNLIGHT. You're only responding to the funds rate then, aren't you, Governor?

MR. GRAMLEY. You're responding to what you observe as the change in demand for excess reserves on a day-to-day basis. You have to be at least one day behind.

CHAIRMAN VOLCKER. But the one day behind is the day that screws it up. The banks already did the borrowing, which made the market tight.

MR. BALLEES. What specific things would you like to see done, Lyle?

MR. GRAMLEY. My thought is that this is really like a change in the multiplier. It's a shift in the demand for excess reserves which we do not want to carry through to a change in the growth rate of the monetary aggregates or a change in the level of interest rates. So if we see excess reserves building up over the course of a week--to be sure, we're always one day behind--we can make some allowance for it as the week goes on.

MR. BALLE. What would you do?

MR. GRAMLEY. I don't have any answers off the top of my head. But this seems to me something we ought to be exploring as a possibility.

MR. ETTIN. The only thing I can add to this argument is that the daily pattern of excess reserves historically has been a very poor indicator of the excess reserves for the week. Sometimes there's a big buildup in excess early in the statement week and the average will be far away from that because it will drop off later in the week. Sometimes it's the exact opposite, as the people taking care of the reserve position in individual institutions are making their own predictions of what the daily pattern in the funds rate will be. As for that [recent] period when the excess reserves were very large, there had been similar periods in the past of substantial excess reserves, say on Thursday and Friday, but they had disappeared by the end of the [statement] week. So, it's very difficult to predict.

CHAIRMAN VOLCKER. I don't think we're going to resolve this here but, as I remember that week, unbeknownst to us they borrowed a whole lot of money on Thursday. We [questioned why] they would borrow so much money on Thursday. We thought they were going to end up with big excess reserves and we figured they would be reducing them [the next day] presumably. Then they borrowed a lot over the weekend. The market remained tight. By that time they were locked into the excess reserves and most of them were left in. If the excess was going to continue the next week and we knew it, then I think you're perfectly right. But I don't know how we can manage it within the week.

MR. GRAMLEY. Well, Ed's argument is a very persuasive one if what has happened on a day-to-day basis in the reserve period up to a particular point can in no way forecast what is going to happen over the rest of the period or what the average for the whole week is [going to be]. That's a persuasive argument for not, in effect, chasing our tail.

MR. WALLICH. I am concerned about the danger of chasing our tail because if excess reserves go up and we say there is this demand for reserves and we have to accommodate it and supply some more, then excess reserves might go up further. We would feel impelled to accommodate that again. Isn't there a danger that we'll find ourselves involved in supplying more reserves than are needed?

MR. GRAMLEY. I think there would be if we didn't take them back out after the demand went down. That's only possible if in fact we can use what's happening over the first three days of the reserve period, let's say, as a reasonable approximation for what's likely to happen over the period as a whole. What we need to look at isn't just what is going to happen in the last couple of days of the reserve period but what is going to happen over the period as whole. Maybe we could take a look at this to see whether or not your hypothesis is correct. If it is, then my suggestion has no merit whatever.

CHAIRMAN VOLCKER. We'll take a look at it.

MR. MORRIS. Peter, with respect to the discount rate and your job of managing the availability of reserves, how would you

describe the optimum relationship of the discount rate to the funds rate under the new operating procedures?

MR. STERNLIGHT. I think we'd like to have a band for the federal funds rate a few percentage points wide so we have the most flexibility. It depends at any particular point on approximately what level of borrowings we're looking toward. In the recent period, when the objective was to have borrowings around the \$100 million level, the relationships have made pretty good sense, with the discount rate at a point such that funds could vary from moderately below to something above the discount rate. [It helps] to have the discount rate somewhere well within that band where we would expect the funds rate to be moving.

MR. MORRIS. [Preferably] on the high side of the band of your expected level?

MR. STERNLIGHT. Well, I don't know. Yes, if borrowing is going to average as low as \$100 million, I would expect the funds rate would more often fall below [the discount rate] than above. To pick numbers out, I'd say from 8-1/2 to 10-1/2 percent surrounding, in a somewhat lopsided way, a 10 percent discount rate.

MR. MORRIS. Are you saying we should aim for a frictional level of borrowing--that that should be the norm?

MR. STERNLIGHT. No, not for all time. I think it has made sense given the objectives that the Committee set out a month ago on wanting to achieve the aggregates that it specified.

CHAIRMAN VOLCKER. Let me try to answer what I think you're getting at. When we have a very low level of borrowings, frictional or very close to frictional, it's natural and convenient to have the discount rate above the federal funds rate, presumably not by too much. But if we have a sizable level of borrowing, which we don't have [now], the federal funds rate will go above the discount rate. And there's not much we can do about it. That's the dilemma we're in because the banks won't borrow unless the funds rate is above the discount rate. So we can't have a penalty [discount rate] under those circumstances. I may be exaggerating a bit, but if we try, it just keeps ratcheting the rates up.

MR. PARTEE. We make it move up?

MR. ROOS. Mr. Chairman, we were disturbed, as perhaps Frank was, that in the Bluebook for the first time there was a reference to the relationship between the fed funds rate and the discount rate. I think it would be a mistake in policy, or at least in practice, if we caused or inhibited the movement of interest rates for the purpose of maintaining some relationship between the fed funds rate and the discount rate. That's a totally new concept, I think.

CHAIRMAN VOLCKER. I think you may be interpreting that the opposite of the way the staff meant you to interpret it. The idea is not to manage the funds rate below the discount rate.

MR. ROOS. It's to move--

CHAIRMAN VOLCKER. It just says that with a given level of borrowings this is what we would expect the federal funds rate to be. And the higher borrowings are, the higher the federal funds rate will be relative to the discount rate, wherever the level may be.

MR. ROOS. Well, I must have misinterpreted that.

MR. MORRIS. If I interpret you [correctly], Paul, what you're saying is that it really doesn't matter what the discount rate is, as long as the level of borrowing is predictable.

CHAIRMAN VOLCKER. Oh, I think it does matter where the discount rate is. All I am saying is a very simple thing. It's very difficult or impossible in the short run to maintain a penalty discount rate when borrowings are sizable, given the way we do everything else--the lagged reserve accounting and these paths and all that. It's not hard to do, obviously, when the borrowings are minimal. But the problem that we had before--and that we may have now to a slight degree--is that when the discount rate was way above the federal funds rate and borrowings were in fact minimal, as soon as borrowings became appreciable the federal funds rate would jump way up to the discount rate. Whereas if the discount rate was lower, the discount rate is somewhat of a drag on that process. That is the main reason why some of us, at least, wanted to get the discount rate down. That way, as soon as we ran into any borrowing we wouldn't have too sharp a jump in the federal funds rate. During a period like we've had in the last three months, I would say it would have been very convenient to have a floating discount rate--to let the discount rate just go down with federal funds rate--and avoid all these announcement effects. But if we did that, what do we do when borrowings increase and we begin putting a little pressure on the money market? The discount rate would go up very fast and maybe we wouldn't want it going up all that fast. We haven't got any brake on the increase in the federal funds rates from a fairly low level of borrowings.

MR. WALLICH. Unless we supply reserves.

CHAIRMAN VOLCKER. Yes, unless we prevented the [rise in] borrowing, in which case we wouldn't be getting the restraint we'd be looking for. That's the dilemma that we have perceived. If we could adopt a floating discount rate on the down side and an administrative one on the up side, it would be all right. But I think we'd end up with more confusion than we started with. We did have a problem on the down side because we were afraid every time we moved [the discount rate] that we would be giving rise to more expectations than we wanted.

MR. PARTEE. The trouble is that we would need to float the differential as well as the rate in some way so that we've got moves from above to below the funds rate. To put it another way--

VICE CHAIRMAN SOLOMON. We have to have the flexibility to send some kind of policy signal if our situation requires it. And if we were to have a completely symmetrical automatic relationship, we'd be tying our own hands.

CHAIRMAN VOLCKER. Well, that's another aspect.

MR. SCHULTZ. That was exactly what happened to us this last time. We wanted to get the discount rate down but we were very nervous about the foreign exchange problem. [Unintelligible] policy that had to come to an end. Then we changed the path. Given the change in the path, it became almost essential that we just go ahead and bite the bullet and lower the discount rate, which we did. It just so happened that we got lucky because at the same time the fed funds rate was strengthening. But the real reason was to attempt to lower that gap because, given the change in the path, we needed to do it.

MR. MORRIS. Back in the days when we were controlling the funds rate, it didn't make much difference where the discount rate was. But now I think it does.

CHAIRMAN VOLCKER. I think it does, too.

MR. MORRIS. I think we need a concept of what rate relationships make the most sense in terms of controlling the rate of growth in bank reserves.

CHAIRMAN VOLCKER. Yes, but what I am resisting--and this confusion arises all the time--is the concept that there is a rate relationship that makes sense on both sides of the cycle. I don't think there is. There may be a general concept [that makes sense] when there's practically no borrowing. Then I would think, ideally, we'd keep [the two rates] pretty close. Look at the other extreme that we were facing maybe a month or two ago: Suppose we really forced excess reserves on the system; the funds rate might have gone way way down if we had done that. I am not sure we would have wanted the discount rate to go down to 5 percent, if that's where the funds rate had been going for a few weeks. And there's the more general consideration that Tony mentioned. I don't see how we get out of this box with an automatic rate, although it would have been convenient for a period of a couple of months or weeks.

MR. BAUGHMAN. It is implicit in your observations that there is little or no reluctance to borrow in this equation.

CHAIRMAN VOLCKER. No, I think implicit in what I am saying is that there is a reluctance to borrow and that's why we can't keep a penalty rate on the way up.

MR. BAUGHMAN. Is it also thought that the reluctance varies with the level of borrowings?

CHAIRMAN VOLCKER. I don't know whether I'd put it that way. There is a reluctance. And the higher the level of borrowings, the more we have moved on the reluctance schedule, so the higher the funds rate gets relative to the discount rate. The more reluctant borrowers we have, the higher the federal funds rate will be relative to the discount rate.

MR. BAUGHMAN. It seems to me that if the reluctance to borrow increased with the level of borrowings, that would tend to moderate the suggested inability to maintain a penalty rate when borrowings are high.

CHAIRMAN VOLCKER. I think it's still harder, if I understand you correctly. I think we just move along a schedule of reluctance; we have more reluctant borrowers with a high level of borrowing. That means the federal funds rate will be more above the discount rate.

MR. BALLEES. I would like to ask Peter a question at this point. If we were to go along with the Banking Committee proposal to tie the discount rate to market rates, how do you see that affecting your ability to carry out the Committee's directive?

MR. STERNLIGHT. It could have an effect on the way we tie in a level of borrowing in our path. I'm not sure I want to try to extemporize entirely on how it might impede our [operations]. But instinctively I feel it would call for some adjustment in the way we have operated in the past with a borrowing level that tends to fall out as the differential [changes]. We have had borrowing levels that rise because demands for required reserves exceed what we have allowed for in the path. If we also had a discount rate that was going to be moving up along with that, it could set in motion this kind of ratcheting process unless we made some adjustment.

MR. WALLICH. Isn't it a technique [that resembles] a halfway [move] toward closing the window altogether? If the gap between the funds rate and the discount rate--that is, the penalty--were large enough, clearly, nobody would borrow. And we would be operating purely on nonborrowed reserves.

CHAIRMAN VOLCKER. I think it's quite clear what would happen if we didn't change our techniques, which might have some implications for whether to change them. What would happen is that we would get more volatility in the federal funds rate in the short run.

