

Meeting of the Federal Open Market Committee

July 6-7, 1981

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., beginning on Monday, July 6, 1981, at 2:30 p.m. and continuing on Tuesday, July 7, 1981, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman  
Mr. Solomon, Vice Chairman  
Mr. Boehne  
Mr. Boykin  
Mr. Corrigan  
Mr. Gramley  
Mr. Keehn  
Mr. Partee  
Mr. Rice  
Mr. Schultz  
Mrs. Teeters  
Mr. Wallich

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

Messrs. Guffey, Morris, and Roos, Presidents of the Federal  
Reserve Banks of Kansas City, Boston, and St. Louis,  
respectively

Mr. Axilrod, Staff Director  
Mr. Altmann, Secretary  
Mr. Bernard, Assistant Secretary  
Mrs. Steele, Deputy Assistant Secretary  
Mr. Bradfield, General Counsel  
Mr. Mannion, Assistant General Counsel  
Mr. Kichline, Economist

Messrs. Burns, Danforth, R. Davis, Keir, Mullineaux,  
Prell, Scheld, Truman, and Zeisel, Associate  
Economists

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

Mr. Coyne, Assistant to the Board of Governors  
Mr. Siegman, Associate Director, Division of International  
Finance, Board of Governors  
Mr. Lindsey, Assistant Director, Division of Research  
and Statistics, Board of Governors  
Mr. Johnson <sup>1/</sup>, and Ms. Scanlon <sup>1/</sup>, Economists, Division  
of Research and Statistics, Board of Governors  
Mrs. Deck, Staff Assistant, Open Market Secretariat,  
Board of Governors

Messrs. J. Davis, T. Davis, Eisenmenger, Keran, and  
Koch, Senior Vice Presidents, Federal Reserve Banks  
of Cleveland, Kansas City, Boston, San Francisco,  
and Atlanta, respectively

Messrs. Broaddus, Burger, and Syron, Vice Presidents,  
Federal Reserve Banks of Richmond, St. Louis, and  
Boston, respectively

Mr. Meek, Monetary Adviser, Federal Reserve Bank of  
New York

Ms. Meulendyke, Research Officer, Federal Reserve Bank  
of New York

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<sup>1/</sup> Mr. Johnson and Ms. Scanlon entered the meeting following the action to ratify system open market transactions in Government securities, agency obligations, and bankers acceptances and left the meeting prior to the adoption of the domestic policy directive.

Transcript of Federal Open Market Committee Meeting of  
July 6-7, 1981

July 6--Afternoon Session

CHAIRMAN VOLCKER. That's only a formal gavel. The meeting can come to order. I should mention first of all that we have a new member of the Committee in the broader sense. Is he a member in the narrower sense--I should know this--at the moment?

MR. ALTMANN. He is a member, which means he has a vote.

CHAIRMAN VOLCKER. I want to welcome Si Keehn from Chicago. I'm sure you are all aware of this at this point. I don't know if you have had any meetings with the Presidents yet.

MR. KEEHN. Not quite yet, just having come in last week.

CHAIRMAN VOLCKER. You haven't been introduced to all the bureaucracy of the Federal Reserve. You can be introduced to this portion of the bureaucracy. We welcome you.

The second item of business is the election of the General Counsel. As you know, Neil Petersen left some weeks ago, and I think we are fortunate here at the Board in having enticed Mike Bradfield to come as General Counsel. And I think it's appropriate that he be made General Counsel of the Committee. I am familiar with Mike, as are some other people here, because he was with the Treasury for some years; and he has recently been in private practice in a firm in Washington. If somebody would like to make a motion to that effect--

MR. SCHULTZ. I move the election of Mr. Bradfield as General Counsel.

VICE CHAIRMAN SOLOMON. Second heartily.

CHAIRMAN VOLCKER. That's right, we have several people here who have worked with him closely in the past. Without objection, we have formally disposed of that.

I would like to change the [order of the] agenda a little because enough has been going on with the money supply and interest rates recently that I think it would be useful to have that background, if you are prepared, Mr. Meek. We will approve the minutes first.

MR. SCHULTZ. So moved.

CHAIRMAN VOLCKER. Without objection the minutes are approved. Are you prepared to talk, Mr. Meek?

MR. MEEK. Yes, sir.

CHAIRMAN VOLCKER. We'll go to Mr. Pardee next just to complete this part [of the agenda] and then go to the general economic situation.

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

CHAIRMAN VOLCKER. Where are the CD rates today?

MR. MEEK. They were about 17.70 percent last Thursday and are somewhat lower than that today--about 17.50 percent after our operations today, I would say.

CHAIRMAN VOLCKER. How is FNMA raising the money [they need] if they have cut back [on their monthly offerings in the market]? Where are they going for money--discount notes?

MR. MEEK. Through the discount notes mostly.

MR. PARTEE. What fraction do they have in the discount notes? Is that a pretty big figure, Paul?

MR. MEEK. I had a call in today to find that out, but I have not gotten the figures. The market says that the rollover is quite substantial.

MR. SCHULTZ. I hope when you are talking about municipals being the "wallflowers in the industry" that you are not suggesting that people are now papering their walls with them!

MR. PARTEE. That comes next year!

CHAIRMAN VOLCKER. Questions or comments?

MR. BOEHNE. Regarding this spread between rates on U.S. Treasuries and agency issues: Is that pretty widespread throughout the agencies?

MR. MEEK. It's pretty widespread. What has happened with FNMA, as I said, is that a good many people have taken them off their [approved] list, and it's harder for FNMA to sell anything longer than the four-year issue that they came out with. It's a much wider spread than I think lasted for any length of time in 1974. There was a brief period [then] when it got up to 75 to 100 basis points. But they have a significant problem. The new management of FNMA met with the industry about a week ago and everyone is impressed with their plans and with the kind of appreciation they have of their problems. But it's going to take some time to resolve them. Basically I believe, as the Fortune article on FNMA reported, that the portfolios are under water by a very substantial amount.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Mr. Chairman as I listen to this and think back over what we've had to read, I become more and more impressed with the fact that we are hung by our own petard in the M-1B concept. If one really tries to convert that to a deposit category, and makes any allowance for the money funds and for repos, then the whole perspective changes. One's whole interpretation and thinking about this changes. I just think we are hanging onto something that is not very real. I know the difficulty of trying to get rid of it, but it certainly--

CHAIRMAN VOLCKER. We have one proposal to get rid of a range on M-1B.

MR. WINN. It really alters one's whole perspective on this to think about it in a realistic sense.

MR. PARTEE. Well, I don't know. The report that Paul gave sounded to me like very tight money in the old fashioned sense of the term.

MR. WINN. Well, I think one understands it a lot better if one thinks of it in terms of the behavior being somewhat different than reported.

MR. WALLICH. Do you mean that it naturally has a higher growth rate or--

MR. WINN. Sure. You get a much higher growth rate if you convert this. We talk to people who are using money funds for their deposits; they're banking the rest of it. Something has to give.

MR. WALLICH. So it ought to have a lower growth rate? I'm just trying to understand the thrust of your remark.

MR. WINN. My thought is that if you change the measurement of what we call [M-1B], then you get a different behavior path. And you get a different outlook on this whole history as well as on current developments.

CHAIRMAN VOLCKER. I don't understand fully the statistics on the money market funds. Everybody I talk to is using them like crazy and the statistics don't show that.

MR. WINN. That's right.

MR. AXILROD. Mr. Chairman, we have the preliminary results of the survey from Michigan in which we surveyed a thousand or so accounts and asked about their money market funds.

CHAIRMAN VOLCKER. [You mean] a thousand or so people, right?

MR. AXILROD. People. And there were very close to a thousand [with] accounts in money market funds.

CHAIRMAN VOLCKER. Oh, really? How big was the sample?

MR. AXILROD. Well, you are going to tax my knowledge here.

MR. PRELL. About 5,000.

MR. AXILROD. It's 5,000 households of which 1165 had an OCD account. Just adding quickly--there's close to a thousand or a little under that have money market fund accounts. We asked all holders [of such accounts] the number of checks written per month. I don't have it by the amount of deposits at the moment, but 76 percent wrote no checks, 18 percent wrote 1 to 3 checks, 2 percent wrote 4 to 9 checks, and 2 percent wrote 10 or more checks per month. That's very consistent, of course, with our measure of the velocity of these accounts, which is very low.

VICE CHAIRMAN SOLOMON. But how many withdrew money on 24-hours notice, Steve, without writing a check?

MR. PARTEE. I don't think we asked that.

VICE CHAIRMAN SOLOMON. You can set up your account right away.

MR. AXILROD. Well, that's true. We asked: If money market funds were not available, where would the money be? That's another indirect way of getting at it. The answers were: Non-interest checking, 2 percent; interest checking, 3 percent; and the rest was in savings accounts, and the bulk in money market certificates.

MR. WALLICH. The analysis that only a very small fraction use the account actively and that, therefore, it is like a savings account may be misleading. That's because [if] only 5 percent or so of the holders use the account as if it were a checking account, that part really ought to be added to M-1B.

MR. BOEHNE. I'm impressed with the number of small bankers in small towns in rural areas who now are running into their own customers who are putting money into money market mutual funds. The sophistication of this is spreading to areas where in the past it has been slow to go. It seems to have happened in the last 4 or 5 months, since the beginning of the year.

CHAIRMAN VOLCKER. Any other questions, comments? Mr. Black.

MR. BLACK. Paul, how did you interpret this "3 percent or lower" [reference to M-1B growth in the directive]? Was there any floor in your mind on that "or lower"? When we voted on the 3 percent or less, most of us would not have anticipated the kind of weakness we had in the aggregates, nor probably would we have voted for that ahead of time had we known it. Yet, as the aggregates began to come in more weakly, you lowered our nonborrowed targets to account for that weakness, which seemed counterproductive to me if you had in mind some floor not too far below 3 percent. If you had in mind no floor, that seems appropriate.

MR. MEEK. When the Committee consulted by phone on the 17th of June, the amount we had lowered [the nonborrowed path] at that point was \$180 million, and the shortfall was not all that great. We have seen quite a lot of weakness, of course, since that time.

MR. BLACK. After you constructed the path on 3-1/2 percent and you got persistently [low] figures, you still moved it down somewhat after that, didn't you?

MR. MEEK. No.

MR. BLACK. Didn't you?

MR. MEEK. No, it has not been moved down.

MR. PARTEE. No, that was the decision in the conference call.

MR. MEEK. Except that there was an adjustment. We came out of that Wednesday with the very high borrowing that I mentioned, and there were some spillover effects into the next week, when borrowing also ran high. And the overshoot in borrowing in that first week was then disregarded in that sense.

CHAIRMAN VOLCKER. It has not been moved down; it also wasn't moved up. And if the borrowings have fallen out since that time, they have just fallen out.

MS. TEETERS. [During this period] we've had some rather peculiar borrowing patterns within the week. Sometimes borrowing was very late in the week and it was very early in the week a couple of times. What explanation do you have for that?

MR. MEEK. I think one has to start with the Memorial Day weekend when there is some suspicion that borrowing was as heavy as it was over the weekend because we were coming toward the end of the quarter and people felt entitled, in some sense, to use the window. It was a long weekend and borrowing was quite heavy over that weekend. Thereafter, we had a kind of alternating pattern in which borrowing tended to be low and then high in successive weeks, which is not an unfamiliar pattern with banks who tend to bet that the next week is going to be like the [current] week. So, if Wednesday is tight, they are likely to figure that out and borrow on Friday. That gives a profile for the week of high borrowing before the weekend and low borrowing afterward. If borrowing then toward the end of the week tends to be low, which happened in several weeks, and money market conditions are easier, that tends to make banks borrow less before the weekend--less than called for by our path--with the result that by Wednesday the amount they have to borrow is substantially more than the average, and interest rates go up.

MS. TEETERS. We've had some exceptionally tight Wednesdays, haven't we?

MR. MEEK. We've had some very tight Wednesdays. And as I [mentioned in my statement], I think [in the days prior to] the Wednesday in the middle of June, the willingness to accumulate deficiencies on the part of the banks reflected a conviction that interest rates were moving lower automatically because the economy seemed to be weakening and the M-1B numbers were coming out weaker. The banks assumed, I think, that at the end of the week it would be cheaper to cover their positions than it was at 18-1/2 percent before the weekend. That presumption was not at all consistent with our reserve path. So, on Wednesday the 17th of June, banks wound up borrowing \$6.4 billion in order to have over \$5 billion of excess reserves that day to balance their position.

MR. AXILROD. Mr. Chairman, I think it might be helpful in response to President Black's question to point out, with regard to the additional very sharp weakness that occurred in M-1B, that the data became available only Wednesday and Thursday when we had a sharp downward revision in deposits of a couple billion dollars for the week of June 24th relative to path. And preliminary data suggested a drop of almost \$7 billion in the week of July 1st.

CHAIRMAN VOLCKER. If I remember it correctly, two weeks ago when we already had some June numbers, we were assuming [that M-1B in] June was minus 3 percent or something like that. We are now assuming two weeks later that it was minus 10 percent.

MR. AXILROD. Most of that occurred in the last two days.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Paul, isn't it our purpose, though, to impose the discipline of monetary policy upon the banks? And won't the fact that they had to pay more teach them a lesson? Won't it teach them that if we want to discourage their extending credit, for example, that they have to take it seriously and not anticipate that we'll be there with the funds they need for their reserve requirements when they need them? In other words, isn't this really the strategy of our whole policy currently, and isn't the level of the fed funds rate reflecting exactly what we want to achieve, if our strategy is right? We're using it as a means of affecting the commercial banks' credit activities.

MR. MEEK. What I was just describing was the conflict between their expectations and our reserve strategy.

MR. ROOS. They haven't had this unfortunate experience in a long time.

MR. MEEK. [Unintelligible] that took place. That changes their expectations, you see, and has market effects [such as I] described.

CHAIRMAN VOLCKER. Where is the federal funds rate today?

MR. MEEK. I walked in here [directly] from the airport, so I don't know.

MR. AXILROD. It may be just under 20 percent by now. It has been right around 19-3/4 to 20 percent all day.

VICE CHAIRMAN SOLOMON. He started doing his operations at 19-3/4 percent; it bounced up a bit.

MR. MEEK. We did \$3-1/2 billion of 3-day repurchase agreements today. On Thursday, both the New York and Board staff projections suggested that we should be absorbing reserves this week and, in fact, that was a fairly general forecast in the Street. We discovered a big shortfall the next day, and the estimates this morning showed a need to add \$1.1 billion of reserves on our numbers and \$1.9 billion on the Board staff's numbers. So we did \$3-1/2 billion of 3-day RPs, which would supply about \$1-1/2 billion [on average for the week].

MS. TEETERS. What was the shortfall? Was it in float?

MR. MEEK. Yes, and the banks' Treasury balances [were a little high].



MR. PARTEE. I was surprised, Larry, by what you said. It seems to me that this could be a miscalculation on the part of the banks. But it could be an unfortunate exercise. We have been spending quite a lot of effort, if I understand it, trying to say to the market that we don't watch the funds rate and that what we do is to operate on aggregates. So, looking at a weakening in the aggregates, I think an intelligent banker might say: Well, that means there are going to be more reserves around and the market is going to ease. So [the banker] operated on that presumption and then, in fact, found that the market didn't ease. Why? Because we were reducing our nonborrowed reserve target in the early part of the first four weeks or so in order to keep the funds rate from declining.

MR. ROOS. Well, Chuck, I thought our strategy essentially was to attempt to bring down inflation by controlling the availability of bank credit. And I think the banks have been accustomed in the past to assuming that when Wednesday came around somehow or other the Fed would supply the necessary reserves in order to resist the otherwise upward movement of the fed funds rate. Now, by letting the fed funds rate flow upward, even though it's more expensive to them, we will discourage their provision of credit. Am I mixed up?

MR. PARTEE. Well, no. My point was simply that on Wednesday they either come into the window or they don't come into the window; [that has been their practice] for a long time. My further point was that they could look at what they regarded as being pretty weak money numbers and they could look at our statements to the press that we were going to provide the reserves and let the funds rate go where it would, and they might conclude that the funds rate ought to ease if the money numbers are weak. Now, Steve's point, I think, is the most relevant one, which is that it has only been in the last few days that the numbers have been all that weak. So, it's the hazard of not following the regime that we said we would.

MR. BOEHNE. Is the weakness that has become apparent in the last couple of days going to show up in the figures that are published this afternoon?

MR. AXILROD. Only to a degree. This afternoon we will publish data for the 24th and that will show no change in M-1B from the previous week. But in the preliminary estimate we had expected a \$2 billion increase. For July 1st our preliminary numbers, for what they're worth, show a \$4-1/2 billion drop in the actual figure from what we had projected. But that won't show up [in our published data] until next Friday, if it stays.

MR. PARTEE. It could be revised quite a bit couldn't it, Steve?

MR. AXILROD. Yes. The preliminary numbers have been revising \$1 to \$2 billion, at least recently since the MCA.

MS. TEETERS. Is it consistently in one direction or not?

MR. AXILROD. Well, we had two downward revisions [in a row].

MR. BOEHNE. We seem to be in one of those patterns [where the revisions] go the same way.

CHAIRMAN VOLCKER. We have to ratify the transactions.

MR. PARTEE. So moved.

SEVERAL. Second.

CHAIRMAN VOLCKER. Mr. Pardee.

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

VICE CHAIRMAN SOLOMON(?). I think [the situation] is serious myself, because there are quite a few industries that are losing competitiveness very rapidly and are having difficulty getting export orders at these levels [of the dollar]. I have a report that the Treasury is projecting a \$50 billion deficit next year on the current account. We've been projecting a somewhat smaller deficit than that.

MR. SCHULTZ. Current account or trade account?

VICE CHAIRMAN SOLOMON. Current account. Under those circumstances, the dollar is going to start crashing and it has a long way to go. And there is going to be very little [foreign central bank] cooperation. I [heard] that at

The feeling is that one of the reasons don't ask for cooperation is first, that they don't want the United States to hold a lot of secondly that, when the dollar starts to fall, they don't want to have created a precedent whereby they would have to give us cooperation. The whole tenor or the atmosphere [is that] the kind of cooperation we've had in the last few years with central banks has been seriously demoralizing. This is what telling me also when I was in Europe. I'm not saying that we are going to be able to do very much about it, given the Treasury's view, but I think it's not a happy situation at all.

MR. WALLICH. Would you think that if we did operate in the market, we could have changed these [exchange] rates much or could have kept them significantly lower?

VICE CHAIRMAN SOLOMON. If we had had consistent and cooperative intervention both by the Bundesbank and ourselves, yes, they would be significantly lower because the foreign exchange market would be influenced by that to some degree. And so maybe would corporations. I'm not saying our intervention as such makes that difference. If the psychology is not handled in such a way that the psychology of the traders is influenced by our cooperative intervention, then it's self-defeating. But we had a problem also with the Bundesbank, which followed extremely erratic intervention policies. They've gone as high as \$700 odd million in one day and then the next day [have done nothing]. For example, today the Deutschmark fell very rapidly and sharply and they didn't spend a dime. On other days they will spend a lot of money. I don't think that kind of intervention, even when large, is of any use at all. It doesn't change the psychology of the traders [and reinforce the view] that it's a two-way street.

MR. ROOS. Tony, weren't these the same guys, though, who back in the fall of 1979 jumped all over our Chairman allegedly

because just the opposite scenario was occurring? They were concerned about the expansiveness of our policies and the dollar was terribly weak, and I remember our discussing this and wringing our hands somewhat around this table about that problem. Aren't we damned whatever we do?

VICE CHAIRMAN SOLOMON. There is a tendency always for the Europeans, and to some extent the whole world, to be super critical of us since we are the biggest economic force. There's no question about that. But I think the situation was very different in the fall of 1979. What they were looking for then was some meaningful monetary policy [action] that would promise to check our rate of inflation, which was running very high and was having an indirect spillover effect on the dollar. There were no complaints in terms of the level of cooperation between central banks on intervention.

MR. PARTEE. Are you hearing reports of noncompetitiveness of U.S. manufacturers?

VICE CHAIRMAN SOLOMON. Yes.

MR. PARTEE. What kinds of industries? Chemical?

VICE CHAIRMAN SOLOMON. Chemicals have been very prominent, but we're getting reports of some others, such as textiles.

MR. GRAMLEY. I don't think one ought to look at the fact that American industries are becoming less competitive as an altogether undesirable thing in the sense that this is one of the ways in which the incidence of monetary policy shifts and gets moved around from those industries that are heavily dependent upon credit to others. The problem as I see it--and this is where I would agree with Tony--is that the lags in this whole process are very different. What may well happen is that two years from now we will be looking at a current account deficit of enormous magnitude [that is] slowing the economy down a lot, and we will be driving interest rates down because we're trying to keep our own domestic economy going, thereby aggravating our inflation problem because of what is happening to the exchange rate. It would be a lot better if we could smooth this process out a little through intervention policy.

VICE CHAIRMAN SOLOMON. We won't be masters of our own domestic monetary policy if at that point it makes sense domestically to ease and we're running a \$50 billion current account deficit and the dollar is reacting the way I would expect it to be reacting. Even [though] last month's German current account and trade figures were disappointing, the Germans are fairly confident that they will come in substantially lower in '81 and with a surplus in '82. At some point the markets will turn around, and I think the extremes of this roller coaster are unnecessary. We could be in a situation where we're going to need that kind of cooperation.

MR. CORRIGAN. Chuck, I've had reports of noncompetitiveness [with foreign producers] even in computers and high technology in the last couple of months.

MR. MORRIS. That's true in Boston, too.

MS. TEETERS. This doesn't jive with the staff presentation this morning on the deficit that is in the projection. The staff doesn't anticipate that the value of the dollar is going to fall more than 4 or 5 percent. Isn't that right, Ted?

MR. TRUMAN. Yes, from the average of the second quarter. It's a decline of 4 percent from where we are now.

MS. TEETERS. I assumed there was a self-correcting mechanism and people say it's not going to work.

MR. BOEHNE. Tony, from the European side, is the main concern with the high dollar a capital outflow problem or is it this issue you're talking about that there's a lack of cooperation here and that countries may not be the masters of their monetary policy?

VICE CHAIRMAN SOLOMON. Oh, I think they're more concerned about the immediate impact on their currencies. There's a secondary level of concern among some of them, not among others, about the fact that in the longer run cooperation is going to be eroded. Some of them, on the other hand, may be perfectly happy to see a major reversal of this, in which they would not come in and support the dollar as strongly [unintelligible]. They feel that the present policy has freed them from that obligation. Obviously, they're still going to support the dollar at some level because it can be very damaging to them for us to get too competitive on exports. But this policy carries things to such an extreme, given the lag in the J curve effect that--

MR. BOEHNE. We trip up with the lag.

VICE CHAIRMAN SOLOMON. It's just begging for more and more amplitude in the swings. Add that to the volatility of our domestic interest rates and it begins to have a damaging effect on the volume of world trade and the volume of economic activity. Anyway, that's my view. I don't know what to recommend, but we are confronted--

CHAIRMAN VOLCKER. The implication is that the Germans want to intervene. I haven't seen any [evidence] of that.

VICE CHAIRMAN SOLOMON. No, the German government would like to see cooperative intervention between the Bundesbank and the Federal Reserve. The Bundesbank, or at least the head of the Bundesbank, is reluctant for the two reasons I mentioned: One, he doesn't want to see the United States holding too many deutschmarks simply because it gives us more independence and we're less controllable; and secondly, when the dollar has turned around, he doesn't want us to be able with more moral clout to ask for intervention because of the fact that he had asked us to intervene earlier. I would say that there's a clear split in many ways right now between the Bundesbank and the German government. The German government's view is that one has to ignore short-term interests in the interest of stronger international cooperation. There's quite a difference of view, which they're prepared to talk about, between them and the Bundesbank right now.

MR. GUFFEY. Does this have any implication at all for our swap arrangements and the conditions under which we could draw on them?

VICE CHAIRMAN SOLOMON. Not in any formal sense. But I think you're right if you're implying--assuming that our policy of benign neglect continues--that if there's a reversal and the dollar comes under heavy pressure and they are reluctant to support it with their own resources and we start supporting it by wanting to activate the swap line, it is possible there will be somewhat less enthusiasm and maybe more foot dragging on our activating the swap line.

MS. TEETERS. Well, there are two different points of view here. We're looking at the possibility of a current account deficit of fairly sizable proportions, which you're saying could bring about a very sharp decline in the value of the dollar.

VICE CHAIRMAN SOLOMON. At a later time.

MS. TEETERS. At a later time. Our staff has taken just the opposite point of view: That we're going to get a sizable deficit and some decline in the dollar but not a collapse. Is that correct, Ted?

MR. TRUMAN. It depends on what you define as a collapse. The dollar today is 1.09 on this weighted average we use. We have it at the end of next year at 1.00. Is a 9 percent decline a collapse or not? That is the first proposition, the trade weighted dollar. The second proposition, after this correction, is that when we try to run it out and see what happens beyond 1982, the current account deficit essentially stabilizes at the \$25 to \$30 billion dollar range. That's not \$50 billion but it is a very large deficit. But it does stabilize under that scenario; it doesn't get worse. Those, I think, are consistent with the kinds of numbers that President Solomon was describing. It is describing a process, though perhaps not as far as others might think it would go. If the dollar moves [down] sooner, then we are not going to get quite as large a deficit, but we might have more--

VICE CHAIRMAN SOLOMON. I would guess--and Ted, I'd be interested in your guess--that a 9 percent decline in the trade weighted value of the dollar probably is going to be something like a 30 percent decline against the deutschmark.

MR. TRUMAN. Probably something like that.

VICE CHAIRMAN SOLOMON. Now, a 30 percent decline is not collapsing in the sense of the whole financial system collapsing or anything like that, but I'm simply saying--

CHAIRMAN VOLCKER. Wait a minute. A 30 percent decline?

MS. TEETERS. That takes us back to 1.80.

MR. TRUMAN. A 20 percent decline would take it into the 1.90s.

MR. WALLICH. That would imply a very sharp rise in the D-mark against most other currencies.

MR. PARTEE. Of course, a higher dollar would be having a very favorable effect on our own inflation rate in the meantime. We'd

be getting the benefit that the foreigners were getting a couple years ago.

CHAIRMAN VOLCKER. Do I detect a ground swell here in favor of intervention?

MR. PARTEE. I don't feel it. I think it's working pretty well.

MR. MORRIS. Does it make any difference?

CHAIRMAN VOLCKER. Yes.

MR. PARTEE. You mean in what the value [of the dollar] would be?

MR. SCHULTZ. Whether the Treasury will [want to intervene], given its--

VICE CHAIRMAN SOLOMON. It's not only the Treasury; it's also the present management of the Bundesbank. The two together I think probably make it less [likely] even if all of you feel very strongly on this side--if you all feel strongly as I do. I don't see it, given the joint position [of the Treasury and the Bundesbank]. Now, in a few months it may be beneficial--

MR. GRAMLEY. Mr. Chairman, does it make any difference what we think?

