

Meeting of the Federal Open Market Committee

July 12-13, 1983

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., starting on Tuesday, July 12, 1983, at 2:30 p.m., and continuing on Wednesday, July 13, 1983, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Gramley
Mr. Guffey
Mr. Keehn
Mr. Martin
Mr. Morris
Mr. Partee
Mr. Rice
Mr. Roberts
Mrs. Teeters
Mr. Wallich

Messrs. Boehne, Boykin, Corrigan, and Mrs. Horn, Alternate Members of the Federal Open Market Committee

Messrs. Balles and Black, Presidents of the Federal Reserve Banks of San Francisco and Richmond, respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele,1/ Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman,1/ Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Balbach,1/ R. Davis,1/ T. Davis,1/ Eisenmenger,1/
Ettin,1/ Prell,1/ Scheld,1/ Siegman,1/ and Zeisel,1/
Associate Economists

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

1/ Attended Tuesday session only.

Mr. Coyne, Assistant to the Board of Governors
Mr. Gemmill,1/ Senior Associate Director, Division
of International Finance, Board of Governors
Mr. Kohn,1/ Associate Director, Division of
Research and Statistics, Board of Governors
Mr. Lindsey,1/ Deputy Associate Director, Division
of Research and Statistics, Board of Governors
Mr. Jensen,1/ Economist, Division of Research and
Statistics, Board of Governors
Mr. Rosine,1/ Economist, Division of Research and
Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant,
Board of Governors

Mr. Forrestal, First Vice President, Federal Reserve
Bank of Atlanta

Messrs. Burns,1/ J. Davis,1/ Keran,1/ Koch,1/ Mullineaux,1/
and Stern,1/ Senior Vice Presidents, Federal Reserve
Banks of Dallas, Cleveland, San Francisco, Atlanta,
Philadelphia, and Minneapolis, respectively

Messrs. Broaddus,1/ Meek, and Soss, Vice Presidents,
Federal Reserve Banks of Richmond, New York,
and New York, respectively

Mr. McCurdy,1/ Research Officer, Federal Reserve Bank of
New York

Transcript of Federal Open Market Committee Meeting of
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July 12--Afternoon Session

[Secretary's note: The meeting began with an executive session, which was not transcribed.]

CHAIRMAN VOLCKER. Let me say now to the assembled group, with a certain amount of sadness, that we just had a little discussion about a problem that has become all too recurrent: either leaks or gossip to the press about our meetings. I think we're going to have to establish some firmer guidelines, which we will discuss at the next meeting. But for the time being I'm afraid that I want to return, reluctantly, to the practice that we adopted a few meetings ago of, in effect, having executive sessions or quasi-executive sessions for the policy discussion. So, during the meeting itself, at the appropriate time we will have a smaller group.

Let me just say one thing further about this while the whole group is here. I find this most distasteful and destructive to the mission of the Federal Reserve. I don't think we can operate effectively if we get conflicting, inaccurate, or on some occasions even accurate stories in the press that are not appropriately timed and don't have the appropriate imprimatur of officially designated Committee statements. Through the years I think there has been a good deal of appreciation of this within the Federal Reserve System. In some sense we are probably under quite a lot more pressure currently in terms of the interest in our behavior and decisions, both in market terms and I suppose in political terms. In my opinion, it puts a very large burden on all of us, if we're going to operate effectively, to preserve the confidentiality of what we do and make our statements in the appropriate setting. It is obviously a consideration that wider participation rather than limited participation is desirable. I understand that. But I have to balance these considerations. The wider participation is fully appropriate when I have a reasonable degree of confidence that the confidentiality will be preserved. Obviously, this has nothing to do with particular individuals. I made the point earlier that a lot of this may come from people who aren't even in this room but who have some sense subsequently, accurately or inaccurately, of what went on and may not feel the same degree of restraint. So, it is a problem of the whole organization in that sense. But if we can't be at these meetings with a feeling of security and respect, I think it's damaging and ultimately damaging to the policy-making process. Now I will ask for approval of the minutes.

MR. MARTIN. Moved.

VICE CHAIRMAN SOLOMON. Second.

CHAIRMAN VOLCKER. We'll turn to the staff report on the economic situation.

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

CHAIRMAN VOLCKER. Do you have budgetary projections beyond
1984?

MR. KICHLINE. No, we have not done that. We did some of those exercises in February, but we have not done anything later than that. As you remember, those exercises did provide for a decline in the actual budget deficit as the economy recovered but a rise in the structural deficit to levels well over \$100 billion. We have not updated those figures; I presume they would roughly be the same.

VICE CHAIRMAN SOLOMON. Our figures show a projected fiscal deficit in 1984 of \$225 billion, significantly higher than yours. And then there are some moderate increases in the few years thereafter.

CHAIRMAN VOLCKER. Assuming continued growth in the two years there?

VICE CHAIRMAN SOLOMON. Assuming 4 percent growth.

MS. TEETERS. Jim, when does the indexing start?

MR. KICHLINE. 1985.

MS. TEETERS. And how much does that take out of revenue?

MR. KICHLINE. There are lots of things I remember, but that I don't remember. I'm sorry. It obviously hinges on one's inflation projection. If we were to run with very mild inflation projections--that is, in the 4 to 5 percent range--it would not be large early on. As you recognize, that cumulates over time in terms of substantial losses. But I would presume that with small rates of inflation, as we could conceivably have for 1985, it would not be huge. This is the last year. That is, the July tax cut [unintelligible] but the full effect of it will be felt in the 1984 fiscal year. I'm sorry, but I don't have a dollar estimate.

VICE CHAIRMAN SOLOMON. I'd like to ask a question. I'm sure this has something to do with statistical intricacies. On the contribution of selected components to real GNP, as I understand it, even though there is a deteriorating export performance you show a positive contribution of net exports in 1984 as contrasted to 1983. Could you explain that to me?

MR. WALLICH. That's when it stops getting worse.

VICE CHAIRMAN SOLOMON. No, it does get some--

MR. ZEISEL. It goes slightly positive, President Solomon.

VICE CHAIRMAN SOLOMON. But why?

CHAIRMAN VOLCKER. What he's saying is that the current account estimate shows it worse.

MR. TRUMAN. Yes, because that's the effect of the price change. We have a [terms of] trade loss, so the import prices rise much more rapidly than the export prices. That's why imports are larger to begin with. So in real terms the net export position improves in 1984, as shown in Jerry's figures, but in nominal terms it gets worse because of the terms of trade loss. The latter adds to our

nominal current account dollar deficit; it doesn't add to our net exports.

VICE CHAIRMAN SOLOMON. Did you say this assumes a 15 percent or a 10 percent depreciation of the dollar?

MR. TRUMAN. It's 15 percent by the end of 1984.

MR. BOEHNE. In the state and local area, that chart that shows surpluses of the state and local governments struck me as being at odds with what one normally perceives [the situation] to be. In my area of New Jersey and Pennsylvania it's quite the contrary; the state and local deficits are quite large. I just have an impression from the national press that there are problems nationwide yet the chart shows a surplus and the surplus is getting bigger. I'm sure you have to be right, but I wonder if you could [explain it].