MR. GRAMLEY. Is it necessary to think of tying the discount rate just to the federal funds rate? If one is worried about the ratchet possibilities, another way to go is to tie it to some market rate of interest or to a combination of market rates. If looked at in that way, it would still be a penalty rate in some sense.

MR. MAYO. But if we used the bill rate, Lyle, given what bill rates have done, we would have a different problem on our hands.

MR. GRAMLEY. Well, I was thinking of tying it perhaps to something other than the bill rate--to a combination of bill rates and other things--precisely because the bill rate is so sensitive to things like foreign demand and technical scarcities in the market.

MR. MAYO. Well, the Canadians--

MR. BALLEES. One can also be judgmental rather than automatic in a formula. We could have a basket of rates but not reduce [the relationship] to a simple formula. We could vary the relation between the basket and our rate if we wanted to go the tying route, I think.

MS. TEETERS. I don't think that would get us out of the problem we've been talking about because if we tied it to a longer-term rate it's going to switch from being a penalty rate to being a subsidy rate when the yield schedule inverts.

MR. MAYO. We always used to show a three-way average rate to our directors, just as a point of contact, [using the rates on] finance paper, Treasury bills, and commercial paper--all fairly short term. We have had to abandon that recently. We give them the table but we don't talk about it because we think it's out of whack.

MR. EASTBURN. If I remember right, Paul, after the change in procedure last fall there was to be a paper written by the staff on this whole question of the [funds] rate and the discount window.

CHAIRMAN VOLCKER. Yes, I thought there was. Where do we stand on all of this? We discussed this once before.

MR. EASTBURN. I think the legislation came along and preempted that to some extent.

CHAIRMAN VOLCKER. I don't remember how far we got on that. We did have a preliminary discussion about it at one point. Did you ever circulate a paper?

MR. ETTIN. No, not to my knowledge. There are some drafts of some of the papers, but President Eastburn is right: The resources have been diverted for work on the Monetary Control Act.

CHAIRMAN VOLCKER. I had forgotten that that had never been done formally, and I think we ought to do it. Meanwhile, I have been answering Congressional and other inquiries along the lines that I have been expounding at this table. I don't think this situation is totally satisfactory, but I don't think the answer is just to [establish] an "automatic" discount rate for the reason that I suggested and for Tony's reason--whatever weight one gives that reason, which is something people have debated back and forth. I don't think technically we have the [alternative of doing that] without changing other things. I think it would call for rather profound changes in path setting, or maybe in whether we open up the discount window or close it, as Henry was suggesting.

MR. EASTBURN. It's [further] complicated by the fact that we now have the thrifts in the situation, which involves Home Loan Bank rates and so on.

CHAIRMAN VOLCKER. Yes, Mr. Ford.

MR. FORD. With regard to the comment of what to peg it to: Should we go to a floating discount rate, my feeling--[given my prior experience at a commercial] bank--would be in line with what Lyle said. We should consider an alternative that no one here has mentioned [yet], and that is tying it to something like the bank issue rate on CDs. From the point of view of the money desk manager of a major bank--and those are the people we are dealing with--whether or not the bank goes to the discount window obviously depends on its alternative sources of funds. And in terms of maturity matchings, since borrowings through the discount window are not normally overnight but rather are done on a more than overnight basis, I would suggest that the staff in its analysis of this question look at the possibility of applying it to the reserve adjusted CD rate for major banks on large quantities of money. That would make the movements in the discount rate less volatile since a longer maturity [is involved]

and would tie it to the alternative source of funds that money desk managers tend to consider. Also, we might consider having the discount rate normally set close to that reserve adjusted cost--perhaps a little below it to give us some leverage--because then [money managers] would want to come in if we set our rate just a little below, but the reluctance factor would sort of balance that out. It would give us some leverage over them.

MR. KEIR. I was just going to comment that we did have a footnote in that earlier study on the discount window, which sort of reviewed the conclusions that come from these other papers we have been doing. The expectation is that those papers will be completed as soon as the staff gets through this other work that they are doing on the discount window.

CHAIRMAN VOLCKER. We have to ratify the transactions of the Domestic Desk. Without objection. Mr. Kichline.

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

CHAIRMAN VOLCKER. Why don't we discuss the economic situation and outlook at this point. Mr. Eastburn.

MR. EASTBURN. One of the most interesting questions is what is going to happen to housing because that may be a clue to how fast the recovery will be. I think the situation with respect to interest rates and the availability of money cuts two ways. A lot of people out there are watching mortgage rates and are waiting to get into the market if they think the bottom has definitely been reached. Therefore, if they see an upward movement in mortgage rates, that could induce some demand to become effective. On the other hand, there must be a lot of other people who will be discouraged as mortgage rates go up. Do you have any feeling about that, Jim?

MR. KICHLINE. That has constituted a large debate in the preparation of our forecast. I would say that in the very short run we would expect the argument to hold that people will jump in. That is, if we are talking about a rise of just a few basis points, those folks who were out of the market in the second quarter but were on the verge of buying may in fact be prompted to move off the fence. In general, however, we believe the impact of tighter financial conditions--in the sense of rising mortgage rates throughout the forecast period, which is implicit in our forecast--would have a significant damping effect. There are two other factors and one is [particularly relevant]. Our forecast implies slower rates of increase in deposits at thrift institutions than in previous cyclical periods when interest rates declined and stayed low. I might mention another factor, which is that the growth of real disposable income in our forecast is really very small--certainly much smaller than in past cycles. And we expect that to act as a drag on generating effective demands for housing.

MR. SCHULTZ. One other factor is the effect of actions by the Federal Home Loan Bank Board. Monthly payments are the crucial [factor for most homebuyers]. If the FHLBB proposes that thrifts drop downpayments from 20 to 10 percent and that [mortgage terms] go from 30 to 40 years, that will considerably lower [the initial outlay and



then] the monthly payments. What effect will that have on the whole picture? That's another factor that probably will be important.

MR. KICHLINE. Oh, I think that's right. That whole area of alternative mortgage instruments is a positive feature, particularly for younger families. But past experience generally indicates that these [practices] grow fairly slowly, particularly in an environment in which the institutions are rather risk averse, which they seem to be. If one starts talking about going out 40 years instead of 30 years, in a fixed-rate environment with today's inflation I think a number of institutions will be fairly reluctant to move in that direction.

MS. TEETERS. Jim, why don't you tell us what happens to interest rates under the monetary assumptions we have? Where does the mortgage rate go?

MR. KICHLINE. For the third quarter we have the quarterly average rate on conventional mortgages at around 12-1/4 percent, which is where it is now, and it goes to the 13-1/4 to 13-1/2 percent area by the latter part of 1981. So in effect, it's drifting up throughout this period.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, the main point of difference we had with the staff continues to be that we expect less inflation than they have been forecasting recently. The Greenbook analysis places almost all the emphasis on the supply side. It talks about the effect of rising oil prices and food prices and unit labor costs causing inflation, but it really doesn't address this question of the continued deceleration we have had--and that we see prospectively--in the money supply. Nor does it address the shift toward a greater surplus in the high employment budget. We would place great weight on this slowdown in the money supply and some also on that shift in the fiscal mix. This will represent about the third year of deceleration in the money supply if [it continues] next year. If anything was right with that October 6 policy, somewhere along the way we are going to see some effect on prices. And we think it will come sooner than the staff does. It's easy to forget that the rate of increase in prices had hovered at double digits before the last downturn and we got [it] down to 4-1/2 percent but we let the aggregates get away from us and [inflation] went back up. Most people don't remember that. We also think that if we are partly right on this, we will have less upward pressure on interest rates than the staff expects, both because of the removal of the inflationary premium on long rates and probably less growth in nominal GNP and more growth in real GNP than the staff is projecting.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. It seems to me that the development President Black describes would imply either that there will be differential wage movements--because we know the movement in the organized sector is for fairly strong increases, the pressures would have to be in the much larger [non-union] sector--or very severe pressures on corporate profits. Is there any other place where a decline in interest rates would work or where productivity would [lead to] a decline in prices?

MR. PARTEE. Raw materials prices.

MR. WALLICH. The dollar could rise.

MR. MORRIS. The difference is that in 1974-75 we had a V-shaped recovery. For a short while we had very big gains in productivity, which were reflected in a big decline in the inflation rate. If we don't get the V-shaped upturn, the rate of gain in productivity is going to be a lot less; I guess that's the reason why you're pessimistic on prices, as I look at this chart.

MR. KICHLINE. That's a principal reason. Unit labor costs in our view are going to be coming down, but precious little. We also have the social security [increase], I might add. That adds directly to business costs beginning in January, and we assume that will be passed through quite quickly. We have the food and energy situation added on, and it's hard to be optimistic there. So overall, our view is that our [inflation] forecast, given our GNP, is perhaps on the low side of what many people might come out with.

CHAIRMAN VOLCKER. I don't know how you forecast interest rates but in the long-term area with your mortgage rate, your bond rate must be up in the neighborhood of 13 to 14 percent. That would be an extraordinarily high interest rate compared to your price indices at the end of next year. It would be the highest real interest rate, in my memory anyway, for a long time. Any comment?

MR. KICHLINE. I'll give you the answer you're looking for first, and that is that we forecast interest rates with great difficulty. It comes from a combination of the model exercise as well as judgmental forecasting. And we take the monetary policy assumption as given, which is 4-1/4 percent [M-1A growth] for 1981. Implicit in that [assumption] is a substantial further downward shift in the money demand function. So in effective terms money is growing more rapidly. But simply to hold money growth to 4-1/4 percent, even with a downward shift, implies to us a substantial further increase in interest rates.

CHAIRMAN VOLCKER. Short-term interest rates.

MR. KICHLINE. We have short-term rates rising above long-term rates by the end of this forecast period. So we're once again back to an inverted yield curve. That seems to me rather an unusual situation for a very sluggish recovery with inflation coming down, if people believe that. But it's very hard to envisage a significant decline in long rates unless one believes that price expectations are changing dramatically and that, in fact, our inflation forecast is wrong. Otherwise, yes, we come out with rising real rates. And that's one of the reasons why we have a sluggish recovery.

MR. MAYO. A \$60 billion budget deficit doesn't help on the rate side either [even] if we keep our eye on the ball of the monetary aggregates.

CHAIRMAN VOLCKER. Well, I will agree that it's hard to forecast [interest rates]. Mr. Winn.

MR. WINN. I have to differ with my colleague on the left on price expectations. I sense quite a feeling that our inflation

problem is not behind us. Labor is very restive, with food costs being a real trigger for their demands. Secondly, new car prices are going to surprise people. Every business that I can find is quietly trying to raise its prices to position itself. In that kind of environment, I think there's an explosive side. The other factor is the political environment on top of that, with everybody trying to out-promise everybody else. If we just look at what has happened to sensitive materials prices in the last few weeks as well as all of the others, it seems to me that, despite our roller coaster ride, we have not dented inflation expectations very much. I think we have a real groundswell for an explosive development on that side again. In spite of all we've done, we haven't laid to rest the inflation expectations very much.

MR. BLACK. Mr. Chairman, I never meant to imply that we had at this point. All I meant to imply was that by next year, with a continuation of the policy we've begun, I would expect some significant effect on prices, or else our actions have been completely futile. And I don't think they have been.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. It seems to me, Mr. Chairman, that we have a good news/bad news syndrome here today. In terms of recent economic statistics as well as the updated and revised forecasts of both the Board's staff and our own staff at San Francisco, we see a better outlook for the economy and better news on the unemployment front. But both sets of forecasts show a worsening picture on inflation.