CHAIRMAN VOLCKER. Of course, we have independent powers [but] we endeavor to cooperate internally as well as externally. Do I detect a ground swell?

MR. MORRIS. I certainly do.

MR. CORRIGAN. A cooperative policy of intervention is better than not having one and I think the arguments that Tony makes are really the cogent ones over a period of time. I'm not sure it matters day-to-day in terms of any particular exchange rates, but in terms of being able to ameliorate at least some of these more violent swings that produce these crazy effects over time, I think it is desirable.

VICE CHAIRMAN SOLOMON. Leutwiler, the head of the Swiss National Bank, said to me a couple of weeks ago that he feels that the more permanent disadvantage of the policy, as distinct from the Bundesbank position, is that the foreign exchange market will not be as easily convinced in the future that there is cooperation among central banks. He feels that when the time comes when there is cooperation again, it's going to take a lot more money and a much longer period of time for that stand to have credibility and to have an impact on the exchange markets. It is true that in the last year or two, when the exchange market would see the Bundesbank and the Federal Reserve acting in very close harmony, they would pay a heck of a lot of attention.

CHAIRMAN VOLCKER. I'm not so sure.

MR. WALLICH. Basically it is a matter of supply and demand in the market. You may change some people's minds and thereby shift the demand and supply schedules, but if we have a \$25 billion deficit, it has to be financed from somewhere. It isn't going to come because traders take positions supporting the dollar. It will have to be financed either by central bank action--they once bought \$35 billion in one year and it didn't accomplish much--or it has to be financed by our borrowing abroad and putting that into the [exchange] market.

VICE CHAIRMAN SOLOMON. Sure. Current account deficits have to be financed. But you would agree I'm sure, Henry, that there are short-term capital flows that, based on expectations and movements in exchange markets, can go way beyond [unintelligible] in the opposite direction, depending on the particular psychology.

MR. WALLICH. Well, it's the possibility of affecting that psychology that I don't feel very optimistic about.

MR. SCHULTZ. I just don't know [at what point] we'd intervene. I recall that we were surprised that the mark moved from 180 to 190 and we were intervening and then it went from 190 to [200]. Those were big moves. Why didn't we go in at that point? I don't know--

MR. PARTEE. We bought quite a few.

MR. SCHULTZ. Yes, we did; we bought quite a few [deutschemarks] at that time. And now look how much further it has gone. It's terribly difficult to know when to intervene. I do think we'd be a lot better off if certain people in the Administration would not make such a public [declaration] about nonintervention and the fact that we're not going to do anything. It seems to me that we'd be a little better off if there were a little less talk about it, but I'm not sure that I'm for jumping in with a policy of [large-scale] intervention.

MR. WALLICH. Well, one has to consider, in addition to the arguments that Tony has made for German nonintervention, that they would be buying dollars at a very unfavorable rate if they bought any [ahead of] a near-term decline. So, that's not--

VICE CHAIRMAN SOLOMON. Nobody would expect them to support the dollar even under the tightest of cooperation at anywhere near these levels. I don't mean to carry this too far. Even though I may be among the most concerned here, Paul, I'm not recommending that you do anything about it and take on a confrontation in this area at the same time that we have other problems in domestic monetary policy. It doesn't seem to make a lot of good sense at this point.

CHAIRMAN VOLCKER. Trade one [problem] for another.

VICE CHAIRMAN SOLOMON. Do you mean now that we're following a more and more [unintelligible] on the domestic scene we can get more [unintelligible]?

CHAIRMAN VOLCKER. Divert the argument. Well, I haven't detected a full-scale ground swell.

MR. GUFFEY. I would join those who would like to have a more cooperative intervention policy. If that, added to the two or three other voices, is a ground swell, then--

MR. WALLICH. I would be very happy to support it.

MR. GRAMLEY. I would be very happy to go back to the old way of doing things, if it could be done without a fight with the Administration. I can't think of grounds on which I would less want to do battle than this one.

MS. TEETERS. Well, at least at this point in time.

MR. PARTEE. I think the question can be left to developing a strategy as the dollar drops. It's too late now to rescue anything on the up side I think. We did, of course, have a very active intervention policy right up until January 20 or thereabouts.

MS. TEETERS. Just as a point of information, when are the Carter bonds due? And how big are our balances over and above the amount that we owe in Carter bonds?

MR. TRUMAN. First, Carter bonds are due at the end of this month. And the answer to the second question is that we have about \$5.8 billion over and above the Carter bonds.

VICE CHAIRMAN SOLOMON. But not in deutschemarks.

MR. TRUMAN. Not all of it. We have \$5.8 billion over and above the Carter bonds, \$3.6 billion of which is in DM. That's it.

MR. BOEHNE. I think Chuck is right. We can't fight this out philosophically. We have to wait until the flag is on our side; we have to wait until the dollar comes down.

MR. GRAMLEY. Unfortunately, if we wait that long we could figure, as Tony indicated earlier, that we wouldn't have the foreign central banks on our side any more. It's going to be a lonely battle to fight. I think the die is cast; there's not much else we can do.

MR. PARTEE. Just demand rules of the gold standard, that's all, right?

MR. WALLICH. You'll hear more about that soon.

CHAIRMAN VOLCKER. I'm not convinced that it would have made much difference in the actual level of the dollar; in terms of atmospheric, it may have made some difference. If we haven't any more questions about that, we can turn to the economic situation over a prolonged period as background to our deliberations, keeping in mind that we have to make quite a few decisions over the course of our meeting, presumably tomorrow morning for the actual decisionmaking. Are you prepared, Mr. Kichline?

MR. KICHLINE. Prepared for what?

CHAIRMAN VOLCKER. Anything! Go ahead.



MESSRS. KICHLINE, ZEISEL, and TRUMAN. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Questions?

MR. CORRIGAN. You didn't say anything about answers.

CHAIRMAN VOLCKER. You have a chart here on the money supply.

MR. GRAMLEY. It's plotted wrong. It's plotted in the middle of the period; it should be plotted at the final period.

CHAIRMAN VOLCKER. Well, that's what I was wondering. I wondered what was plotted. I can't find it at the moment.

MR. KICHLINE. For M-1B?

CHAIRMAN VOLCKER. Yes. Those are the changes fourth quarter-to-fourth quarter?

MR. KICHLINE. They are changes fourth quarter-to-fourth quarter, adjusted, beginning in 1975 to date. We tried to incorporate some ad hoc adjustments for ATS and NOW accounts. I think they are the familiar numbers.

CHAIRMAN VOLCKER. Yes, I just didn't know whether they were fourth quarter-to-fourth quarter.

MR. KICHLINE. In 1980 it's 6-3/4 percent.

CHAIRMAN VOLCKER. I would note in that connection that I've been trying to keep track of the annual year-to-year changes. Of course, we won't know what the quarter-to-quarter changes will be for this year either until we finish the year. But it looked for a long while as if it was going to be difficult to make the year-to-year change less than it was last year. Last year adjusted it was 6.7 percent, which was the same as in '79. With this slump in June, if we remain within our targets without a weird pattern, we're going to have a year-to-year decline. If we're at the midpoint of the range or below, it will be a sizable year-to-year decline in the adjusted figure. It will be an increase in the unadjusted figure, but I guess that's to be expected.

MR. GRAMLEY. Do you really mean a decline or a reduction in the rate of increase?

CHAIRMAN VOLCKER. A reduction in the rate of increase--a decline in the year-to-year change. What did I look at? I was looking at the wrong numbers. My conclusion is right, but it's not much of a decline. That's right. I'm sorry. We have to be at the midpoint or below to get a year-to-year decline--I'll get this straight now--for M-1B adjusted. For M-1B unadjusted, we'll never get a decline.

MS. TEETERS. Why do you want a decline on a year-to-year basis?

CHAIRMAN VOLCKER. Because that's what we're supposed to be doing.

MS. TEETERS. I thought it was fourth quarter-to-fourth quarter.

CHAIRMAN VOLCKER. Well, it depends upon which figures you think are more significant. I happen to think the first three quarters are not excluded from the year. But I may be peculiar in that respect. On M2, we are not going to get a decline year-to-year; regardless of what we do, we're going to get an increase of some size. And it looks as if we'll get a big increase in M3 on a year-to-year basis. I just cite this as background. We'll probably get a small decline in M-1B adjusted and some increase in all the other numbers year-to-year.

Let me ask another question and then I want to say something else. The Treasury seems to think that the budget this [fiscal] year is going to be only about \$50 billion in deficit, if I interpret them correctly. How do we have a \$10 billion dollar difference with only two months left to go?

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

CHAIRMAN VOLCKER. My other question is: How much [reflects] the difference in your [interest rate assumptions]? They were assuming a 9 percent interest rate next year for the bill rate, and you're assuming what--15 percent or something?

MR. KICHLINE. Yes. How much is that worth in fiscal terms?

CHAIRMAN VOLCKER. Yes.

MR. KICHLINE. It's \$17 billion additional expenditures using the staff forecast because of higher interest payments compared to their March numbers. The actual level of interest payments in the budget for fiscal '81 in our forecast--and I presume ours is reasonably close to the Administration's--is nearly \$71 billion, and it would rise to \$88 billion next year.

CHAIRMAN VOLCKER. What is the figure on interest payments?

MR. KICHLINE. \$71 billion.

CHAIRMAN VOLCKER. I have a tabulation of the tentative forecasts, at least, that were made by various members of the Committee. I don't know whether you can review this better than I, Mr. Kichline; I don't know whether you are prepared to. Are these staff forecasts the same as the ones you have here or--

MR. KICHLINE. Yes, they are.

CHAIRMAN VOLCKER. Somehow, the Committee members straddle the staff forecast in every item for this year and for next year except [for nominal GNP].

MS. TEETERS. You mean [unintelligible]?

CHAIRMAN VOLCKER. Yes, in [nearly] everything. Technically they straddle [the staff forecasts]. The staff's forecast of real GNP is in the middle of the others for this year. For the GNP deflator, the staff is on the low side and for unemployment it's about in the middle. But next year the staff is on the low side on real GNP and I guess on prices. It's not unanimous but it's about in the middle I guess on unemployment. If this [table] is right in terms of the Administration's forecast, no member of the Open Market Committee who has expressed himself so far [has a forecast close to] the real GNP growth implied in the Administration forecast [for 1982].

MR. FORD. Paul, [our forecast is] much closer to the Administration's than the staff's but we're still well below the Administration's. [Real GNP growth of] 5.2 percent [in 1982] does seem optimistic. The question I have that builds on your observation about their T-bill rate [assumption] is this: Jim, am I reading your charts right in trying to put them together for the corporate AAA bond rate, the T-bill rate, and the implicit price deflator in 1982? If I do the arithmetic correctly, are you really projecting that in 1982 the 3-month Treasury bill rate will be a flat 16 percent in the face of a 7 percent GNP deflator and an 8 percent CPI, yielding real rates of interest of 8 percent on the short end of the yield curve and real rates of interest of 7 to 8 percent on the long end? These seem to me awfully high real rates if I'm reading your charts right.

CHAIRMAN VOLCKER. This has been a matter of some discussion. Maybe we ought to linger on this point a moment, Mr. Kichline.

MR. FORD. If you lower that, it seems to me then that you can allow for a lower deficit, you can allow for more investment spending, and you can get a little closer to the Administration's real forecast, which is where we come in.

MR. KICHLINE. As you know, forecasting interest rates is a real problem, and I tried to say in my [briefing] that there are a lot of pitfalls involved in this process. We've tried to look at this in a variety of ways. The charts aren't plotted incorrectly, and you've described what is there and what the implications are. Our general view is that we do have very strong latent demands for goods and services in the economy in a variety of sectors; [those demands] are being held down by interest rates. We're stuck with an assumption of 4-1/4 percent [growth in] M-1B and a good deal of uncertainty about how to interpret that measure of money. Is it really the sort of thing that one would have perceived in the past, linking it closely to transactions demands? Or is it changing? In our forecast, looking at 4-1/4 percent money [growth], we have what we've termed some further downward drift in the money demand function. That is, money is acting in a more powerful way than the 4-1/4 percent [growth] we observe. But even so, using any of the standard models, to get the economy to limit growth of money demand to 4-1/4 percent takes incredibly high short-term rates. The Board's model has much higher rates than we have here. At the same time, we get very high long-term rates, which is one of the factors damping investment growth in our forecast. And, in response to a question earlier this morning, my [comment] was that with the kinds of rates we have built in one could easily argue a case for a lower investment demand than the staff has forecast. That is, the implied real rates are very high.

So, we're really fighting this issue of what kind of [interest] rates would be associated with the 4-1/4 percent growth in money, whether [that] is sustainable, or whether in fact we might just find the economy collapsing in that environment and [money growth] then snapping back. But it's a key issue with regard to the staff forecast. Projecting nominal interest rate levels out a year or a year and a half is something I wouldn't like to stake a lot of confidence on. So, you pointed to a real problem. It seems to me that we could not expect that situation [of high real rates] to persist for an extended period of time. It would have to be resolved in one way or another, either by the economy collapsing and dragging rates down or by rates falling with changing price expectations. We do have in this forecast a rather favorable price performance, and one would think there would be an unwillingness to pay those long rates. So, it would need to be resolved.

MR. WALLICH. Well, as long as the short-term rates are significantly above the long rates, people have an expectation that rates will come down. And that is why they're willing to pay very high rates temporarily. If they ever gave up on that expectation, the [yield] structure presumably would flatten out, and it's only then that we would see the full restraining power of those interest rates.

CHAIRMAN VOLCKER. I don't know whether anybody is enough of an historian here [to know]. There have been lots of times in history when short-term rates have been above long-term rates, going way back.

MR. WALLICH. During the 1920s.

CHAIRMAN VOLCKER. Does this happen when the general structure of interest rates is going down--that short-term interest rates are persistently higher than long-term interest rates and the general trend is downward? In the 1920s I guess the trend was down.

MR. WALLICH. It seems very logical in terms of the structure. People expect rates to go down and they do go down; but in order to hold short-term securities, they have to be paid a premium. Otherwise, they do like Merrill Lynch and start buying bonds.

CHAIRMAN VOLCKER. I don't know what the historical record has been.

MR. FORD. Paul, may I just expand briefly on the point you made? Has there ever been a time in our history--I just don't remember seeing a good chart on this--when long-term and short-term [real] rates were both in the 7 to 8 percent range for a period longer than a year, which seems to be implied here? Right now we have high real rates, so it's not impossible. We have them temporarily right now. I guess one has to believe that anything that is reality has to be believable.

CHAIRMAN VOLCKER. The trouble with that analysis, to me anyway, is that it doesn't take taxes into account. And we've never had the kind of inflation, interest rates, and high marginal tax rates of the sort we have now. I don't know how high these interest rates are. They're high for some people and they're not high for other people. I don't know how to resolve that.

MR. BOEHNE. Well, I came out the way Bill did on the real rate route. It seems to me that these kinds of rates could not persist over this long a period without causing some kind of collapse. I have found in the last six weeks that the apprehension and the anxiety level have been increasing in the thrift industry and in small and medium size businesses. I think their expectation is that interest rates are going to come down before the end of the year. If this kind of view prevailed in the economy, I think we'd have a massive spread of heart attacks.

MR. BALLE. Starting at this table!

MR. BOEHNE. Yes, starting at this table probably. It just does not seem to me that we can have this kind of interest rate structure lasting for two years without some very serious financial collapses.

MR. PARTEE. But the question is: Do [rates] come down because the GNP weakens or for some independent reason? What Jim says is driving them is [the assumption of] a relatively small money supply expansion and [the staff forecast] has to force that on an economy with quite a lot of nominal GNP. The staff could be making a mistake in velocity; turnover could be faster than has been predicted. But otherwise, it either has to be a faster increase in money or a smaller increase in nominal GNP.

MR. BOEHNE. You've got a collision there.

MR. PARTEE. The [problem] may be that what this forecast doesn't show is the collapse that you said would develop.

MR. FORD. Something does not add up.

MR. BOEHNE. This forecast cannot come about in reality. Something has to give between now and the time we get to it.

MR. GRAMLEY. But there are possible adaptations to this forecast, setting apart the collapse of the thrift industry--or assuming that the thrift industry is handled by merging three-fourths of them into banks or something like that. You could make this forecast work by pushing up the deflator somewhat so the real interest rates don't look quite that fierce and by shifting the mix of GNP. If, for example, we got a substantial consumer anticipatory response to a 3-year tax cut and less housing and less business fixed investment, we might get 1 percent [real] GNP and a somewhat higher deflator; the overall outlines might work. But then we'd still have to worry about how to handle the collapse of the thrifts and what sort of additional structural damage would be happening. I agree that we are looking at a situation in which very, very substantial structural damage is probably ahead if this is--

MR. FORD. If the rates stay up.

MR. WALLICH. What would happen if the M-1B estimate is really, in effective terms, much too low? In other words, if a substantial shift in the demand schedule were ahead because of the use of substitutes, would that lower interest rates in your context or--?

MR. KICHLINE. Yes. Another way of saying that is that we would have more money growth than the measured M-1B picks up.

MR. WALLICH. And it would mean lower interest rates, then.

MR. PARTEE. For this nominal GNP.

MR. KICHLINE. Right, other things unchanged.

MR. WALLICH. Which is what has happened to us again and again, hasn't it? We set what looked like a very low M1 target and then a shift occurred and it turned out not to be very low.

MR. AXILROD. Governor Wallich, that hasn't really occurred since 1975-76. That's when it most clearly occurred. Thus far this year, unless we get further shifts, we're pretty much on the "schedule" that we tended to project--that is, a so-called downward shift on the order of 2-1/2 to 2-3/4 percentage points. If there's no further shift this year, that's about what we'll end up with.

MR. WALLICH. Yes, but aren't you arguing in effect that because we've had such a large shift in the first half of the year, we're therefore unlikely to get any in the second?

MR. AXILROD. If we get a similar shift in the second half then we'll have a much more expansionary policy than was voted for.

MS. TEETERS. Do you have a major shift in the demand for money built into the '82 forecast also?

MR. KICHLINE. About the same as in 1981. I would say that in February we had a high interest rate scenario. We had assumed some downward shift of the money demand function, as Steve mentioned. We didn't, however, have it all occurring essentially in the first quarter. We're stuck with the question of what to do at this point, and we made the assumption that, in fact, a demand shift of 2 to 2-1/2 percent for the year was reasonable. So, we wouldn't anticipate any shift over the balance of this year, but we have once again put in a similar shift for 1982. Even with that, however, we get very high interest rates in order to hold the M1 growth down.

CHAIRMAN VOLCKER. I'll reverse the question. It's easy to ask the questions of Mr. Kichline, but almost everybody in this room has a similar forecast for nominal GNP. You were told to assume somewhat lower monetary growth next year. What interest rates are you assuming and how do you get there on the basis of historical experience?

MR. FORD. Well, I think we have to assume--we better assume it and if we don't assume it, we better pray for it--that what's wrong about the way [the components of the staff's forecast] add up is that they do not believe that real interest rates will come down and that that will be accompanied by a decline in nominal interest rates. That's what solves the puzzle. That's what we have to hope for.

CHAIRMAN VOLCKER. It solves the puzzle unless you consider part of the puzzle [to be the] historical relationships between money and nominal interest rates.

MR. FORD. Perhaps what we have to do--I've been thinking more and more about this--is to consider another shift adjustment. Now, listen fellows, if we project these kinds of interest rates of 16 percent out for another two years then I think we have to hire those guys to do the Michigan survey every month from now on. I haven't had the benefit of [seeing] that but I used to work at that survey center so I know how they operate. If I understood you right, you said that 18 percent of the thousand households that have such an account said they were writing 3 or 4 more checks [per month].

MR. AXILROD. Four percent of those who have money market funds--is that what you meant?--were writing more than 3 checks.

MR. FORD. Yes, but that could be consistent.... Let me put it to you as a question: Couldn't that be consistent with a much larger percentage of the balances in money market funds being drawn in the form of transactions if the wealthier households are the ones that are doing it? Each check would have to be a minimum of \$500, right? Then there is a learning curve. I would say that over the next year or two, if you guys believe that these high interest rates will last, that percentage of households and especially the percentage of dollars that get used as checking accounts--assuming Congress doesn't take your advice, Paul, and puts reserve requirements on them--[is going to rise]. We are going to see a big shift. The shift we're going to be talking about six months or a year from now isn't going to be the shift to NOWs out of checking; it's going to be the shift to checking in the form of MMFs. And since normally we think of checking account money as an M1 type number and since MMFs we think of as M2, we may have to think some more about that.

CHAIRMAN VOLCKER. I'm not sure that resolves your dilemma. The deus ex machina that brings that about is the high interest rates that you don't want to assume in the first place.

MR. FORD. I'm saying that if you're assuming it, then you have to do some shift adjusting of this other type.

CHAIRMAN VOLCKER. You can consider that we may have an insolvable problem here and that Mr. Kichline is right: That barring a so-called disaster, if interest rates go down, then the GNP will jump up. And if interest rates don't decline, the economy will decline sharply.

MR. SCHULTZ. Isn't that what's likely to happen--that we'll have periods of weakness that will tend to be followed by some strength? It seems to me perfectly reasonable to expect some weakness in the latter half of the year followed by some strength in the first part of next year caused to some extent by lower interest rates, by the tax bill that will go into effect, and by [higher] defense spending. And given the kind of monetary policy we have had, if we have some strengthening in the economy, we most certainly will have some upward movement again in interest rates. So, are we not likely to be faced by these opposing forces going back and forth?

MS. TEETERS. [Interest rates] never go down, Fred.

MR. SCHULTZ. Oh, I think they do; they go down. I think they're going to go down in the latter half of this year.

VICE CHAIRMAN SOLOMON. I don't think it's likely that we're going to have that kind of gradual change. I think it's more likely that after a protracted period of these high real interest rate levels we will see a significant recession both here and abroad. I don't know whether that will be in 6 months, 9 months, or a year, but at some point I think we will see a significant recession; inflationary expectations will get lowered and interest rates, both nominal and real, will come down. But I don't know if we have any alternative to the policy that we're following. I don't see any gradual way for this scenario to be different than that.

MR. WALLICH. An average of 1 percent growth or 1/2 percent growth over a period of two years is historically very rare. I don't know if it has ever happened. I think that's the kind of scenario one projects when one doesn't know whether [economic activity] is going up or going down. So, you have the economy growing very slowly and unemployment rising. But it doesn't have a very high percentage probability, as Otto Eckstein would put it.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. Well, for a more optimistic scenario: Our staff has recently gotten into this treacherous business of forecasting interest rates and they come up with much lower rates by '82 and going on into '83 than the Board's model. That reminds me of that old story about a tough question in an economics exam where the student wrote "God only knows what the answer is." The professor came back and said "God gets an A and you get an F." Without going into a long harangue on methodology here, the Board's model is this large structural model. As I understand it, there's a lag of about 4 years between money and prices. By using a much smaller model with about a 2-year lag and by using a loanable funds theory of interest rates rather than the traditional liquidity preference theory, we get more real growth, less inflation, and lower interest rates. That's really rather startling. Specifically, as opposed to, say, a 16 to 17 percent level for the 3-month Treasury bill for this year and next year, we would show the Treasury bill rate coming down to about 9 percent in '82 and going down to about 7 percent in '83. As I say, God only knows which model is right, but I wouldn't--

MR. SCHULTZ. What do you get for real growth and inflation?

MR. BALLE. We get more real growth and less inflation.

MS. TEETERS. What money supply do you get?

MR. BALLE. We're using the same assumptions as the Board's model.

MR. GRAMLEY. What kind of increase in velocity are you talking about, then? Well over 10 percent?

MR. BALLE. No. As I understand it--and we'll get beyond my technical knowledge pretty fast here--one of the things that's keeping interest rates very high in the Board staff's big structural model is the need for a big increase in velocity. In our particular way of looking at the world, we get a quicker decline in inflation by reducing the rate of monetary growth in each of the last 2 years. As



you remember, there has been a slight decline in the growth of M-1B and there apparently will be a bigger one this year. That reacts faster in our way of looking at the world in getting inflation down; hence, interest rates come down faster.

CHAIRMAN VOLCKER. If this table is right that I have in front of me and you haven't changed your numbers, your nominal GNP forecast for next year is a lot higher than the staff's. Right?

MR. BALLEES. Yes, without trying to be overly precise.

CHAIRMAN VOLCKER. Which means your velocity must be much higher than this, assuming you use the same money assumption, with lower interest rates. You have much lower interest rates and much higher velocity.

MR. FORD. That's the key to it.

MR. AXILROD. About [unintelligible] percent velocity.

MR. GRAMLEY. If you figure out how to make that work, it would be great. It's the kind of thing in which you've not looked at the specific [unintelligible] about the implications for money demand. How is it that you get this sort of money demand relationship with interest rates declining? If you have a big shift in the money demand function, then it will work. Otherwise, you're sort of out in limbo.

MR. BALLEES. Well, one of the things that we are assuming has happened, and I think the Board staff has arrived at the same conclusion, is that there probably has been a big downward shift in the demand for money so far this year. We have the same ingredients working that we had in '74 and '75 when we had big institutional changes--remember that corporations and municipal governments could get into savings accounts--and extraordinarily high interest rates. At that time we were [registering] an all time new record as well. And of the various episodes of history in which we have thought that there might have been a downward shift in money demand, the 1974-75 experience stands out as one of the more likely episodes. We're guessing now that the same thing has occurred this year.

MR. PARTEE. And will continue.

MR. BALLEES. And will continue.

MR. PARTEE. So, you're not that far from Bill.