MR. MORRIS. It's pension plans, which are carried in a state's budget as an expense.

MR. PRELL. These are the operating budgets, taking out those retirement plans. I think what has happened in many locales--New York City, for example--is that the financial situation has improved much more rapidly than had been expected. Of course, there have been sizable tax increases; in the aggregate I think they're on the order of \$5 to \$6 billion. And the cumulative effect of all this has been a significant swing into what is a relatively sizable operating surplus, according to the data we have.

MR. KICHLINE. All of the quarters in 1982 on that basis were deficit quarters, but the current figures show they were in surplus in the first quarter [of 1983] and the second quarter as well.

CHAIRMAN VOLCKER. These are national income accounting figures?

MR. KICHLINE. Correct.

MR. MARTIN. Jim, I wonder if you could enlighten me a little with regard to the interest rate assumptions consistent with the [Greenbook GNP projection] as shown in Appendix I in the Bluebook. It seems to me that the projected increase in interest rates, particularly for the Aaa utilities and the fixed rate mortgages, is rather modest. It's an increase of 5/8 point or 60 basis points or something of that sort. That seems to me to be a relatively low threshold for these rates to achieve. Can you help me understand why you have such low ceilings as your--?

MR. KICHLINE. Well, as you can appreciate, things have been happening since we put this forecast together. When I looked at this chart on interest rates, as a matter of fact, I had in mind that interest rates would be moving up about a percentage point. But as of yesterday it was about forty-five basis points for the bill rate because that rate already had taken a 50 basis point increase along the way. So, part of the answer is that just in the last few weeks market rates, indeed, have been moving up. The numbers that we have in the forecast are the ones shown in Appendix I. Some of those rates in long markets and the mortgage market in particular clearly have

been moving up. They are almost to the levels we had envisaged as an average rate for the third quarter. So, implicitly, what we are thinking is that the rate moves that would be encompassed in this forecast would allow room for some further rise in rates but not a great deal.

MR. MARTIN. So, indeed, if the structure has a higher threshold than you've shown, wouldn't that cast some doubt over the housing forecast and particularly the less creditworthy bank borrowers who resort to the commercial bank window as you've indicated they will be pushing to do in 1984? And that perhaps would affect the volume of consumer borrowing. It's all on the negative side.

MR. KICHLINE. I must say, though, that if you look back over the performance of the last six months, we clearly have raised our [forecast of] real GNP and we have raised our view on the Ms as well as the interest rates that go with the forecast. We did not have a clear interpretation of what rate levels or changes in rates would be consistent with activity in the first half. It turned out that they were consistent with much stronger activity. So, we believe that that will be at work in the future. But one of the arguments for a moderation in growth of economic activity late this year, and especially in 1984, comes from the financial side. The explanation is that those rates, in our view, should be high enough to damp activity a bit.

MR. ROBERTS. You mentioned a revision in manufacturing capacity. Could you comment on that?

MR. KICHLINE. I think Jerry mentioned it, so we'll let him comment.

MR. ZEISEL. Thank you. This is part of a series of such adjustments that have occurred over the years, periodically. We will be bringing the new numbers out later this month. They involve an adjustment in capital and capacity utilization figures, utilizing all sorts of data that we can put our hands on: industry data, survey data from McGraw-Hill, data from our own Census Bureau survey, and so on. It involves a revision of capital stock, which raises the capacity utilization rate by 1-2/3 percentage points at the current time. There are substantially larger increases in some industries, particularly some hard goods industries, but on balance it really doesn't change the situation dramatically. I might say that we've had to be rather conservative in the way we approach these adjustments, particularly in the middle of a contraction phase of the cycle, because what firms say they are putting out of production today they may change their minds on six months down the line if production increases considerably. So, we tend to be rather cautious about it. But, generally, that is the nature of the adjustment.

VICE CHAIRMAN SOLOMON. How much are you reducing the capacity of the steel industry?

MR. ZEISEL. I think the capacity utilization rate changes 5 percentage points. But, of course, it remains relatively low, so that [the reduction] doesn't have any particular significance for pressures on that industry.

MR. BALLEES. Jim, I'd like to ask a question, if I may, on the federal government share of total credit flows, which was [depicted in] the lower half of the first chart that Mike Prell referred to. I believe that has quite a bearing on the outlook for interest rates, real and nominal. My question specifically, Mike, is: Do you have anything in here other than the unified budget deficit? That is, have you included off-budget deficits and mortgage pools and guaranteed loans? Just what is in this measurement?

MR. PRELL. This measurement is borrowing by the U.S. Treasury, which covers both the unified deficit and the off-budget deficit. It does not include government guaranteed or sponsored agency issues.

MR. BALLEES. All right, thank you.

MR. WALLICH. When I look at your chart on GNP prices and unit labor costs, they've been moving closely together since 1977 and that suggests that there's a basis for your declining inflation projection. But there are many other forecasters who have a projection of rising inflation. Do they have different assumptions as to unit labor costs that are necessary in [arriving at] such forecasts?

MR. ZEISEL. I don't think it's a fundamental [difference in] unit labor costs trends, although there are differences in the views of productivity trends. We may be a little more optimistic in our view of productivity than some, but not a great deal because we remain rather conservative. Our view is that long-term productivity growth at this point is just a little over 1 percent, up about a half point from where it was assumed to be but certainly nothing like the kinds of productivity [trends] that we had earlier. I think it's more a function of a reading of the implications of the speed of recovery and its effect on wage adjustments and pricing performance. I must say that our staff, in evaluating past performance and utilizing whatever quantitative tools we have available, tends to come out with rather optimistic results about the inflation outlook--somewhat more optimistic, in fact, than we have incorporated here.

MS. TEETERS. Jerry, you have non-oil import prices here. What assumption do you have on imported oil prices?

MR. ZEISEL. I think those are relatively stable in real terms.

MR. TRUMAN. No, they are stable in nominal terms, as I mentioned. Essentially, the assumption underlying the forecast is that oil prices will be unchanged throughout the projection [period]; we have built in a small adjustment for the very slight rise of something like 50 cents a barrel from currently recorded figures, but that [reflects] a tightening of spot [prices].

VICE CHAIRMAN SOLOMON. Coming back to Governor Wallich's point: Most forecasters are projecting a higher rate of inflation than we are. Certainly, that's the feeling in the financial community; they are looking toward inflation of 5 to 6 percent instead of around 4 percent. Is it that their assumptions and models are different or is it that they are factoring in, in an intangible way,

psychological expectations, commodity prices, etcetera, and are not basing it primarily on unit labor costs? How does the CEA come out with a higher inflation [projection]?