CHAIRMAN VOLCKER. When you say "better"--I just want to help Mr. Altmann a little [in preparing the record of Committee member's views]--are you saying better than the staff is projecting?

MR. BALLEES. No. I mean both staffs are now forecasting more inflation, less decline in real GNP, a shorter period for the recession, and less of a rise in the unemployment rate than they were a month ago.

CHAIRMAN VOLCKER. I just wanted a clarification of your statement. You're not saying you are necessarily more optimistic than the staff?

MR. BALLEES. No.

CHAIRMAN VOLCKER. You're more optimistic than you were last month, which they are too.

MR. BALLEES. I find no quarrel with the general thrust of their updated forecast relative to where they stood a month ago. It's better on the real side, better on unemployment, and worse on inflation. To put our current recession in some perspective, for what it may be worth, we went back and looked at the behavior of prices during the last two recessions. We looked at the behavior of the GNP deflator--and I had forgotten this, frankly--but it turned out that at the end of the last recession, the GNP deflator was no better than it had been at the beginning of the recession. That was also true of the recession prior to that. In fact for the 1974-75 segment, it was four quarters after the trough of the recession that the inflation rate, as

measured by the GNP deflator, hit its low point. Now, if I look at what seems to lie ahead--if the Board's staff and my staff are correct that this dip in the economy will be over by the fourth quarter of this year and we will then be into the next expansion phase, as weak and anemic as it may be--to the [projected] GNP deflator by the end of '81, which is four quarters after the now projected trough of the recession, I get very disturbed indeed. The Board's staff shows the GNP deflator still rising at an 8.7 percent annual rate. My staff would be a bit more optimistic. But that's an awfully high inflation rate to have at the beginning of the next expansion phase of the cycle.

Also, with respect to the comments a little earlier on where long-term rates are headed, with special attention to the mortgage rate, I am distressed to see how high those rates are forecast to be. But I am also convinced that we won't get those rates lower than that 12 to 13 plus percent for both the corporate bond issues as well as mortgage rates until we get the inflation rate down. Obviously, long-term interest rates are very heavily influenced by both actual and expected inflation. I think we have a real dilemma here.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. In terms of the real economy, Mr. Chairman, I would be inclined also to view it as a little better this month than it looked last month. I am also inclined to the view that, at least over the next couple of quarters, the real economy might be a bit stronger than the staff forecast. But I am only willing to say that for the next couple of quarters. I think, for example, that we may see a little more strength in housing in that period and that auto sales might be a little stronger than is suggested simply because of the greater availability of fuel efficient cars. Partly because of consumer credit reductions but also because of what's happening in the stock markets, consumer balance sheets are probably a good deal stronger than they were, which I think is consistent with that development. But looking out a bit further I see some risks, including the point that has already been made about what will in fact happen to interest rates and what that may mean for housing and capital goods. On the price side, we have a situation where in the near term the CPI certainly will look better. But my own perception, like that of others, is that the price outlook and [inflation] expectations actually have deteriorated in the last month or so. The unit labor cost situation, of course, looks terrible. The budget deficit situation, in terms of its implications for expectations, is a matter of concern. The weather and [its impact on] food prices is an unknown, but at least for now I think it can only work in one direction. And I sense a growing element of concern in the markets [about] the recent money statistics and what they may portend for inflation over a longer period of time. The fiscal [side], as has been said, is full of uncertainties. The one thing we are sure of is that the deficits are going to be big. Financing requirements of the Treasury are going to be substantial, whatever that implies. Certainly we think we know something about what it implies for interest rates. In summary, as I look at the situation, I think the relative risks have shifted. While we still have a weak economy, in the near term it may be a little stronger than we thought it was. But the price situation, if anything, looks a little worse--conceivably a good deal more than a little worse--rather than a little better.

CHAIRMAN VOLCKER. Mr. Wallich.

MR. WALLICH. I share John Balles' view that the real sector looks a little better and inflation looks a little worse. I think that's a fairly general impression among forecasters. I also see two characteristics of our economy that seem to be visible now. It has very quick defenses against a sharp downturn, given that the downturn didn't go very fast. Automatic stabilizers went into action and seem to have been holding--

MR. PARTEE. It went pretty fast.

MR. WALLICH. That's what I said. It caught--

CHAIRMAN VOLCKER. You say the downturn went pretty fast?

MR. WALLICH. The downturn went fast but didn't go very far. It caught itself pretty fast, and we are already beginning to feel the counterforces on the other side. That is, interest rates are already beginning to rise, which I think could choke off the expansion. In other words, the economy now reacts very quickly on both sides. What we have not gotten at all out of the recession is much adjustment. There doesn't seem to have been time for much adjustment in corporate balance sheets or household balance sheets. I don't think anybody's expectations and behavior patterns are likely to have been changed very much by this experience. Not to put too fine a point on it, nobody has gone broke. Nobody has been hanging on the cliff for a very long time except some of the thrift institutions. In other words, this has been a surprisingly mild recession. It is very unlikely to have [set the stage for] much long-term improvement if in fact it now takes off from here. It's not likely to change our attention, expectations, or behavior in a favorable direction if [the economy] bottoms out quickly and resumes a modest advance, as seems likely. So the conclusion I draw is that this is a situation that calls for continued restraint in order to get some more effect out of the situation.

CHAIRMAN VOLCKER. Mr. Kichline, I meant to ask you earlier, and I didn't, about consumer balance sheets. Governor Wallich says they haven't had a lot of time to improve all that much. There has not been much time, that's for sure; but the decline in debt at least has been much sharper, I think, than in earlier recessions. How does the improvement in the consumer's financial position look compared to earlier recessions? Do you have any judgment on that?

MR. KICHLINE. As you know, the ratio of debt outstanding to disposable personal income peaked [last] summer, in the third quarter of '79. It came down a little in the fourth quarter and a bit more in the first quarter. We don't have a final second-quarter figure but, obviously, given what has been happening with the run-off in consumer debt and the slow growth in mortgage debt, there was a significant further improvement in the second quarter. I would think the change in debt outstanding we've seen in the second quarter is just a huge change in terms of historical [patterns of] debt reduction. So while it hasn't gone very far, my guess would be that it ranks with some of the largest declines in consumer debt outstanding that we've seen in a six-month period.

MR. SCHULTZ. Jim, I thought I saw some figures the other day that [the ratio] had peaked at 18 or so percent and has dropped now to less than 15 percent in this very short period of time.

MR. KICHLINE. Yes, that's just for consumer debt. We've combined consumer and mortgage debt, and the mortgage debt helps that story because it grew at a much reduced rate in the second quarter. I don't have the figures at hand.

MR. GRAMLEY. Mr. Chairman, another point that Mr. Corrigan mentioned, which I think is worth remembering, is that we've had a very marked upswing in the stock market this time in contrast to a very very weak stock market in late '74 and in '75. We were massively destroying consumer wealth in that earlier recession and this time I think we're creating it. It would make a big difference if we took that into account, too.

MR. CORRIGAN. Yes, if one looks at both the asset side and the liability side, we really do have a--

MS. TEETERS. But didn't interest rates hold up for a longer period in the recession of 1974-75? We've had a terrific drop in interest rates, which is going to have a bouyant effect on the stock market at this point.

MR. GRAMLEY. I don't think they held up particularly. They didn't go down as fast as they did this time, but my recollection is that interest rates started declining about September or October '74 and continued on down into the spring of '75. In terms of timing there has not been a lot of difference, but the speed of movement is certainly [different].

CHAIRMAN VOLCKER. Are there any other comments on the business picture?

MR. MAYO. The stock market seems very unreal and a lot of people are predicting that we will have a correction. Of course, our former Secretary of the Treasury announced he was selling all his holdings and the market went up 20 points in the next two days!

MR. PARTEE. It's based on his past record!

MR. MAYO. I see a lot of the investment people from LaSalle Street and almost without exception they are expecting at least a 75 to 100 point correction.

MR. MORRIS. Of course, that never happens when the judgment is unanimous that it's going to happen.

MR. MAYO. I know.

CHAIRMAN VOLCKER. Mr. Altmann is left at this point with saying [in the policy record for this meeting] that you all agree with the staff's outlook. Is that the impression you want to leave him with?

MR. MAYO. Basically, it's all right.

MR. PARTEE. I am impressed by the signs of the economy catching as we've [eased our policy]. I don't know to what extent we should regard that as unusual. The decline in consumer spending was exceedingly rapid and took us to pretty low levels in real terms in some areas such as automobiles. It may not be that unusual to have a little recovery after we've had a decline of that extent--a little catching up--particularly with money and credit conditions easing. So, I guess I am not as convinced by the evidence that the recession is nicely bottoming out and that it won't be very long before we get an upturn. I don't agree that this is conclusive since [the period of improvement] is so brief and since it seems any market would have a little see-sawing when big changes occur. I wouldn't agree with the comment that Henry made that nobody has gone bankrupt. I believe bankruptcies are at an all-time high all over the country. Small businesses are going bankrupt and the automobile dealers are having a major shakeup. It's just that no big companies have gone bankrupt because we didn't permit Chrysler to do so. Otherwise we would have had a big bankruptcy as we've had before. Also I would point out that there is a long tail on this. If Bob is right, even if the staff is right in their price projections, we're going to have a period of quite restrained profit performance. And when that occurs, there is a frequency distribution around it; some [firms] are going to be a lot less good than average and they might be bad enough to go bankrupt. So there's still a lot to be played out. What gives me most pause about being somewhat bearish about the outlook is the stock market, which has performed extraordinarily well, and sensitive industrial materials prices have moved up without fail for two months or more by a rather marked amount. And there are a lot of people out there who, unlike us, are putting their money behind their forecasts. They say that profits are going to go up--I presume in order to justify the stock market--and that prices are going to go up because of the demand for raw materials. And that does give me a pause. So, I am just uncertain. But I wouldn't be quite as favorably inclined on the outlook as the discussion around the table has [suggested] so far.

MR. GRAMLEY. I'd just like to add a few comments. I am very much in agreement with the staff's forecast for real activity. All the signs are now pointing to a fairly near-term bottoming out of the recession and to the recovery beginning in the monthly statistics before the end of the year, although it may well be that the real GNP figure would be negative for the fourth quarter. To comment further on what Governor Wallich was saying, I think the business community learns something a little different from each recession. In the recession of 1974-75 what the business community learned was that by Jove they better not have excess inventories. They didn't forget that. So they are reacting very strongly in this recession, as they did throughout the whole recovery. In this recession what I think they will have learned is that they better not borrow at the prime plus 2 percentage points because the interest rate risks they face are ferocious, given the kind of inflation that we have and given the policies that the Federal Reserve is now following. That is going to have a very, very sobering influence on planning in the business community in the next several years.