MR. FORD. No. And what's more, with regard to velocity and how much GNP can be supported, M-1B is what you gave us for the specification. You did not give us [a specification] for M2 or demand that we respond [on the basis of] M2. It might be, if indeed the public meets more of its needs for money with these tricky MMFs used as checking accounts, especially where big dollars are involved, that lower money growth can hold up more GNP. So, yes, we get more velocity; and it may be believable if this structural change that the Michigan survey talks about is happening.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, all this conversation, or much of it, suggests to me that we ought to face up to the fact that we do not know how to measure transactions balances in our present society. M-1B is somewhat of a nostalgic attempt to maintain a concept of transactions balances and I think it's leading us into all kinds of problems. First of all, we don't know what M-1B unadjusted is in the sense that we don't know how much of M-1B is really not a transactions balance. For example, in the areas where there are very high minimum balance requirements for NOW accounts, people will shift assets into their NOW account in order to get the free services. In Connecticut, for example, the average balance in a NOW account is \$6,000. This is substantially higher than the average balance in personal checking accounts in Connecticut before the NOW account came into being. The reason is that [banks] learned from the Massachusetts pricing of NOWs and put in very high minimum balance [requirements]. So, some part of M-1B unadjusted is not a transactions balance. Then we adjust the M-1B for shift adjustments, and I suspect this is done on the basis of--to put it mildly--incomplete evidence. In addition to that we have the evidence just cited that some 4 percent of the money market funds are being used, at least to some degree, as transactions balances. I suspect that percentage will rise over time. We have overnight RPs, for example, that are used by a good many corporations as transactions balances, and RPs are not in M-1B at all. I really don't think we will ever, from now on, be able to have a concept of a transactions balance in which we can have the same confidence we used to have in the old M1. At least we knew then that M1 was the store of money that people had available to them to make payments. It seems to me that we could be splitting hairs on M-1B for a great many years and talking about these wild changes in velocity, about these changes in money demand, and so on, and all we'd be doing is covering up the fact that we simply don't have any basis for measuring what transactions balances are any more. And that's likely to be [more] true in the future than--

VICE CHAIRMAN SOLOMON. Once Reg Q is gone completely and all deposits bear some kind of competitive market rates, it's mind-boggling to think of [where] to cut off the so-called money supply in terms of a coherent [measure of] transactions--

CHAIRMAN VOLCKER. Is there anyone who would like to defend M-1B or M1-A or M1?

MR. PARTEE. Well, I think M-1B is quite a bit better than Frank has said. What we really have to do is to talk about first differences. We need something to steer by. Now, the fact that there are some idle balances in a transactions total of M1 doesn't mean a thing. There have always been a lot of idle balances in there, and what we need to do--

MR. MORRIS. There are a lot of transactions balances that are not in there, too.

MR. PARTEE. And that, of course, one allows for in the velocity estimate. You can take any number and modify it to take account of other things that you think are happening in the economy. I don't see that M2 is that much better [than M1]. If I understand what the DIDC did, in another 25 days we're going to have 4-year certificates in M2 that are probably going to sell like wildfire. Are

you going to consider those transactions balances? They're going to be in M2.

MR. MORRIS. I think M2 is too narrow, too.

CHAIRMAN VOLCKER. I don't know whether it helps or hurts, but we had a conversation similar to this about a year ago I suspect. I thought that M1 [growth] would never come up. And no sooner did I so state in public testimony, it came back up to the point where [M-1B] was [above the Committee's ranges] by the end of the year.

MR. SCHULTZ. But it seems to me that this is<sup>^</sup> only half of the problem. Half of the problem is that we don't know what the monetary aggregates are; the other half of the problem is that we don't know what the relationship is between the aggregates and GNP.

MR. ROOS. Maybe we're getting to where we ought to give some thought to the monetary base.

MR. WALLICH. I do think it can be said in favor of M-1B that transactions balances are a unique concept. There's a logical reason why they might be related to GNP. Once you go beyond that to M2 or M3, there's really no place to stop. All you can do is stop with total credit, like Henry Kaufman, because changes in credit presumably indicate the degree to which people and businesses are overspending or underspending their income. If you measure all forms of credit, then maybe you can measure excess demand or deficient demand. But by just measuring what is related to depository institutions, such as M3, you don't capture the whole. There still are possible substitutions for depository institution credit and open market credit, and one may be misled.

MR. PARTEE. That is what led the Board many years ago to promote the development of the flow of funds accounts.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I'll start off by saying that I didn't really use any model, but for the balance of this year my view of the economy is very similar to that in the Greenbook for essentially the same reasons. I do see a bit steeper drop in the second and third quarters but a little faster snapback in the fourth quarter. For 1982 I haven't seen all those forecasts you have in front of you there, but I suspect that mine is probably an outlier in that I'm looking for real growth in the 3-1/2 to 4 percent range, a slight fall in unemployment over the year back to where we are now, and inflation around 8 percent but with a hunch that we could do better on that.

There are several reasons why I put down that kind of scenario. One is the pent-up demand that Mr. Kichline referred to before, combined with the tendencies toward creative financing. At any level of interest rates I think we're liable to see more activity than we might otherwise assume simply because of the way things are being financed these days. The second point that I think is important is the implication of this improved inflationary outlook, regardless of whose numbers one looks at. With any of those numbers, we're getting near the point where we've got to see some improvement in

inflationary expectations begin to feed through into long-term interest rates, along the lines perhaps that Mr. Ford was suggesting before. Certainly in the long-term area I do expect to see interest rates quite a bit lower than they are now. I'm not as pessimistic as the staff is either in terms of the near-term or the longer-term outlook for interest rates in general, partly for the reasons I just mentioned. But I also think that financial innovation, or however you want to describe it, will have continuing implications in terms of the behavior of M-1B, even if interest rates are lower. I also am inclined to the view that at least in the context of next year, we probably will see a fairly exuberant response to the tax package, although I'm not sure about the durability of that going out to '83 and '84. So, there's a good chance that we could see a fairly strong economy throughout next year.

I have to hedge my bets a little, too, though. Obviously, an outlook like mine assumes, among other things, that we do get at least some give in wages; and it assumes that we don't get any fresh shocks from energy or food. More importantly, it assumes that we're able to sneak through this [period of] financial strain and keep things reasonably in check. There I must confess to being a little more nervous now than I was even a month ago. Paul Meek mentioned the FNMA situation. I think it is symptomatic. I had another incident relayed to me the other day when the people at the Independent State Bank in Minnesota who are [pooling] bank CDs and selling them [as] money market mutual funds told me that they were now having trouble selling these funds, even [though they consist of] bank CDs that are fully insured by the FDIC. The sensitivity level has reached that point, so they reported to me. That's obviously a major question mark.

The other thing I'll mention in terms of major question marks is this deficit outlook. Obviously, we still don't know where we're going to come out on the tax package. But if we look at the staff's estimate for the '82 deficit, they have about \$80 billion compared to \$45 billion. They have about \$100 billion in Treasury and agency financing for the year as a whole and they are \$30 billion above the Administration's estimate of outlays despite, I think, having lowered defense expenditures as well. Now, if the staff is right and the Administration and Congress are unable to make offsets, that comes near to resulting in a \$50 billion deficit and I think we will have problems both in terms of the real economy and in terms of expectations and everything else. For the moment in my own forecast I'm willing to assume the best, but I wouldn't bet all I own on it.

MR. PARTEE. You wouldn't?

MR. CORRIGAN. No.

CHAIRMAN VOLCKER. Who else would like to go on the couch? Nobody else has anything to say about the outlook?

MR. ROOS. Is this in addition to [the forecasts] we wired in?

CHAIRMAN VOLCKER. Well, just any general comment that you would like to make.

MR. BLACK. Mr. Chairman, I think the key is what happens to inflationary expectations. If we keep the money supply on target, as I think we will, I believe we're going to see lower interest rates and drastically improved inflationary expectations. So, I come out fairly close to John Balles and Jerry on that. My figures are a little different. I didn't have to contend with a speed-up in velocity, John, because we put our nominal GNP at 8 percent, which is a little less than the Board staff [forecast]. But we come out with real growth of about 3 percent for '82, about the same on nominal GNP both years, and an implicit price deflator of 5 percent in '81. The latter is probably whistling Dixie, but I think we could see some drastic improvement there.

MR. SCHULTZ. I thought I was the outlier on that deflator. I had 6 to 7 percent, but you have me beat!

CHAIRMAN VOLCKER. I'm not sure I share all this optimism about inflation.

MR. PARTEE. Yes, I was just going to say the same thing.

CHAIRMAN VOLCKER. Let me just report on a few very scientific surveys I've made in my own research.

VICE CHAIRMAN SOLOMON. You've [talked to] lots of taxicab drivers!

CHAIRMAN VOLCKER. Yes, that's right! I asked a few businessmen recently what they are assuming on inflation for the next five years in their internal planning. I haven't found one who is not close to 10 percent. I also asked them, when I've had a chance, what it would take to change their mind. And they say a couple of years of less than 10 percent!

MR. FORD. It's a distributed lag effect.

CHAIRMAN VOLCKER. I just wonder with how much speed we can expect these changes in expectations to materialize. As nearly as I can see, they haven't been dented by anything--well, I shouldn't say they haven't been dented. There is more questioning; business people are not so likely to say [inflation] is going to accelerate. They're ready to concede that they may be wrong, but I'm not sure they are yet ready to take a strike to have wages rise at 8 percent, let's say, given that kind of expectation. And I don't think labor is going to ask for less than 10 percent, so where are we?

MR. SCHULTZ. Corporate profits aren't going to be very strong and [corporations] are going to have some real incentive to start getting a little tougher.

CHAIRMAN VOLCKER. Well, I don't know. Theoretically, yes. But as they look around, they say look at what happened to our friend Mr. McCardell at International Harvester. He took a nice strike and tried to get wages down and damn near bankrupted the company.

MR. FORD. The tax cut will pay for that union settlement.

CHAIRMAN VOLCKER. The corporate tax cut will pay for the union settlement?

MR. FORD. Yes, that's what I mean.

VICE CHAIRMAN SOLOMON. Market people that I talk with feel that inflationary expectations are not down. That's a view among their clients as well as their own view. And, of course, that is corroborated by the long rates we see. So, I come back to a very pessimistic view. It seems to me that there's a good deal of likelihood that [the economy] will stay stagnant. If the economy picks up in the fourth quarter the way some people feel it will, it will put a lot of pressure on interest rates. And we will have had by then, unless we [see rates decline] in the coming weeks of this quarter, a protracted period of very high real interest rates. It seems to me that some companies are getting to the limit of their abilities [to cope with these high interest rates] and there will be some failures. I think this will change inflationary expectations and in the process there will probably be a certain amount of recession, too. But that's a [scenario] that doesn't give us a gradual transition to a much better world.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. As far as inflationary expectations are concerned, people I've been talking to are really not convinced at this point that we'll make a lot of progress. There seems to be more conversation about that possibility, but decisions are being made every day down our way based on expectations of [continued high] inflation.

As for the economic outlook, we don't differ greatly with the Board staff's forecast. Though we think the rate of inflation might be a little less in 1981, our 1982 forecast is just about where the Board staff is. But we feel the economy in 1982 is probably going to be a bit stronger than the Board staff is forecasting.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I didn't submit estimates so perhaps it's unfair to say anything. But I come out a lot closer to Tony than anybody else who has commented. I think we have a heroic staff forecast here in saying that inflation is going to drop this much. I'm inclined not to believe it because I don't think we've had the confrontation with costs that is going to be required to call for a permanently lower increase in costs than we've been seeing. I don't think that's easily handled by people just saying that they will settle for a lower pay increase or take lower corporate profits without fighting back. I think they will fight back, and it's going to be a very difficult period. I have the feeling--and have had it for the last year or so--that the way we're running monetary policy now, and it's a way that's probably appropriate, is as a governor on the economy. Essentially what we have here is a governor-type operation in the way the staff has run their forecast through '82. Any time those latent demands begin to perk up and we get an overrun in money, we will tighten up and interest rates will go higher. That will then force the economy down [to] the point where the money demand will be [less] strong and interest rates will fall. And we'll get a

little better [economic performance] coming up to that limit again and then tend to go through it while interest rates will be high until the inflation rate is significantly reduced.

I guess I would be rather in agreement with the staff projection except that I would have put inflation a little higher than they have it, for next year certainly. I think there's going to be a big food price increase next year. Also, I can't really buy the recovery they have in the second half of '82 because by then we'll be faced with financial distress on all sides. And I think that will have enough of an expectational influence that the economy won't, in fact, recover. That's all.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I put down numbers for 1982 that are not a lot different from what the staff is forecasting. My real growth number was 1 percent; my implicit deflator number was, as I remember, 8-1/2 percent or somewhere around there. But I put those numbers down with a lot more foreboding than has been expressed in some of the comments around the table, because I think those numbers are realizable only if we get very, very lucky and have a big shift in money demand or if we have a sequence of developments in which we get more consumption than the staff is talking about and a lot less investment, with all that means for potential problems for the future. Particularly, I want to call the Committee's attention to what I think could be a degree of self-deception. That is, we have to be awfully careful about what we're accomplishing, if in fact we live within our targets of money growth but get a lot more effective increase in money because we've had big downward shifts in money demand. I don't buy the argument, for example, that because nominal money growth is actually falling we can get declining inflation but because we're getting such a big drop in money demand we can also get real growth. That in effect says somehow that the inflation rate is some mystical property of expectations and has nothing to do with what is really going on in the economy. I don't think it's going to happen that way. Inflation is going to come down if, and only if, we're awfully lucky and at the same time have very, very constrained growth in real economic activity. We'd be very lucky indeed to get the kind of improvement on the inflation front that the staff is forecasting. We will get it only if real growth is constrained to somewhere around where we're talking about. I worry a lot about the implications of interest rate levels that persist at where they are now for another 18 months. I think we're really looking at major, major problems ahead.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I played with the numbers also and I came up with two scenarios. Basically, the overall [unintelligible] is the governor on the rate of growth of nominal GNP. And given the reduction in the rate of growth in money and the assumed reduction for next year, we don't have much room for a nominal GNP that is very large. One of the two scenarios that seemed to fall out of my working with the numbers was that we would have a full blown recession this year. Yes, it could happen. With all the growth that we've had, [growth for the year] could still come out at 1 percent because of the first quarter, but we could have zero or a negative in the other quarters. If you look at the flash on real GNP in the second quarter,

the only thing that is positive is inventories; everything else is down. Basically, it's a negative quarter. If we got the recession this year and we stayed with high interest rates, then we could get some recovery but not a very vigorous one next year. The other scenario that can work here, with these high levels of interest rates, is that we could squeak by this year without a major recession and then have very, very slow growth next year also--basically two very low growth years rather than a recession and a recovery. I don't think we can live with these interest rates over that period of time without really causing a recession, the timing of which I'm uncertain about. But with these rates of interest we will be there probably sooner rather than later.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Our projections for 1982 are almost exactly in sync with the staff's, whereas we project a little stronger economic growth in 1981 than does the staff and are a little less sanguine about the deflator. However--and I guess maybe I'm always out of synchronization myself--for once I feel a lot more satisfied with what is happening than do some of my colleagues here at this table. I think one has to look at it with a little perspective, recognizing that we have embarked on something quite different than what we had back in October of '79. We had an understandable year of adjustment procedurally to get the effect of what we said we were going to do. We did this against a backdrop of a public and financial markets that had been promised an awful lot repeatedly and they were, and still are to some extent, somewhat cynical and understandably so as to what they might expect either from the Administration or from the Federal Reserve. However, I think in the last several months our record on monetary policy--our record of holding monetary growth under control--has been quite remarkable; and at least the utterances of the Administration, whether or not one agrees with them philosophically, are somewhat of a departure from anything that has been presented to the citizenry in a long time. It seems to me that the key to the future depends very much on the next 6 to 9 months. If we're able, as we appear to be doing now, to control the growth of money and if the Administration--and the politics of this are somewhat important in terms of people's attitudes--is able to produce and to persist in having a friendly understanding on the part of the public of what it's trying to do, and if we can stick with this over the period of the immediate future, I think the entire ball game might be significantly changed and changed for the better. I am a little apprehensive. Two months of control of M-1B or the monetary base or whatever else one may look at is not indicative of long-term results. But it certainly is better than anything I've seen in a long time. And I feel pretty good about it.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I was away so I didn't put in any numbers. My only reaction to the staff forecast is that I'm skeptical of the favorable inflation developments. I can't prove that outcome isn't likely but it seems more optimistic than I would expect in light of the details of the situation, both in terms of the particular developments in food and energy and what I see on the side of costs. As for the slow growth, I have no sense of which way it's going to go. It seems to me that Chuck is right in saying that we have a governor



on the up side. Any time the economy breaks out on the up side it will be pushed down again by rising interest rates. If we have a symmetrical policy, that would be true also on the down side. That is to say, any time the economy slows down interest rates will be pushed down if we keep the money supply on track. So, I wouldn't anticipate any very severe recession. But the economy could fluctuate between moderate expansion and moderate contraction. Now, I hope the analysis is true regarding this quasi-equilibrium of [the economy] moving something like 1 percent for two years as a result of strong private demands. It would give us an opportunity for the future. It would be equally well rationalized in terms of there being a very strong demand for credit on the part of the government through a rising deficit that keeps interest rates high rather than the strong and unsatisfied private demands. If we get out of this inflation, it's unlikely to be by what Lyle calls some mythical relationship. I think it will be because costs are coming down. And costs will come down in the [usual] painful and unpleasant way--falling profits, rising excess capacity and, unhappily, higher unemployment. There is some tradeoff, I think, in terms of lowering the level of unemployment, excess capacity, and the duration; the lower level and longer duration will accomplish about the same. But I think it would be surprising if we got out of this inflation without more sacrifice than is implied in the optimistic interpretation of our situation.

CHAIRMAN VOLCKER. Mr. Keehn. This may be your only chance to give us a view from the outside world uncontaminated by deliberations within the Federal Reserve.

MR. KEEHN. Well, having been in the chair about three or four days, I'm sure you can appreciate that my impressions and opinions are rather freshly minted. But I must say, reading the forecast and hearing it today, that I find it exceptionally gloomy; the figures we submitted were slightly on the more optimistic side. But as I relate this to the individual industries in our area--and I think you have heard in the past that some of our industries are indeed troubled, and certainly since the last meeting, if anything, they have deteriorated further--I really end up not finding any particular disagreement with the way the forecast looks.

But just to add a comment to what Lyle said earlier, there is a growing impatience, if you will, in our area about the high level of rates. Many of our industries which are troubled now really are imperilled by the high level of rates. Though our board, for example, understands the need for this, they are taking the view that at some point we have to bring rates down or we're going to cause some very significant problems with some basic industries in our area. On a lighter note, at our board meeting a week or so ago at which we discussed the discount rate, there was a comment--more in desperation than I think as a serious comment--that we should recommend a reduction in the discount rate of about 4 percentage points. But in thinking about that, it did occur to our directors that if I walked in for my first meeting with that kind of suggestion, you might really look up to see what just came in the door! I did want to report, however, that the interest rate scenario is of increasing concern and is increasingly worrying the people in the Middle West.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Mr. Chairman, we've mentioned very little about wages, but we have the backdrop of the air traffic controllers, the upcoming post office [negotiations], and baseball as another indication of the popular mood on wages.

MR. GRAMLEY. Foul ball!

SPEAKER(?). It sounds like you're getting [unintelligible].

MR. WINN. I don't see much easing of inflation occurring. It may show up. But at the moment, with utility rates going up and the possibility of food [price increases], the mood in the public toward inflation easing isn't very evident. Everybody is looking more for it to hold [steady].

MR. PARTEE. Yes.

MR. WINN. My second point is that in talking around--I've been in the building game a little recently--builders all complain that they haven't had a chance to increase their prices in the last two years because of the status of housing. They are all sitting there with [price hikes of] 20 percent or more ready to go anytime there's a little uptick in the housing area. Now, this may be wishful thinking, but they certainly are not psychologically adapted toward holding the line. Finally, all our scenarios suggest a smooth process developing. I just think about all the uncertainties and the questions. I don't think we have a year to go on the thrift industry before we start to see some major shifts of funds. I don't know whether it will be people getting scared and shifting funds, or an acceleration [of flows] into the money funds, or a money fund going kaput. Then we could wake up with \$100 billion more looking for a place to go. We may have major problems from crises and movements of money, which are going to impact institutions in a way we don't foresee. And that's going to be the biggest psychological change to take place in the period ahead.

CHAIRMAN VOLCKER. Have we exhausted the comments? I guess we can't carry this much further this afternoon. We didn't get quite as far as I thought we would. Maybe we'll start off with Mr. Axilrod tomorrow.

Let me just say that, when I look at where we are today as compared to where we were six months ago, I share Larry Roos's feeling of some satisfaction thus far. But it's a limited satisfaction. I think we have clearly taken the froth out of inflation. All those prices that are sensitive to tight money or expectations, or both, are pretty well deflated. In fact, I think many of them are deflated below the cost of production and, therefore, if things got easier, they would go up again at some point. If the economy began going up again and interest rates began going down, we probably [could expect] increases in some raw materials prices anyway. I think we've been exceptionally lucky on oil--I don't know how long that will last--and we've been pretty lucky on food. The trick is to convert that luck, to the extent that it is luck--it's partly tight money--into a more lasting wage and cost pattern. Views differ on that. I don't quite believe that we're seeing it yet, but I hope we will see it. I think we can begin to say that something may be happening on the inflation

side. I'll concede that much, Mr. Kichline, even though it will take some time to be confirmed.

I also think conditions are softening in the economy, which may be optimistic compared to the view of some in the markets that even this level of interest rates wouldn't soften anything in the economy. I believe we are seeing, at the moment at least, some softening; but the burden of all the comments that were made around the table is that there is no simple way to get from here to there. I don't know whether the staff forecast or many of the other forecasts imply a fairly simple way. They don't imply big recessions or a big backtracking on inflation. I'm not sure that there is an easy way to get from here to there or any way that doesn't involve a lot more real problems and controversies than we've had so far. But we don't know where all that is going to lead or precisely what direction it's going to take.

Meanwhile, we have to make a few decisions. We unfortunately have to use these fragile numbers that we have, and some of them are getting increasingly fragile. I agree with Frank Morris in terms of direction, but we happen to have a law as well as an expectation that says that we have to review our present targets and have to put down some new ones for next year. We are in a happy or unhappy situation that practically everything is outside the target range. It's not quite that bad: Some are high within the range; others are above or below; it depends upon which one you look at. I think we do have inconsistencies among the targets for the first half of this year. I suspect the staff analysis, when Mr. Axilrod gets to it, will suggest that those inconsistencies will become less as the year progresses. I guess he has to assume that because they were estimated in a consistent way originally and if they're off path for six months--if the original analysis was right--they have to come back toward consistency in the next six months.

MR. AXILROD. We're not that stubborn!

CHAIRMAN VOLCKER. In any event, at the moment they are inconsistent. We have to consider, therefore, whether to change the present targets to realign their internal relationships. I don't mean to suggest that that's positively necessary; it depends upon the analysis. And they all have ranges, so we have some room for some inconsistencies. But we do have to consider this internal alignment question. We have to consider all the questions that were raised about what velocity is likely to do and what all the new institutional arrangements mean. When we get through all that technical [analysis], we have to decide where policy ought to be in some sense in terms of real pressure. And the policy [discussion] only comes after we get through that morass of technical questions, the way this is set up. We're going to do all that for this year and, obviously, we have to set some ranges for next year. Again, we have what one might think of as pictorial questions in terms of how the targets look against this year's targets and this year's performance relative to all those expectations out there, and we have to reconcile that somehow with our policy predilections.

The policy question comes down, I suspect, to a question of where we want to take our chances because--at least speaking for myself--I doubt that anybody can be all that certain about any

particular outlook or all that certain about what some of these internal relationships are. Not only do we have to make substantive decisions, but we have to portray them to the public. And we are going to have to lean one way or the other on where we want to take our risks. I would only say in that connection that we may not be quite as far along as we thought but we are some distance along the road of taking the risks that a constraining policy [presents] in the interest of dealing with the inflationary problem--risks for not only the financial system but the real side of the economy. I suppose everybody is looking to see whether that's where the risk is going to be balanced in the future or not. With that much comment, I guess it is late enough so that we can retire for the evening and come back at what time?

MR. ALTMANN. 9:30.

CHAIRMAN VOLCKER. At 9:30 in the morning we will take up the long-term discussion. We will consider revisions in the targets for this year, if any--and I'm not implying there should be any--and whether we want to make any changes in the targets from this year for next year. And then we will come back to what we want to do in the next month.

VICE CHAIRMAN SOLOMON. Mr. Chairman, isn't it worth pointing out that the staff originally recommended a much higher M2 as being consistent with--

CHAIRMAN VOLCKER. Well, they recommended a somewhat higher M2, but the distance--

SPEAKER(?). 10 to 12--

CHAIRMAN VOLCKER. I don't know. It wasn't that high; it was 1/2 to 1 percentage point higher. The discrepancy could explain, one can say, perhaps half [of the overshoot from the target]; I think their original analysis probably would have explained one-third or two-thirds of it or less.

[Meeting recessed]

July 7, 1981--Morning Session

CHAIRMAN VOLCKER. Mr. Kichline, do you want to take about a minute to describe the producer price index figures that came out this morning?

MR. KICHLINE. In June the producer price index for total finished goods rose 0.6 percent; that compares with 0.4 percent in May and 0.8 percent in April. For the second quarter as a whole, it was up 7.1 percent at a compound annual rate compared with 12 percent in the first quarter. Food prices rose 0.5 percent compared with no change in the preceding two months. Finished energy goods rose 0.2 percent compared with a decline in the preceding month. But excluding food and energy, the total was up 0.6 percent, with a bit slower or pretty much unchanged rates of increase across the board. For example, capital equipment prices were up 0.7 percent compared with 0.9 percent in the preceding two months. On average there does not appear to be much of surprise in this particular index compared to our earlier expectations.

MS. TEETERS. The crude food [component] was up very strongly, though, wasn't it?

MR. KICHLINE. That's correct. It was up 2.8 percent compared with a 2 percent decline in the preceding month. I might say on food that it's principally the meat prices that are up, particularly beef but pork as well, and we had in our forecast a continued further rise in those prices. So it appears as if the rise in meat prices has begun.

MR. SCHULTZ. But futures prices for meat in the last couple of weeks have been down surprisingly. I don't understand that.

MR. KICHLINE. Yes. Some of the spot prices, though, have been moving up. I think the crude materials prices reflect that rise in the food area, in beef and cattle particularly; it's just there that we've seen increases in spot prices. The rise has been erratic but [generally] up. You're quite correct, though, that there is [that] expectation. I don't know about the last couple of days, but the futures prices did not show anything that unusual.

CHAIRMAN VOLCKER. Mr. Axilrod, do you want to proceed with a laying out of these difficult arithmetic issues and presumably some economic implications thereof with respect to the targets with which we are blessed or hung--one or the other?

SPEAKER(?). Hoisted!

MR. AXILROD. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Well, it's all complicated, as Mr. Axilrod suggests. Let me just make a couple of comments. If I can, I will separate the substance from the numerology; that distinction may not be accepted by everybody around the table, but let me make it for the moment. I do think there are some signs of progress on inflation and inflationary psychology; I'm not one to overstate that, as I suggested yesterday. Largely we have affected the things that are most likely

to be affected by restraint in the short run: commodity prices, precious metals prices, and the exchange rate to some extent. The hardest part of the battle is ahead in terms of affecting the underlying rate of inflation. Maybe something is happening there but it's still in the "maybe" stage. Nevertheless, the stage is at least set more favorably than we've had it in the past. All that is on the plus side.