MR. KICHLINE. Well, that one is easy to answer. That tracks right into the budget numbers that one is going to display. In developing the Administration forecast, a number of the participants argued for lower rates in their belief that there will be a better inflation [outcome], but that of course drives up the budget deficit. I think the answer is that a number of things are important in influencing expectations. One is the dollar and one is the notion of [the economy] growing rapidly; there will be speed limit effects and we will have lessened slack by 1984. It's very difficult to use past experience and come up with a substantial acceleration in wage rates in the future. If you want to argue the case, you could say that a lot of the good performance we've had recently represents concessions and that as soon as profits pick up that's going to disappear. That may be the case. But we've just seen in the second quarter more companies added to the list of those still [getting] concessions and three-year contracts with no wage increases. We have a view that, yes, there are cyclical effects here but that we will have enough slack, judged in terms of the level of underutilized resources, to keep putting downward pressure on wage rates. We view that as a fundamental.

VICE CHAIRMAN SOLOMON. Have you fed back in Ted Truman's 15 percent depreciation of the dollar?

MR. KICHLINE. Yes. He's causing us difficulty, obviously. Without Ted Truman we would have lower rates of inflation! We do believe that to be a very important argument for 1985. That is one thing I should note: The partial dollar impact that we have on domestic prices in 1984 would build in 1985 and would have a larger effect.

MR. TRUMAN. That's the reason why we had that alternative chart there.

VICE CHAIRMAN SOLOMON. We all have been assuming a depreciation of the dollar and factoring it in for the last year, and it hasn't come about.

MR. MORRIS. You're showing in 1984 a drop of 0.8 in the unemployment rate associated with a 4.2 percent real growth rate. My staff suggests that that is a rather large drop in the unemployment rate historically for a 4.2 percent real growth rate. Are you assuming labor force growth is dropping off sharply or what is it?

MR. ZEISEL. No, labor force growth doesn't drop off sharply; actually, it increases quite a bit. We feel that a 4-1/4 percent increase in GNP is close to 2 percent above capacity growth and that this decline in the unemployment rate of about 3/4 of a point is historically reasonable using something like an Okun's law calculation.

MR. MORRIS. Really? As a matter of fact, our staff thinks it's high.

CHAIRMAN VOLCKER. You have a very low productivity growth in 1984 compared to historical cyclical experience, don't you?

MR. ZEISEL. Our productivity is low, certainly based on earlier postwar experience, [such as] in the '60s when productivity was rising [unintelligible] percent or so. It is now in the [1-1/4] percent range. But it is higher than it was running in the 1970s; it is twice as high, and that of course plays a role. That is, in fact, relatively low productivity. But incorporating that productivity trend into the calculation--if one wants to take this kind of mechanical, that is, purely the Okun's law approach--I think does give us a decline of something like that magnitude for a rate of [GNP] increase of 4-1/4 percent.

MR. PRELL. In mechanical terms, if we move above the cyclical trend in the early part of recovery, as the recovery matures we are going to have a period when productivity growth is somewhat below the trend rate of growth so as to return to the trend line.

VICE CHAIRMAN SOLOMON. Haven't we begun to see that already? In recent months hasn't productivity declined?

MR. ZEISEL. No, I don't think so. We still have fairly vigorous productivity gains. In manufacturing, productivity is rising certainly 4 percent or [even] above that.

MR. KEEHN. May I go back to capacity utilization? You show a reasonably good increase in capacity utilization in 1983 and 1984. The capital expenditure line looks awfully steep. Do you have a pretty good confidence factor on that?

MR. ZEISEL. The growth in capital outlays? Well, the only thing we have hard evidence on at the moment is new orders for nondefense capital equipment, which shows a pretty vigorous turnaround. Now, that doesn't tell us much about what is going to happen in 1984 but it tends to be a reasonably good lead indicator for the near term.

CHAIRMAN VOLCKER. Where are those new orders in relation to sales?

MR. GRAMLEY. Are unfilled orders rising or falling at this point?

MR. ZEISEL. I think they have started to fall. Excuse me, they have turned around.

CHAIRMAN VOLCKER. Just by a little. Aren't the new orders barely above sales?

MR. KICHLINE. Yes, but they were running the other way and there is a hint that we have reached the bottom and there is a turn where new orders--

CHAIRMAN VOLCKER. Now, if you want to be pessimistic, you can say this order increase is necessary to maintain the current level of sales.

MR. ZEISEL. Yes, you can. Our forecasts for capital spending are based upon relationships with real output and the multiple effects of demand on capital outlays. And in this case they are pretty much in line with past performance.

MR. KEEHN. Your confidence factor is pretty high?

MR. KICHLINE. Yes, given interest rates now. In answer to your question, there are some things going on behind this that we try to take into account. One is that we have petroleum drilling, which gets wrapped up in these numbers, rising but not a lot because we think that market is going to be rather depressed given the oil price situation. We do think that in many areas of the country a major collapse is underway in certain commercial and office building construction, and that is likely to be negative going into 1984 for some time. In the past what has happened, however, is that equipment purchases have been the first to pick up and we have seen a good deal of that. Now, early on, the [sales of] autos collapsed and they were [selling] at a discount. And they get wrapped up in these numbers. But office equipment, computer-related products, have been very strong. So, that is the sustaining force early on. But [our forecast] is conservative, I think, in the sense that most of the models say--and certainly the cyclical experience says--that we're running a little below what has happened in past cycles.

CHAIRMAN VOLCKER. This new orders figure is for plant as well as equipment?

MR. ZEISEL. No, the new orders figure is for nondefense equipment alone.

CHAIRMAN VOLCKER. I have one other question, which I will insert. You have credit growth rising more rapidly than GNP and you say that is contrary to usual cyclical experience. Why?

MR. PRELL. We go through this on a sector-by-sector basis, as well as looking at it in the aggregate. Taking existing balance sheet positions as a start, trying to maintain reasonable levels of liquidity in the business sector and building up all these flows, this is what we come up with. Going back and then looking at that again and asking whether we are comfortable with this, I guess we've suggested before that we don't have any great theory of credit aggregate behavior. What we're left with is the feeling that given the size of the federal deficit and the kind of spending and borrowing relationships that might come from that, this relatively rapid growth of debt is sensible. I would note that we were expecting a somewhat bigger gap than seems to be materializing this year. But there is, nonetheless, this gap. We don't see the development thus far this year of what would be a normal pattern where, on average, credit growth is falling short of GNP growth by a couple percentage points in the first year of recovery. We think it probably has something to do with this very large government borrowing.

MR. PARTEE. That could be a result of government borrowing not being as stimulative as private borrowing. That could be because it's mainly receipts reduction. And it could have a flow-through effect on savings, although the saving rate is awfully low in your forecast, which was the point I was going to make. It seems to me

that you have a rather low saving rate for the next 6 quarters compared to historical experience. There is no evidence whatsoever of savings being stimulated by tax incentives and so forth, from what I can see.

MR. PRELL. Well, it could be that there is something going on in the disinflationary process, for example, that makes people want to hold more financial assets relative to income than had been true previously. Essentially, we had a very big accumulation of financial assets relative to income last year. There's an enormous gap, and we're carrying this through; it's not going away. We have in our forecast a continuing moderate inflation picture; we have regulatory changes that make some forms of financial assets more attractive on the whole.