I am more pessimistic than the staff on the price outlook for next year. I think compensation is not going to moderate as much as the staff indicates. More of a rise in prices relative to compensation than the staff has forecast is likely also. I think

that's what the stock market is saying: That businesses are going to raise prices to get profit margins up as soon as activity begins to improve. That's exactly what Chrysler is doing in pricing its K cars. But the price situation for next year poses for us a very profound problem. The staff has a weak outlook for economic growth and a very weak outlook by historical standards for a recovery period, despite the fact that they're assuming--with no good basis for it, really, and they know that--that the money demand function is going to shift down again. If it doesn't and if prices go up still more than the staff is forecasting, then holding to the kind of targets that we have is going to produce a very, very sick economy. It's something we don't have to face as a Committee now, but it's something that is going to give us agony as the next 18 months unwind.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. As perhaps the two newest members might not know, we base our projections on output and prices primarily on the rate of money growth, M-1B specifically. Our projections show a significant difference in what will happen depending on whether M-1B grows, for example, at a rate of 3 percent or 5 percent or 7 percent from the third quarter of this year on. Let me very briefly give you the different results that we would anticipate for GNP growth in 1981. If money were to grow at only a 3 percent rate, we would see real GNP growth throughout 1981 at a negative rate of minus 1/2 to minus 1 percent, whereas if we persist in our announced target of about 5 percent money growth, we would see positive real GNP growth of approximately 3/4 to 1 percent. If we lost our good judgment--that's a subjective statement--and permitted money to grow at a 7 percent rate, we would see real GNP growth at a rate of between 2-1/2 to 3 percent next year. Price-wise, there is also a significant difference. If we had the 3 percent money growth next year, by the end of '81 we would see a deflator of maybe 6-3/4 percent by the fourth quarter of next year. If we persist in our 5 percent growth, we feel that prices as measured by the deflator would rise at about 7-1/4 percent rate on an annual basis. And if we lost our good judgment and went to 7 percent growth, the deflator would be up close to 8 percent, as we see it, by the end of next year. So we feel there is a significant degree of responsibility in our hands in determining the rate of money growth and thereby influencing both prices and output for 1981.

CHAIRMAN VOLCKER. A lot of people might conclude from that analysis that good judgment is 7 percent, Larry.

SPEAKER(?). But you don't know about '82.

MR. ROOS. I'm a 5 percenter, Mr. Chairman. That used to be a bad word--5 percenter--wasn't it?

MS. TEETERS. I'm a little surprised at the strong change in sentiment based on so few facts. We have a few good numbers or a few numbers that aren't terrible. That's about what it comes down to. We don't have a good indication of what the third quarter will be yet. The labor force data on the payroll basis are going to catch up with us. We've just had some good luck on the size of the labor force in the last month or so. I would also point out that the past five years have been characterized by a good quarter followed by a bad quarter.



It hasn't been a smooth recovery or [pattern of] growth anyway. Many times we thought we were on the verge of a recession and then recouped from it. So, I think [the economy] is just jiggling around. I am also terribly concerned about 1981 because I think we have a very strong possibility, with the low rates of growth that are being projected, that this will turn into a 1959/1961 situation where we'll have a double recession--one right after the other. There is just no strength in this particular forecast; [activity is at] very low levels. I think this forecast has the longest string of negative business investment--if it turns out to be as forecast--on record. That gives us a very, very poor outlook over a fairly long period of time. So I don't think we need to hit the horse any harder than we're doing at the present time. We've knocked it off its feet. Let's give it a chance to rest awhile and hopefully let it get up at some point rather than constantly pushing it back down again. I would say that if we move for any further restraint, we're almost guaranteeing that the housing market will not recoup. The prices of cars are such that nobody can buy them; and even though the industry is trying to push up prices, the consumer is in no position to meet those higher prices. We have a lot of uncertainties at this point. I think we've gotten something out of [our posture of restraint]. I'm worried about prices. But we haven't had any time at all for [our policy] to be reflected in the current statistics.

CHAIRMAN VOLCKER. Why don't we turn to Mr. Ettin [and then have coffee].

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

[Coffee break]

CHAIRMAN VOLCKER. Why don't we have what I hope will be a relatively brief general discussion or questioning of Mr. Ettin and then we'll get around to the [policy] specifications. We can divide it up. We have an hour and a quarter. Henry has put his hand up, too, but we'll let Mr. Eastburn go first.

MR. EASTBURN. Right before we adjourned, Ed was giving some parameters for M2. I said to him [during the coffee break] that M-1A is not much good to us anymore and M2 doesn't seem very good either, so we're reduced to M-1B, I think.

CHAIRMAN VOLCKER. Which isn't very good either. Don't look at these too carefully. That's [the message].

MR. EASTBURN. It's the least worst, perhaps.

CHAIRMAN VOLCKER. Try M3.

MR. EASTBURN. I was just asking whether he had any guesses on that, particularly. I'm looking for something in the Bluebook, but I can't put my finger on it, about the presumption that the recent changes in interest rates are going to narrow the gap. How confident do you feel about that and what do you think the magnitude of that might be?

MR. ETTIN. We're reasonably confident that that's the trend, because as market rates rise relative to the ceiling rate on passbook

accounts, we think that's going to slow down. It's hard for me to estimate how much that strength in savings deposits is adding to M-1B because the amount of ATS accounts relative to M-1A is relatively small. I would say maybe 1/2 percentage point, but that number is pulled out of [the air]. The point is that I'd make it on the modest side.

CHAIRMAN VOLCKER. I don't really think we can assume any of these numbers are the right numbers. We know M-1A is bad because more goes out of demand deposits than from M-1B; but to the extent [funds] go out of savings deposits into M-1B, that measure also is distorted. We just don't know the extent of this.

MR. MORRIS. Maybe we ought to move to L.

CHAIRMAN VOLCKER. Well, I tell you: The M3 chart is such a beautiful one that I am tempted to move to M3; we're right in the middle [of the range].

MR. WALLICH. M3 is another of those [variables] that maintains its stability because one [component] goes down and something else goes up, which is a little suspect.

MS. TEETERS. That's what we thought we were doing with M2.

CHAIRMAN VOLCKER. You had some comments, Henry?

MR. WALLICH. I really want to say the same as Dave: M-1A is not much good and M2 is not much good. Isn't the main argument in favor of M-1A--and the reason why we keep talking about it--that it is used in the model?

MR. ETTIN. That's the reason why the staff places particular emphasis on it.

MR. WALLICH. Can't we re-program [the model] for M-1B?

MR. KICHLINE. Certainly, but the model is not the problem.

CHAIRMAN VOLCKER. What makes you think M-1B is [any better]? To say that M-1B is better than M-1A, you are making an assumption that there is very little movement from savings deposits into M-1B. That may be true, but I don't think you know it.

MR. WALLICH. There is another guide that we could go to, which is to look at what happened in 1974-75. The impressive experience at that time was that we all underestimated--except maybe your distinguished predecessor by one--the increase in velocity that we were likely to get. So, I ask myself: Do we see something in the economy that implies a very large increase in velocity? All I can see is that we have had a tremendous experience of very high interest rates and, as someone just said, the economy has learned [from that]. As Lyle said, [firms] learned not to borrow at the prime rate plus two percent. I think they also learned not to have idle money around with a prime rate of 20 percent. So that may be the thing that has triggered a new increase in velocity.

MR. ETTIN. If I may, Governor Wallich, I would point out that to the extent that kind of [positive] ratchet effect would be hitting [velocity] after a sharp run up [of interest rates then], interest rates would be hitting money demand [negatively]. Each period with that impact should be shorter and shorter; indeed, the evidence we have is that when it first begin in 1974 it took a little longer than the next round. I think the evidence supports that the drop-off [in demand for M1] in the second quarter was very short-lived.

CHAIRMAN VOLCKER. Yes, one could argue just that. I think we had a big impact in the second quarter, but now because we have had that impact it will make the velocity relationship even tighter than it was before.

MR. PARTEE. The staff projection for the third quarter [implies] a decline in every velocity measure.

MR. WALLICH. Well, that's simply the result of dividing a falling income by--

MR. PARTEE. But what is [velocity in] the second quarter, except the simple result of dividing income by money supply?

MR. WALLICH. Yes, but one has to think about what happens at a constant level of interest rates in order to measure the velocity trend. We have to hold the rates constant and then see whether or not there is an increase.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I wanted to talk about this very subject. I wanted to indicate that I am somewhat dubious about giving much importance to M2 in the current environment for several reasons. Number one, our range for M2 was developed on the basis of a relationship the staff presented to us some time ago, which might have been right or might not have been right. Certainly, it is at least dealing with an instrument that has different components in it than before. Number two, the top end of our range for M2, an aggregate which includes most kinds of instant liquidity that people can think of, is 9 percent. That is about equal to the rate of inflation; so at the top end that means the real value of liquid assets will not change. That doesn't sound all that great. And we have the [prospect of] these shifts of the sort that Ed was mentioning, which do strike me as possible. M3 is better than M2, I think, because of the possibility that M3 components--that is, large CDs [primarily]--are moving to identified M2 components as a result of interest rate strategies and so forth on the part of holders. I don't find M-1A all that bad an indicator. I think what we have to recognize about M-1A is that it has a downward bias. That is, there is some shifting away from M-1A, and we can't quite quantify it, but the basis for M-1A's relationship to the economy is pretty well established over time and has been pretty well researched. M-1A still does have currency in it and it still does have demand deposits in it so that we see what the relationship might be. It seems to me the best thing to do is to look at M-1A principally and make an allowance--I don't care whether we make it a 2 percent allowance or what--for the understatement of the growth rate that is occurring because of shifts into other

instruments. I think that's the safer way to go. An alternative way, along our usual lines of suggestion, is why not average M-1A and [M-1B] and say that's our goal, on the [grounds that] neither is right. One has an understatement and one has an overstatement, so let's take the average. It can't be all that bad. But I think M2 is very dangerous to use importantly in trying to steer monetary policy, and I would certainly advise against that.

CHAIRMAN VOLCKER. Mr. Gramley.

MR. GRAMLEY. First, I'd like to compliment Ed on some perceptive remarks on the interpretation of these numbers. This is the kind of thing we always need to watch very carefully to see if we can analyze the particular factors that are influencing the growth rates of these numbers. None of them is perfect and we need to try to make some judgments about what is influencing their behavior. I guess I don't really understand, Ed, the comments that you made on ATS deposits. Let me ask a question first and then ask you to elaborate a bit. Do you have hard information on the ATS deposits? Or is this an estimated number based on an assumption that so much of the growth of savings deposits must be in ATS accounts?

MR. ETTIN. We have hard numbers for member banks and estimates and samples for nonmember banks.

MR. GRAMLEY. Could you make that point again that you were making about ATS deposits?

MR. ETTIN. The ceiling rate for ATS accounts and regular passbook accounts at commercial banks is identical, at 5-1/4 percent. One would presume, because our evidence is that everybody is paying the ceiling rate, that it would be unlikely that an ATS account holder would have both an ATS account and a regular savings account. It's probably one account. To the extent, for whatever reason, that passbook accounts generally have been strong, some of the [depositors] who would be increasing their savings account funds would call their account an ATS account. So the measure of those transaction balances would be biased upward.

MR. GRAMLEY. Thank you.

MR. MORRIS. It's also true of NOW accounts, even though there is a penalty, a quarter [point lower return]. A lot of the NOW account total really, in a sense, represents savings accounts.

MR. ETTIN. While that's true, I feel less certain that the big run-up in savings may also be [spilling] over into NOWs because we have heard, and have some evidence, that people in fact have a NOW account and a savings account. I don't know how much weight to put on it. We don't know. I am more certain about it for ATS accounts because there is no ceiling differential.

CHAIRMAN VOLCKER. We [face] a real problem next year, in my role wearing my other hat as Depository Institutions Chairman, on whether to differentiate these rates. There is going to be a lot of arguing about that. Mr. Corrigan.

MR. CORRIGAN. Two quick questions, Ed. I am inclined to the same view that you articulated in terms of M2 and these asset preference shifts. If that's right, is it also your judgment that that pattern will likely continue for at least several months? If anything, presumably in this environment, we are talking about at least a couple of months in which money market certificates or savings certificates are going to be perhaps even more competitive.