We discussed at great length the economic outlook yesterday. I don't think anybody is very satisfied with any of the projections in terms of their internal logic and plausibility for continuing over a period of time. There is a high risk premium in any of them and our job is assessing where the risks lie in our own policy in terms of our broadest objectives. I haven't much doubt in my mind that it's appropriate in substance to take the risk of more softness in the economy in the short run than one might ideally like in order to capitalize on the anti-inflationary momentum to the extent it exists. That is much more likely to give a more satisfactory economic as well as inflationary outlook over a period of time as compared to the opposite scenario of heading off economic sluggishness or even a downturn at the expense of rapidly getting back into the kind of situation we were in last fall where we had some retreat on inflationary psychology and the latent demands in the economy immediately reasserted themselves. Then we would look forward to another prolonged period of high interest rates and strain and face the same dilemmas over and over again. Neither of these outlooks is very simple or happy in a sense. But between the two I suspect, hard as it is to say, that the lesser risk in the long run is taking a chance on more sluggishness in the short run rather than devoting all our efforts to avoiding the sluggishness in the short run.

How that converts into these numbers is another thing. We have technical problems of internal consistency between M-1B unadjusted and M-1B adjusted and between M1 and M2. We have the problem--if it is a problem--that we're low on M-1B and that to come back within the range or at least near the midpoint of the range, as Steve said, gives us very high growth rates in M-1B for a period of months. If we had those high growth rates, we'd probably overshoot on M2. We wouldn't be overshooting on the annual objective for M1 but we would probably be overshooting on M2. So, we have a question as to what to do with this year's ranges. I have some predilection myself, but it's no more than a mild predilection, not to fool around with changing them this year on the grounds that to change them has an atmosphere of fine-tuning and it's even harder to explain at the end of the year why we are outside of the ranges if we are outside of them. [Changing them implies] a kind of renewed commitment to coming within them and we may lose a little flexibility that it may be desirable to have.

On the other hand, internal consistency and the actual level of M-1B could easily suggest that some reduction in that range would not be out of line. So, one could argue it either way. If we raise [the range for] M2 or M3, which is another possibility, as Steve suggested, it creates something of a problem of giving confusing signals to the market, just in terms of the surface impression of "easing." And if we change this year's targets, particularly if we lower the M-1B range for this year, we have to consider what that does in terms of what we can say about next year in the portrayal of some

year-to-year declines. [The task] is not impossible, but we just have to consider what those implications are. So, we have a lot of permutations and combinations, starting from my own predilection that the general risk is that we in some sense may be too easy rather than too tight during the period ahead. I think we ought to take our risks on the side of being tighter rather than looser. I leave it to you to convert that into numbers, but that's my general sense of the direction in which we should be moving.

With that much introduction, I open the discussion at this point not to a consideration of the short-run operational decision for the next month or quarter or weeks--although obviously that's going to be in the back of people's minds--but of this problem of what to do with [the ranges for] this year in terms of internal consistency or broader changes and what to do about next year. We are not looking at this point at the short run but recognize that the [dilemma] we're in is going to be greatly colored if we have the [large] decline in M-1B for the next published figure that the preliminary data suggested. The way we start out the next quarter is going to be considerably affected by whether we get a big increase in the following week, which is now the instinct of the projectors and some people in the market. We have an [estimated] increase of \$5 or \$6 billion in the week of July 8, which seems possible. We started out July with a better posture in terms of our targets; if M-1B goes down by \$4 billion in the next published figure and remains there, then we are really behind the eight ball in terms of the targets in the short run. Whereas, if we have that big recovery in the following week, we would not be faced with that same drastic low starting point. In an ironic way I rather hope that the July 8th figure is a big increase. The ideal thing would be that we recover from the big decrease of the coming week and start off at a reasonable level for the next quarter. But that's all in the lap of the gods, so far as I know. All I know is that it's going to color where we start off this quarter. But since we don't know that and we can't do anything about it, I don't think we can take it too much into consideration at the moment. Let us proceed. Mr. Roos.

MR. ROOS. I think you've resolved the question I had. I was going to ask a procedural question. Maybe I'm alone in this, but when Steve reports a lot of figures as he did--four pages of them--I don't have the mental ability to absorb that and to translate that into where we are going. I was going to ask the question--

CHAIRMAN VOLCKER. Let me make a comment in that respect, if I may. I think we are all in the position you are in. I suspect that if we arrive at some tentative figures, after some preliminary discussion, we better have a recess for figuring out the implications of all these figures in terms of growth rates over the next couple of quarters to make sure we are really where we want to be. There's too much arithmetic involved to put together the figures casually. So, I think we ought to get a general feel of what people think and then go back and do some of the arithmetic and see whether we are really where we want to be in terms of all these targets and their interrelationships. Go ahead.

MR. ROOS. Well, I would support the basic position you expressed a little while ago: That if we are going to err, which I hope we won't, it ought to be on the side of constraint rather than

ease. I think that one of the big problems we have is the problem of credibility and how people see what we are doing. If we were to do anything that would give the appearance of easing monetary policy significantly at the present time, I think we'd frustrate what would be the apparent objective of ease--bringing down interest rates and bringing relief to a soft economy. So, I would support, Mr. Chairman, what you have said as far as basic policies are concerned.

CHAIRMAN VOLCKER. That may be pretty vague, and I was pretty vague. I raised the question of lowering the M-1B target [for this year]. But whether or not we lower it, I would not aim right now aggressively, in quotation marks, for something like the A alternative presented here in the short run and what that means for the long run--returning to the midpoint of the present target. I think we have the alternative of either lowering the target or saying that we are going to be low in the range--not necessarily outside the target, but we don't expect to be in the upper part of this range. We could either be below the target or in the lower part of the range. Those are the two choices I see for changing the M-1B target for this year.

MR. ROOS. Well, alternative 2 on page 8 [of the Bluebook] would be my preference in that regard. That's the more restrictive of the two for the remainder of this year.

MR. SCHULTZ. I think that's moving too fast.

MR. ROOS. Are we moving up?

CHAIRMAN VOLCKER. Page 8 is where are we.

MR. SCHULTZ. That's 3-1/2 percent. You are not suggesting that we attempt to get on a path right now of getting back to 3-1/2 percent by the end of the year, are you?

MR. ROOS. No.

MR. PARTEE. I didn't think we were talking about the short run.

CHAIRMAN VOLCKER. No, we shouldn't be talking about the short run. Is page 8 the short-run stuff?

MR. ROOS. That's the last half of this year.

MR. BLACK. To hit the bottom part of the present range of 3-1/2 percent--

MR. PARTEE. Well, I don't know. You say it's fast. Let me remind you that a year ago we were sitting here talking about how in the world we could get back up into the ranges. In fact that was the key note of your July presentation. So, who knows? I think we ought to choose these numbers with respect to what we think the longer-run effect will be and then struggle with the question of whether we come in low or go above or anything like that in the short run. But we ought to try to keep in mind what the economy requires.

Quickly, Paul, I happen to agree: Alternative 2 looks all right to me.



CHAIRMAN VOLCKER. What page?

MR. PARTEE. Page 8. That's the--

CHAIRMAN VOLCKER. Look, I'm confused about what those alternatives are. What are they?

MR. AXILROD. Those, Mr. Chairman, are simply the growth rates--in some sense the midpoint growth rates--we'd expect. So, alternative 1 is the midpoint of the present longer-run range of 3-1/2 to 6 percent and we would expect M2 and M3 to grow at rates above the upper ends of the present ranges. If, however, growth in M-1B were held to the lower limit of the present 3-1/2 to 6 percent range for the year, we would expect that growth in M2 would be in its range and growth of M3 just a tick above its range. That [table on page 8] shows those relationships.

MS. TEETERS. Steve, in Appendix III, the associated interest rates for the third and fourth quarters are 19-1/2 and 21 percent, is that right?

MR. AXILROD. Yes.

MR. PARTEE. They're high rates.

MR. SCHULTZ. If you believe that.

MR. PARTEE. But I think the point is that we can, in fact, accept the strategy of alternative 2 and not change the long-range targets for this year.

CHAIRMAN VOLCKER. That's right. Let me just clarify this. If we implicitly accept the strategy of alternative 2 in a rough way, we are left then with the question before us of whether we keep the M-1B range unchanged or whether we lower it. [That strategy] is consistent with either hypothesis, and we wouldn't have to change the M2 range. We could, but we wouldn't have to. Now, I don't know whether any of you people who have commented already want to say anything about 1982. In effect, you have said alternative 2. You haven't said anything about 1982, and I don't know whether you want to at this stage.

MR. WALLICH. The 1982 ranges and the changes for 1981 are somewhat separable topics. We can separate out the very short run and separate out the rest of year, and then we can talk about 1982. I think those three topics are more manageable than if we try to get into all of them at the same time.

VICE CHAIRMAN SOLOMON. I disagree, Henry. I think one has to discuss what one is recommending for '82 in discussing whether to revise the remainder of '81 or not. If you want to revise the remainder of '81, you then are going to be much less willing to announce a further reduction [for '82], presumably, at this time.

CHAIRMAN VOLCKER. I think there is a relationship between the two. We have too many numbers to discuss here, we all agree. But I think we should just get out on the table initially a feeling--I

guess it's broadly reflected on page 8 and then it's reflected on page 14, too--about what's implied for next year.

MR. ROOS. I would recommend alternative II in '82 also, going slowly at [our job of reducing monetary growth]. Alternative II is consistent with our long-range objective of reducing our M-1B [range] by about 1 percentage point a year.

CHAIRMAN VOLCKER. You have an Arabic number 2 on page 8 and a Roman numeral II on page 14.

MR. PARTEE. I wouldn't go with the Roman II; I would say Roman I, possibly with a 3-point range.

MS. TEETERS. We don't have the answers, but implicit in these is the level of interest rates. Alternative I is the one that keeps interest rates in the 18 percent range for the full 18 months, isn't that correct? Presumably alternatives II and III would put interest rates in the 20 or perhaps 22 percent range.

MR. AXILROD. Well, it probably would, if you assume the economy unchanged.

MR. PARTEE. Until the economy collapses!

MR. WALLICH. It doesn't have to collapse; it just needs to ease a little.

VICE CHAIRMAN SOLOMON. There's a further complication. At least we in New York, Steve, are a little surprised by the interest rate levels projected to be consistent with each of these alternatives. To me these interest rates are very much on the high side. Certainly the market would think they are on the high side. And since they're derived on fairly unreliable historical relationships based on the model, it may be that the market is less wrong and more right. We ought to take with a grain of salt the interest rate projections; I'd think of them as being more the outside limit on the upper side rather than as the most likely result.

CHAIRMAN VOLCKER. May I just go back and ask Mr. Roos and Mr. Partee if they are ready to pronounce judgment? This all should be considered very tentative. All I want is an instinct at this point. Consistent with alternative 2 for the short run, meaning this year, would you leave the ranges unchanged or would you lower M-1B presumably?

MR. ROOS. For the short run?

MR. PARTEE. No for this year.

CHAIRMAN VOLCKER. I mean this year. Not really short run but this year as opposed to next year.

MR. ROOS. The ranges should be left unchanged. I think we ought to opt for the lower of the two alternatives to stay within the ranges, if I understand it.

CHAIRMAN VOLCKER. Yes. We have two questions here. One is where we should aim in substance and the other is whether we should change the range. That's a pictorial question. We can go either way on the pictorial question.

MR. ROOS. I would think, and this may be unrealistic, that at this particular time whichever way we go, it would be appropriate [to provide] an early explanation in a public statement by the Chairman or through some other mechanism as to what we actually were seeking to accomplish in this meeting. In other words, in this situation an understanding of what we are trying to do is so critical currently that getting our story across through signaling [may not be the way to go]. Maybe it is too early to talk about this--maybe it ought to be in the directive--but whatever we come up with, if we opt for what the Chairman implied earlier, I just wonder whether this shouldn't be expressed and explained quite openly or publicly without the 30-day lapse that usually accompanies these things.

CHAIRMAN VOLCKER. Well, it presumably will be explained in the testimony.

MR. ROOS. That's when--the 21st? [Secretary's note: Chairman Volcker testified on July 20, 1981.]

MR. PARTEE. On your question, I think it's really a matter of taste. We could say, as we often have with these ranges, that they are there for a purpose. That is, things change, and we change [our view of where we want to be] within the ranges. It looks as if there was a change in the demand function for money and, therefore, we are going to come in low on M-1B and we're going to come in high on M2 and M3. Or, if you prefer, we could say there has been an apparent change in the relationships here and, therefore, we are going to reduce the M-1B range 1/2 point and increase the M2 and M3 ranges 1/2 point. It's just a matter of taste as to the cosmetics of how we go about it, Paul.

CHAIRMAN VOLCKER. Yes, I think it is a matter of pictorial taste. Mr. Black.

MR. BLACK. Mr. Chairman, I am very sympathetic to your expression and Larry Roos' expression of the way in which we ought to err if we have to. I would take a different position on the ranges, however, and suggest that the more prudent thing to do in light of the weakness in the aggregates in the first half may be to take the bottom half of this range that we previously adopted. That would mean that if M-1B could grow 10.4 percent, it would hit the midpoint of the present ranges; it would end up considerably below that, of course, if [second-half growth] came in below that. The reason I think this is important is that even to hit the bottom part of that range, we have to have a pretty good rate of increase in terms of how the market judges that. We would have to have [growth at a rate of] 7.4 percent between now and December. And since they remember what we did last year, if they start seeing figures like that and we have not taken any explicit action to lower that range, I think that would disturb them more than if we do lower it. It is quite true, as Larry says, that if we explain this at an early stage, that will help some. But all too often the market doesn't seem to listen to these explanations; they just look at the cold figures. So, I would say we really ought to

make [our objective] explicit and try to come in somewhere in that lower half. I would rather come in a little above the lower part of it, though, and would want growth a little higher than that of alternative 2, which would bring us nearly to the lower part of the M-1B range. So far as the ranges for M2 and M3 are concerned, I'd leave those unchanged. If we come in somewhere in the lower part of the existing M-1B range, that would enhance the chances that M2 and M3 would come in within the ranges that we specified; if they should turn out to be lower than that, then we have plenty of range to accommodate that, too.

MR. PARTEE. Would you just cut the range? Is that the idea, Bob?

MR. BLACK. Yes, I'd cut it off at the midpoint of 4-3/4 percent and have the range be 3-1/2 to 4-3/4 percent and try to come in somewhere within it. If we had had stronger performance in the aggregates up until now, I would not be as sympathetic to that, but--

CHAIRMAN VOLCKER. Where are you for next year?

MR. BLACK. Next year I would cut [the range for] M-1B down to 3 to 4-1/2 percent. That's not exactly what any of these alternatives specify.

MR. PARTEE. 3 to 4-1/2?

MR. BLACK. Yes, 3 to 4-1/2 percent for M-1B and then I would take the alternative III [ranges for the other aggregates] but I'd clip the top half of M2, M3, and bank credit by about 1 percentage point and leave it there. Most of those ranges might be pretty reasonable. They are not all that far apart so I don't feel as strongly about that as I do about the desirability of emphasizing, either through explicitly cutting the range or through stating it very clearly, that we are aiming at somewhere in the bottom half this year. That's really the important point.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I'd like to say a few words first about how I get to where I am. It's useful for thinking about ranges in the future to remember that we are dealing in a world now in which the money demand function has been shifting all over the lot. And I agree with Tony that one can't make interest rate forecasts from the money growth ranges under these circumstances without having a great deal of uncertainty. But I wouldn't express it the way he does. I don't think we ought to take these interest rate forecasts with a grain of salt. I think we ought to look very, very carefully at the possibility that they may be right and at what that means for the selection of ranges. It seems to me we are looking at an economy with some very strong increases. We have a lot of expansive forces going on, but the economy is being held in check by very, very tight monetary policy. High interest rates have slowed economic growth essentially to nothing. And if interest rates went down a lot, the economy would bounce right back again. On the other hand, I also think we have real interest rates where we want them now because we are making progress on inflation. If one believes the staff is correct that we are going to make more progress over the next 18

months, we are going to have a rather dramatic shift in expectations about inflation. That means that unless nominal interest rates come down as inflation subsides, we are going to have real interest rates increasing substantially. We are going to have a lot tighter monetary policy than we really want. If nominal interest rates come down, then the downward shifts in money demand that we have been experiencing in the past several years are much less likely to occur. I'd like to remind you of how much this has meant for the course of the economy this year. If you look on page 6 of the Bluebook, you find that over the fourth quarter of '80 through the second quarter of '81 shift adjusted M-1B went up 2.2 percent at an annual rate. But if you add the 5 percentage point shift in the money demand function that took place, that number converts to 7.2 percent. The point is that we may not be anywhere near that lucky in getting downward shifts in money demand in the future.

So, I think Chuck Partee is right. We may be sitting on a situation in which, in order to keep interest rates from going up like gangbusters, we have to permit a lot faster money growth than we have had in the first half of this year. That means to me that we should stick for '81 with the same ranges we have. If we are fortunate and money demand continues to move down, growth will come in near the lower end of the ranges. If we are not so fortunate, we may end up with growth over the four quarters more like the midpoint of the range. I would leave M2 alone; I don't think we need to change the M2 range. And I would be inclined to abandon altogether the actual M1 range along the lines that Steve suggested. For '82, I would be leaning in the direction of something like a 3 to 7 percent range for M-1B and maybe even 6-1/2 to 9-1/2 percent for M2 because I think we have seen somewhat of a change in the relationship between the two-- although heaven knows, developments may come along that would alter those relationships between now and then. I'm wondering, in light of the uncertainty with which we've been looking at these M-1B numbers, if we ought to be thinking over the long run of leaning more heavily on a broader aggregate such as M2 and perhaps indicate in our announcement this July that we are thinking along those lines.

MR. PARTEE. The trouble with going toward leaning on M2 is that we still haven't had a presentation of information that would indicate that it's a more reliable guide. One has an instinctive sense of that because it's more stable and closer to GNP, but we haven't had that analysis.

MR. SCHULTZ. But some comment in the directive to indicate that it is indeed being looked at might well be worthwhile. Given that we are in fact looking at a family of aggregates and that none of these aggregates is behaving very well, it might be a good idea to indicate to people in the market that we are indeed looking at least to some degree at M2.

CHAIRMAN VOLCKER. Let me just make one comment on one of Governor Gramley's points, which I think is valid, but maybe not too much in the very short run. At some point, if inflation does come down and interest rates come down, we may find we need much higher growth in transactions balances relative to nominal GNP than anything in recent experience has suggested. How we would ever make that shift is very difficult psychologically in terms of all this numerology because we all keep talking about the need to reduce money growth, and

it would give the wrong signal if we actually set a projection based upon [the need for faster growth]. It's too early to assume that need anyway. Some day it's going to happen or it may happen. My reaction is that it's premature [to act on it now]. It may not be premature to raise the subject as a possibility for the future, but it's too early to raise the subject in terms of the actual targets we put down because I don't think we are there yet. And we might give a wrong signal by leaning on it now even though I suspect it is going to happen at some point. Some day we are going to have to say rather flatly that the target is higher relative to nominal GNP precisely for this reason, and I would consider putting a sentence or two of that sort in the testimony. But it's probably too early to reflect it in any actual targets we set, because it will not be identified in the public mind with this rather sophisticated analysis but would just be interpreted as a straightforward easing of policy. And that is not what would be meant. Governor Wallich.

MR. WALLICH. Well, I think Lyle has given us a very sophisticated argument against the proposition that the way to get inflation down is to keep pulling the aggregates down. I get the similar argument from a very theoretical side. The people who are examining the post-World War I inflations conclude that at the end of the inflation [the monetary authority] can enormously increase the money supply without rekindling inflation because that is what happened then. But I share the Chairman's view that we are far from that point. Moreover, typically when one has had declining interest rates, velocity has not changed back to its previous behavior but has remained high because there's an underlying trend that increases it. So, I would be very hesitant now to move in the direction of allowing higher targets.

There are two things we need to bear in mind. One is the substantive point about what we want to do; the other is the strategic. The two substantive things we need to do are to avoid the repetition of 1980 by going to a very high rate from a low level, perhaps in order to get back on track, and thus conveying the impression of a massive expansion. That suggests to me that we ought to keep M-1B growing slowly the rest of the year, if necessary by changing the target range downward. But that can also be done by specifying that we're aiming at the lower end of the range. That's what the Germans have been doing, and recently they actually have changed the target. The other thing we ought to do is to get M2 and M3 more or less on track. Yesterday's discussion shows that M-1B is increasingly regarded as unreliable. I say that very reluctantly because I've favored transactions balances as a criterion. But it doesn't seem to be a feasible criterion, at the present time at least. So, I think we need to focus on M2 and M3, and that suggests to me again that either we lower the M-1B target or aim specifically at its lower end. In either event, I come out with something like the alternative 2 growth rates for '81.

Now, for '82 I see Tony Solomon's point that if we make a big move on anything in '81, we can't make a very large move in '82. That's the strategic aspect of the matter. But I think there's still room for some reduction in the target for M-1B this year and a smaller reduction for it next year. I would go somewhere along the lines of the ranges in alternatives II and III on page 14.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. Well, with the exception of Mr. Black, I was the outlier on my forecast for inflation for next year. [My forecast was] predicated on the idea that we would continue with the policy of monetary restraint. I disagree with Governor Wallich. I think we have a real opportunity at this point to bring inflation down. There are a lot of indications that the groundwork has been laid and that there is sensitivity [to that possibility]. I certainly would agree with Mr. Solomon, though, that it takes a period of intense price and wage competition to bring inflation down. We have that opportunity over the next four quarters and I think it is very important that we not lose this opportunity for two reasons: (1) because the American public are going to get very impatient if they don't start to see some real effects from the kind of policy we've been carrying out; and (2) because we have another big tax cut coming up on the first of July of next year and that's likely to be very stimulative.

So, to me, the next four quarters are really crucial. It is vital that we have a continued policy of monetary restraint. There are risks on both sides. There is a risk in what I really would like to see, which is a period of very slow growth or a mild recession, and the risk is that it could get out of hand on the down side. I don't think that's likely to happen, first because there is a great deal of latent demand in the economy and if the economy does weaken to that degree, interest rates would come down and that would have a stimulative effect. Also we have another tax cut coming on October 1 and we have continued heavy defense spending, [both of] which I think are likely to prove to be a support underneath the economy if it should get much weaker than I would anticipate. The risk on the other side of not having a firm policy of monetary restraint is that we could have a very difficult time early next year. It seems to me that the period of greatest danger for the thrifts is that period; if we ease up and then have this tax cut and the defense spending and the other things that could well take place, we could easily be in a situation in the first quarter of next year where interest rates are rising and there is tremendous pressure on the thrifts. I think that's the period of great danger. It seems to me that we have a real opportunity here and it's very important that we not let this situation get out of hand as we did last year. The economy is poised so that we can exert a real effect on inflation.

So, I would like to see us reduce the lower M1-B band for this year to 3 percent from 3-1/2 percent. I see the arguments on the other side, but if we leave it at 3-1/2 percent the market would look at it and say: "That points to a big increase for the remainder of this year and if the Fed weren't going to try to hit that target, why did they leave it there?" I think that makes a lot of sense. The argument can be made that if we put in 3 percent, then that is a real target and maybe we would have to hit it in spite of what may happen in the meantime. It seems to me that the stronger argument is that if we leave it at 3-1/2 percent, the market will anticipate that we're going to be pumping up the money supply pretty rapidly between now and the end of the year to get to that figure. So, I'd like to see us lower that range to 3 percent on the down side.

Next year, I do think there's likely to be a wide swing, particularly in M-1B. My anticipation is that the economy likely will

remain somewhat sluggish in the first half. But if we do have some success in getting inflation down and that tax cut hits on July 1, the second half of the year could be pretty strong and I think we are likely to get some rather wide swings [in monetary growth]. I would opt for alternative III, which would mean a further lowering of the target range for M-1B on the bottom side but retaining the 3-point range.

MR. PARTEE. May I ask: What does 3 percent imply for the rest of the year? If [M-1B growth] were to come in at 3 percent, Steve, what would June to December be then?

MR. AXILROD. Well, the June-to-December growth would be around 6-1/2 percent. That would be the alternative C.

CHAIRMAN VOLCKER. It's consistent with alternative C in continuing to--

MR. AXILROD. That's alternative C. [M-1B growth] comes in at 3 percent for the year.

MR. BLACK. You'd leave the upper part of the range unchanged then, Fred?

MR. SCHULTZ. I would. I'm very much afraid--

CHAIRMAN VOLCKER. You're also saying you'd leave it unchanged in '82?

MR. SCHULTZ. I'd leave the upper part of the range alone for this year or lower it 1/2 point. I wouldn't lower it by more than that. I am afraid of tightening these ranges too far.

CHAIRMAN VOLCKER. If you reduce the bottom limit of the range for this year, just pictorially, I think you'd want to reduce the top too because you wouldn't want to be widening the range in the middle of the year.

MR. SCHULTZ. All right. I'd accept that. I'm really much more concerned about the bottom part than I am the top. I'd accept the lowering of the top.

VICE CHAIRMAN SOLOMON. What would you do for '82?

MR. SCHULTZ. 2-1/2 to 5-1/2 percent.

CHAIRMAN VOLCKER. That would leave the top the same as this year and would reduce the bottom by 1/2 point further from this year. Governor Teeters.

MS. TEETERS. May I remind you that we shouldn't take too much credit for the price easing? I never thought we were totally at fault for the price increases that we suffered from OPEC and food; and I don't think the fact that OPEC and food have calmed down has a great deal to do with monetary policy per se, except in the very long run. As a result, I think we ought to be very careful about what we do in terms of interest rates. Nobody yet has mentioned housing; nobody has mentioned the Chrysler problem; nobody has mentioned all the companies



that have had their credit ratings downgraded; nobody has mentioned the possibility that the thrifts are going to go [under] if we keep interest rates up. I get the impression that we're really tearing at the fabric of the financial world and the economy. If we persist in having very high interest rates over very long periods of time, we're going to cause a disaster in this country. It may not be next month and it may not be next quarter, but it's going to be a severe problem and it's going to come down on our shoulders for having pushed the economy over the edge.

I happen to agree with Tony Solomon on the short run because if we aim for the 3-1/2 percent lower end of the M-1B range for this year, then we have no place to go next year. We can put our ranges at any place up to 5 percent, but if growth were to come in [at or] above 3-1/2 percent, we're going to be in a position of increasing the rate of growth of the money supply and not decreasing it. So, I think it's foolish to try to come in at that lower end. I think we're going to come in at the lower end and I think we're going to come in at the higher end on M2, which we've known since the staff was telling us that in February. However, the markets are totally aware of our problems with M1-A and M-1B and M2. If you read the most recent DRI report it describes exactly what our problems are in getting these things to come together. Therefore, I don't think we have any credibility problem in explaining the difference between M-1B at the lower end of the range and M2 at the upper end of the range. That leads me to the decision that I don't think we should change the ranges. We should stick with the M-1 B range of 3-1/2 to 6 percent. We ought to have good conversations and a good flow of information back and forth between ourselves, the market, and increasingly with the Congress, and we can explain what is happening. We don't have to change the ranges to do that. I don't think we should go for alternative II; it's too strict. If people look at the first half of this year, everybody is aware that we're way under on the M-1B growth rate. Even if we don't achieve our current range the second half of the year, they will be understanding of it. And we can talk about it.