CHAIRMAN VOLCKER. You're taking a position that all this liquidity isn't going to be reflected in a higher GNP.

MR. PRELL. Implicitly--in the same way that we don't have a tremendous reversal of the velocity behavior of the last year.

MR. BALLE. I'd like to ask Jim another question or two about the first page of his charts, the lower panel that dealt with interest rates. Do you care to share with us, Jim, your explanation, or rationale if you have one, of the underlying cause of this rise in interest rates shown for midyear up to the fourth quarter and then a decline by the fourth quarter of next year? That's a tough one.

MR. KICHLINE. Well, for one, it has something to do with monetary policy assumptions. That's a place one might start. It also has something to do, obviously, with our view that at the present time we have strong underlying demands for spending and credit and that the combination of those things, given our monetary policy assumption, will likely result in some upward drift [in rates]. I noted before that these charts may give one the feeling that there is more movement here than is in fact in store, because some of it already has occurred. The 1984 projection on interest rates comes out of a considered judgment and a great deal of thought and hope on our part. But I'm not so sure I can say more than that. What has influenced us, particularly on long rates, is the feeling that we are most likely to see a much better inflation performance than markets generally anticipate and that, as each month goes by and we see low rates of inflation, double digit long rates indeed will look pretty attractive so that there is room [for some decline] in 1984. In addition, we think the higher rate levels that have occurred now will lead to some maturing of the expansion and to some slowing and thus take a little of the pressure off of the credit markets. But I would not wish to stake all of what we said this morning on the basis of these interest rate forecasts for that year. That's a central area.

MR. BALLE. I appreciate your sharing those thoughts with us. I gather, based on your remarks, that you share to some extent the view that long rates are influenced considerably by inflation expectations. And yet the pattern that we see both in your chart as well as in Appendix I in the Bluebook shows short rates and long rates generally moving up and down together. If you look back a few years, the [unintelligible] doctrine was that if we could convince markets that we were going to pursue anti-inflationary policies on into the

future, we would reduce inflation expectations and have downward pressure on long rates. The thing I'm agonizing about the most, and I guess a lot of people around the table are, is: What in the heck has caused this serious increase in long rates since the middle of May or for about 2 months now? Have inflation expectations worsened or are we in a new era where if short rates go up, the arbitrage effects are going to cause long rates to go up right along with them irrespective of any changes or lack thereof in inflation expectations?

MR. KICHLINE. Well, I could say something, but maybe Steve or Paul would want to comment on their interpretation of the markets in terms of what has happened in the very short run.

MR. AXILROD. President Balles, even some years ago short rates and long rates tended to move together in differing degrees. In the very recent period, actually, long rates have moved up about as much as short rates. I myself think it's somewhat surprising, and I think that [reflects] an anticipation or fear of further monetary tightening. I would dare say that if the short rates went down in a sustained way, there would be a very sharp drop in long rates. I don't think at this very moment that this is reflecting a change in inflationary expectations. Now, the level of long rates--being high in real terms--might have something to do with the budget deficit and the fact that you need higher real rates when the government is the propelling force than you do when private expenditures are the propelling force, with the same level of real GNP. At least most of our big models would give that result. So, private spending wouldn't be so high at this level of real rates, independently, without the government stimulus.

MR. MEEK. I'd just add one market factor, which is that the Treasury in the third quarter, for example, will be selling about \$60 billion of coupon issues to replace approximately \$23 billion that mature. We're really getting a lot of supply and the markets are having trouble finding a widening circle of buyers for that supply.

MR. BALLEES. Well, that's right. And it comes back to a point made in that first chart that Mike Prell showed: that the percent of total credit flows being taken by the federal government, as projected forward a year to the fourth quarter of 1984, apparently isn't going to come down nearly as much as it usually does following an economic recovery. We have this new structural deficit in there that's keeping that share up. Is that the way you'd interpret it, Mike? And that, in turn, could have an effect of keeping interest rates up, I guess.

MR. BOEHNE. Why wouldn't that argue for higher rates in 1984 rather than lower rates?

MR. PARTEE. Well, the GNP increase is not all that large in 1984, if you look at it. They have 4-1/4 percent real and around 8 percent nominal. If, in the abstract, somebody said there was going to be an 8 percent increase in nominal GNP, I don't think you'd be talking about higher rates.

MR. CORRIGAN. I think the market thinks you're talking about higher rates.

CHAIRMAN VOLCKER. I think I have on my desk a study from the Treasury saying that government deficits don't have any influence on interest rates. I haven't read the study yet; I just read the newspaper reports earlier. I now have the study. Have you seen that?

MR. KICHLINE. Yes, we got it last evening. I've had a lot to read in the last few days. I'm not sure it quite says that. I think what it says is that pure theory can't give you an answer--that one can construct alternative views of the world in which government deficits have no impact on interest rates or inflation. It also says that under certain assumptions those are quite reasonable, but it does not come to any definitive conclusion and to some extent depends on rather extreme assumptions. One critical one, for example--a hypothesis that has been floating around for some time--says interest rates are invariant no matter what level of deficit you have. That proposition is simply that individuals see through this veil of government debt financing and know that in their lifetime or their children's lifetimes somebody will have to repay it, so they will simply increase their saving to exactly offset it--deficit saving.

MR. WALLICH. That's why the saving rate goes down!

CHAIRMAN VOLCKER. This is not an econometric study?

MR. KICHLINE. No, it's not.

MS. TEETERS. Well, one of the problems is that our huge deficits have always occurred in recessions. If they took periods of time in which there were large deficits and high utilization, I think they'd find a different result.

CHAIRMAN VOLCKER. Exactly.

MR. PRELL. As Jim was saying, it's largely an analytical study as opposed to an econometric one.

MR. WALLICH. If one does a sufficiently poor job of taking out the cycle, one would find that the high deficits are associated with low interest rates. If you take out the cycle properly, I don't believe you get that result.

CHAIRMAN VOLCKER. You have a chart on deficits which shows the current cycle against the median of previous postwar cycles. What would it look like in 1975 and the subsequent expansion?

MR. KICHLINE. Well, I don't believe I have the individual cycle data with me. No, I don't. But as I remember, the rebate came early in the spring of 1975, so we would have had an actual budget deficit decline at that time but then economic activity continued to rise. As I remember, the 1975 cycle does indeed approximate this upper line; it's below the black line for the median of previous cycles, but the first quarter into the cycle there is this plunge when we had the \$50 rebate or whatever, and then it goes back on track--that is, it's going toward a surplus.

MR. CORRIGAN. The earlier period is shown in this other chart, isn't it, Jim?

MR. PRELL. That shows a proportion of credit.

MR. KICHLINE. It's going down; you're correct.

MR. BOEHNE. My question has already been answered.

CHAIRMAN VOLCKER. Well, we have had all the specific questions and we have all the projections, so presumably we have a statistical analysis of what everybody thinks. Those should be looked at again for any changes you want to make subsequent to our decisions. You have to send in any revisions you want to make in a hurry so we can prepare the [Humphrey-Hawkins report]. I just glanced at these, and there may be some obvious explanation, but I think the Board members are in a relatively narrow range of 5 to 6 percent, fourth quarter-to-fourth quarter, but with half the year over they are 3 to 5 percent on the annual average. It doesn't seem mathematically consistent to me somehow.