MR. ETTIN. My answer, President Corrigan, would depend on how rapidly interest rates rise over the next several months. To the extent that market rates do rise, I think there will be some slowing in M2 because market instruments will look somewhat more attractive. But I don't think it will make a great difference.

MR. CORRIGAN. One other quick question. I have heard that there is already talk in the markets, for whatever it's worth, of a very, very, large money supply number this Friday. Do your numbers suggest that?

MR. ETTIN. Yes, our preliminary estimates suggest that in the week of August 6th there will be an increase in M-1A of over \$3 billion. I think the market talk may be reflecting Mr. Sindlinger, who is expecting an \$8 billion increase in the first two weeks.

MR. CORRIGAN. The number I've heard--and I've heard it from two sources--is \$4 to \$5 billion on M-1. So I was just wondering.

MR. ETTIN. Part of it also is the social security--

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. A couple of points. Ed made the point very well on savings bond redemptions; that has eased off a little now. But a lot of that money is just parked waiting for what people think will be [higher] interest rates, I think. Also, the Treasury has a 9 percent bond coming due August 15, which was subscribed to by a lot of [individuals], at least in our area. They are already making inquiries as to what [return] is available [on Treasury securities] and typically are saying: "Oh well, I'll put [the proceeds] in a money market mutual fund when it comes due. So we will be seeing more of that, which again leads credence to the fascination with M3. But it also gets to the point that the further out we go in the Ms, the less control we have over what we are doing. So I think we have to be careful not to get too fascinated with M3. I'm inclined to differ a little with Chuck [on the relative merits of] M-1A and M-1B. We'd have to adjust either one of them, whatever we were doing, and M-1B may be the better one going out a year or so. Also, that is what the market is looking at. I think not much attention is paid to M2 in the everyday market. Whether Peter [Sternlight] and Allen [Holmes] would agree with that or not, [I don't know].

MR. STERNLIGHT. I think M2 gets less attention largely because it only comes out monthly. There has been some notice taken of it.

CHAIRMAN VOLCKER. We hope 18 months from now M-1B will be that number, and we will have washed out all these--

MR. MAYO. Well, we hope so. We will have a different reason maybe a year from now. But the further out in the Ms we go, the more trouble we get into in terms of what we can influence. I feel we are better off sticking pretty much with M-1A and M-1B for the moment.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I'm in line with what Bob said. Our research department has done quite a bit of work recently in checking the predictive value of these various aggregates. Their conclusion is quite clearly that M-1B has predicted output much more accurately than the other aggregates. If we can ever get this material edited, Mr. Chairman, we will circulate our wisdom to this wiser body if you'd like.

CHAIRMAN VOLCKER. We will look at it with great interest.

MR. ROOS. Thank you, sir.

CHAIRMAN VOLCKER. Lyle, you had a comment?

MR. GRAMLEY. I was just going to say that Mr. Sternlight is right [about M2]. And we might be well advised to choose an aggregate for which we only have monthly figures.

CHAIRMAN VOLCKER. Any other general comments? I take it there is a good deal of acceptance of some of Mr. Ettin's comments, and there is some question about being too serious about M2. Maybe I have misstated that. [Perhaps it's more accurate to say] we should look at it but there is some reason to think it may be somewhat distorted on the up side.

MR. WALLICH. Just a comment. If we are getting sufficiently frustrated with the aggregates, there is the old standby of real interest rates, after tax. We have done a certain amount of work on that now.

MR. PARTEE. The "old standby" of real interest rates?

MR. WALLICH. After tax, real interest rates.

MR. PARTEE. Your old standby.

MR. WALLICH. I've mentioned it from time to time here. I just wanted to tell you that it's available now. It has been run through the computer, so perhaps it has acquired a little more--

CHAIRMAN VOLCKER. Along with Mr. Roos' material, you can circulate that.

Now we have to turn to the serious business of the Committee. A number of people, John Balles and others, have described our basic dilemma in that we have both a serious inflation problem--or more pessimism about inflation and great sensitivity to expectations of inflation--against a rather shaky business recovery. So some of the things one might ordinarily think would be good for the business recovery may not be good for the business recovery if they maximize the inflationary uncertainties and have an adverse repercussion on the

market for that reason. As one market caller put it to me the other day, if the money supply really goes up very sharply for a couple of weeks, we will have big increases in long-term interest rates. I think that is descriptive of the kind of dilemma we are in. I don't know how we get out of that without going through a painful process of deflating the inflationary expectations, which are not deflated yet. And I don't know how they get deflated without deflating the economy more than one would like to see it deflated. I don't have a ready answer to that.

MR. MAYO. Paul, there is one other option that we haven't explored for a long time. It's probably not practical, but as I told a number of you, when I was in Frankfurt some years ago, Emminger said: "Mayo, we've got one advantage here over you folks that we are never going to give up." I asked: "What is that?" He said: "We have no weekly figures on the money supply and we're never going to have any." Arthur Burns even threatened at one point to put out daily figures on the money supply to point up the absurdity [of following short-term fluctuations so closely] and then obviously thought better of the idea. Is there any chance in the reporting from all these 40,000 customers we have now--it's probably too late even to suggest it--that we can solemnly decide that we should have only monthly figures on the money supply? Or is the world too sophisticated to accept that?

CHAIRMAN VOLCKER. My instinct is that we couldn't get by with it. And I don't really think it would cure the problem. People would wait for the monthly figure.

MR. PARTEE. We couldn't do it unless we didn't collect them, Bob. Then we wouldn't have anything for our own use either.

MR. MAYO. Well, that's the problem. But it's tempting to talk about; we'd have one eruption a month instead of four.

CHAIRMAN VOLCKER. It would help in terms of these intra-monthly gyrations, but I don't think it would deal with the dilemma that I am referring to, which is a real dilemma for the economy. Actually, the Washington Post had a good editorial just the other day. They put the same dilemma [in terms of] New York versus Washington. Washington wants to expand whenever the economy gets into a recession and New York will run for cover with inflationary expectations if that happens, which will undermine the expansion. Therefore, you can't do either. And I think there is a lot of reality to that.

I don't know if it will speed up the process or not but, if I may, let me give you something to shoot at. When I look at these pretty charts--though obviously when we are talking about differences as small as those in "A" and "B," it is not a widely different picture--I come away with the feeling that alternative A is not in any sense off course. Under alternative A, so far as the M-1A figure is concerned--it's not true of M-1B, which has been rising more rapidly--if we took off from M-1A the target for the quarter is the same as [the one we had previously]. It is consistent with a higher M-1B figure according to the current estimates, if they are any good, and a considerably higher M2 figure than we were talking about at the last meeting. But those charts don't give a very disturbing picture; in fact, they give a rather nice picture. If we held to it and just

extended [money growth] at the same rate, M-1A would end up right at the bottom of the range for the quarter or a little above it by the time we got to December. M-1B, if I am right, would be just about in the middle, or maybe a bit below for the quarter and a little above in December. For M2, alternatives A and B are very close together, but it's high in either case. M3 is in the middle.

We are dealing with an extremely [unintelligible.] The market, as nearly as I can read it, has anticipated some tightening which hasn't taken place. Maybe another way of stating it is that they also have a heavy supply of securities. They see better business news and anticipate perhaps a bigger increase in the money supply and assume that would bring a higher federal funds rate. That may or may not be true. I myself don't see any reason, particularly, to bias that question at the moment. If we are satisfied with something like the alternative A money supply figures, I don't think we have to do anything now to bias where we are in terms of the federal funds rate. I am talking, really, about the borrowing figure at the moment. If the money supply comes in higher, that doesn't imply, with our ordinary techniques, that [policy] would be tighter. But [in that event] we would have seen evidence that the money supply is in fact running even [above] this figures which looks all right. Or if it came in lower, we would be moving somewhat in the other direction. So I would be inclined, in general terms, to take something like "A" and unbiased the decision this week. I don't know whether that means \$100 million of borrowing or maybe a trifle less than that, but something in that neighborhood. And as I say, if the money supply comes in-- just in M-1A terms with similar changes in the others--at 9 percent, let's say, the borrowings would go up and presumably we'd get an increase in the funds rate. If it came in weaker, as I guess the New York projection suggests, we could perhaps run down to truly frictional levels of borrowing and the funds rate might go in the other direction. But in either case, there would be better evidence than we have at the moment. I don't think it's clear that we are off course, if we discount M2 a little at the moment. So I don't see any reason for a bias at the moment in one direction or another, particularly given the sensitivities in the market. With the dollar in a little better shape, conceivably we could make the bottom end of the federal funds range a little less close to the current market level than it is. I don't know that we have much risk of running into either of those constraints, but it might look a little better. So we could alter that a bit if you wanted to, but those are the very general thoughts that I have. Why don't you proceed from there, Governor Schultz.

MR. SCHULTZ. Well, as everyone around this table knows, I believe that inflation is the major problem and that hasn't changed at all, so I think we have a long hard pull ahead of us. I believe, though, that alternative B would be a mistake at this time because it seems to me, short term, that we are already getting some restraint. Interest rates have already backed up some, and I think it is not likely that mortgage rates will come down from where they are. They might rise a little. One of the things we didn't talk about is the fact that mortgage rates are much more sensitive to bond rates because of the passthroughs. We have this enormous backlog of securities that are sitting there, and it's just hard for me to see that mortgage rates are going to come down any; they might even back up a little. We have already seen some of that in California, where they are



particularly sensitive to this kind of thing. So it seems to me that the path we are presently on is already giving us some restraint. I get the feeling that we are doing reasonably well at this point and I don't see much sense in trying to shut down further. In addition, I have a feeling that longer term we may need some flexibility next year. I don't know what shape recession we're going to have--whether it will be a square root or an L or a W or whatever. But one characteristic I think it will have--and I think properly so--is that it will be a very slow recovery. I don't see how we can get out of the mess we are in without that slow recovery, because I don't see how we are going to be able to get unit labor costs down without some pain. And we are not getting very much pain in this economy at this time; corporations still are looking to increase prices, as President Winn said. And until there is some real restraint on them in terms of their corporate profit margins--and I think there will be next year--I doubt that they are going to start getting really serious about trying to hold wage rates down. So it seems to me that we are looking at a very slow period of recovery for next year. I have the feeling that I would like to go into next year [with money growth] near the middle of the range, and not biased toward the bottom, to give us the kind of flexibility we may need. So my feeling is that alternative A is much superior [to alternative B], both for the short run and the long run.

MR. BALLEES. I'd like to present the case for alternative B. The dilemma that I described earlier might be put in a little broader context. If you remember, last spring quite a few of us were a little worried about the undershoots in the aggregates and the fact that failure to achieve [our objectives for] them might unnecessarily and considerably exacerbate the recession that was then under way. I've been pleased, of course, by the catchup in the aggregates produced in the June and July figures--and they're pretty solid--and in the projected August figures. I suppose part of what determines how one comes out here depends on one's reading of the tea leaves on the business outlook but also on the judgments one makes as to which M is the lesser of the evils in terms of its reliability as a predictor. I have to say that on the outlook I came out much closer to the views Governor Gramley has articulated than the opposite view. And with respect to M-1A versus M-1B versus M2, the research that we've done at our Bank indicates that M-1B is a better predictor of future price movements than M-1A. Now, they're both obviously contaminated to some extent, but I think M-1B is less so than M-1A. For that reason, and because of the failure to achieve any significant progress thus far on the inflation front--especially if one looks at the staff's forecast on where inflation will be by the end of 1981--I am very concerned. So, all things considered--in view of the catchup we've now had on the Ms and in view of what I consider to be a less gloomy or, if you like, a more optimistic outlook in terms of the recession being shorter and shallower than we had earlier expected-- I'd begin to shade [money growth down] a little now. Speaking for this year as a whole, I'd move broadly in the direction of aiming somewhere in the lower part--certainly at or below the midpoint--of the range we have set for M-1B, which I would consider the most reliable of the three Ms for the moment. That may change next year when we get NOW accounts. But I wouldn't be unhappy if we reduced our sights a shade and tried [for growth in] M-1B at what we had said in July would be our target for the third quarter, which is around 8 percent. So "B" or "B minus" would be the way I would lean, Mr. Chairman.