When we come to next year, if we aim for a higher rate of growth in money and presumably some easing in interest rates, which I think is appropriate at this point in time, then my preference is with Lyle; I don't see any reason to tighten up. Nominal GNP next year is going to be a great deal larger than it is this year. Why reduce the money supply and almost assure ourselves that we're going to maintain high interest rates for this long a period of time? It seems to me that we don't have to adopt any of these strategies. We could stick almost exactly with the numbers that we have this year and, in effect, that represents a fairly tight monetary policy. So, I come down somewhere between alternatives 1 and 2 on page 8 and for retaining the 1981 targets for 1982, particularly since we are setting preliminary targets for 1982. In the past we've trapped ourselves by setting [new] targets in July and reaffirming them in February. With all the uncertainties that we have, it seems to me we'd be better off to stay put now and, if necessary, change them in February but not commit ourselves to a lowering of the targets this far in advance of actual economic developments.

MR. PARTEE. Well, all of those ranges on page 14 lower the targets a bit, Nancy. Alternative I lowers the target ranges by 1/2 point.

MR. FORD. It raises the M2 and M3 and bank credit ranges.

MS. TEETERS. I wouldn't take any of these, Chuck.

MR. PARTEE. Oh, I thought you said you'd take alternative I.

MS. TEETERS. No, I'm talking about alternative 1 on page 8, which is the shorter-run target. I'd take the present ranges for '81 [instead of any of those] on page 14. I don't see any reason to change them.

MR. PARTEE. I see.

CHAIRMAN VOLCKER. Well, let me just make one point as a footnote. I think you are correct in worrying about [high] interest rates and what that might do to the financial fabric. The question of strategy is whether we take that risk in the short run or exacerbate that risk by being too easy in some sense in the short run and having high interest rates longer. I think that's the issue before us.

MS. TEETERS. But that has been the issue repeatedly.

CHAIRMAN VOLCKER. That's right.

MS. TEETERS. It has been over the past 2-1/2 years that I've been here, and all we do is end up with high interest rates.

CHAIRMAN VOLCKER. Well, you could argue we haven't been tight enough.

MS. TEETERS. Try to tell that to the construction industry.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I'm embarrassed to say that I have changed my position every day in the last four days, as I looked at each of these permutations and combinations. I was in favor of almost every single one that has been mentioned at one point or another. And I must say I've come full circle. I won't bother you with why I came full circle. The disadvantages of each of these approaches are pretty obvious, but let me explain why I now would recommend that we stay [with the targets we have] for the remainder of the year. The problem, I think we all agree, is primarily presentational. Fred, even though I agree with much of what you said, I would disagree with you on the reaction of the market and the public. If we leave the target unchanged for this year and say that we expect to come in at the lower end--I'm talking about M-1B obviously--I think that is better than lowering it a half point. If we lower it a half point, the market will believe we're going to make an enormous effort to come in at that lower target because, otherwise, why make the adjustment? If we leave the target range alone and say we expect to come in at the lower end or possibly even undershoot given unusual situations--velocity or what have you--I think the market would expect less of an expansionary policy from us in the remaining few months. They would expect less of a repeat of last year. There are so many disadvantages of adjusting any of this or fine-tuning that I'm not sure what we gain that is significant, and we constrain our hand for '82.

We have a wide range of possibilities [for next year] because of this velocity question. It seems to me, however--and here I would disagree with Nancy--that for '82 we still need to show continuity of policy and continued severe monetary restraint. What I would do is give a preliminary view--emphasizing that it's very much subject to review if there are unexpected changes in velocity and as we assess the state of the economy--that we would cut the range for M-1B for '82 by 1/2 point and leave the M2 and M3 ranges alone, recognizing that we have not cut them for 2 or 3 years. It seems to me that there are overwhelming technical arguments for that and I think they're fully explanatory. Everybody knows about the surge in money market funds, and in general I think we have convinced everybody that we have a very restrictive policy. I don't think we have to worry about the fact that we haven't cut the M2 range in a couple of years. There are good reasons, which everybody will accept. So, that would be my recommendation.

MR. WALLICH. That's a tighter fit for M2 than is proposed by any of the alternatives I through III on page 14, isn't it?

CHAIRMAN VOLCKER. He said leave it unchanged.

MR. WALLICH. He'd leave it unchanged at 6 to 9 percent.

CHAIRMAN VOLCKER. 6 to 9.

VICE CHAIRMAN SOLOMON. I would not lower it, right.

MR. WALLICH. But the alternatives here all raise it, you see.

MR. PARTEE. They all raise it.

VICE CHAIRMAN SOLOMON. Part of this whole credibility issue is a perception of a kind of simple-minded, if you want to call it that, approach. If we ignored the recommendations of the staff last year to raise the M2 range for '81, at this point I don't see the argument for going ahead and raising it [now]. I don't believe the innovations in financial instruments that we should expect next year are going to be such that we should have the kind of growth in money market funds that will put more pressure [on M2]. I would not raise the range.

MR. WALLICH. I wasn't disagreeing with your proposal; I was just trying to point out that you were really making a very tough proposal.

VICE CHAIRMAN SOLOMON. Oh, I think it's reasonably tough. In some ways, as I explained earlier, I think the markets are still focusing more on M-1B. And as I said, perversely I'm afraid, if we lower the range a half point, the markets will expect us to make an even greater effort to hit it than if we leave it alone and say we expect growth to come in at the lower end.

MR. SCHULTZ. Explain to me what worries you about that. Are you worried that we would be making a major effort to get growth up to 3 percent? Is that what bothers you? Or are you worried that that is too constraining? Which side are you on?

VICE CHAIRMAN SOLOMON. I'm not talking about the substantive decision on how we actually handle ourselves for the rest of the year, because we don't have full control of where we're going to come in. I'm talking about my impression of the public reaction or the market reaction, which is that if we say that we're going to lower it a half point, rather than say that we're leaving it alone but we expect to come in at the low end, then the markets will expect a more determined expansionary effort on our part because we are fine-tuning the range.

MR. SCHULTZ. A more determined expansionary effort if we lower it to 3 percent than if we leave it where it is?

VICE CHAIRMAN SOLOMON. Than if we leave it alone and say we expect to come in at the lower end or even possibly undershoot.

MR. WALLICH. But the substance of it is that we shouldn't make M-1B grow very fast; whether we express that in terms of a target or by saying we expect its growth to come in low is a matter of strategy.

VICE CHAIRMAN SOLOMON. Let me say this, on the substance of it: I feel that we should be careful not to [let growth] exceed the lower end and we should accept a little undershooting. I don't think we'll get that much criticism because I don't see that it's going to be timed with a recession. Obviously, if we were undershooting and we had a recession simultaneously, we would get an enormous amount of criticism.

CHAIRMAN VOLCKER. The next appointee to the Open market Committee is going to be a market psychiatrist!

VICE CHAIRMAN SOLOMON. Well, we have every kind of therapist here.

MR. SCHULTZ. And the one who goes off will also need a psychiatrist!

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I think we're positioned really rather well with respect to our '81 targets. Looking forward from last February, I didn't expect that we'd be as well off as we are now, and I think we ought to accept the good fortune that we have. So, I wouldn't tinker with the '81 targets. To be at the bottom end with respect to M-1B and at the upper end with respect to M2 is about as good as we can hope for. In fact, I'd be very happy if we ended the year in roughly that position. So, I would leave those targets unchanged. I am concerned somewhat by the shortfall that we are getting in M-1B. We've now had [minus] 5 percent in May and [minus] 10 percent in June. We do have a forecast of growth in July and I think there's an underlying feeling that the risks are for too much growth in the second half of the year. But I have seen this pattern develop before, so I have no problem in beginning to resist this shortfall some, which I think is consistent with the idea of moving between now and year-end toward the lower end of the M-1B range. It doesn't do us any good in the market to run double-digit shortfalls because what comes from that is the expectation that we can't tolerate that for very long and we're

going to have to resist it. So, I think some resistance to that is appropriate.

As far as 1982 goes, I think we ought to keep the ranges for the broader aggregates about the same as those we now have for 1981 and I am torn between whether we should lower the M-1B range by a half or a whole point. I could live with either. If we lowered it by a whole point, we'd be getting a little more consistency between the narrower and the broader aggregates. But the important thing is that we lower the M-1B range; whether we lower it a half point or a whole point I'm not sure is significant. We are going through a period of maximum danger with regard to the inflation problem and the potential danger to structure as well as a possible recession over the next 12 months. However, I'd rather be running that gauntlet over the next 12 months than the 12 months after that or the 12 months after that because we have begun to make some progress down the anti-inflation road and the costs and the amount of that risk will be less over the next 12 months than in the subsequent 12-month periods. From the strategic point of view, we have to try to keep this anti-inflationary momentum, of which monetary policy is a part, going over this year and next year.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, making a couple of general points first, I certainly count myself solidly in the camp of those who would say we should err on the side of firmness now. I think that is very important. I also tend to agree with Mr. Solomon that in all of the scenarios that are laid out here, particularly in the short term but maybe even beyond that, the interest rate profiles are too high. I also think that the actual growth of money over the second half of the year is very important in terms of how we start off 1982. And when I look at some of those numbers that have money growth at 8 or 10 percent in the second half of this year looking toward getting down to 2 or 3 percent next year, the trajectory that presents creates some real problems for me as well. One other general point: I think Steve implied that the staff thought that some of the definitional kinds of problems associated with M2 and M3 relative to M1 might be less next year. I'm not at all sure of that. It seems to me they could be greater, given what the DIDC is doing and the possibility of legislation for an all-saver type certificate or something like that.

MR. AXILROD. I didn't mean to imply that.

MR. CORRIGAN. Okay. Well, I don't think we're out of the woods by any means in terms of those problems with the broader aggregates. As far as the specifics, taking the 1981 targets first, I rather strongly favor the view of retaining the '81 targets as is. To change them involves two problems for me: One is the strategic problem for next year; and the other, which may be more important, is that to do so would give the impression that we really know enough to be able to fine-tune these aggregates at midstream by 1/2 point or whatever. I don't find that very appealing. So, I would retain the existing targets for 1981 although, as I will indicate later, I certainly would not mind an outcome that looks like alternative 2 on page 8. I would not change the targets. I do have some sympathy for the idea of getting rid of the M1-A measure just to get rid of it.

In terms of 1982, again partly because of this potential problem I see with M2, M3, and bank credit, my view at this time would be to state a target for M-1B of 2-1/2 to 5-1/2 percent, using the 3-point band. And as Mr. Solomon suggests, right now I would leave the targets for the broader aggregates for '82 where they are for '81, with some rather full explanation in your testimony that partly because of uncertainties about the tax legislation or whatever we will have to take a harder look at these at the beginning of next year.

VICE CHAIRMAN SOLOMON. So you're recommending a full point reduction in the M-1B rate for 1982?

MR. CORRIGAN. It's a half point on the top and a full point on the bottom.

CHAIRMAN VOLCKER. Mr. Morris. You would solve half the problems by abandoning M-1.

MR. MORRIS. That's right.

CHAIRMAN VOLCKER. That simplifies it.

MR. BLACK. If he wants to get rid of M2, he can do so.

MR. MORRIS. Well, I wasn't proposing that we do that in '81. In general, in order to improve communications between the Federal Reserve and the public, we shouldn't change the guidelines unless there's a pressing need to do so. I think it generates confusion. And I don't see any pressing need to change the 1981 guidelines. But I'm not sure I would do what you're suggesting, Paul, which is to suggest to the [Congressional] Committees that we're confident we are going to come in at the lower end of the range, because this M-1B monster is an extremely volatile instrument. Last year half of the year's total increase in M-1B occurred in one week. I think it would be fine to say that we want to be within the range, but I'm not sure I'd want to commit myself to coming in at the lower end even though we're way below it at the moment. I thought Steve's remarks supported extremely well my view of getting rid of the M-1s as a guideline. He only concluded that we should get rid of M1-A; I don't quite understand that. But I would go beyond Lyle Gramley's position and use M3 and bank credit as guidelines rather than go to the halfway house of M2. If we were to do [as I suggest], we would accomplish one of the things that we're concerned about. That is, we're concerned about a one-time shift in the demand for the narrow aggregates in the event of a sharp decline in interest rates, and it would no longer be a problem. I just don't see how we could accommodate that with an M-1B guideline. But if we had an M3 and bank credit guideline, we could accommodate it very easily. There are two other advantages, it seems to me, of such a shift. One is that there's a great deal less noise in the broader aggregates than in a narrower one. The noise factor, which is huge in M-1B, gives the monetarists a shot at us several times a year. They say the money supply is either growing too fast or too slow. There's no way we're going to get M-1B growing at anything approximating a straight line because of the heavy noise content, which was even demonstrated recently in the [article published by] the St. Louis Federal Reserve Bank.

MR. ROOS. Monetarists don't shoot at other monetarists, Frank, and we're all monetarists.

MR. MORRIS. Another nice little problem it would solve is the weekly money supply problem because even though we'd be giving information to the market every week on the M1s, the market would not be weighing that so heavily since they would know we were no longer gearing policy to M1 but to the broader aggregates. Now, assuming this advice is not going to be accepted--

MR. GRAMLEY. I find it very persuasive. You ought keep on.

MR. PARTEE. You ought to be a debater, Frank.

MR. MORRIS. --if we could get away with cutting the range for M-1B by 1/2 of one percentage point next year and with keeping the other ranges where they were, I think that would be an excellent outcome. If we can't, then I would be willing to cut the whole batch by 1/2 percentage point. And I would support Steve's suggestion that if we're going to have an M-1B target, we have solely a shift-adjusted target. Having two targets for M-1B is also a source of confusion.

CHAIRMAN VOLCKER. Well, I'm not sure that's what Steve was suggesting. We would have an M1 target period, not shift-adjusted.

MR. AXILROD. Yes, no M1-A.

CHAIRMAN VOLCKER. That's on the presumption that we declare the shift is completed.

MR. MORRIS. I see.

MR. AXILROD. Or irrelevant.

CHAIRMAN VOLCKER. Either completed or irrelevant, one or the other.

MR. MORRIS. But it may not be completed.

MR. PARTEE. That's the problem.

MR. AXILROD. That's why I was suggesting widening the range.

VICE CHAIRMAN SOLOMON. I'd like to make a parenthetical comment that may be of some use. I encountered enormous resentment in Europe among government officials and central bank officials about our continuing to publish the weekly money supply statistics. Maybe their reaction is much too excessive, but they believe that we unnecessarily encourage extra volatility above and beyond what our October '79 approach involved by our continuation of the weekly publications. I just pass that along for what it's worth.

CHAIRMAN VOLCKER. We're going to have to consider that one of these days. I take it that the predominant comment from market people, as you would expect, is that they want us to continue it. There are some comments in the other direction, however; but all the market people argue that the more information they get the better.

VICE CHAIRMAN SOLOMON. I find that quite a few leading bankers in New York feel exactly the opposite.

CHAIRMAN VOLCKER. The farther away you get from the market operator types, the less sympathetic people, including the more senior bankers, are to that. Governor Rice.

MR. RICE. Well, Mr. Chairman, I agree with the general thrust of your opening statement, especially the part where you seemed to say that we should take the risk on the side of more softness in the economy rather than try to counter any sluggishness that might occur in the short run. From my point of view, probably the most critical question right now is whether we continue to do what we said we were going to do--whether we are going to continue to reduce gradually the growth of money--or whether we are going to try to adjust our position in light of what we think we see developing in the economy. To me it's extremely important to be perceived as doing what we said we were going to do. Rather than try to adjust to the short-run changes that we see, which might make more sense from the short-run point of view, I think it's better to continue to do what we said we were going to do. That is likely to have a much more decisive impact on inflationary expectations. So, for that reason I would favor, as have others, keeping the 1981 targets where they are. I would not change the ranges at all for the reasons set forth by several of you, particularly those set forth by Tony Solomon. I would also for the rest of 1981 opt for alternative 2 on page 8. But it's important to try to keep M2 and M3 as close to their target ranges as possible, and therefore, I would be willing to accept growth in M-1B of 3-1/2 percent [or less in the second half of this year]. In the interest of trying to keep M2 and M3 close to their ranges, it's important to accept the shortfall for the rest of the year in M-1B.

As for 1982, I would favor strategy 2 as indicated on page 12, accepting the 3-1/2 percent growth for M-1B for 1981, and moving back to the 4-1/4 percent midpoint of the range for 1982. That, I think, implies some variant of alternative II on page 14.

MR. PARTEE. I think it's alternative I.

MR. RICE. You may be right.

MR. PARTEE. Well, you might ask what the staff had in mind.

MR. RICE. What I was going to propose is that, in effect, we do what we said we were going to do and reduce the M-1B range by 1/2 percentage point. So, [for 1982] I'd move to a range of 3 to 5-1/2 percent and leave the ranges for M2 and M3 where they are right now.

CHAIRMAN VOLCKER. Let me just say that given all the complications of this, I think the meeting is going to run until after lunch. I'd like to get through this preliminary go-around and maybe before we resolve this turn to the short run because I think that has some influence on how we finally come out. I suspect we're going to continue the meeting after lunch. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Let me just make a couple of preliminary comments as background to my recommendations. First of all, I feel that there's a good deal of latent strength in



the economy and that at any indication of lower interest rates, for example, that strength will come forth and we'll have a quite different problem than we may be facing right now. Secondly, it does seem to me that we've made some real progress against inflation and that the public is at least willing to accept that. To be sure, most of it has not been of our own making; it has been in both energy and food prices. Nonetheless, the stage is set. And one last observation: If it is true that we've come to this point for whatever reasons, whether we've had a part in it or not isn't important. Historically, the Federal Reserve has always come up to the hitching post and then backed off simply because the Administration and the Congress have thrown bricks at us or have not been supportive of a policy of restraint. Through the course of recent history at least, we've backed off and we've made a mistake each time. I think we have an opportunity this time to carry forward what we should have done before because for the first time ever we do have, for whatever length of time, the support of the Administration at least. So, we ought to take advantage of that opportunity. That is the background.

With that background, I would like to propose that we not change the ranges for the remainder of 1981. I'd leave them the same with the understanding, [explained] through testimony or otherwise-- and I think the market already understands--that we're probably looking to the lower end of the range. The fact that M2 and M3 are running very high in the range or outside of the range at the moment seems to me to be consistent with perhaps running at the bottom end of, or even below, the M-1B range for the remainder of this year, while M2 and M3 are right at the top of their ranges. As a result, the fact that we may end up with M-1B below the lower end of the range for 1981 is not important. I wouldn't move the ranges downward simply to accommodate that shortfall.

MR. MORRIS. We could juggle the shift adjustment.

CHAIRMAN VOLCKER. Unfortunately, the only new evidence we have on the shift adjustment would lower the adjusted M-1B. If we wanted to take that evidence from this Michigan survey, that's--

MR. GUFFEY. Well, I think we ought to leave it right where it is. That story can be told from the picture that will unfold in 1981, and I think it leaves open the lines of communication even with the monetarists. For 1982, from the alternatives on page 14, I like lowering the range of M-1B coupled with broadening the range to 3 percentage points, so 2-1/2 to 5-1/2 percent has some attractiveness to me. But I'd also retain the present ranges for M2, M3, and bank credit. I'm not sure what those all mean. For M2 at least I'd retain the present range, the 6 to 9 percent. As to the short run and what we do in the next month, as I understand the procedure, we're not going to talk about that right now. So I'll stop. I do have some comments to make about that, however.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. On the substantive issues of where policy should go, I agree with your opening statement and with the consensus that's developing that, given that there are risks on both sides, we have to run the risk of holding tight.

CHAIRMAN VOLCKER. Let me just restate my own semantics. I think you have stated it correctly. There are risks in everything we do. I think the lesser risk is--

MR. FORD. The holding tight.

CHAIRMAN VOLCKER. --holding tight, not that that's the greater risk.

MR. RICE. Did I summarize it wrong?

CHAIRMAN VOLCKER. No, I think the sense of it is clear enough, but just as a semantic matter I think we're minimizing what inevitable risks there are by doing that. There are risks with any of these alternatives.

MR. FORD. Next, with due regard for Nancy's and other people's concern about the thrifts, I very deeply share that concern, but I think we can lose with the thrifts either way in that there's a lesser risk of playing to win now in the next few months than by letting their equity run down longer and facing the same problem a year from now with less equity when that turnaround comes, as Fred so nicely put it. Substantively, my thinking goes from that point. That says then, concerning the '81 targets, to leave the ranges where they are. There are two approaches: the one Fred suggested or leaving the ranges where they are and explaining that we're willing to accept being at the lower end or even a little below [on M-1B]. I'd put more stress on getting M2 within the top of the target, if we possibly can, even though the staff forecast suggests it will be a hard thing to do without blowing interest rates through the roof. But I just am skeptical of that view, or I should say more optimistic about the outlook for interest rates than they show in their forecast. We're praying for a better interest rate forecast than the one they have. If theirs is right, we're in big trouble with the consensus that we're developing here.

Concerning the 1982 targets, like a number of previous speakers, I think we need an alternative to the ones shown. Basically, it's alternative II with a modification on the M2 target. I'd like to see M2 kept where it is because if we set an M2 target with a cap of 9-1/2 percent, that would be the highest rate we've had at any time--if my table here is correct--since July of 1977. And I'm worried that even though there are technical reasons for seeing M2 as being somewhat more expansive than previously, the markets keep records of this stuff and if they see us moving M2 to the highest range we've set in four years, that could hurt our credibility and exacerbate the problem of getting within the targets. So, I'd say let's go for alternative II on the M-1B range, but cut M2 down to the present range of 6 to 9 percent [despite] the grounds that it's hard to cut it given the structural changes that Steve and the staff have pointed out to us. Concerning the short run--well, we don't need to talk about the next quarter yet since you want to do that after lunch. The only other thing I'd say is that, Frank, you're not completely alone in the woods. I have developed a touch of Morrismania and I'd say we should move in the direction of considering dropping M1-A immediately. I'd go at least that far with Frank.

MR. MORRIS. You don't have much mania!

MR. BLACK. Even I have that much!

MR. FORD. And step two toward Morrismania is at least to restate our concerns about the very substantial structural problems with M-1B. Deemphasizing M-1B a bit in our statements would be the way I'd lean toward Mr. Morris's position on which aggregates to emphasize.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. Basically I'm in favor of what I call the KISS approach: Keep it simple, sir.

MR. SCHULTZ. Or keep it simple, stupid.

MR. BALLEES. Your opening statement, which has been supported widely around the table now, was that there's much more to be lost than to be gained by tinkering with these 1981 ranges. In fact, I don't recall that we've done a midyear correction heretofore. If that's wrong, I withdraw the comment.

CHAIRMAN VOLCKER. We haven't had much experience. I think what that means is that we haven't done it for two years.

MR. BALLEES. The latitude with the present ranges seems to me to be adequate for the balance of this year. With respect to the alternatives for 1982 set forth on page 14, I would go for alternative I for M-1B, which is to drop the range by 1/2 point, but I find it difficult to buy any of those alternatives for M2, M3, and bank credit. A number of people have spoken on this so far, and I would come out bottom line the same way, to leave those ranges for the broader aggregates the same as they are now. However, I would begin formally and more explicitly, following up on what Lyle said, to give more recognition to M2. We have done that in a very subjective way in our recent published directives. We can all recall the time when we went as far as saying we would give it equal weight. That has been some years ago now. Perhaps it needs to be discussed at some length how far we go in the formal sense in giving more recognition to M2. If you look at the spread between M1 and M2 over quite a long period of time, it bounces all over. I have a table--Bill says he has one too--that shows that over the last 20 years that spread has averaged about 3-1/4 percentage points. The 4-1/4 point spread which is shown on page 14 between the midpoints of M-1B and M2 just seems to me to be excessively high. Coming in somewhere around the historical average spread of 3-1/4 points would justify leaving the M2 range at 6 to 9 percent for next year, which is where it is now. One of the reasons I would lean more toward M2 in a formal sense in our policy deliberations is that I have some skepticism about M-1B; I don't share Frank's view completely, but we are dealing with a very tricky animal in the shift-adjusted M-1B. And at least for next year, that gives us perhaps good reason to place more weight on M2. As a number of others have said, I wouldn't be unhappy at all if we dropped M1-A altogether and do it right now. When we get into the short-run specs, the June-to-September period, I'd like to say more about leaning as aggressively against undershoots as overshoots, but that discussion comes up later.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Yes, Mr. Chairman. I also would agree with the substantive comments that you made in your opening statement. With respect to the strategy for the rest of 1981, I would tend to favor alternative 2 on page 8. I would not make any adjustments in the '81 ranges; I would just let those stand the way they are.

As for the strategy for 1982-83, I would look to strategy 2. With respect to the ranges for 1982, I would go for a 1/2 point reduction in the M-1B range to 3 to 5-1/2 percent. I would also be very inclined to leave the M2, M3, and bank credit ranges where they are currently. It may be because I sit next to Frank Morris, but I'm beginning to find quite a bit of sympathy for looking a little closer at M2.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Mr. Chairman, I'm impressed with the power of the number. We should remind ourselves that [when] we were sitting here a year ago and thinking about the future we forgot base drift in setting our targets. If we go back and adjust for that and secondly if we adjust for the changes that have occurred in M-1B--and the Michigan survey, I think, does not include corporations' use of money funds in the transactions balance set-up--the adjustment probably is in the other direction. [If] we were sitting around the table at the moment faced with the fact that we were over our targets, not under our targets because of the base-drift problem and the adjustment of M-1B, I wonder what our reactions would be. I think we can get trapped by the numbers we're playing with here if we're not careful.

Second, contrary to the view most people have expressed, I'd be very strongly in favor of changing our targets at the moment. I think we're going to get trapped next spring if we don't. Suppose we're successful in the sense of coming in at the lower end or less; that becomes our base, if we use precedent on this score. Think what kind of adjustments we're going to have to make and to explain at that stage to make this fit any kind of economic analysis related to those that we've heard. If we're not careful, we're going to be increasing our numbers in February. I feel it's much easier to try to explain it now. Also, if we set targets, we ought to try to shoot for the midpoint. When we set targets and say we're going to shoot at the lower end or less, I think we're playing games a little. Moreover, if we have to make an adjustment, I think it is easier to make it now and then not make one in February. I think we have ourselves trapped by this annual review, particularly when we base it on where we are rather than on having some continuity in the series over time. I'd be in favor of making the adjustment now and, if we're lucky, that would bring us closer to the midpoint of the adjusted range. Then we would not have to make a change on an annual basis to make a continuous effort to achieve our inflation objective. It seems to me that we ought to avoid getting trapped into basing our ranges on where we are and do it rather on a continuous series over time.