MR. PARTEE. I didn't provide an annual average because I didn't have the resources to figure it out.

CHAIRMAN VOLCKER. Did they put you in as zero? Is that what brought the average down? Something there looks [wrong]; people may want to examine the consistency. Maybe I'm wrong and there is some obvious statistical explanation, but with half the year gone and a similar range for fourth quarter-to-fourth quarter, I don't know how it comes up so differently on the annual average.

MS. TEETERS. A 3-1/4 percent annual average is consistent with the 5-1/2 percent.

CHAIRMAN VOLCKER. The problem is the 5 percent.

MR. PARTEE. It depends so much on the quarterly pattern one has.

CHAIRMAN VOLCKER. I think it might be useful, after all these specific questions, for people to express any views they have-- and there must be some that affect one's judgment--as to either a difference of opinion in general or whether the risks lie on the up side or the down side and how that relates to monetary policy.

VICE CHAIRMAN SOLOMON. Let me say that I think the projection of 7.1 percent real GNP for the third quarter is a bit on the high side, or at least that the risk is that it won't be that strong. It seems very high with the bulk of the inventory adjustment being completed in the second quarter.

MR. PARTEE. Well, of course, we have the tax cut.

MR. ZEISEL. Obviously, we really don't have a great deal to go on, but we had some data for June employment and related production data. They already indicated that we're coming into the third quarter with a very considerable degree of momentum. We ran through some arithmetic exercises making rather conservative assumptions about the next couple of months. They provide the basis for, I think, a conservative estimate of the GNP increase or at least an increase in non-agricultural output of this general magnitude.

CHAIRMAN VOLCKER. Let me ask a longer-range question. Many people have expressed the thought, including me upon occasion, that given these interest rates--and you have essentially flat interest rates--it proved fine in the early stages of recovery that you and everybody else overestimated the restraining effect. We have pent up demand for housing and we have an inventory reversal that comes along early in the recovery; but once we get through that, which may be after the third or fourth quarter, the economy cannot continue to expand at this rate of speed at those interest rates.

MR. KICHLINE. I think that's a relevant concern. In addressing that, I think we have to ask ourselves the question "Why did we miss over the last couple of quarters?" Is it because we underestimated the effect of a change in interest rates and that the level is still biting? Is it just that we had some pent up demands and that a change in rates permitted some things to be accomplished, particularly in the housing market and consumer durables, but the level is still binding so that the effect of an interest rate decline wears out and we're going to find that the recovery slows rather sharply? That's the way we had thought about it. We tried to put one foot on each side. We think that probably we underestimated the restraining effect of the level and underestimated as well the effects of the rate of change. So, for 1984 we have a smaller rate of increase in real GNP now than we did previously, but we have a higher level of activity because we have allowed 1983 to show through in terms of this higher level. I would say that there is a serious question on that rate effect, particularly in interest-sensitive sectors, which is where I might tend to put the downside risks; housing is one of those. On the other hand, there are a lot of things one can point to that could be potential offsets. But if you begin to think in terms of changing attitudes, we now are entering a period after four very lean years in consumer spending and lots of other things. It seems to me that there is the potential for substantial spending in a variety of sectors, particularly those that are less interest-sensitive.

CHAIRMAN VOLCKER. Any other comments or observations?

MR. PARTEE. I would say that I think this is a reasonable working hypothesis. To me, the most important feature of the projection is the slowing rate of increase that you are speaking of that sets in by the fourth quarter. I think that's terribly important to us from the standpoint of conducting monetary policy because it could be argued that this is an explosive and self-building recovery that will accelerate longer than that and create real pressures. But this doesn't have it. I would have been inclined to slow the rate of increase a little more, just along the lines you have been discussing, Paul. Also, the export market is an awfully important variable here, and there is an important and so far incorrect expectation of a sharply declining dollar. That's important to getting that second half of 1984 still to show a good increase, and I'm not at all sure that will occur. So, I would have put that a little lower. But I agree with the basic premise that what we are seeing right now is a second-quarter inventory upsurge and a third-quarter carrying through of the income effects on spending of that and of the tax cut and that there will be a slowing in the rate of increase later on. The levels of the markets that have been mentioned, I would point out, are not notably high. Housing starts are up nicely but they are a half

million below what they were in previous booms. Car sales are up nicely but we used to talk about 11 million cars a year and this is well below 11 million cars at its best point. I guess that's an expression of the high real interest rate, which is offset in the aggregate statistics by the effect of the stimulus of the government deficit. I think it's pretty reasonable.

One other comment I might make, just to be complete about it, is that on balance I would be inclined to feel a little less optimistic about the price outlook in 1984 than the staff. I think something could break here in agriculture; with all these efforts to raise farm prices, they might actually manage to do it and we might get more inflation in that area. I also am concerned, if we do get a decline in the dollar, about the effects on domestic pricing that a decline in the dollar would make possible; that is, higher import prices would make it possible, in terms of retaliation efforts, for businesses here to restore margins. So, I would come in with a little higher price increase than the staff has. But the general profile, I think, is really quite reasonable. And I can't detect whether the major risk is that we might have more expansion or less expansion than shown here.

MR. BOEHNE. I agree with much of what Chuck has said. It seems to me that the risk of a runaway boom is very small. We may have a little more growth or we may have a little less. The prospects of a runaway boom strike me as being very low, largely because of the restraint of interest rates. I don't think it would take very much of an increase in rates to cut housing down sharply. We've already seen in some areas an increase of 100 basis points or so in mortgage rates. I'm told that on a typical \$60,000 mortgage, 100 basis points is \$45 or \$50 a month on a monthly payment, which is a substantial amount in a tight consumer budget. We've seen how sensitive auto sales are to interest rates. We're certainly not at boom levels there. I think it would not take much of an increase in interest rates to cut substantially into that whole psychological area of consumer attitudes. The improvement of business attitudes, I think, has been conditioned to a great extent on the drop in interest rates. A reversal of that to any significant degree over a year's horizon, let's say, would quickly damp that. So, I think it is a reasonable forecast. And I put a very low probability [on the prospect] that we will have to be concerned here about a runaway boom.

CHAIRMAN VOLCKER. "Runaway boom" is pretty extreme. Moderating the wording "runaway boom," is there agreement with that proposition?

MR. MORRIS. I would agree with that proposition.

MR. PARTEE. An "accelerating recovery."

MR. BOEHNE. I'm about to fall asleep; I wanted to use a little more--

MR. MORRIS. One newspaper article I saw that I thought was rather interesting talked about the second quarter as the strongest quarter we've had since the first quarter of 1981--not that I'm suggesting the second quarter is going to be similar. But it seems to me that the risks of aborting the recovery are still pretty high.

MR. WALLICH. I would like to come in on the other side. As much as I believe that monetary policy is effective, with a \$200 billion deficit and no increase in savings I don't see how we could help but get a very strong economy.