CHAIRMAN VOLCKER. "B minus" meaning even less than "B"?

MR. BALLEES. Yes. I'd like about 8 percent for M-1B for the June-to-September quarter.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I come out very close to the [approach] you advocated. I don't see much difference between "A" and "B" and I have a slight preference for "A." I lean, like most here, toward M-1B for the reasons indicated, although I duly heeded your admonition that we ought not to take this at face value. There's a temptation, I think, to go with "B" because of the inflation we see. But if the staff is right in its projections on M-1B, that would mean that its growth would decelerate to a rate of 5.5 percent this year from 7.6 percent last year and 8.1 percent the year before. That seems to me sufficiently fast deceleration to work toward gradually reaching a noninflationary rate of expansion in the aggregates. And it would set the stage for a further reduction next year, as we have promised every one we would [seek]. I do have a little concern about the overshoot in M2 because of the credibility problem, but the overshoot is very small; and as others have stressed, the [narrow] aggregates are looked at much more carefully than M2. And I think the points that Ed Ettin made about M2 are quite valid. But if for some unexpected reason M2 did come in high, we might want to take another look at it. I also have sympathy for your position that maybe we ought to [reduce] the lower end of that funds rate range. I have long stated that I don't favor any range on the funds rate, but I think we might be having in the aggregates the kind of [pattern] Chuck Partee was stressing on the behavior of consumer spending, where we have very rapid declines and then a bounceback. So with the abandonment of the special credit restraint program, the aggregates may have taken off more than they ordinarily would have. If that is the case, we might have to come down a little more on interest rates in order to keep the aggregates on target. Therefore, I would be inclined to drop the lower end to about 7-1/2 percent.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I want to second John Ballees for many of the same reasons [he cited]. When we talked about the recession some months ago, it was frequently said that we shouldn't be too tight because of the danger that we might overshoot on the low end. Now we see that it's likely, although not certain, that this will be a milder recession than anticipated. And that doesn't give me any reason for wanting to go on a more expansionary course. I don't see much achieved by the recession so far. There have been no great changes in expectations. It may well be that a few years from now we will look at this experience as something that was unnecessary because it didn't produce anything except a resumption of inflation from a new higher plateau into new and higher levels. I think we're in some [danger] of concluding that because it's reasonable to expect the recovery to be slow we therefore ought to be relatively easy now. If we are relatively easy now, we will be prejudicing our policy next year toward being still easier, precisely because the recovery is likely to be slow. Finally, as I look at our policy for next year, if we take the hypothetical assumption that we go for the midpoint of the ranges that we've now supplied, which are 1/2 percentage point below this

year's ranges, that will mean a drastic reduction in the rate of money growth in early 1981. For instance, on M-1A the range is 3 to 5-1/2 percent. So presumably we would have to shift to somewhere close to the midpoint of that from what on the present course is [growth of] 7-1/2 percent from the second to the fourth quarter of this year if we go with alternative A. If we go with alternative B, we will be shifting to the midpoint of 3 to 5-1/2 percent, or about 4-1/2 percent, from the 6-1/4 percent rate B implied for QII to QIV of 1980. If we look at M-1B a similar picture prevails; the midpoint of its range of 3-1/2 to 6 percent is 4-3/4 percent. And we would have to shift to that from 9-1/4 percent [growth] on "A" or 8-1/4 percent on "B." These could be some very drastic changes in course, if we really were to stick by our policy when the economy begins to turn around. I would rather minimize the degree of change that we have to introduce-- not go down so far with interest rates now and not have to change their direction so drastically, or else abandon the proposed targets. That is why I would go with "B."

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Mr. Chairman, I probably am as optimistic as almost anybody around the table about the prospects for the end of the recession in the near term, but it is still a forecast. And there is absolutely nothing in the statistics yet that suggests that a turn has occurred. We all agree, I think, that the recovery next year is going to be quite weak. I don't see any reason at all, therefore, to let interest rates go up at the present time. I don't mind staying where we are. I don't know if interest rates need to go down to shorten the recession but I certainly don't think we need to knock the [economy] in the head once more and make sure we have killed inflationary expectations. I just don't think that's a feasible course. We have to remember that the staff is forecasting a recovery so weak that unemployment does not go down at all. I think that's as weak a recovery as we need. I agree with Governor Schultz completely in that respect. But if the recovery is so weak that unemployment continues to rise, then I don't think we're following a policy that we can stick with over the long run. That's the only way we can deal with this problem: To look at it as a very, very long-run problem and a long-term commitment [on our part] to try to bring inflation down. So, I am quite prepared to go with your suggestion of alternative A. I would wonder, if we go in that direction, if we shouldn't do something about taking M2 out [as an operational variable] because if M2 keeps going up as rapidly as it has been, we might end up having to turn the screws to push interest rates up. And that may not be what we want to do.

CHAIRMAN VOLCKER. What did M2 do in the last month?

SPEAKER(?). It grew at a 17 percent rate.

VICE CHAIRMAN SOLOMON. I don't understand what Lyle means by taking M2 out.

MR. GRAMLEY. In the directive we have targets for M2 along with M-1A and M-1B and we're giving the same weight to the three; all three are mentioned in the directive as such. So if M2 were to exceed its target level, then we would begin to tighten up again, even if M-1A and M-1B did not.

VICE CHAIRMAN SOLOMON. Well, from what I understand, the way the staff calculates the reserve paths, it is basically a qualitative correction of a path constructed primarily on M-1. If M2 is moving up very rapidly, it's not given equal weight by any means.

MR. PARTEE. It doesn't have much arithmetic effect, I agree, Tony.

CHAIRMAN VOLCKER. Well, it may; the only effect it can have is if we change the path on the basis of [its behavior].

MR. WALLICH. If we eliminate those aggregates that misbehave in our view, what kind of credibility do we have?

VICE CHAIRMAN SOLOMON. We're still left with the fact that at the end of the year the public and the Congress are going to see what the behavior of M2 was in relation to the targets.

MR. GRAMLEY. They will probably also see that M-1A is at the lower end of that chart.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. As a well-known Washington philosopher a few years ago was fond of saying: "If the thing ain't broke, don't fix it." I don't think the thing is broke here. It seems to me [the aggregates] have been moving rather nicely along their path with an interest rate performance that was, if not pleasing, at least acceptable to almost everybody after that abysmal April break in the numbers. And as you said, Mr. Chairman, a continuation of our earlier statement [regarding our objectives for the quarter], particularly in terms of the profile for M-1A but to a large degree for M-1B, would be alternative A. It seems to me that that's the path we have and it's working quite fine. So I would certainly [support] that. I do believe that there will be a tolerance in the society as a whole, though not in Washington, of higher interest rates if we can say: "Look, we've had a big rise in the aggregates so we've got to resist that rise because that will bring inflation." But if we have higher interest rates because we're fiddling around with a path that we earlier specified with the Congress--and if we're on that path or would have been on it had we not changed it--there isn't going to be that tolerance. I think that's a very dangerous game to get involved in. We may have an explosion in the aggregates; some are forecasting it. If we do, then we'll raise interest rates. But we may not. And if we don't, I don't think we have any basis for trying to bias interest rate movements upward. So I would take "A" for sure.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I come out very close to the position that you set forth for the reasons that you did and for the reasons set forth by Governors Schultz, Gramley, and Partee. I would simply emphasize that the outlook for the economy is for a slow recovery--one which will be lackluster and far from robust. It also looks as if it is going to be interest sensitive because, as has been noted, the recovery in housing is going to be interest sensitive and the recovery in investment is probably going to be interest sensitive. We have to note that under either alternative A or alternative B,

we're likely to see some increase in interest rates. The increase in interest rates under alternative B will be significantly greater than under alternative A. And at this point we have to be very careful not to do anything unnecessarily that would choke off the recovery. It seems to me distinctly possible that fiddling around [and getting] interest rates up runs the risk, as Governor Partee suggested, of choking off the recovery before it begins. So it seems to me that alternative A is a much [safer] course to take.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. I think it is clear that we have a timing problem here. It is compounded by the fact that we're in a cycle with no precedent and we don't really know how to time our action. On the one hand, Nancy's earlier comment is right that in the discussion about the business outlook we really are basing our opinions on some fairly small evidence over a short period of time. That would lead one to alternative A. On the other hand, Henry's argument has a lot of [merit] in that we're dealing with an exceptionally difficult situation and we have the possibility of [substantial] growth in the aggregates ahead of us. So perhaps we should take this opportunity to move earlier than we ordinarily would to meet that. Between those two positions, I come out about in the middle. I'd take "A" and shade it toward "B." There is a one point [difference in the growth rates] in the two alternatives, which is wider than we have quibbled about at times. I don't think it's quibbling too much to [aim for] something in the middle. That's what I'd do.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. We are again, I think, magnifying very small differences. I could be comfortable with either "A" or "B," but I lean toward "A" basically for the reasons that have already been stated. As for the recession, everybody is looking for good news now and I think they have over-emphasized what little good news has been in the papers. We probably have at least another six months to go before we get any real positive signs of economic recovery. I would rather, as the cliché at the moment goes, "keep our powder dry" and stick with "A." I do not worry at all about the overshoot in M2; in fact it helps, especially with M-1A coming out at the low end under either "A" or "B." It tends to illustrate again the fragile nature of these figures. It isn't that we should say cavalierly that the targets aren't worth anything, but let's be practical about it. We have our own little security blanket here of being at the low end on M-1A, in the middle on M-1B, and overshooting on M2. So what? It doesn't bother me. It gives us a beautiful array to illustrate our point that there is no such thing as the perfect aggregate. I would also comment that if we narrowed our ranges, which some of our friends on Capitol Hill wish we would do, it wouldn't solve anything. We might end up below on M-1A and way over on M2 and be in the same situation we are now. It wouldn't make us any better hewers to the line, if I can put it that way. So, I lean toward "A" as the solution.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I hate to disappoint the Washington Post editorial [staff], but between "A" and "B," I prefer "A" [even

though I'm a New Yorker]. I have a slight preference for splitting the difference, as Dave Eastburn suggested, and going with a \$75 to \$100 million borrowing assumption. But--

MR. PARTEE. When you say split the difference, Tony, do you mean the July-to-September difference?

VICE CHAIRMAN SOLOMON. Yes, and that would give us for July to September [6] percent for M-1A, [about] 7-1/2 percent for M-1B, and 9 percent for M2 with, as I say, a \$75 or \$100 million borrowing assumption. But if the consensus is for alternative A, I'd go along with that. I certainly prefer it to alternative B.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I have a preference for alternative B. It's not a sharp preference, but I base my position on a belief that because of increased business borrowing and the extent of borrowing by the government, an increase in interest rates toward the end of this year is probably inevitable. And if, as I sense, there is a reluctance among some of us to permit interest rates to rise because that would be viewed as contributing to cutting off the [recovery]--if indeed one were to occur--then I would see the prospect of expansionary policies ahead. So I'd much rather position ourselves in a more restrained position a la "B" than the other alternative. But I'm not going to dig in my troops on that particular decision because I don't think there's that much difference [between the alternatives].