CHAIRMAN VOLCKER. Mr. Keehn, you can make an interim concluding comment and we can have a coffee break.

MR. KEEHN. Well, I'd best be brief! With regard to 1981, it seems to me that from the earlier discussion, we're clearly in a learning phase [regarding the relationship] between M-1B and M2. And

until we learn more about the downward shifts, it's awfully hard to be precise. To change either range at this point implies a greater degree of precision than may perhaps be the case. I don't see how we can logically change one without the other. Being new to this, I think the outside perception is that the actual results count much more than how they actually relate to our ranges. So, I'd be in favor of not making any change at this point.

With regard to 1982, it seems to me that a great deal has already been accomplished and that for all the reasons that have been stated we will have lost a great deal if we do not continue the downward shift. The visibility of reducing the numbers somewhat has a great positive effect. Therefore, I'd be in favor of alternative I for M-1B but would leave the other ranges where they currently are for fear that if we raise them at all, it would have a negative market reaction.

CHAIRMAN VOLCKER. Let me just make one or maybe two comments before the coffee break. Most people have said: "Keep the ranges this year the same," which was my instinct when I was thinking about it before. However, I found that Governor Schultz raised some rather cogent points. I did a little arithmetic this morning and I think one can argue, although I'd want to confirm this arithmetic, that it's reasonably safe--that may overstate it a bit--to expect that we would come within the M-1B range if we lowered it by 1/2 percentage point. That may give us the leeway that Frank is worried about in the unfortunate circumstance that M-1B growth would go up. I still don't think it's going to go up above the upper end, but as opposed to saying we're going to be in the lower end of the range there may be some advantage in just reducing the range a little this year. Everybody probably changes their mind on this, like Tony Solomon, but I find the case for keeping the range less persuasive than my own initial instinct suggested, depending upon just how the arithmetic works out. I think the arithmetic works out rather favorably on that, although I'd want to look at it again. Anyhow, let's go to the coffee break and after the coffee break we'll go to the short run; and then we'll go back to the long run again and make sure the short run fits with what we want to do in the long run.

[Coffee break]

CHAIRMAN VOLCKER. I guess we are back on page 15 [of the Bluebook]. Is that where we are, Mr. Axilrod, for the short-run ranges? I'm not sure on the arithmetic of how the short-term ranges match with the long-term ranges. Maybe you can inject something now. Do you have another statement to make about the short-term ranges?

MR. AXILROD. Well, Mr. Chairman, I had not planned on any substantial statement in view of the preceding one. But I thought it might be useful to expand at least a little bit on how these short-run ranges relate to the longer-run ranges. And that would give me an opportunity to provide some additional data that would be relevant to the Committee's preceding discussion. We constructed alternative A to reach the midpoint of the present longer-run range for M-1B by the fourth quarter. Given the shortfall in money growth in May and then in June bringing the level down even further, unfortunately that [calls for] a very rapid growth rate for M-1B month by month [in the June-to-September period] of around 10-1/2 percent. Alternative A is

associated with a slower growth rate on a quarterly average basis in the third quarter of around 4 percent, and then of course by the fourth quarter [as the quarterly growth rate] veers toward the 10-1/2 percent monthly rate, the fourth-quarter average rate would be around 10.3 percent. Alternative B again has a relatively rapid growth month by month of 8-1/2 percent in M-1B, and that alternative was constructed to get toward the bottom end of the present range. It actually implies a growth Q4 to Q4 of 3.9 percent, which is somewhat above the bottom of the present range.

CHAIRMAN VOLCKER. Fourth quarter to fourth quarter? And it implies for the two quarters, 2.8--

MR. AXILROD. For the two quarters it's about 5-1/2 percent.

CHAIRMAN VOLCKER. Yes, for the two quarters on average. But it would imply [quarterly average growth rates], assuming [a fairly smooth trajectory month-by-month], of 2.8 and 8.2 percent, right?

MR. AXILROD. That's right. And alternative C, Mr. Chairman, goes to the bottom end of a range that is 1/2 point lower than the current 3-1/2 to 6 percent range, should the Committee be considering that. Even so, that would imply month-by-month growth in M-1B on the order of 6-1/2 percent, again given the low starting point of June. Of course, if there should be any upward revision in that figure and if you're thinking of the level as the ultimate target, it would tend to lower that growth rate; and a downward revision would tend to [raise] that growth rate. That would give you growth of 1-1/2 percent in the third quarter and 6 percent in the fourth quarter, again veering toward the monthly growth rate by the time of the fourth quarter, and it would only give you 3 percent Q4 to Q4.

Now, those are a lot of numbers, but if the Committee would indulge me with a little patience for a bit, I think it would be helpful, Mr. Chairman, to give two more sets of numbers that aren't shown [in the Bluebook], because the upper ends of the ranges are not irrelevant in terms of announcement effects when the Committee reaffirms or changes or does whatever to its targets. Given what has happened in the first half of the year, the growth rates in the second half implied by the upper ends of the ranges are, of course, very large as you can tell. For example, if we had Q4-to-Q4 growth of 6 percent, which is the upper end of the M-1B range, given what has happened thus far this year, the monthly growth rate would be on the order of 13-1/2 percent; that would give you quarterly average growth of 6 percent in the third quarter and 13-1/2 percent in the fourth. If the upper end of the present range were reduced by 1/2 point, say, the potential monthly growth to get 5-1/2 percent would be around 12-1/4 percent from now on, with a third quarter of 5-1/4 percent, which looks reasonable, and a fourth quarter, as the arithmetic works out, of around 12-1/2 percent. That gives you an idea of the dimensions that are involved.

Finally, associated funds rate ranges were presented [in the Bluebook] with the three alternatives. The only range that implies an easing in the money market, from our analysis, is the rapid growth rates of alternative A, and that I think has been amply explained. It comes out of this dilemma involved in analyzing money demand relative to GNP. If there is a further sharp downward shift in money demand or

if GNP is indeed weaker than we have projected, then of course that lower funds rate range of alternative A could well develop with less rapid growth than is called for in alternative A. But under the assumptions that we have been working with, we have more moderate money market conditions associated with "A," while "B" and "C" imply current or somewhat tighter money market conditions on our analysis, again I stress, given the GNP projection.

CHAIRMAN VOLCKER. Yes, that's apart from the difficulties of any short-run interest rate forecast. According to the model they depend upon a GNP projection, which may be unreliable; and, therefore, if we get a weaker GNP we can get much lower interest rates consistent with any of these forecasts. Who would like to wade into this short-run problem? Mr. Boehne.

MR. BOEHNE. I think it comes down to how one weighs the risks of growth in the aggregates in the second half of this year that is too rapid and a repeat of what happened last year versus a cumulative shortfall in the aggregates. We've seen the possible beginnings of [a cumulative shortfall] in June and July and I do give some weight to that possibility. I would come out somewhere between "B" and "C" on page 15, preferring to err more in the direction of "C" than "B," but somewhere in that "B" to "C" area.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman I would support alternative B. I like the idea of having a plan to hit the lower level of the range or to get close to it by November. I don't think I would want to publish that objective in the report we put out or, in other words, commit ourselves to being on that particular course, given the volatility of these numbers.

CHAIRMAN VOLCKER. What alternative do we have other than to publish?

MR. MORRIS. The alternative would simply be to state that our objective for the June-to-September period is to produce the growth rates in alternative B, without stating explicitly that they are designed--

CHAIRMAN VOLCKER. Okay, you would put in the 8-1/2 percent.

MR. MORRIS. Oh, yes. But I'd just not say that these are designed to get us to the lower end of the range by November. Since I think the third quarter is going to be weaker than the staff is projecting, this can probably be accomplished without as much interest rate pressure as in the forecast, so I would support a funds range of 14 to 20 percent rather than the 16 to 22 percent shown.

CHAIRMAN VOLCKER. Do you have a comment on the funds range, Mr. Boehne?

MR. BOEHNE. Yes, I would have something like 16 to 22 percent.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I don't think we can afford to do a repeat of last year and that seems to be a pretty widespread feeling in the Committee. It seems to me, therefore, that we have to be fairly close to alternative C for the remainder of this year. I would go for something between 6-1/2 and 7 percent [for M-1B]. We could phrase it as "6-1/2 percent or slightly more" in the directive. That would be consistent with a borrowing assumption of \$1-1/2 billion in our view and would probably give us a fed funds range of 15 to 20 percent. The midpoint of that is where we would likely come out, which would be a fed funds rate in the 17 to 18 percent area. That would be my view, Mr. Chairman.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I share the view that we have to avoid a repetition of '80 but we also have to avoid a repetition of '79. It would be the third year if that happened. I don't think M-1B by itself is all that important, but the appearance that it is rising rapidly would be very damaging. I think we ought to stress that more weight is being attached to M2 and, in that context, I would say M2 growth at 8 percent seems desirable with M-1B at 7 percent, let's say, and the funds rate range at 17 to 22 or 23 percent.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think the near-term growth rate [for M-1B] shown in alternative B would be about right and, as Steve indicated a moment ago, that would give us a fourth quarter '80 to fourth quarter '81 growth rate of 3.9 percent, which would put us a little above the floor of our current range. I think the more important question may be what we do with the federal funds rate range. As I have stated several times, I favor elimination of these funds rate ranges, and we have moved several steps in that general direction. We first widened them, and then we had the top and lower limits as points where we would check, and now we have moved into the realm where they are points where you may ask us to consult. I'd like to go a step further and just eliminate those altogether. But I recognize that that's probably not going to be the consensus of the group. So, I would put the range at about 14 to 20 percent.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would opt for alternative C as shown on page 15 for both M-1B and M2 for the intermeeting period. Because of all the uncertainty that surrounds the velocity and shift in demand for money and all the other boogie-men we seem to come up with, it seems to me that it is a time to focus a little more closely on interest rates. Thus, I would start out on the side of not wanting to see interest rates drop very quickly through the remainder of this year, and a 16 to 20 percent range is my preference for federal funds.

CHAIRMAN VOLCKER. 16 to 20 percent?

MR. GUFFEY. I beg your pardon, 16 to 22 percent. The "B" federal funds rate range, but the "C" aggregates rates.

CHAIRMAN VOLCKER. Mr. Ford.



MR. FORD. I come out close to "C" with the fed funds range of "B," as Roger has just said, or better yet widening the band further or certainly not narrowing it because fed funds today I'm told are trading at 19 percent. A couple of people have suggested that we put the cap at 20 percent; were that to lead the Desk under any circumstances to start injecting funds after we walk out of here, that would undermine the whole philosophy or strategy that you laid out at the beginning of the meeting. So, I think we either have to widen the fed funds range or for sure not lower its upper end to avoid giving any signals in the next few days of loosening policy significantly. I am concerned about the target base drift question, which only one person raised--about where all of this leaves us at the end of the year, depending on where we come out in the range, and how we adjust to that. I don't have the answer, but I want to share the expression of concern--I think it was Willis who put it on the table--that we should think ahead as to where this short-run decision we're making today leaves us at the end of the year in terms of bringing the aggregates in line with the longer-range objectives that you have to talk about on the 21st of July. I just need more information from the staff as to whether we face a base drift problem that is the reverse of the usual drift up. If I understood Willis right, he was implying that if growth comes in low and we have trouble getting M-1B up into the range, we might have a reverse base drift problem. I don't know about that. I'd like to hear more. So, put me down for a little less tight than "C," keeping the fed funds range about centered on where it is now, 19 percent, and either loosening that up or certainly not lowering the top.

CHAIRMAN VOLCKER. Let me just explore the implications. You say leave the federal funds where it is, meaning--

MR. FORD. It's 16 to 22 percent now.

CHAIRMAN VOLCKER. Okay, that's the range. But where would you put the borrowing? If you lower the borrowing, the funds rate presumably will come down. The borrowing this week was \$1.4 billion. Was that what--

MR. FORD. Yes, \$1.5 billion seems consistent with that; I'm not exactly sure.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, Mr. Chairman, I think we as members of the Committee are indulging ourselves a bit in picking and choosing from these various alternatives in trying to get a package here. I'd like the monetary aggregates to come in low and interest rates to be a little lower and the economy to keep going where it is. I don't know if we can get there from here.

CHAIRMAN VOLCKER. Do we have a consensus on that?

MR. SCHULTZ. No, I want the economy to be a little weaker.

MR. GRAMLEY. I would suggest something along the following lines: Using the aggregates of "B," a federal funds rate range of 15 to 21 percent, a borrowing figure of \$1-1/2 to \$1-3/4 billion, and an understanding that if the aggregates fall short and that does not

happen in the context of a weakening economy, we let them. I am prepared to see actual money growth well below where we are targeted so long as it reflects a downward shift in money demand. And that's, in effect, what I'm saying. If we get a continuation of the downward shift in money demand and, therefore, low growth in the aggregates, I would not fight it. But I would like to see us arrive at some agreement that if in fact the staff is right and we get a reversion of money demand to what normal relationships would suggest, we won't let interest rates go up a long way.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Well, I come down close to where Lyle does. I would put the federal funds rate at 14 to 20 percent and borrowings between \$1-1/4 and \$1-3/4 billion. If [money growth] begins to fall short, I would permit it, but I certainly wouldn't permit it to the extent that we did in May and June. I think we overdid it in moving down on that particular path. Like Frank, I think the [nominal GNP] is going to be somewhat weaker than is being projected, and I'm not sure whether it's going to come out of the real side or inflation. We have had some short-term inflation gains that are going to be temporary and we may get a nominal GNP that's a little low over this third quarter; so we could get the 8-1/2 percent rate of real growth with the 14 to 20 percent fed funds rate at this point. If growth falls short because we don't get the rebound in money, that's one thing; but if it's falling short because the economy is plunging, I will have a different attitude toward it. I assume that if we get information that the economy is either growing too fast or too slow in terms of what we're anticipating, we will have a conference call.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Steve, what's the published fed funds band in the last directive?

MR. AXILROD. 16 to 22 percent. It will be published.

MR. CORRIGAN. For the past 3 weeks in this past intermeeting period, what did you think the borrowing level was?

MR. AXILROD. First we thought \$1.6 billion; that was a week ago. This week we think \$1.4 billion, but it's averaging \$1.9 billion to this time. We thought consistent with \$1.6 billion we'd have to see the funds rate move down toward 18 percent and it didn't; and we thought consistent with \$1.4 billion, the funds rate would be in the 17 to 18 percent area and it isn't there yet.

MR. CORRIGAN. Okay.

CHAIRMAN VOLCKER. Theoretically, they ought to be giving away federal funds tomorrow afternoon.

MR. CORRIGAN. Mr. Chairman, I'm in the area of "C" partly because I think we don't want to repeat 1980 but also because I have an eye on where we're going to start off 1982. Steve said that the quarterly average number toward the end of the year with "B" gets us up in the 8-1/2 percent area and that to me is troublesome. I get more and more attracted to "C" with the advantage of Mr. Solomon's

comment to the effect that, at least as they view the world, we could get [the growth rates of] "C" with a funds rate of 15 to 20 or 21 percent--either one would be all right with me--and an initial borrowings level of \$1-1/2 billion.

CHAIRMAN VOLCKER. I ran out of names--no, Mr. Schultz.

MR. SCHULTZ. I think the economy is going to be a little weaker in the third quarter and to me that's a consummation devoutly to be wished for. I would not move too rapidly to offset a little economic weakness; and under those circumstance I think alternative C is as fast as we ought to go, not as slow as we ought to go. So, I would favor alternative C for M-1B and M2 and I would start the borrowings at \$1.5 billion and put the fed funds range at 15 to 21 percent.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. This platter of choices is almost enough to give us indigestion. Reverting to what Bob Black had to say in his opening remarks yesterday about the June 17th conference call, I share the view that the weakness we accepted was a little more than I had in mind at the time. But after last year's M-1B growth of 6-3/4 percent, if I recall the adjusted figure, the 3-1/2 percent lower end of the range, if that's where we're going to end up this year, is an awfully sharp deceleration. The only way I can justify that in terms of not pushing the economy over the brink and creating a serious recession is the evidence, reasonably persuasive, that there has been a downward shift in the demand for money. I think it would be a great mistake if we ended up the year under that 3-1/2 percent lower limit, even given what seems to be going on in terms of a downward shift in money demand. But to hedge my bet to make sure that we don't undershoot for the year as a whole, for the June-to-September period I'd lean more toward the alternative B specs, including the [associated] federal funds range, than I would those of alternative C. Again, I would like to raise the issue of whether we should at this time explicitly place more emphasis on M2, which I would favor.

CHAIRMAN VOLCKER. Let me just comment on this sharp deceleration. I think it really is misleading. I looked at some figures yesterday on the annual growth. We started out this year from the highest quarter we had last year, and it was an exceptionally high quarter. When you look at this in a broader perspective, taking all the quarters into account, if we end up at the 3-1/2 percent lower end of the range, we're only slightly below the average we had for last year--on the order of 1/2 percentage point below as I remember the figures. And we had an increase for the whole of last year of what?

MR. AXILROD. 5.8 percent.

CHAIRMAN VOLCKER. 5.8 percent. If we end up at the bottom of the range in the fourth quarter, in a straight line from here to there, the annual growth in M-1B would be what?

MR. AXILROD. 5.1 percent.

CHAIRMAN VOLCKER. It would only be about 3/4 of a percentage point reduction in growth from a year ago.

MS. TEETERS. But we can always get those sorts of peculiarities.

CHAIRMAN VOLCKER. Well, my argument is that I don't think that's a peculiarity. The peculiarity is the fourth quarter. The fourth quarter happened to be the only quarter last year when we were above target, and it was an abnormally high quarter. If we say the world begins and ends with the fourth quarter of last year, we get a different picture than if we say the money supply was lower during the first three quarters of last year than it was in the fourth quarter. Anybody putting in any kind of econometric equation puts in an annual figure. Nobody just picks out one quarter to put in.

MR. BLACK. Mr. Chairman, to put this in a slightly different light, but I think it reinforces what you're saying: If we had drawn our cone not from where we ended up in the fourth quarter but from the midpoint of the range, [unintelligible] is 3-1/2 percent, which is now the lower part of our 1981 range. It would be a little above the midpoint of that range--

CHAIRMAN VOLCKER. That's another way of saying the same thing. Or if we draw it as a channel from the end of the cone last year, as I sometimes draw it, we are now a little below the middle of the channel, or maybe quite far below in June. But for the first half of the year as a whole, we're right in the middle of the channel.

VICE CHAIRMAN SOLOMON. If there were a credible way of de-emphasizing the fourth quarter-to-fourth quarter growth to formulate the target--I don't know how--the right formulation would be year over year in some broad sense.

CHAIRMAN VOLCKER. I thought of doing that last year. The reason I didn't was because it looked too damn difficult to get the annual average down. But it looks as if we have achieved it, or may achieve it.

MR. PARTEE. Possibilities.

CHAIRMAN VOLCKER. But that is in a sense more meaningfully in economic terms. One can argue it either way. Obviously the year-to-year change is influenced by what happened last year. But just picking out one quarter and saying that's the end of all existence is clearly not right either.

VICE CHAIRMAN SOLOMON. The scary thing is the psychological pressure on us [depending on] where we end [in any] fourth quarter. If we're seriously overshooting or undershooting, we're going to make three times the effort--or at least we're going to be under that kind of pressure psychologically--to make a much bigger response than is good for the economy, simply because it happens arbitrarily to be the fourth quarter and people will be judging us on the fourth quarter.

CHAIRMAN VOLCKER. I don't have the figures, but if we looked at the year-to-year changes in M1 now, they are still high, I think. If we looked at the first half of this year against the first half of last year--

MR. AXILROD. Oh, I don't have that.

MR. GRAMLEY. I can look it up. Six months this year over last year's is plus 6.3 percent. The second quarter of this year relative to last year is [plus] 7.4 percent.

MR. PARTEE. Because it dropped out of bed in April.

CHAIRMAN VOLCKER. That's right.

MR. PARTEE. Wait until we get to the third quarter.

MR. GRAMLEY. Then the year-over-year will be--

CHAIRMAN VOLCKER. No, it will narrow from now on with any of these numbers. By the end of the year we would be down just a bit below where we were last year.

VICE CHAIRMAN SOLOMON. It's becoming a seasonal pattern.

CHAIRMAN VOLCKER. Next year we'll straighten this out by putting back the first half of the year in the seasonal patterns that we left out and then it will all look very even during the year. Governor Partee.

MR. PARTEE. I would opt for alternative B. And I would point out that in a way we're getting a deceptive look because we're taking a snapshot as of June, which is the very low point, we hope, of the [downward] movement. After all, as a result of the cumulative effects of a minus 5 and a minus 10, alternative B gets us a third-quarter growth rate of 2.8 percent. Now, 2.8 percent is not a high monetary growth number, so it seems to me quite a reasonable thing to shoot at.

CHAIRMAN VOLCKER. Quite true.

MR. PARTEE. We'll have to decide on the fourth quarter a little later. But, you know, it's a long time to the fourth quarter. We may well have a double-digit plus or a double-digit minus between now and then so we will be talking in an entirely different arena when we get to discussing the fourth-quarter average, which I wouldn't want to see go up as fast as that 8.2 percent or whatever Steve has on that. I also disagree with Lyle that we should not pay any attention to shortfalls below the number because I can't tell whether there's a demand shift or not. That is, when we're experiencing it, it can be either a demand shift or it can be a weakening in the economy; and the money supply numbers can very well predate the weakening in the economy somewhat so that we're not all that aware of it. But we're not talking about a very strong economy when the auto companies report an annual sales rate of 5.4 million and wonder whether they can survive to the end of the year. That's not a strong economy. It's also obvious in housing that we're not talking about a strong economy. Builders are going out of business every day. So, I don't want to take a lot of risk of a cumulative shortfall. Remember, if we put May and June together we have as much of a drop as the April drop last year, which really galvanized us, perhaps improperly, into action. So, I think we shouldn't accept a substantial shortfall from the numbers that would be occasioned by alternative 2. I guess the funds range could be 15 to 21 percent. Interestingly, I had great difficulty finding what the funds rate range had been over the last

period when I read the Bluebook; it wasn't in the usual place. We've deemphasized it to the point that we don't even report it now! Assuming it was 16 to 22 percent, which is in the crossed out section of the directive, 15 to 21 percent seems all right. I wouldn't want to see the borrowing target above \$1.4 billion, which as I understand it is where we are currently in this period. I don't think we ought to raise the borrowing target above what it now is.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I favor alternative B. It seems to me that if we pursue alternative C, we run a substantial risk of not getting M-1B back even to the lower part of the target range. We just may not get back to the range. Alternative B gets us back to the range by November and we're still on the low side, so alternative B makes more sense to me. And I would go with a federal funds range of 16 to 22 percent and borrowing at \$2 billion.

CHAIRMAN VOLCKER. \$2 billion?

MR. RICE. \$2 billion. That's the borrowing that goes with "B." I'm being a purist.

CHAIRMAN VOLCKER. Well, that may be what they have in here. Okay.

MR. RICE. That's what one has to expect with a--

MR. ROOS. I would opt for "C" in its entirety. I just think we [can't] afford to announce that we're going to tolerate aggregate growth above the "C" figures. We must remember that these are adjusted. If you take off the adjustment, the rate of growth is even higher. But I'd suggest a borrowing assumption of about \$1-1/2 billion.

CHAIRMAN VOLCKER. You may be right. These are adjusted figures, certainly; and if we continue to get some growth in NOW accounts, the unadjusted figure will be still higher. It's a point worth making. I'm not so sure that we're going to get much growth in NOW accounts from now on. In the last couple of months we haven't gotten much, but nobody knows, obviously. It may be that these figures are coming together. But the chances are you're right.

MR. ROOS. I would just add that I was very much intrigued or impressed with Fred's suggestion of reducing the bottom of the longer-term targets by 1/2 point, which would enable us to come up to the bottom of what we're seeking with this alternative C, if I understand it right.

MR. BLACK. If we go with "C," we need to lower the bottom of the M-1B range.

MR. ROOS. Yes.

MR. SCHULTZ. To be consistent.

CHAIRMAN VOLCKER. There are a few more people who have to talk here. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I would go with alternative C, a borrowing assumption of \$1-1/2 billion and a fed funds range of 16 to 22 percent.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. I remind the group that we come back together in about six weeks, so we are not casting this in cement for the next six months. I'd be inclined to somewhere between "B" and "C" with the funds rate range of 15 to 21 percent or something of that nature and \$1.4 billion in borrowing.

CHAIRMAN VOLCKER. Mr. Keehne, you bring up the caboose again.

MR. KEEHN. Well, for the reasons that have been reasonably covered, I would be in favor of alternative C with a federal funds range of 16 to 22 percent; and if mathematically the \$1.5 billion borrowing level results from that, I'd be in favor of that.

CHAIRMAN VOLCKER. Well, let's see where we are. Obviously, we're between--

MR. GRAMLEY. Let me ask for a staff interpretation of the consistency of a borrowing number of \$1-1/2 billion with a midpoint of 19 percent on the funds range. I thought when we last talked about a funds rate in the 19 to 20 percent area we were talking about borrowings of about \$2-1/4 billion. I think we're talking about numbers here that are just inconsistent with one another.

MR. AXILROD. Well, we wouldn't know. The money supply numbers, depending on developments in the economy, could be consistent. But we wouldn't think that borrowing of \$1-1/2 billion would be consistent with a funds rate of 19 to 20 percent. We think that implies lower funds rates.

VICE CHAIRMAN SOLOMON. We would argue somewhat differently. We believe that borrowing of \$1-1/2 billion implies a fed funds rate of 17 to 18 percent. We'd be about a point--

MR. SCHULTZ & MS. TEETERS. That's what he said.

VICE CHAIRMAN SOLOMON. I thought he said 19 to 20 percent.

MR. SCHULTZ. No, he said it would not be consistent with 19 to 20 percent.

MR. PARTEE. I don't think your numbers are terribly inconsistent [with the staff's numbers], Tony.

MR. SCHULTZ. That's why I picked the 15 to 21 percent funds range for a borrowing [assumption] of \$1-1/2 billion.

MR. RICE. And \$2 billion would be consistent with what kind of funds rate?

MR. AXILROD. Well, it had been running in the 18-1/2 to 20 percent area, or more like 18-1/2 to 19-1/2 percent. That's a discount rate structure.

VICE CHAIRMAN SOLOMON. Are you still using a rough rule of thumb, Steve, that a \$100 million difference in borrowing represents 1/2 of a point?

MR. AXILROD. Yes, that's very rough.

MR. PARTEE. It's rough on amount and timing.