CHAIRMAN VOLCKER. We've had a certain amount of monetary growth too.

MR. GRAMLEY. I agree with the staff's forecast for this year, and I don't think we're looking at a runaway boom. I would think the case for some deceleration of growth in 1984 is a strong one, given the net export picture we're looking at. The question is how much deceleration. And I think the area where the staff may have underestimated the amount of strength is in the business fixed investment area where the magnitude of the increase over the four quarters of next year is 7-3/4 percent. That's rather weak relative to what we typically see. I know one can make a case for it in terms of the weakness in the nonresidential construction area. But to turn to your question about interest rates, this is why I think you're really going to have to look harder. The survey of inflation expectations that we get from this guy Hoey came in today; we get a copy of it.

CHAIRMAN VOLCKER. I haven't seen it.

MR. GRAMLEY. It turns out that in the last quarter inflationary expectations worsened somewhat over every time horizon, and the 5- and 10-year expectations of inflation are in the range of 6-1/2 to 7 percent. If you take today's interest rates on corporate bonds and put them on an after-tax basis to compare with that kind of inflation expectation, you don't have any positive real interest rate at all. The corporate bonds are forecast at [unintelligible] after taxes. So, I'm not inclined to the view that the economy is going to stop in its tracks at the present level of interest rates. I think there is a case that could be made that we may have somewhat more of a buildup of business fixed investment plans this year than the staff has forecast.

MR. MORRIS. Of course, most corporate bonds are bought by pension funds that don't pay any taxes.

MR. GRAMLEY. I was looking at it from the borrower's viewpoint in thinking about this.

CHAIRMAN VOLCKER. I think that's a tricky concept. A borrower's income is taxable too [unintelligible] corporation. We're not getting into that today. Mr. Corrigan.

MR. PARTEE. Twelve percent drops to seven, say, with the rate of inflation at 6.35 percent or whatever we have for the ten years. You get very little positive--

CHAIRMAN VOLCKER. Matching it against the return from a new investment [unintelligible] to do it after taxes. Mr. Corrigan.

MR. CORRIGAN. Well, Mr. Chairman, I look at the situation as a Catch-22. By way of a preparatory remark, I don't have a great deal of problem with the staff's forecast in terms of real economic

activity. I'm also somewhat influenced by what Mr. Prell said earlier about this tremendous buildup in liquid asset holdings of the public; whether they're in the form of things we count in M1 or "M21," they're all there. Against that background, a lot has been said about the deficit. I don't know about this Treasury paper, but it seems to me that we unambiguously have a situation in which the structural deficit is increasing when most of us were hoping a year or two ago that it would be decreasing. Now, there are a lot of ways to measure it, but one interesting way that I came across, which somebody on my staff [worked out], was to use the CBO estimates all the way out to 1988. And what is interesting about that is that they have the unemployment rate in 1988 basically the same as it was in 1980, about 7.4 percent, but they have the deficit in 1988 at 5.6 percent of GNP as opposed to the 2.3 percent in 1980. That's at least one measure of where things stand with regard to the deficit.

I also am inclined to think that a number of people, including the Chairman, have done such a good job of educating people about at least a potential for crowding out that, Treasury studies notwithstanding, the [perceptions] of crowding out and the implications for interest rates are very, very real. I don't have an answer for that quandary, but clearly the potential for anything being done about the deficit for at least 18 months is slim to none. I had felt that we had some breathing room in regard to how much pressure that deficit was going to put on the financial markets and interest rates over the forecast period, but I am no longer sure of that. I don't know how you look at it, Mike, but I observe that private credit demands right now are rising in this cycle as fast as they have in postwar cycles as a whole. And if that continues for any period of time when we have the Treasury borrowing where it is, my hope that we had some room there becomes rather diminished.

CHAIRMAN VOLCKER. If that fact is true, I'd like to know about it by the time I have to appear in public.

MR. CORRIGAN. We did it on one of those trough-to-cycle peaks, Mike. We took the average for the postwar recoveries, and I think it's true that the lines are pretty close together. Well, that's part of my Catch-22. The other part is that even in the context of the staff forecast, which is very much like my own, I am worried about the potential for some adverse developments on the up side with regard to inflation. I also think it's true that taking the postwar cycles as a group we have a situation in this recovery where raw industrial prices and foodstuff prices are actually rising faster than they did in the postwar recoveries even though crude materials are rising a bit more slowly. We have rapid money growth. The staff is assuming, among other things, that we can hold compensation costs to 5 percent. Maybe we can, but maybe we can't. We're going to get a tremendous burst in profits in this quarter and next quarter and how durable that more moderate rate of wage increases is going to prove to be is a big question.

More generally, again looking back at history for what it tells us, we find that in the second year of recoveries the spread of price increases over unit labor costs tends to be about 2 percent, roughly. Again, the staff forecast and my own forecast essentially assume that that spread is close to zero in 1984. What that implies about pressures on the part of corporations that raise prices is a

good question. It seems to me that the only real hope in terms of mitigating some of those pressures is that we may get productivity behavior that's a good deal stronger than what is implied in the staff's forecast, recognizing that it has its own tradeoffs with regard to how fast unemployment can come down. Now, my concern about those considerations is fundamentally based in a deeper concern that I have, and that is that looking out to 1984 in the context in which the deficit situation and the financing requirements of the Treasury are what they are, it seems to me that there is at least a risk, however small, that if inflation started to move up, it could jump up rather sharply. Instead of getting the nice little modest 1/2 point or 1 point acceleration in inflation, we could get something well in excess of that in a context in which we would already have enormous pressures on interest rates and in a situation in which financial deregulation has made it almost an absolute necessity that banks and other financial intermediaries pass through the full cost of higher interest rates onto the borrowers who, in turn, pass them onto the consumer through their products. I don't equate that, to take Mr. Boehne's phrase, with the potential for a runaway boom--

MR. PARTEE. That sounds the opposite of a runaway boom to me.

MR. BOEHNE. In more professional language, an accelerating recovery.

MR. CORRIGAN. Well, in the short run, it's a situation that to me holds the potential for a heck of a collision out there, to put it mildly. That's why I look at it as a Catch-22, because even in the context of the staff's forecast I can see where we could run into some very, very nasty problems.

VICE CHAIRMAN SOLOMON. Well, we always can run into problems on either side. You said no matter how low the probability. Are you saying that the probability of a sudden pickup in inflation is low?

MR. CORRIGAN. I'm not saying it's 50-50, but I'm not saying it's 90-10, either.

MR. MARTIN. I would echo the comments that have been made with regard to the staff forecast for the balance of this year. But in answer to your question, Mr. Chairman, I have some problems with the projection for '84 in specific areas. As far as housing is concerned, it seems to me that this sector is as usual very vulnerable to the level of rates [rising] 25 or 50 basis points [as shown in the Bluebook] in Appendix I. So far as the housing boom--and that's what it has been, conceding it started from very low levels--almost half of it has been a function of the first-time home buyer. And it has been fueled particularly by the fixed rate, fixed term mortgage, whose use the various housing financial agencies are now attempting to decrease as strongly as they can--I take it without much attention to what it might do to the total economy, but hoping that it will solve some problems that the thrift institutions have. Given a slightly higher set of interest rate assumptions, we can recall the already red figures for the thrift industry; that sort of impact, of course, is itself a downside factor.