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I would prefer "A." For once we don't have to worry about the international value of the dollar currently, which is somewhat of a relief.

CHAIRMAN VOLCKER. Wait a week.

MS. TEETERS. Yes, I know that. Given that, we seem to be on a pretty steady course and we're getting where we want to go with it. It seems unconscionable to raise interest rates when the economy is still going down--and I don't think anybody expects the third quarter to be a positive number on real growth. I would say if we are going to have to raise interest rates for international reasons, I certainly would like to save the room and do it at a later date. So I would come out in support of "A" and just leave [the path] the way it is at the present time.

VICE CHAIRMAN SOLOMON. I don't think there has been much--let me use the word "distortion"--in domestic monetary policy by international considerations in the time that I've been on the FOMC. There have been some considerations of timing, maybe a 1/2 point difference from time to time on the low end of the fed funds range. It hasn't been very significant.

CHAIRMAN VOLCKER. The position I've taken publicly, in the sense of responding to Congressional inquiries, is that it was a consideration in the background and tended to parallel the more important considerations of what we had domestically. [For example], we didn't press for as quick a makeup of the shortfall in the money

supply as we theoretically could have. That was not a decision based just on international grounds, although that happened to be an ingredient in that decision.

MR. SCHULTZ. I think the Congressional comment was that he'd make a very good prisoner of war because he'd tell the enemy--

CHAIRMAN VOLCKER. I think [my statement] is also true. Mr. Winn.

MR. WINN. I am a bit on the fence. I guess I'd join those who favor splitting [the difference] in terms of the target set-up. I'm a little confused, as I listen to the conversation, as to whether we're following our resolve to try to target the aggregates or whether we're back on an interest rate course. It seems to me that we've all based this [analysis] on a projection of growth in the aggregates that may or may not occur. If it doesn't, then it seems to me that we have some responsibility to get the path back up and let the [funds] rate hit the bottom. If the aggregates explode, it seems to me that we have to face the interest rate problem right now. And we will have deferred it. I've been around this table for some time, and I've seen us drag our feet time after time and then get caught in a real squeeze. I'd rather face it now if this explosive problem--

CHAIRMAN VOLCKER. You are saying, I think, that the question to debate now is between assuming that the aggregates are going to explode and biasing the decision upward--

MR. WINN. No, I wouldn't bias it upward. I'd wait and see what happens. But if the aggregates explode, it seems to me we'd have to face it.

CHAIRMAN VOLCKER. Well, I didn't hear anybody saying anything different, but I agree the temptation historically has been not to do anything about it. Mr. Ford.

MR. FORD. Well, as one of the novices here, I must say I am very relieved by the narrow range and the bias of the two alternatives before us in that I see no danger that the markets--

CHAIRMAN VOLCKER. You are not necessarily confined to those alternatives.

MR. FORD. I may choose at some future date to suggest a third. But I like the way the alternatives have been structured here because whichever way we go with this decision there seems to me no danger that we'll be reading in the newspaper--even without a leak but after due time when we release the [record]--that we biased ourselves toward getting off the path that we set last October. We will probably not be accused of loosening monetary policy based on limited information of a recovery, and so on. So either way we go, I think this decision can be viewed in the marketplace as a reasonable one. With regard to the arguments on whether we should make this minor adjustment toward tightness, [as in] "B," I am persuaded by [several] things. First of all, I've seen virtually no evidence of price softening, which is what the name of the game is supposed to be as I understand it. [Our goal is] to promote a view in the world which says that we're determined to wring inflation out of the economy. And

the facts as I have heard them and see them are that we're not seeing that price relief yet. The second argument that persuades me is the one that Mr. Wallich made, assuming he is correct about the course of the aggregates and that we will have to crank down the numbers later. For smoothing reasons, I find it rather persuasive to think ahead and to try to avoid the need to bring the aggregates down later at a time that may inopportune. Also, with the limited evidence we have that the aggregates may be expanding in the next few days, I would lean, along with the rest of the splitters, toward "B."

MR. ROOS. It's nice to have you aboard.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I would support "A."

MR. BAUGHMAN. Mr. Chairman, I would be inclined toward "B." We see the economy essentially as the staff has in its outlook, with the exception of the strength in interest rates. I am inclined to view the strength we see in interest rates as temporarily greater than justified by what is happening in the economy. So I think there may be a softening rather than a continued rise in interest rates. The [behavior of] inflation, as has been mentioned, is critical. There has been no reference to the presumably substantial additional thrust to prices that is going to flow from the food sector. I think it's going to be very difficult to keep that from simply passing through, as our policies over a period of years have permitted energy prices to pass through and raise prices generally through the economy. I think it would take pretty substantial restraint to keep that from happening again, in this instance flowing from food. Also, I am inclined to think that we're seeing a rather rapid buildup in liquidity in the economy, whether it appears in the particular measures we call money or in other measures. In this inflationary environment, it's entirely possible that people will behave with less money the way they normally would behave with more money. So I think "B" would be the preferable posture right now.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I am very comfortable with "A" at this time. I say "at this time" because I am inclined to the view that the near-term risks on the aggregates are probably on the up side. I am willing to wait and see what happens. But if in fact that strength in the aggregates were to materialize, a lot of this debate about rates would be academic because the mere fact of that strength would quickly reflect itself in higher interest rates in the marketplace in any event. If that too were to occur, we would be a lot closer to the kinds of real dilemmas we were talking about earlier, which were very well captured in Governor Wallich's comments about the task of getting back to where we want to be for 1981. So, I think "A" is fine for now, but if indeed the aggregates do run strong, we're going to have a dilemma immediately in front of us. All of this underscores to me the point that somehow, somewhere, we have to get help from other elements of public policy in this [fight against] inflation. And I just don't see that coming. I'm not sure how or where we get it.

CHAIRMAN VOLCKER. Mr. Czerwinski.



MR. CZERWINSKI. Mr. Chairman, it is our view that alternative B might result in a more rapid run-up in interest rates than might be desirable. On the other hand, alternative A would push M2 above the top of its range, which might not be desirable from a perception standpoint, particularly with all the attention being given lately to the ranges established by the Committee. So for those reasons, we would tend to favor the ranges that were suggested by President Solomon, [about] 6 percent for M-1A, around 7-1/2 percent for M-1B, and about 9 percent for M2.

CHAIRMAN VOLCKER. Well, there seems to be a good deal of agreement around the table. I think what really happens between now and the next meeting is going to be determined, by everybody's specifications, by what happens to the aggregates. And since that range of uncertainty is much greater than the one percentage point difference between these figures [for the quarter], that is the perspective in which I would view this, as many people already have. My main concern is that we not bias this. The bias is more in the borrowing level that we start with than in the difference between "A" and "B." Actually, the difference between "A" and "B" is more than one percentage point for the remainder of the quarter; it's 1-1/2 percentage points. Considering the lags and all the rest, we don't have a lot of room for changing this between now and the end of the quarter. The predominant view is clearly "A," but there was some sentiment for "B," obviously, and some people were willing--and maybe prepared--to go in between. I suppose the practical choice is whether [or not] we go with A. If we did, I would be inclined to put the federal funds rate range at 8 to 13 percent if we want the [width of the range to be] 5 percentage points. It's 5-1/2 points now, but we could [set it at] 8 to 13 or 8 to 14 or 8 to 13-1/2 percent. So let me assume something like that for the moment.

MR. ROOS. Wouldn't that have a perceptions effect?

CHAIRMAN VOLCKER. Well, I've thought about that. I am not sure it's going to have much effect because it will come out a month [or so after this meeting]. [The funds rate] either will have been there or not have been there. I don't know; I may be wrong. I have thought about it and I am not sure it will have one because of the delay in the release of the record. I think it would have an effect if we were announcing this today. What do you think, Peter?

MR. STERNLIGHT. Well, it's true that you won't announce this today. You will be announcing in a few days that at the July meeting the funds range was 8-1/2 to 14 percent. So if the market should see the Desk being more accommodative--if the numbers worked out that way --and funds were trading in the 8 to 8-1/2 percent range, then I think they would get the idea before [the new range is released], perhaps even in the next--

CHAIRMAN VOLCKER. If the funds rate works out that way, I agree. But it won't work out that way, presumably, unless the money supply is also running pretty low.

MR. RICE. What's the advantage of narrowing the range?

CHAIRMAN VOLCKER. My purpose is not to narrow it; I just wanted to lower it.

MR. PARTEE. Why don't we make it 8 to 14 percent and make the width 6 points?

MR. SCHULTZ. I think 8 to 14 percent looks better; that leaves the top of the range at the same place.

MR. PARTEE. [The top of the range] doesn't seem operational.

MR. SCHULTZ. I think that would be important.

MS. TEETERS. What do you expect the funds rate to be with these specifications? You expect it to be around 10 percent, right?

MR. STERNLIGHT. With borrowing averaging \$100 million, I'd expect it to be a little more often below 10 percent than above, perhaps in a range of 9 to 10-1/4 percent.

MS. TEETERS. So that's basically an increase in the rates over the month from where they are now.

CHAIRMAN VOLCKER. If you want 8 to 14 percent, that wouldn't bother me. Just to complete this, I would start off the borrowings at maybe \$75 million--I'm thinking of the federal funds rate at around 9 percent or a little more, perhaps 9 to 9-1/2 percent now--if that's the [borrowing] number that's consistent with that [level of the funds rate]. We are just talking about the first week here really, but I'd be inclined to say \$75 million. Let me just test the sentiment and see whether this in-between [number is acceptable]. The intention is to put the quarterly figure in the directive now?

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. So we are really talking about the top part of this [Bluebook] table if we assume that. And that's probably the safest thing. If we went halfway, the rates would be 6-1/2, 8-3/4, and 11-3/4 percent, if I calculated correctly. Now, that makes a bigger difference for the remaining part of the quarter, but those are the numbers that would appear in the directive. As I said, there was a clear majority for "A." Let's see whether people are happier with the halfway between numbers.

MR. ETTIN. Mr. Chairman, [some of] those who talked about splitting the difference were talking about the numbers for July to September. Just arithmetically, if you do it for the June-to-September figures, you are biasing the numbers a little tighter for the remaining two months of the quarter.

CHAIRMAN VOLCKER. June to September is what appears in the directive, right?

MR. ETTIN. Yes.

CHAIRMAN VOLCKER. Presumably, it means the difference for the July-to-September figure is halfway in between, too, doesn't it? Isn't that correct arithmetically? It's just a bigger distance in between, in effect.

MR. ETTIN. Yes, but given the fact that July itself was stronger for each of the aggregates than the targets adopted the last time--

CHAIRMAN VOLCKER. But don't we get the right July-to-September numbers if we average those numbers in the table below?

MR. ETTIN. I don't think so.

MR. PARTEE. I would think so.

CHAIRMAN VOLCKER. It isn't immediately obvious to me.

MR. PARTEE. Did we publish June to September last time?

CHAIRMAN VOLCKER. What we would have is 6 percent [for M-1A for July to September].

MR. ETTIN. We'll publish it in a few days.

MR. MAYO. What we did before was 7, 8, and 8 percent.

CHAIRMAN VOLCKER. For the quarterly figure, right?

MR. PARTEE. For the third quarter.