CHAIRMAN VOLCKER. Well, the funds market has been rather mixed up for some weeks now, really beginning around Memorial Day, I guess, as Paul Meek suggested. It is mixed up partly because the staff said weakness in M-1B should bring a pretty prompt easing and it hasn't happened, so they don't know where it should be. We have sentiment ranging from "B" to "C" with some emphasis on "C." I share the concern about just the publication effects of saying we want to aim for 8-1/2 percent over any period of time. I would not mind a big rebound in July, if we could sneak it in there and get it over with. In fact, that would be the desirable result. But we're starting July from a very low base and I don't know what the chances are of getting a very high growth rate in July, considering how low we're starting--if last week's figure is borne out when we get the final numbers. A number of people have mentioned M2. I would be strongly inclined, whatever we say about M1, to stick something in the directive that says we don't really want to see M2 going outside its range. That provides something of a fail-safe. Having done that, we swallow the pictorial effects of any of these things. So, we're someplace between "B" and "C." For the borrowing assumption, \$1-1/2 billion seems to be about where we are now; it's not too bad to start with. The real questions are the ones that Lyle and others raised about what happens under various contingencies. The most straightforward way to play it, I suppose--if we decide on an initial borrowing level of, let's say, \$1-1/2 billion at the moment, which is lower than the staff says is needed to restrain the money supply over the whole quarter--is to take it symmetrically. If the money supply began rising faster than is projected here, we would simply let the mechanical [process work]; we wouldn't change the nonborrowed reserve path but would let borrowings rise. It depends upon what happens to M2, but if M2 is behaving itself, we would just let borrowings rise, which would mean a rather gradual rise in borrowings to a higher number. And we'd do the reverse if it's falling short, which would mean a rather gradual fall in borrowings. If it fell short, we'd bring the caveat on M2 into play. If M2 were rising very fast, that might trigger a change in the nonborrowed reserve path.

MS. TEETERS. You mean to lower it.

CHAIRMAN VOLCKER. Well, if M2 was high, we'd lower the path. Or if it was low, we'd raise the path.

MR. WALLICH. But why start with what seems to be an unrealistic relationship between borrowing and the funds rate?

CHAIRMAN VOLCKER. What's unrealistic to you? What would you suggest? I don't know. You didn't suggest anything, I guess.



MR. SCHULTZ. He suggested something very high.

MR. WALLICH. I suggested a high funds rate, but I didn't know what the borrowing assumption was that would match it.

CHAIRMAN VOLCKER. I don't have a borrowing number down for you.

MR. WALLICH. I didn't put one down because I don't have the relationship in mind. But it seems to me that it should be closer perhaps to \$2 billion than to \$1.5 billion, or somewhere in the middle there.

CHAIRMAN VOLCKER. We haven't been at \$2 billion for a long time, theoretically, and we've had a decline in the money supply. We were at or above \$2 billion on the borrowings at the beginning of some weeks. But we haven't been aiming for a \$2 billion number for a month or more.

VICE CHAIRMAN SOLOMON. We believe that there have been some hang-ups in the fed funds market recently and that if we stay at this borrowing level we will see the fed funds rate get lower over a period of time--I don't know how long--at the same borrowing level.

MR. CORRIGAN. A question to Paul Meek: Do the market people perceive that the 18 percent surcharge rate is a de facto [floor] on the federal funds rate? It shouldn't be, but is that the perception?

MR. MEEK. I don't think it's perceived that way. I have some feeling that with that 18 percent rate it may be a little harder than it otherwise would be for the rate to go much below 18 percent.

MR. CORRIGAN. If you're selling federal funds--

CHAIRMAN VOLCKER. Well, I think that's true. It's harder to go below but I think the experience is that it will go below. It's just that the higher that rate is, the higher the funds rate will be.

If we cited the target in terms of a quarterly average, it wouldn't look frightening because that's going to be low. Suppose we put that in the directive. Can you give us your evaluation of the pros and cons of citing the target that way, Mr. Axilrod?

MR. AXILROD. If you put it in the directive along with the growth rate for June to September, I think it would have diminished importance. It would just call to the market's attention that this is not such a high growth rate month-by-month. If you put it in without the growth rates month-by-month, unless we understood what it is the Committee intended for the growth rates month-by-month, there would be some difficulty in targeting. That is, if July came in very strong, the quarterly average would really depend on the projections for August and September. So, if that average were the sole target, we would be back in the arena of simply making the money market conditions depend to a great extent on how the staff happened to see the projections, right or wrong, in the months and weeks ahead. Whereas if we had some idea of the implicit monthly targets that the Committee preferred, then we would not be so dependent on projections.

MR. PARTEE. I don't think we ought to operate on a quarterly average, but it would be very reasonable to talk about 8 percent, or whatever we have in mind, for June to September and to say that would mean a second-to-third quarter increase of about 2-3/4 percent.

CHAIRMAN VOLCKER. You raise some question in my mind about what kind of quarterly pattern you have in mind.

MR. AXILROD. What we normally would put down is a straight line. But this time, as you can see, we put a little more in July and slightly less in August and September simply because we expect the social security payment in the week of July 8th to add a couple billion dollars in that week and 1 percentage point at an annual rate for July as a whole. That's probably excess perfectionism, but it--

CHAIRMAN VOLCKER. That would be right if we were starting from a reasonably high level or a normal level. But we need an awfully high figure in that first week just to get any growth in July.

MR. AXILROD. July 8th doesn't show an increase from July 1st. If July 1st is at the low level, then we'll have a very low July probably. And if the Committee adopts 8 percent for the quarter--we didn't project a very high latter part of July--presumably an easing process would be needed.

MR. PARTEE. Right away I'd expect.

CHAIRMAN VOLCKER. I just don't know how this works out arithmetically. But I have some concern that if we don't have a really big increase in the week of July 8th, we are starting July so low that we'd have to drive the borrowing down to \$700 million or something to have any chance of getting there.

MS. TEETERS. Well, isn't that what you're--

MR. AXILROD. We're very dependent on tomorrow's figures. There are such big [differences] implied.

MS. TEETERS. If we don't get that rebound in the week of the 8th, then we're off the bottom of the chart, aren't we?

CHAIRMAN VOLCKER. I'd like to get a rebound. I just don't know what we'll do if we don't get it. I devoutly hope that if in fact we have a big decline this week, we'll get an offsetting increase or a little more next week.

MR. BLACK. That touches upon the reason I want to lower the top of that range somewhat because I foresee that we would have to have very high rates. And if the range had been dropped, it would be more acceptable to the market.

MR. PARTEE. This is the old principle of aggregates on the high side and interest rates on the low side.

MR. BLACK. If we don't lower the top bound, we could have 12.4 percent growth between June and December on that.

CHAIRMAN VOLCKER. We'll return to that question.

MR. BLACK. Well, I would just like the market to know we aren't even thinking about that. And if we hit the middle of the range, we could have, as I suggested, 10.4 percent.

CHAIRMAN VOLCKER. You can return to that argument at the next round.

MR. BLACK. I was trying to help you with your problem; I was saying that it doesn't look as bad against that background as it does if we don't lower that top.

VICE CHAIRMAN SOLOMON. We could put a footnote in that we're not seriously thinking of getting to the top.

CHAIRMAN VOLCKER. In some sense the specifications here are easy enough. It's just how we should act if we go off course that is a little more difficult. The specification seems to me to be something like--well, just to use a round number--7 percent. We may want to have a small range and say provided that M2 is within its range. I don't see why borrowing somewhere around the present level of \$1-1/2 billion isn't reasonable.

MR. RICE. But is it consistent?

CHAIRMAN VOLCKER. The staff says no. Or, what is coming out of the machine says that we have to have a higher borrowing level. But I don't know. A lot of skepticism was expressed around the table about whether in fact we do need a borrowing number that high. Balancing my general feeling about where the major risks lie, given the shortfalls that we have had, I don't want to run an undue risk of a further shortfall. Borrowing of \$2 billion would produce, at least I would think, a 20 percent federal funds rate around this time. I'm not sure we want to be that tight; and 20 percent is what the staff says that \$2 billion would produce.

MR. RICE. I thought \$2 billion would give us 18 percent.

CHAIRMAN VOLCKER. 18 percent on the funds rate?

MR. RICE. That's what Steve just said.

MR. AXILROD. With alternative B, we say the funds rate would be in the 19 to 20 percent area. That's in paragraph 22.

MR. RICE. But in answer to my question just a minute ago, I thought you said 18 percent.

CHAIRMAN VOLCKER. Two billion dollars is literally higher than what we have had for a month.

MR. AXILROD. Well, [\$2.1] billion was the average level of borrowing last month. It only fluctuated a bit.

CHAIRMAN VOLCKER. We'd have to have one week of \$2.3 billion or something.

MR. AXILROD. In June, borrowing ran \$2.0, \$2.2, \$1.9 and \$2.3 billion; then it dropped in the first week of July to \$1.7

billion and it's running \$1.9 billion thus far this week with some expectation of a drop-off.

CHAIRMAN VOLCKER. It has been higher than I thought it was.

MR. SCHULTZ. At any rate, \$1.5 billion should certainly be consistent with a lower funds rate than we're experiencing right now.

MR. AXILROD. That's what we think, if we get it.

MR. SCHULTZ. Theoretically, yes.

MR. AXILROD. Theoretically, a lot lower on borrowing and the funds rate.

CHAIRMAN VOLCKER. Well, we can be a little higher on the borrowing, but I think that's taking a chance of the money--. These differences are so small. Let me try 7 percent and \$1-1/2 billion.

SPEAKER(?). What was the second number?

MR. SCHULTZ. Borrowings of \$1-1/2 billion.

CHAIRMAN VOLCKER. And 15 to 21 percent. I'd be happy with 15 to 20 percent, but 15 to 21 percent seems to catch more people. What else do we need to know? And the caveat on M2.

MR. CORRIGAN. Does that mean that M2 is within its range for the year?

CHAIRMAN VOLCKER. Yes. Right now it's at the upper end of the range, so it means M2 growing at 9 percent or a bit less.

MR. CORRIGAN. The implication is that it has some relevance for whether or when we change the nonborrowed path?

MR. ROOS. If we have the top of the fed funds range at 21 percent and it reaches 21 percent and the Desk starts injecting reserves, won't that be as--

MR. SCHULTZ. That's not the way it works, though.

CHAIRMAN VOLCKER. That's not what they will do. We will just have a consultation.

VICE CHAIRMAN SOLOMON. That caveat on M2 may be very easily triggered.

CHAIRMAN VOLCKER. Well, we're right on the margin of it now. There's no question about that.

MR. PARTEE. Especially with the wild card [certificate] coming at the end of this month, we could almost--

VICE CHAIRMAN SOLOMON. I don't object to it, but I don't want to underestimate the importance of that--

CHAIRMAN VOLCKER. Well, I think it's very important.

VICE CHAIRMAN SOLOMON. Even though M2 grew only 5 percent in each of the last two months, that's because M-1B was negative. Therefore, if we get M-1B--

CHAIRMAN VOLCKER. To have a very high M-1B figure and have M2 within the 9 percent would be very unlikely.

VICE CHAIRMAN SOLOMON. So, if the caveat is triggered--and it is very likely--we may end up seriously falling short of the 7 percent objective.

CHAIRMAN VOLCKER. What has the growth in the nontransactions part of M2 been in the last couple of months at an annual rate? Do you have such a number?

MR. AXILROD. Yes, the question is whether I can find it. It was running 7-1/4 percent in May and 10 percent in June; both of those are a lot lower than it ran in the previous months.

CHAIRMAN VOLCKER. I don't know what the arithmetic is, but I presume the nontransactions part of M2 could run at approximately 10 percent with this kind of M1 figure.

MR. AXILROD. That's right; it's about 75 percent of M2.

MS. TEETERS. What about Chuck's point about the lifting of the Regulation Q ceilings on the longer-term CDs? We could get a surge in some of those.

MR. SCHULTZ. Yes, but we're likely to have some offsetting weakness in the money market funds.

MR. PARTEE. Or it could come out of the securities markets.

VICE CHAIRMAN SOLOMON. What we need is an M-2A and M-2B--a transactions component, shift adjusted--

CHAIRMAN VOLCKER. Shift-adjusted M2 numbers.

MR. BALLE. Updated seasonally.

CHAIRMAN VOLCKER. Well, I don't intend this to be quite as precise as you're talking about. We can't judge M2 that closely. The figures come in a little late. But if M2 is running 9-1/2 percent--and we won't even know it [currently]--that's within our range of tolerance. If it's clearly running high, it's very important--

MS. TEETERS. But shouldn't we take a look as to why it's running high?

CHAIRMAN VOLCKER. Inevitably we have to [unintelligible]. Well, let me try this. Have I mentioned all the variables: 7 percent, \$1.5 billion, 15 to 21 percent, and a strong M2 caveat.

MR. PARTEE. With any kind of target number for the period?

CHAIRMAN VOLCKER. 7 percent for M-1B.

MR. PARTEE. For M2 I mean.

CHAIRMAN VOLCKER. For M2 I think it would be rather explicit that we're talking about 9 percent or less. If it got over 9 percent, we'd be concerned about it.

MR. PARTEE. Restrain it if it's over 9 percent?

VICE CHAIRMAN SOLOMON. You mean 9 percent for the next intermeeting period.

MR. FORD. It's over 9 percent now.

MR. PARTEE. No, he means for the period ahead.

CHAIRMAN VOLCKER. We [tried to draft] some wording. We can come back to the precise wording, but let me see what Steve has: "In the short run the Committee seeks behavior of reserve aggregates consistent with growth in M-1B from June to September at an annual rate of 7 percent"--or whatever number we put in--"after allowance..., provided such growth is consistent with M2 growth remaining around the upper limit of or moving within its range for the year." Everybody knows that's 9 percent, I presume.

MR. WALLICH. That's really between "A" and "B," when most of the discussion has been for between "B" and "C."

MS. TEETERS. It's a combination of all three of them. M-1B is between "B" and "C;" M2 is between "A" and "B;" the borrowings are at "A;" and the interest rates are between "A" and "B." You guys scrambled the whole mess!

MR. PARTEE. We could conceivably have a very weak M-1B that we would encourage getting weaker because our M2 constraint is at the upper end--

MR. WALLICH. I think M2 is the more critical variable now.

MR. PARTEE. You don't mind minus numbers in M-1B?

MR. WALLICH. I mind very strong numbers in M-1B.

CHAIRMAN VOLCKER. I don't think any of these relationships is all that precise but it's true that, according to the staff's estimate, if we got 7 percent, the 9 percent M2 constraint wouldn't operate.

MR. AXILROD. We have a relatively restrained growth in the nontransactions component, not very different from last month. It's a little lower actually in most cases than the June growth. It's pretty restrained.

MR. BOEHNE. Mr. Chairman, what does this mean for M-1B? How weak would M-1B have to get--how far below 7 percent would it have to be--before it would trigger something?

CHAIRMAN VOLCKER. Well, the answer is: I don't know. But if you accept the staff's analysis here, they would say there's no

problem. Their estimate is that if we get 7 percent on M-1B, M2 will come in at 8-1/4 percent. It has met this--

MR. BOEHNE. I could conceive of a situation where we could end up with M2 approaching the 9 percent upper limit and the bottom falls out of M-1B.

MR. WALLICH. I think that would be more a reflection on M-1B than on the economy.

CHAIRMAN VOLCKER. That's precisely what this would say. We wouldn't worry very much about that shortfall in M-1B if M2 is rising rapidly. That's what we would be saying.

MR. BOEHNE. Well, I'd have some problems with another month or two of negative growth in M-1B.

CHAIRMAN VOLCKER. Well, with the negative growth in M-1B we've had an M2 figure of 5 percent or so. So, we're not likely to get a combination of 9 percent on M2 and a negative M-1B.

MR. BLACK. If we get 7 percent, it's still coming in below the lower limit of our long-term ranges. It takes 7.4 percent to hit the lower limit. I don't know whether we really want to set it that low just from the standpoint of appearance because it's deliberately saying we're not going to hit our target.

CHAIRMAN VOLCKER. Well, I'm not so concerned about the question of what the appearance is.

MR. BLACK. Well, I prefer Fred's suggestion. Or Willis' suggestion could take care of that aspect, if that's what we want to do with it.

MR. SCHULTZ. Well, the proposal is not quite as constraining as I would like. I still prefer a straight alternative C, with a little lower figure on everything; but you're halfway between "B" and "C" on both M-1B and M2.

MR. PARTEE. It's not halfway; it's closer to "C."

MR. SCHULTZ. Well, okay, you're right; it's closer to "C."

CHAIRMAN VOLCKER. I'm happy to go all the way to "C," if that's where you people want to go.

MR. GRAMLEY. I don't.

MS. TEETERS. That's too stringent.

MR. PARTEE. I can't even [unintelligible] accept what we've got.

MR. BOEHNE. Is there some way to build in that a little weight would be given to weakness in M-1B? It's all loaded the other way.

CHAIRMAN VOLCKER. I don't know how much you want to build in. But to the extent you want to build some in, you have the staff's estimate, for what it is worth--and the staff's estimate is always the best technical analysis that can be provided--that M2 is going to come in below this constraint if M1 is really weak.

MR. BOEHNE. Well, as I recall, for June we started out with an estimate of plus 5 percent and ended up in the negative at minus 10 percent.

CHAIRMAN VOLCKER. That's right.

MR. AXILROD. Mr. Chairman, did I understand your explanation right that for whatever number the Committee chooses for M-1B, if it runs weak and required reserves go down and M2 stays at 9 percent or something like that, the borrowing would tend to come down and we'd adhere to the nonborrowed path and vice versa if it went up? I was not sure exactly.

CHAIRMAN VOLCKER. I'm not sure exactly either, because we have 19 different permutations and combinations. I didn't go quite as far as what you said. I said that if M1 were coming in weak, we would just let the natural result come in on the borrowings. I haven't faced explicitly what we would do if M1 is in fact [weak] and M2 is above 9 percent. I suppose at some point if M2 got strong enough--there's some shady area there--we would have to reduce the nonborrowed reserve path.

VICE CHAIRMAN SOLOMON. At that point, I think we'd want a consultation, if we really had a head-on collision between too weak an M-1B and too strong an M2, because of the caveat you're building in.

CHAIRMAN VOLCKER. Obviously, there are lots of circumstances in which we'd have enough of a conflict that we would have a consultation, but the clear implication is that we would let M-1B get weaker than 7 percent if M2 is running strong in the short run pending--

MR. GRAMLEY. One thing that I think would [address] the concerns of a number of people is [to agree that it] would be a signal for a consultation also if we were to see some significant weakness in incoming economic statistics and at the same time a weak M-1B number.

MR. WALLICH. Let me give you an argument that's against my own case. If interest rates should come down, M2 probably would accelerate because money market funds would gain relative to market investments. That gives me some pause in the mechanics of the constraint.

MR. PARTEE. You know, M2 growth in the second quarter was 10.8 percent.

MR. SCHULTZ. But if the economy weakened, even though interest rates were coming down, in fact there would be some force pushing M2 up, but at the same time M-1B is likely to be--



CHAIRMAN VOLCKER. We can't handle every possible contingency here. The ultimate answer has to be we would have a consultation if things go askew enough.

VICE CHAIRMAN SOLOMON. Mr. Chairman, would you want to consider that we would have an understanding on this M2 caveat but not include it in the published directive?

CHAIRMAN VOLCKER. I'd like to get it in the published directive, frankly, because I am hesitant. Whatever the M1 figure, the arithmetic of what we publish is going to look high, and I'd like to get something in the directive that says we're not going wild in increasing the monetary aggregates. And the way to do that is to get M2 in there.

MR. GRAMLEY. I think your earlier suggestion of perhaps putting something about the quarterly average in the operating paragraph would be very useful.

VICE CHAIRMAN SOLOMON. Would that create a precedent, Lyle, for later quarters when we don't want to put in a quarterly figure?

MR. ALTMANN. We have done it before.

MR. CORRIGAN. We could say that just in terms of setting this objective, the Committee noted that the quarterly average was such and such. That would clearly divorce it from any operational significance.

MR. WALLICH. Will you qualify your M2 constraint in the sense that unless there are special factors causing it to rise--

CHAIRMAN VOLCKER. We're getting into an area where there are more things than we can write into the directive. If there are special factors causing it to rise, we better consult. But what we're talking about here is a relatively brief statement that eventually is going to come out in the public and we're talking about the best way of expressing it. We can be straightforward and just say we're looking for M2 growth of around 8 to 8-1/2 percent; that's what this draft says.

MR. WALLICH. And let it overshoot if it does? M2 at 8 percent would suit me.

MR. SCHULTZ. That's what I argued for before, Henry; I ran that up the flag pole and there were some who didn't salute.

CHAIRMAN VOLCKER. That's the more traditional way of doing it--just to say we want x percent on M-1B and 8 or 8-1/2 percent on M2. You think the staff is wrong, Mr. Solomon?

VICE CHAIRMAN SOLOMON. Right. Given what we've been saying, I don't see how we're only going to get one point more growth in M2 than in M-1B.

CHAIRMAN VOLCKER. Well, I cannot resolve that technical argument; I don't know what the answer is. I suggested the way I suggested because I think we probably want to be in a posture of not

easily looking at overshoots of the broader aggregates. And that's what this attempts to express.

VICE CHAIRMAN SOLOMON. I prefer your caveat to spelling out 8 percent.

MR. GRAMLEY. I much prefer language that would suggest something below the upper end of the range.

MR. FORD. Paul, you read us just a small part of the suggested language; I take it there's a lot more on both sides of it that doesn't leave the impression, as that one paragraph does, that this whole decision--even though it's the most conservative choice--sounds expansive. You have 7 percent--

CHAIRMAN VOLCKER. Well, I think there's enough problem in this language that we ought to fiddle around with language during lunch and get wording that we're satisfied with. But the substance of it is what I'm suggesting. Have we had enough discussion? It's 1:00 p.m. and I don't see anything better at the moment than the 7 percent, \$1.5 billion, 15 to 21 percent and the caveat of M2 staying within the range basically.

MR. FORD. It's a helluva formula!

CHAIRMAN VOLCKER. How many find that acceptable?

SPEAKER(?). Voting members only, right?

CHAIRMAN VOLCKER. Well, I guess a lot of people find it acceptable. If nobody has anything better to suggest, let's have a vote.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Mr. Boehne	Yes
Mr. Boykin	Yes
Mr. Corrigan	Yes
Mr. Gramley	Yes
Mr. Keehn	Yes
Mr. Partee	No
Mr. Rice	Yes
Mr. Schultz	Yes
Ms. Teeters	Yes
Mr. Wallich	Yes

CHAIRMAN VOLCKER. We have sandwiches out here. Let's take a little time to begin eating the sandwiches and return to the longer-run discussion in the light of the shorter-run decision.

[Lunch recess]

CHAIRMAN VOLCKER. I think we more or less solved the problem of where we are for the rest of this year--that's implicit in the decision we just made--which is around the lower end of the range for M1 and around the upper end of the ranges for M2 and M3 and [credit]. I'm not sure that needs a lot more discussion. What we have to decide

is whether to change any of the ranges for this year and what to do for next year. On next year, there isn't a tremendous amount of difference in the alternatives the staff has given us. I share the predilection cited by a good many people that we probably shouldn't raise M2 and M3, which means that M2 would be lower than cited in any of these alternatives by a full 1/2 percentage point if we neither lowered them nor raised them. My own feeling about M-1B, though I'm not even sure at this stage whether we will call it M-1B next year-- I'm assuming we can be rather general and just call it M1, but it's not adjusted--is that we are left with an unknowable about what the nontransactions component of M1 means conceptually. One can argue, as I guess Steve argued--I'm not sure he quantified it--that having that component in there and the fact that it is household transactions accounts at best, means that it has a higher growth trend than the others and that, all things equal, [its growth] ought to be what--1/2 to 1 percent higher on this combined basis?

MR. AXILROD. Well, our calculations are a little lower than that. It depends on the ratio one expects at the end. Maybe 0.3 to 0.5 percent is a little too specific, but it's 1/2 point or lower.

CHAIRMAN VOLCKER. I also worry a bit about the opposite of that. We have a lot of nontransactions [balances] in the initial adjustment of M-1B, but when people get [funds] in there and look around at all these attractive rates in the market, they may take it out over time, which artificially depresses that aggregate.

MR. GRAMLEY. May I just ask what the logic of this is? Is this just an empirical result or is it an argument that the income elasticity of demand for household deposits--

MR. AXILROD. It's essentially that. It's higher than the demand for other transactions deposits in M-1B. And with the increased weight of the household balances in M-1B, this is an effort to see, for any given growth rate in M-1B prior to the increased weight, what this would mean. So, 5 percent might mean 5.3 percent to start with but, of course, we would reduce it 1/2 point thereafter. But's that's purely mechanical; the increased savings deposits may be compensating balances for all I know and not really--

CHAIRMAN VOLCKER. The burden of my comment is not that we know any of these things empirically or logically. The burden is that [we have] all these uncertainties. I'm basically agreeing with Frank Morris; I'm going a long distance [in that direction] but I don't think we can abandon M1 because people would question our good faith if we abandon M1 at this point, given all the emphasis on it. I think we have to end up giving them a target for M1. But I don't see why we can't make a radical change and make it a 3-point range instead of 2-1/2 points and just tell them there are all these uncertainties in both directions. So what I would be inclined to do--I don't know whether to call it alternative III or not--is to take that 2-1/2 to 5-1/2 percent range [under alternative III], which gives us a reduction of 1 percentage point on the lower end of the range and 1/2 percentage point on the upper end of the range from where we now are, and leave the others unchanged tentatively.

SPEAKER(?). We're back on what page?

SPEAKER(?). 14.

CHAIRMAN VOLCKER. It's about what a lot of people are suggesting, but I would cast my vote on widening the M1 range a bit. You might want to say a word about M3, Steve. You told me you have the feeling that it may be a little high here or that it could be comfortably lowered. I don't know whether we want to do that or not, given the--

MR. AXILROD. Well, just to be clear on these ranges, we had centered them in alternatives I, II, and III on our projections of the midpoints [of the associated M1 ranges]. The alternative III range, therefore, has a midpoint of 8 percent [for M3 and for alternative I it's] 8-1/2 percent. And with the Committee willing to say that growth in the broader aggregates could be in the upper ends of the ranges, it would not be too difficult to lower the 6-1/2 to 9-1/2 percent range to 6 to 9 percent because we're not projecting growth above that [upper limit]; our midpoint is not above or even very near that 9 percent.

CHAIRMAN VOLCKER. For both M2 and M3?

MR. AXILROD. Well, particularly for M3. If you lowered the M2 range to 5-1/2 to 8-1/2 percent, the top of that range is really roughly the "midpoint." It's not a case where the top of that range would be uncomfortably near the midpoint we're actually projecting.

CHAIRMAN VOLCKER. Let me just be clear. Your analysis says M2 would grow faster than M3?

MR. AXILROD. No, they're growing about the same. But if growth is about the same next year, I would say that if you can stand the 6 to 9 percent range for M2, you can also stand the 6 to 9 percent range for M3. But for M3 that would be 1/2 point lower than the range you now have.