Moving on from housing, we have not talked extensively about the [interest rate] implications for export markets. Indeed, if the interest rate projections here are on the low side, that would reflect a considerably higher interest burden on both our trading partners on the one hand and the developing countries' potentials on the other. The impact of these rates on business borrowing I have alluded to before. If you take the Aaa figures here and increase them some, that has employment implications which, in turn, obviously have other potential downside effects. What I'm getting at is that if it is true that small business firms are the source of much of the increase in employment, which is to say the decrease in the unemployment rate, then somewhat higher rates than these admittedly increased rates have both business investment implications--as far as the smaller firms are concerned there will be less of that--and employment implications with regard to '84, not '83. In other words, it seems to me that we do face a dilemma here in that the interest-sensitive areas are carrying the increase in economic activity and, therefore, a substantial increase in economic recovery does indeed have a very low probability, and we have some downside implications that I think we need to be very aware of as we examine the alternatives for monetary policy for 1984. If we together choose one of the alternatives that is going to push up rates, I think we need to be fully aware of the implications--the social costs, if you will, or at least the costs in an economic sense that we will pay in terms of housing, small business, export industries, and other interest-sensitive areas.

CHAIRMAN VOLCKER. On this debt figure: You have an enormous current account deficit projected. Is debt in those figures when it's held by foreigners?

MR. TRUMAN. Payment of interest on them?

CHAIRMAN VOLCKER. No, these outstanding credit figures that we have.

MR. PRELL. The credit aggregate excludes foreign borrowing.

CHAIRMAN VOLCKER. So you already have a high figure for credit, excluding that \$75 billion or whatever it is of foreign holdings.

MR. MORRIS. That excludes foreign borrowing; it doesn't exclude foreign investment.

MR. PRELL. No, it doesn't. Indeed, part of the counterpart in the current account deficit will have to be a substantial flow of funds into the U.S. Treasury.

CHAIRMAN VOLCKER. Is that included in those credit figures? That's what I'm asking.

MR. PRELL. Well, it's the supply side, and--

CHAIRMAN VOLCKER. The credit figures are built up from the debtor not from the creditor. It says domestic.

MR. GRAMLEY. Yes, domestic borrowing.

MR. WALLICH. Regardless of who holds the debt.

MR. PRELL. That's right.

MR. BLACK. Mr. Chairman, we have been for some time more bullish than the staff and we still are a tad more bullish for 1983. It seems to me that every time we get a wave of new statistics they suggest that there is more strength out there than we had previously assumed. So, we end up with a slightly larger real GNP for 1983 and a bit more inflation, although as the days go by and the [inflation] figures have come in better than I thought, I have less confidence in that for the short run. We do not have significant differences in 1983 but when we move into 1984 we begin to show many more differences because we believe we're going to have to pay the piper somewhere along the way for the large growth in M1. So, we end up with approximately the same kind of real growth but a larger implicit deflator. I don't know really how to answer [the question of] what is most likely until we deal with this policy problem. We're assuming certain things in regard to the behavior of the aggregates and we also assume more or less a return to normal velocity behavior, which may or may not occur. Until we know the answer to that, I don't think we're going to know the answer to where we will end up. But so far as the implications for policy that you asked us to address earlier, the implication I draw from that is that we're going to have to move to some degree against this burst in M1 that we have had.

MS. TEETERS. I came out with almost exactly what the staff did for the calendar year 1983 but I am lower for 1984 because I think the level of interest rates will bite once [unintelligible] accommodated. Consequently, I think interest rates will have to go down if we're going to keep [the recovery] going. However, I think the most important assumption here on inflation is the constant level of oil prices. I think it's a reasonable assumption because of the excess capacity that's available in the world and the conservation that has occurred over these 4 or 5 years. If oil prices break loose for whatever reason, then all of our forecasts are going to be wrong. And that has been the major source of much of the inflation in the past 10 years. So, I can accept the staff's forecast, but I do think there's more of a problem of slower growth in the year 1984 than they are currently forecasting.

CHAIRMAN VOLCKER. Well, if that concludes the comments that people want to make, we can turn to Mr. Axilrod and we can have technical questions anyway on his proposals and comments. We'll quit at 5 o'clock.

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

CHAIRMAN VOLCKER. I'm not sure I understood that next to the last sentence.

MR. AXILROD. Well, there is some question, at least in my mind, that the rate of real growth might not be as high as we have projected.

CHAIRMAN VOLCKER. You say that inflation might then be higher?

MR. AXILROD. To lower the level of real rates--

CHAIRMAN VOLCKER. Suppose velocity were lower?

MR. AXILROD. If velocity were lower? Well, I think velocity then would be higher, if we have higher price increases.

CHAIRMAN VOLCKER. Suppose we don't have higher prices but lower; that could be some funny kind of outlook if we got lower real growth and more inflation.

MR. AXILROD. Lower real growth than projected and more inflation than projected.

CHAIRMAN VOLCKER. You're assuming you know what nominal GNP is, I guess.

MR. AXILROD. No, I was making an assumption that the real interest rates in our forecast and the real GNP in our forecast might be inconsistent and that to make them consistent I would have to lower the real interest rates. I could lower them in one of two ways: either by raising prices, which might be a very reasonable outcome, or by lowering the level of nominal interest rates to make this level of real GNP more sustainable if prices are indeed as low as projected.

CHAIRMAN VOLCKER. You raise a great many questions about velocity. Let's maybe take the next 5 or 10 minutes for hearing what anybody has to say about it.

MR. GRAMLEY. I'd like to ask a question. What specifically do you assume for M1 velocity for the latter half of this year?

MR. AXILROD. That was in Mr. Lindsey's [memo]; let me just track it down. It's an average of around 2-1/2 percent.

MR. GRAMLEY. I got a little shaky when I read his number.

MR. PARTEE. Compared to a cyclical [average] of 5 or 6 percent?

MR. AXILROD. Oh yes, it's much lower, but it's still a lot stronger than in the first half of this year.

MR. GRAMLEY. I thought I saw a number that said 5.

MR. AXILROD. You did; for the fourth quarter you saw a 5.

MR. GRAMLEY. So, you have a zero in the third quarter and a 5 in the fourth quarter.

MR. AXILROD. Yes. And I would say, if anything, that would tend to be high. That assumes a very low growth rate in the fourth quarter and assumes some considerable responsiveness to somewhat higher interest rates, which is built into our forecast.

MR. BLACK. Steve, excuse me, but are you saying that you think the velocity forecast may be a little higher than you really believe?

MR. AXILROD. Well, I think the fourth quarter, which Governor Gramley was focusing on, may be a little high.