MS. TEETERS. If we took the midway point, what would you expect to happen to the funds rate?

CHAIRMAN VOLCKER. Well, it biases [the funds rate] a bit toward rising subsequently. I am saying we don't bias it at all initially. But in practice what it says, just looking at M-1A--if the arithmetic is correct--that we have an objective of 6 percent growth from now to the end of the quarter instead of 6-3/4 percent [under "A"].

VICE CHAIRMAN SOLOMON. But if we assume only \$75 million in borrowing, we are going to be supplying more reserves.

CHAIRMAN VOLCKER. For the first period, that's right.

MR. PARTEE. \$25 million more.

CHAIRMAN VOLCKER. What we are looking at in practice is that if the \$3 billion figure holds up for this week--I don't know whether it will--it will depend to some degree upon the projections thereafter. We will get a preliminary figure for the week after. But if the \$3 billion held up and there wasn't any reason to think it was going to be reversed immediately, we would presumably have a higher borrowing level a couple of weeks from now. And your straightforward projection of "A" even implies a slight increase in interest rates, you believe.

MR. ETTIN. In my view, yes.

CHAIRMAN VOLCKER. Those estimates are obviously unreliable, but even [a forecast of] an ordinary figure for next week is unreliable. These figures have been jumping all over the place. But

if [the estimate] held up, whatever path we set now is likely to imply more borrowings. That's one of the reasons I don't want to set the path so we get an increase now and then automatically get an increase two weeks from now. That, I think, is [moving] too strongly.

MR. STERNLIGHT. Mr. Chairman, if that estimated \$3 billion increase [in M-1A] holds up, I don't think anything would flow automatically from that in terms of raising the borrowing because we would build the paths assuming that \$3 billion.

CHAIRMAN VOLCKER. It depends. Right now the \$3 billion, as I see it, depends upon your projection--

MR. STERNLIGHT. Yes.

CHAIRMAN VOLCKER. If the \$3 billion is a harbinger of [M-1A] running high, it's going to affect [borrowing]. We can technically allow for that if your subsequent projections say no [it will not run high]. But presumably you would want to allow for [an increase in borrowing] if the next preliminary figure is another \$3 billion or so. There's an element of judgment here. You can wash it out completely if you think it's of no significance. But in the path--

VICE CHAIRMAN SOLOMON. I have no reason to assume that our [estimate] is any more correct than Ed's, but our calculation is that alternative A does not involve even a slight increase in interest rates. It might involve a slight decrease in interest rates, depending upon the assumption.

CHAIRMAN VOLCKER. Well, we're saying interest rates. What I am talking about is the federal funds rate. I am not sure that the other rates aren't too high relative to the federal funds rate right at the moment. So if it worked out that we didn't get an increase in the federal funds rate, the other rates might come down again. We are talking now about expectations among other things. What we are talking about operationally, just to repeat it, is that if we went halfway in between, that involves knocking three quarters of a percentage point off the growth objective for the period between now and the end of September. And there's no assurance about that; we never come out that close. We are not going to have a 3/4 percentage point difference in any measurable way. What we will have is a somewhat higher level of borrowing and, therefore, a somewhat higher level of the federal funds rate however the aggregates finally come out. So the bias--well, bias may not be the right word. It sets up an increased probability of a somewhat higher federal funds rate, obviously, the more we reduce the aggregate numbers.

VICE CHAIRMAN SOLOMON. As contrasted to alternative A.

CHAIRMAN VOLCKER. Yes, as contrasted to alternative A.

VICE CHAIRMAN SOLOMON. I think we are trying to walk a balance here because we don't want a perception in the markets that there has been a shift in policy. If it does work out that the fed funds rate is at the floor--that we have to move toward the 8 percent floor--which I would be willing to live with, particularly combined with the intermediate target between "A" and "B," we would be flirting a little with a possible adverse reaction in the long market. There

could be a perception of a definite easing. If we go for alternative A, we might be well advised to keep the funds floor where it is.

MR. WALLICH. There has been a great deal of discussion of that abroad, a great deal of exploration of that in the market and an interpretation of our actions. So, I think if they smoked out that we are willing to let the funds rate go to 8 percent on average, that would be regarded as a clear signal that we have eased.

MR. PARTEE. It would be associated with weak growth in the aggregates.

MR. WALLICH. Well, if they understood the process correctly. But since they always look at the interest rate anyway--

VICE CHAIRMAN SOLOMON. I would rather [not] lower the floor to 8 percent, Chuck, if we [went with] the compromise.

MR. PARTEE. It's such a small issue that I am prepared to go either way.

CHAIRMAN VOLCKER. It's a question of which way the preference is. I'll put them both to a vote for preferences. Let me take the compromise first with an 8 percent floor in this case and an initial borrowing assumption, let's say, of \$75 million. We'll take all of the decisions on the easy side and go.

MS. TEETERS. Are they consistent?

CHAIRMAN VOLCKER. Well, anything is consistent. Who knows?

MR. GRAMLEY. What goes with this--"A" or "A minus"?

MR. PARTEE. "A minus."

CHAIRMAN VOLCKER. This is "A minus" or "B plus."

MR. GRAMLEY. What's the alternative?

CHAIRMAN VOLCKER. "A."

MS. TEETERS. On "A" would you drop the floor to 8 percent, too?

CHAIRMAN VOLCKER. There may be a little argument about that. I'd be willing to, but--. Let me put it this way, just so you have two choices in front of you. One is 8 to 14 percent and \$75 million not interpreted too closely--we're only talking about a \$25 million difference here--with the numbers halfway between "A" and "B." That's one choice.

MR. ALTMANN. On June to September?

MR. PARTEE. It's the same either way.

CHAIRMAN VOLCKER. It's the same, assuming the arithmetic translation is right. It involves different numbers, but the numbers

are halfway between those in "A" and "B." That against "A" straight, let me say.

MR. PARTEE. With 8-1/2 to 14 percent. Those are our two choices.

CHAIRMAN VOLCKER. That and \$100 million of borrowing.

MR. SCHULTZ. It's not a big difference, is it?

CHAIRMAN VOLCKER. No.

MR. MORRIS. I find it hard to understand why we have a more liberal funds range with a more restrictive monetary growth rate.

CHAIRMAN VOLCKER. Well, it looks a little funny. The argument is Tony's here, in that he doesn't want to take too much risk of the funds rate going too much lower. So the more we risk it on one side, the more he wants to block out the risk on the other side.

MR. PARTEE. Where are all these people who thought there was going to be explosive growth in the aggregates? I guess they are not represented.

CHAIRMAN VOLCKER. My gut feeling is that [growth] is more likely to be up than down. But that's a feeling.

VICE CHAIRMAN SOLOMON. But we never know. So if we are going to be perceived as planning our targets on M-1B, and M2 to some degree, I think it makes some sense to be a little cautious.

CHAIRMAN VOLCKER. Let's take those two choices. Do you understand them?

MR. WALLICH. It's 8 percent and \$75 million on the one and 8-1/2 percent and \$100 million on the other. We are not offered anything "better" than that?

CHAIRMAN VOLCKER. What can be better than these wonderful options? As a matter of pure preference, it's likely to be 50/50, but let me just try. The first one is the halfway in between with the adjustments that I suggested.

SPEAKER(?). Voting members only?

MR. ALTMANN. Voting members, please. Five.

CHAIRMAN VOLCKER. That leaves me with straight "A." I'd like a show of hands to see if everybody is voting. That's five. I didn't vote. Who else didn't vote?

MR. WALLICH. I didn't vote.

CHAIRMAN VOLCKER. Well, that's what I was afraid of. We have exactly [half who voted for each].

MR. PARTEE. Do you want to try a straight "A" with 8 to 14 percent and \$75 million?

CHAIRMAN VOLCKER. Well, in some sense that's more liberal than either. What about that one? The trouble is we are going to get more intense feelings the other way, too. It seems as if these two choices are going to maximize the vote, and I suspect there is a lot of indifference between them.

MR. PARTEE. Why don't you try "can live with" on "A"?

MS. TEETERS. We could [all probably] live with either one of them.

CHAIRMAN VOLCKER. I suspect everybody could live with either one.

MR. PARTEE. Then you can state your preference.

CHAIRMAN VOLCKER. Yes, I guess it comes really down to my preference.

MR. GRAMLEY. We're giving the Chairman unlimited power!

CHAIRMAN VOLCKER. Oh, I guess I'd go with the "B plus" or "A minus" one, whatever you want to call it.

MS. TEETERS. Is it possible to get that sort of peculiar specification?

MR. PARTEE. Sure.

MR. MORRIS. The Committee can specify anything.

MS. TEETERS. I know, but I'd like to know if it works or not.

CHAIRMAN VOLCKER. Well, in fact, we are expecting the funds rate to fall well within the [range].

MR. PARTEE. Yes, we're just lowering the lower limit on the funds range; we may not use it at all.

MS. TEETERS. Yes, but the way we are setting the policy is to bias the funds rate up.

MR. PARTEE. Well, it has plenty of room to go to 14 percent.

MR. MORRIS. But we are starting with [borrowing of] only \$75 million.

CHAIRMAN VOLCKER. The Secretary points out to me, and he's probably right in one sense, that if we go halfway in between, we will have fractions that we have never used before for quarterly growth rates.

MR. SCHULTZ. Take them up one quarter point toward "A" and that will take care of everybody!

MR. PARTEE. Yes, except for the M-1A figure, which we could leave [at the precise average] of 6-1/2 percent.

CHAIRMAN VOLCKER. Maybe that is the way to do it. Let me try to modify this again. This comes a little closer to "A," I guess. What would be in the directive is 6-1/2, 9, and 12 percent. I think that does look a little better somehow.

MR. ALTMANN. That's for June to September.

CHAIRMAN VOLCKER. Yes, that's what would appear in the directive.

MS. TEETERS. Again, are those consistent relationships?

CHAIRMAN VOLCKER. Look, the staff projection of a consistent relationship has been off by 2 percentage points, I think.

MR. SCHULTZ. The staff takes an awful beating!

CHAIRMAN VOLCKER. I don't say that in any way as criticism of the staff but only of the reality of the uncertainty inherent in these numbers and the idea that we could project down to the quarter percentage point. That may be a better [formulation] anyway. Why don't we vote on that: 6-1/2, 9, and 12 percent in the directive.

MS. TEETERS. And the funds range is what--8 to 14 percent?

CHAIRMAN VOLCKER. Yes.

MS. TEETERS. And what about borrowing?

CHAIRMAN VOLCKER. We can put \$75 to \$100 million in there. If you want to say \$75 million, that's fine with me. Whatever you say. When the staff makes that great judgment about how to handle the \$3 billion bulge that appears next week, it will be more important than whether we have a borrowing assumption of \$75 or \$100 million, but I think we've given the staff a tone with which to approach this that they understand.

VICE CHAIRMAN SOLOMON. If I had a different last name, I'd tell you it was truly Solomonic!

CHAIRMAN VOLCKER. Does everyone understand what we are voting on?

MR. ALTMANN.	
Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Morris	Yes
Governor Partee	Yes
Governor Rice	Yes
President Roos	Yes
Governor Schultz	Yes
Governor Teeters	Yes
Governor Wallich	Yes
President Winn	Yes
President Balles	Yes

SPEAKER(?). I think you ought to congratulate Henry.



8/12/80

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CHAIRMAN VOLCKER. Governor Wallich will have a concurring statement. September 16 is the date of the next meeting and we will discuss the future calendar at that meeting on the basis of some memorandum I will send you before then.

END OF MEETING