CHAIRMAN VOLCKER. Right. Well, that's an alternative that we could consider then. It gets us another reduction in one of these ranges.

MR. PARTEE. Why wouldn't we hold off making that change?

CHAIRMAN VOLCKER. We could.

MR. PARTEE. We could do that in January, if it still seemed to be relevant.

VICE CHAIRMAN SOLOMON. I think you're right. We have to keep--

MR. PARTEE. Yes.

MS. TEETERS. Why announce any reduction now? By January we'll have a much better idea of which way we're going.

MR. PARTEE. That's what I said.

CHAIRMAN VOLCKER. The only reduction that this would involve at this point is M-1B.

MS. TEETERS. I don't think we even need to reduce the range for M-1B at this point.

MR. WALLICH. If we don't, aren't we saying that we now think we're not going to reduce it?

MR. PARTEE. Because we'll have it so low this year--

CHAIRMAN VOLCKER. Let me restate that. I said M-1B; what I stated [earlier] is that we are just calling it M1. It will be conceptually the same as the present M-1B, but it would be an unadjusted number.

MS. TEETERS. Then it would be 3-1/2 to 6 percent.

CHAIRMAN VOLCKER. I'm saying 2-1/2 to 5-1/2 percent but 3-1/2 to 6 percent is the present range. Well I don't know if it is; it's 3-1/2 to 6 percent or 6 to 8-1/2 percent, depending upon which way you look at it.

MR. ROOS. How would that relate to our present range, which is 3-1/2 to 6 percent? Is that unadjusted or adjusted or--?

MESSRS. PARTEE and SCHULTZ. That's adjusted.

CHAIRMAN VOLCKER. Well, the argument is purely intellectual because I don't think we have any empirical evidence. If you took the Axilrod analysis, you would say that the effective range is reduced by another 1/4 to 1/2 percentage point because of this growth factor that he builds into the total. If you gave weight to my suspicion that that wouldn't be true, it might even be the opposite. But who knows? My suspicion is that people have excess money in M-1B now, unadjusted, that might be withdrawn.

MS. TEETERS. Is Steve saying, on purely technical grounds because of the technical factors he's referring to, that if we wanted no change we'd add 1/2 percentage point to the range?

CHAIRMAN VOLCKER. Yes.

MR. AXILROD. Conceivably, if you wanted to make some allowance for the fact that household deposit balances may have a higher income elasticity than balances of nonhouseholds.

MR. GRAMLEY. This would mean you are moving the midpoint of the range down by roughly 1 percentage point and possibly more.

CHAIRMAN VOLCKER. It means moving it 1/2 percentage point more than you otherwise would.

MR. GRAMLEY. And the movement down from the present figure is just 3/4 of a percentage point.

CHAIRMAN VOLCKER. In terms of the midpoint, that's correct.

MR. PARTEE. On an unadjusted basis wouldn't 3 to 6 percent be sufficient?

MR. GRAMLEY. I would be much more comfortable with 3 to 6 percent. I think we're building trouble for ourselves. You're right, Mr. Chairman. We'll probably not [unintelligible] today when the relation between money growth and GNP is going to revert to something more nearly normal, given the reduction of inflation. But that isn't going to happen all at once; it's going to happen progressively. If the rate of inflation comes down and nominal interest rates fall and we keep real interest rates where they are, the target next year--even the same target--will be more binding in terms of its meaning for economic activity than it was this year. And that's going to be increasingly the case, if one takes into account the fact that it's--

MR. SCHULTZ. But the midpoint between 2-1/2 and 5-1/2 is 4 percent, which is above where I certainly hope growth will be this year. So, in fact, if we adopt 2-1/2 to 5-1/2 percent, we are actually allowing for more growth than we're likely to get this year.

MR. GRAMLEY. But that ignores the shift adjustment that has been taking place. This year we will be adding roughly if we haven't already--if the staff is right and we have no further shift in money demand--about 2-1/2 percentage points of money growth, effectively, that doesn't show up in the numbers. And one needs to take that into account. There is just as much effect on the economy from a 1 percentage point drop in money demand, given the money supply, as there is by adding 1 percent to money supply, holding demand constant. It has no different effects on output, employment, prices, or anything. And we just can't count on this concealed money growth; sometimes we don't even want to recognize it ourselves, but it is happening. It's not going to continue to happen unless this process of innovation develops new steam.

MR. SCHULTZ. Well, don't you think the process of innovation is going to continue, though, to some degree? The momentum involved now--

MR. GRAMLEY. To some degree, yes. But the staff has pointed out that this process of innovation is stimulated by the move of interest rates to new peaks. Following new peaks we have this burst of innovations which then settles down. We had it last year in the second quarter; we had it in 1975-76; we had it again in the first half of this year. And while it will continue, it will be at a much slower rate.

MR. WALLICH. I thought theory said that the income elasticity for transactions balances was a good deal less than unity.

MR. GRAMLEY. It is. It's about .75 by most estimates.

MR. WALLICH. Then we would expect a continuing rise in velocity, wouldn't we?

SPEAKER(?). Why?

MR. GRAMLEY. Oh, for velocity, sure. It's only a question of the rate of increase in velocity. There's a trend factor that

would take place even if there were no innovations because the income elasticity of money with respect to real income is less than 1.

MR. WALLICH. Right.

CHAIRMAN VOLCKER. Do you have copies of this that you can distribute, Mr. Altmann?

MR. ALTMANN. Yes.

MR. PARTEE. In addition, we have the shift adjustment question, Fred. Since we're going to give them a plain figure, that adds something.

CHAIRMAN VOLCKER. We don't have to do that. But at some point fiddling around with a very small adjustment--

MR. PARTEE. I would very much like to do it.

CHAIRMAN VOLCKER. We can change our minds at the end of this year, if we think a big shift is going on.

MS. TEETERS. But in the past we haven't changed our minds at the end of the year. We feel stuck with what we do [at this meeting each year].

VICE CHAIRMAN SOLOMON. He's just talking about calling it M1 rather than doing a shift-adjusted--

MS. TEETERS. Oh.

MR. SCHULTZ. But the other side of it is that we would certainly, we hope, get substantially less nominal GNP next year than this year.

MR. PARTEE. Remember, though, that we have to say whether or not this is consistent with the Administration's 12 percent nominal GNP growth [forecast].

MR. SCHULTZ. Well, it isn't.

CHAIRMAN VOLCKER. Yes, but we have a--

MR. SCHULTZ. Yes, but listen: When you talk to [Administration officials] in private they are very clear about the fact that they really don't believe in these numbers that they are publishing here at midyear. They say it quite directly. They have said it to me.

CHAIRMAN VOLCKER. We have unreconcilable inconsistencies in that respect, I guess. There's a great question as to whether it's consistent with their GNP forecast. On the other hand, they will presume that the money supply is declining from year-to-year. So, we'll have to say we are inconsistent with that assumption if we--

MR. PARTEE. Yes, they [assume] rising velocity, too. Well, maybe it will go up.

MR. SCHULTZ. I know, but they just have wild numbers. Privately they say quite directly: Don't pay much attention to these midyear figures we are coming out with.

CHAIRMAN VOLCKER. I recognize all the problems, but it's a little hard to say we're not going to reduce the target next year in any respect.

MR. GRAMLEY. 3 to 6 percent would be a reduction of 1/2 percentage point.

VICE CHAIRMAN SOLOMON. But on the nonbinding end of it.

SPEAKER(?). On the floor, not the ceiling.

MR. WALLICH. We used to do that--nibble at the upper edge of one and then next time at the lower edge of the other. I figured out it took ten years to bring about a moderate reduction. I think we have to go across the board.

MR. SCHULTZ. By across the board, do you mean on all the aggregates or on the top and bottom of M1?

MR. PARTEE. Top and bottom.

MR. WALLICH. I think, barring technical inconsistencies, all of them.

CHAIRMAN VOLCKER. The only other decision we have to make, as nearly as I can see based upon the earlier discussion--tell me if I'm wrong--is [on M1]. Nobody talked about--well, maybe somebody did, but the great majority did not--changing the M2, M3, and bank credit ranges. We had this debate. We had a predominant view, which was not to change anything. But Mr. Schultz raised some arguments, and one or two others did, on reducing the [M1 range] this year, which may have some bearing on this. That's the only other decision I think we have to make here.

MR. MORRIS. Except that Steve told us we can reduce M3 next year.

MR. PARTEE. Next year.

MR. AXILROD. It seemed, within these numbers, relatively--

CHAIRMAN VOLCKER. That's right; we could do that. So the open questions are M-1B this year, M1 next year, and M3 next year if we're sticking with the 6 to 9 percent for M2 next year, which seems to be reasonably satisfactory. These differences are small but, unfortunately, the one that is critical is the M1 range for next year just in terms of public appreciation and the psychology of getting something down.

MR. BALLEES. I have a question on that Mr. Chairman. Obviously we're making some provisional statements on the 1982 ranges, but at what point in time do you foresee our moving to the actual M-1B as compared to the shift adjusted?



CHAIRMAN VOLCKER. Well, I am hoping--

MR. BALLE. I can see us going on forever and ever ignoring what the actual is.

CHAIRMAN VOLCKER. I think we've run out of speed on this already. It has exceeded my tolerance for having any faith in the adjustment now.

VICE CHAIRMAN SOLOMON. You'd start it for next year, wouldn't you?

CHAIRMAN VOLCKER. I hope that we will find in the next six months that there isn't much difference between the two and that against that background we'll say "Forget about it next year." I would plan to say in the testimony as background for whatever number we put in here that we don't think [the shift] is going to be significant next year, so we are very tentatively assuming it's not going to be. But if it still looks significant by December, we'll have to give you a different judgment. However, we are assuming in this very tentative way that it's not going to be significant next year.

MR. ROOS. If that's the case and if these next six months are critical and we will have another opportunity to change what we're going to do for '82 next February, in order to reassure the markets and to be consistent, why don't we say this time that we're going to reduce the numbers on M1 by 1 percentage point at both ends? And if at the end of the year the picture is different, we can still make an adjustment next February with less problem, in my opinion, than we'd have if we come out with testimony on July 22nd that we're really not going to continue our 1 percentage point reduction each year. I think this is an important time to state once again what we're doing.

CHAIRMAN VOLCKER. Just to make sure you realize the arithmetic of what Mr. Roos said: If we reduce the range by 1 percentage point on both ends, it would be 2-1/2 to 5 percent.

MR. ROOS. Yes.

VICE CHAIRMAN SOLOMON. That's horrendous. One would have to assume an increase in velocity of circulation of something on the order of twice--or 1-1/2 to 2-1/2 times--the normal secular increase in velocity of circulation. That is too heroic an assumption to make, Larry. The fact that we've come in comfortably so far is strictly due to this rather fluky situation. If the staff is right and we don't see that, and we just have the normal situation continue for the rest of the year, if I'm understanding this right, we would still come in at about what--5 + 3, Steve? Is 5 the increase for the first half?

MR. AXILROD. For which aggregate?

VICE CHAIRMAN SOLOMON. For the velocity of circulation.

MR. AXILROD. Oh, yes.

VICE CHAIRMAN SOLOMON. The growth plus the normal.

MR. AXILROD. That's right; the excess is more like 5 to 7.

VICE CHAIRMAN SOLOMON. Right. The chances of repeating that situation don't look very good. If I were a betting man, I would bet the chances are maybe 1 out of 5 that we're going to get that kind of growth in velocity next year.

MR. WALLICH. We seem to assume that growth in velocity is a special event due to definable changes in technology. But if people are circumventing the need for transactions balances right and left by using money market funds and overnight arrangements and so forth, then really all that is happening is that M-1B is becoming a smaller part of the transactions balances. And its velocity isn't really a meaningful figure; it's just a statistical number relating M-1B to GNP. But it doesn't exert any constraint. That is what I fear may be happening, although one can't be very sure. But that makes a rise in velocity more probable than thinking of it in terms of a special innovation.

VICE CHAIRMAN SOLOMON. I think that much of a rise seems unlikely to be repeated next year because we won't have, I assume, as big a growth in money market funds starting from the present base as we had this year.

MR. SCHULTZ. But we don't need anything like that kind of rise next year, depending on what one is assuming on nominal GNP. If [GNP growth] is in the 9 to 10 percent range and [money grows at the] midpoint of 4 percent and normal velocity is 3, that would give you an extra velocity of 3 rather than 5. You can play with numbers like that. I don't think you--

SPEAKER(?). A lot of that is possible.

CHAIRMAN VOLCKER. The fact is we don't know. We're all giving grist to Mr. Morris's mill.

MR. PARTEE. Well, what does M2 mean?

MR. GRAMLEY. But you could also argue that M-1B doesn't make any difference. Whether our money supply comes in at 2 or 3 percentage points above what is otherwise stated, what difference does it make if we have more money or more velocity? It all accomplishes the same objective.

MR. SCHULTZ. No, I wasn't making that kind of--

MR. GRAMLEY. Well, you slip into that sort of argument that somehow the economy will always manage with whatever money we put out. If M-1B is that elusive in terms of its relationship with GNP, then the proper interpretation is that we ought not to be targeting M-1B. We ought to be looking at what we think is relevant.

MR. SCHULTZ. Well, I think you know that I have less and less confidence in M-1B; I give less and less weight to it.

MR. BLACK. One thing that has been overlooked is the assumption that the inflation rate will be as high as the staff has

said. If it's lower than that, one doesn't have to make such heroic assumptions about the increase in velocity.

MR. PARTEE. And if it's higher than that?

MR. BLACK. Well, then you have to be really--

MR. ROOS. If our primary purpose at this moment--maybe this isn't our purpose--is to impact inflationary expectations, we would have to announce, in understandable terms, a reduction in the rate of growth of the narrower aggregates. I don't think it's realistic to think that we can say we're only going to shade down M1--if we're going to call it that--very slightly because we think something is going to happen to a thing called velocity or the money demand function. When I read these financial letters, I seldom see any reference made to these more technical aspects of what we're trying to do. They talk about our published ranges in simple terms and whether or not they think we're going to be able to achieve them. So, I think they are two different things. The technical aspect of what we're doing is something different from the impact we're trying to make on inflationary expectations. And the latter has to be done in a simple manner and has to involve a discernable reduction in the actual figures from the current 3-1/2 to 6 percent to something that to less knowledgeable and less technically oriented people looks like a continuation of our resolve to reduce these ranges gradually.

MS. TEETERS. There are two other problems here, though. It's going to be impossible for us to raise the number. Suppose we get a repeat of last year and get a sudden expansion in the money supply over the fall; we will end up with a high base. Then we will face the problem we faced at the end of last year as to whether we can even meet the targets that we set for ourselves in July. And if we lower them too much--by a whole percentage point, say, or even if we lower them at all at this point--and then in February we really need to raise them 1/2 percentage point, we're not going to be able to do it. A second consideration here is that if we get the ranges too low, we will never be able to get within them and we'll lose credibility because we can't achieve our targets. We have to balance whether we're going to achieve the targets as well as whether we're ever going to have the opportunity to raise them, which I don't think we are.

VICE CHAIRMAN SOLOMON. Obviously there's no perfect solution, but I would argue that the right balance to strike is one that retains our credibility in terms of continuing to squeeze inflation. Certainly there's a widespread perception in the country that the Federal Reserve is very strictly committed and dedicated to monetary restraint. I think we can achieve that with only a 1/2 point reduction; I don't think we need a full point reduction. There is a continuity in policy with a 1/2 point reduction and it lessens somewhat the problem that Nancy is talking about. If we end up at the low end of the target this year, or even with some undershooting, we have to start from that point; we can't go back to where we were supposed to be. Then it's quite a tight target. So, my sense of balance between the expectations of the country for us to continue this policy in a persistent way and the danger that it's going to be too tight is to strike a balance with a 1/2 point reduction. Now, I don't particularly care if we lower the floor a full point because I don't think that's the meaningful constraint. I have a slight

preference for a 1/2 point reduction on both the floor and the ceiling. But if you want to lower the floor a point, and you don't think we're going to get criticism because we're widening the range, [I could accept that]. You were telling me that Senator Proxmire was pushing you to narrow the range.

CHAIRMAN VOLCKER. At midyear. But I see some positive benefit to widening the range to explain to them that these numbers are not so solid and reliable. It's a symbolic recognition of the fact that there are great uncertainties about M1 and what M1 means these days.

VICE CHAIRMAN SOLOMON. I don't think we should lower the ceiling a whole point. That really is risking a major problem in the economy in terms of our not making--

CHAIRMAN VOLCKER. Well, we've heard the arguments on both sides. Having heard both sides, I conclude that 2-1/2 to 5-1/2 percent is still the right compromise. I feel somewhat open-minded about M3. Let me just try 2-1/2 to 5-1/2, 6 to 9, and 6-1/2 to 9-1/2 percent, but I am perfectly happy to try the same [M1 range] and 6 to 9 percent for both M2 and M3. What are the preferences between those two?

VICE CHAIRMAN SOLOMON. If it doesn't cause any more problems to lower M3 a half point--

MR. AXILROD. That's what it looks like at this point. There's no guarantee on what it will look like in December.

MR. PARTEE. We don't need to do that.

VICE CHAIRMAN SOLOMON. What about not doing it now but waiting to see the situation?

MR. AXILROD. Last year, Mr. Chairman, I believe the Committee lowered M2 at midyear and then raised it back.

CHAIRMAN VOLCKER. Is that what we did? I thought we raised one of these.

MR. AXILROD. Yes, that's right. I think it was M2. You lowered it at midyear and then at the beginning of last year--

CHAIRMAN VOLCKER. So we have precedence for that. Let me just ask the preference between those two approaches. There are other combinations and permutations, but let me just see how those two go. Everything the same with 2-1/2 to 5-1/2, 6 to 9, but a 1/2-point difference on the M3 range. Who is for the leaving the M3 range at 6-1/2 to 9-1/2 percent, given that choice.

MR. SCHULTZ. I think Chuck made a pretty good argument for not doing it now and taking a look at it later.

CHAIRMAN VOLCKER. How many have a reasonably strong feeling about the 6-1/2 to 9-1/2 percent versus 6 to 9 percent? Well, among those registering feelings anyway, the 6-1/2 to 9-1/2 percent commands a little more support. Now, let me just ask a general question. Does

anybody else, after hearing this debate on both sides--on lower or higher, visual, substance, or uncertainty--want to propose another change? If not, I am going to go ahead with the 2-1/2 to 5-1/2, 6 to 9, and 6-1/2 to 9-1/2 percent.

MS. TEETERS. I would much prefer 3 to 6 percent on M-1B.

CHAIRMAN VOLCKER. There have been preferences expressed on both sides, but let me just ask--

MR. RICE. How about 3 to 5-1/2 percent?

MR. GRAMLEY. It's only the upper limit that is really binding.

MS. TEETERS. Yes, except that we--

CHAIRMAN VOLCKER. There are other possibilities. There's a whole range of numbers we can put down--different higher limits, different lower limits, whatever.

MS. TEETERS. We have never responded when [the growth rates] went down to the bottom; we only respond when they go to the top.

CHAIRMAN VOLCKER. Is there some reasonable contentment with 2-1/2 to 5-1/2 percent?

MR. SCHULTZ. Do you want a show of hands?

CHAIRMAN VOLCKER. Yes. Well, [unintelligible], let's just reserve that for the moment. That's tentative. Now, what do you want to do about this year? I've been on both sides of this issue and will remain on both sides of the issue. The argument, as I understand it, is: Why horse around for 1/2 percentage point and raise questions about fine-tuning and all the rest. If we go that way, I think we have to say something about being comfortable on the low side however that is precisely expressed.

MS. TEETERS. [Comfortable] for M-1B. We're uncomfortable on the high side for M2.

CHAIRMAN VOLCKER. Yes, that's right.

MR. PARTEE. Given what we voted for on the short run, I think we really ought to reduce the lower end. Growth is going to come out awfully low.

CHAIRMAN VOLCKER. The other side is: If we lower it, we have a target that is more attainable on the low side, consistent with the decision we made earlier. It's less frightening on the up side. It comes down, in part, to how convinced one is that if we saw a sudden radical move in the other direction so that the upper side is threatened, we'd be prepared to pull out even more stops than we otherwise would, given that we went out of our way now to lower it.

MR. CORRIGAN. That's the decisive thing. I don't like this fine-tuning; that argument is the one that is a real potential trap.

And I just don't see why we want even to run the risk of finding ourselves in that position.

MR. GRAMLEY. We gain so little by lowering the lower end of the target. [M-1B is] running below the lower end of the target and everybody is saying right now "Gee, the Fed is doing great." If it ended up the year below 3-1/2 percent, I doubt that anybody would be seriously concerned about it as long as the economy--

CHAIRMAN VOLCKER. Does anybody have anything to add to this argument? Does anybody want to make a final statement that's going to be persuasive on this score before I ask for preferences? Or does anyone want to make a statement that's not going to be persuasive but that they want to get off their chest?

MR. BLACK. I'd like to make one statement. What we have--

MR. PARTEE. On the top half.

MR. BLACK. No, I am going to leave that one alone. What we have voted for would involve a rate of growth of 3.9 percent between the fourth quarter of 1980 and the fourth quarter of 1981. No, wait a minute; I'm okay. I got mixed up.

MR. ROOS. It's an expression: I'm okay, you're okay.

CHAIRMAN VOLCKER. Does anybody else want to make a statement? One choice, as I understand it, is to leave the ranges unchanged but say something [specifically] about being low in, or maybe even below, [the M-1B range] if necessary to remain comfortable. But we are not unduly uncomfortable on M2 and M3. We would expect to be high in the M2 and M3 ranges. That's one approach. The other is that we'd still say that we're going to be high in the M2 and M3 ranges but in recognition of the undershoot in M-1B, in effect, we are lowering its range by a half point. Those are the two choices.

MR. PARTEE. Lower both ends [of the M-1B range] by a half point?

CHAIRMAN VOLCKER. I'd lower both ends by a half point if we were doing it. I don't think we can widen the range in the middle of the year. Part of the purpose in lowering it actually is to constrain us on the up side and indicate that we are constrained. So, those are the two choices. They seem to be quite evenly balanced, in my judgment. Who does not want to change them, with that explanation?

That seems to be the wide consensus, so I guess we don't move them.

MR. SCHULTZ. And I made such a beautiful argument!

CHAIRMAN VOLCKER. That was a beautiful argument.

MR. PARTEE. Sometimes that happens.

MR. SCHULTZ. Some get rained out.

MR. ROOS. Hey, Fred, I changed my vote; I voted the [unintelligible]. I looked at it again.

CHAIRMAN VOLCKER. He would have changed my vote, too. But we are still in the minority. Mr. Axilrod raises a question, which reraises a question about what we just said before. I am hesitant to recite it to you but I will out of a feeling of loyalty. He says that in general we are putting some additional emphasis on the broader aggregates and the decision for next year doesn't lower any of the broader aggregates. Is that going to diminish the psychological impact? I guess that reraises the question of M3. Does anybody feel strongly that we should reconsider the question of M3? If not, we won't. So, what we have here is: No change this year with the explanation that I cited; for next year 2-1/2 to 5-1/2 percent tentatively for M1 period, 6 to 9 percent for M2, and 6-1/2 to 9-1/2 percent for M3. Nobody discussed bank credit, which is still what-- 6-1/2 to 9-1/2 percent?

MR. AXILROD. It's 6 to 9.

CHAIRMAN VOLCKER. Are we at 6 to 9 percent? Oh, yes, it's the same. I see. So, 6 to 9 percent on bank credit.

MS. TEETERS. We don't have to vote on the whole package [for the two years] do we?

CHAIRMAN VOLCKER. At this stage, I think yes. It's clear that for 1981 there isn't going to be any change.

MS. TEETERS. Are we just voting for '82?

CHAIRMAN VOLCKER. Well, let's do it separately. It might affect somebody's vote, I guess. Shall we formally vote on '81? All right, we will have a separate vote on '81.

VICE CHAIRMAN SOLOMON. We earn our salaries!

CHAIRMAN VOLCKER. I have a footnote in my mind to all of this, that if the figures for the next two weeks come out widely different than our current expectation, I think we need to have a consultation and relook at all these decisions. So, I will make a [mental] footnote. Maybe we ought to put in our record that we are going to consult at--

MS. TEETERS. That will give you time before your testimony.

CHAIRMAN VOLCKER. Yes, we will have a consultation before the testimony to confirm all of this. Maybe just put it like that, neutrally. But I don't expect any change unless we get some radically wild figures in the next two weeks. Now we are just voting on '81.

MR. CORRIGAN. Leaving the targets as is.

MS. TEETERS. Yes.

MR. SCHULTZ. We're not changing '81.

CHAIRMAN VOLCKER. Exactly.

MR. BOEHNE. We could say it both ways!

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	Yes
President Keehn	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Schultz	I guess I have to vote "Yes."

VICE CHAIRMAN SOLOMON. Have you ever dissented before? Now is your time.

MR. SCHULTZ. I was worried about how I would look if I dissented.

MR. WALLICH. They'd think you want it easier.

MR. SCHULTZ. No, that's not the problem.

CHAIRMAN VOLCKER. You can explain your vote.

MR. SCHULTZ. I'll vote "Yes."

MR. ALTMANN.

Governor Teeters	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. Okay. That leaves us with 1982. This is all going to be described as tentative. The coloration around it is clear. It's 2-1/2 to 5-1/2, 6 to 9, 6-1/2 to 9-1/2, and 6 to 9 percent, which is no change for any of the ranges except for M-1B.

MR. BALLE. What was the rationale, Mr. Chairman, on the three-point spread, just so we understand that?

CHAIRMAN VOLCKER. The rationale is "modified Morris." Is that clear? There's a lot of uncertainty about what is going to happen to M1 in terms of the technical interpretation of the figure.

VICE CHAIRMAN SOLOMON. And the press headline will be: "Volcker uncertain."

CHAIRMAN VOLCKER. That is the problem in explaining. There's so much invested in this now. It's difficult to go up there and say we don't have any faith in these figures. It happens to be the case. We have more credibility, a lot more credibility, saying it when they are low than when they are high. Do you all remember what you are voting on?

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes



President Boykin	Yes
President Corrigan	Yes
Governor Gramley	Yes
President Keehn	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Schultz	Yes
Governor Teeters	No
Governor Wallich	Yes

CHAIRMAN VOLCKER. Okay, I guess we are finished. Oh, no. Will you hand out this directive language? Let us suspend the Open Market Committee meeting for the moment and spend a little time on these other things. And while you are uninterested in this other conversation, you can read the directive language and we will reassess that language in 15 or 20 minutes. Let me try and run through some of these other things rather quickly. I have a note here that you are prepared to report on our readiness on the pricing, Governor Gramley, if you would do that.

[Secretary's note: The Committee's discussion of the directive language was not recorded. The language adopted, of course, has been published in records of the Committee.]

END OF MEETING