VICE CHAIRMAN SOLOMON. I admire the consistent and persistent courage of the staff in trying to forecast velocity of circulation of M1. I suppose they have to do it here. The swings are so enormous and so arbitrary and there's so little predictability that I shudder at the thought that we're really going to come out with monetary policy conclusions--specifically, targets for M1--based on velocity of circulation or something.

MR. ROBERTS. Are you suggesting that the velocity of M2 is more stable?

VICE CHAIRMAN SOLOMON. Oh, definitely. I'm not going back over 20 years. I looked at the 20-year average too, but if you look at it in terms of the last few years and the current situation, M2 and M3 are running at pretty much zero velocity--exact relationships to nominal GNP.

MR. PARTEE. There was a decline of 5 to 6 percent last year, as I recall, in M2 velocity.

MR. AXILROD. President Solomon, we don't really project nominal GNP by making assumptions about velocity and tying that into money. We tend to do it somewhat more judgmentally and then see what velocity results we have and see if that makes a certain sense to us. We have a large range of tolerance around the variations of velocity.

MR. BALLE. Mr. Chairman, I'm having a hard time trying to reconcile what I thought were the central conclusions of the staff studies made here at the Board plus staff studies at our Banks with what I think I am hearing from Steve and some of the skepticism about how much reliance we can have on M1--whether or not we should reinstitute it as a target for monetary policy and return to giving it equal weight. I just wonder if I could raise a few questions to [assemble] some facts or at least some judgments, Steve. Am I wrong in thinking that your findings pretty definitely show, now that we have the history of this period since the introduction of MMDAs and Super NOWs behind us, that on balance M1 has not been distorted--that the ins and outs just about offset each other, contrary to what most of us thought would happen a year ago? So, if I'm right on this, we can no longer take the position that one of the reasons we should deemphasize M1 is that it is being influenced by these institutional developments and new accounts. That's the first question.

MR. AXILROD. Well, on balance, we don't think the measured level of M1 has been distorted by the Super NOWs and MMDAs. We think there generally have been offsetting flows in that respect. We think that M1 was distorted by the introduction of regular NOW accounts at the beginning of 1981 on a nationwide basis; they introduced a savings character to M1 that it didn't have before. And seemingly, so far as we can judge from the past year's behavior, that has made M1 in technical jargon more interest elastic. The reason it has made it more interest elastic is that unlike demand deposits, these accounts have a 5-1/4 or 5-1/2 percent explicit interest rate, so the fall in market rates from 20 to 8 percent has reduced the opportunity cost of holding these to, say, at the low end, 3 percent--[the difference]

between 8 and 5 percent. So, they have moved more sensitively than they would have if they had a zero explicit interest rate; one would have had a much bigger loss involved if one had held [demand deposits].

Now, what I don't know is what happens on the reverse side of this. If interest rates begin going up, do we get a fast move out of these accounts just as we got a fast move into them? If we do, then we would have some hope of NOW account growth slowing and money growth slowing. The second thing that has been a problem in M1 is that we simply have not forecast or made the judgment that demand deposits would grow as strongly as they have. Demand deposits have grown very strongly and steadily since late last year, except in January and February. I cannot offer the Committee a very strong explanation for that. In large part, it might be compensating balances; and it also might be a foreshadowing of some transactions needs. So, there is a large element of uncertainty about M1 because it is a new animal. That's why I sound somewhat ambivalent about whether the Committee should or shouldn't go back to it as strongly as before.

MS. TEETERS. Steve, if your interest elasticity theory is correct and you have a big exodus from M1 as interest rates rise, doesn't that just transfer the more rapid rate of growth to M2?

MR. AXILROD. Well, it depends on where it goes. If it goes into market instruments, no; if it goes into other accounts that are in M2, it's sort of a wash. You're just left with M2--

CHAIRMAN VOLCKER. If it goes into other accounts, then the answer is yes.

MR. AXILROD. No, not if it goes into other accounts in M2. It's neutral; it's reducing M1.

CHAIRMAN VOLCKER. Neutral? If it goes in the market, it will reduce M2, too.

MR. AXILROD. [That] reduces M2; if it goes into other accounts in M2, it has no effect on M2.

MR. MARTIN. But you're not saying that the demand curve has shifted. You're saying the demand curve probably has a different configuration.

MR. AXILROD. Well, that get's into higher metaphysics in some sense.

MR. MARTIN. We're pretty high in metaphysics already!

MR. AXILROD. I happen to think that the demand curve has changed its slope and that maybe we're moving down the slope of a different demand curve. Whether that's a shift or not, I don't know.

MR. MARTIN. It's not a shift.

CHAIRMAN VOLCKER. Did you have further questions, Mr. Balles?

MR. BALLEES. Well, I think Preston asked the question I had in mind. In other words, your conclusion--it is mine and if you disagree, Steve, I hope you would say so--is that what we have seen is the surge of money responding to the drop in interest rates, and that's not a shift in demand for money but a moving along a given demand function. If that is true, based on the experimental Board models that you unveiled for us at the last FOMC meeting and on work that we've been doing at our Bank, I end up judgmentally concluding that the demand for money has not really shifted in any basic sense relative to income and interest rates in the last couple of years. If that's true, then I am forced to conclude that from this point on we need to put more emphasis on the growth rate of M1. Now, if that is wrong, tell me why you think it's wrong.

MR. AXILROD. Whether or not one would tend to put more weight on M1, I happen to think that it's different from the way it was before 1981. I think it's probably more interest sensitive than it was before. I would not conclude from that that I could use that same interest sensitivity in making my judgments in the future because Super NOWs have become more important. And I have a vague feeling in my gut that when interest rates go up, people, once they have these NOW accounts, are not going to move as rapidly to get out of them as they did to get in. Now, that's just a gut feeling. But that, too, would affect these interest rate/money relationships.

CHAIRMAN VOLCKER. If we're approaching gut feelings, we're going to stop soon! We have Mr. Morris and then Mr. Corrigan.

MR. MORRIS. Mr. Chairman, I think there's something new on the horizon as far as the aggregates are concerned, and that is the 5 percent capital limitation on large banks and the impact that may have once we get back to an era where we see strong demand for business loans occurring again at the large banks. I think we will find a number of banks running into this limitation and doing what they did in 1969--packaging these loans and moving them out into the market. So, what will happen is that we will get a slower rate of growth of bank liabilities and a larger rate of growth in market instruments, which might impact both M1 and M2 and have some relevance to the usefulness of M3 as a target. Have you given any thought to this?

MR. AXILROD. No, not in exactly those terms, President Morris.

MR. MORRIS. But would you agree that there is a further potential here for a different kind of bank behavior?

MR. AXILROD. Well, you're right that the M2 measure does cover a large variety of financial institutions, including money market funds. If they are packaging those loans and happen to be selling them to instrumentalities other than those covered by M2, we wouldn't particularly get it. My mind is working in other ways. I would think that they might be doing that; but if the capital controls were of real concern, we might at the margin get a little more rationing and a little less interest rate pressures. I know that's not a popular view, but that is not exactly impossible if the capital controls are very effective.

MR. MORRIS. Yes, but in 1969, when we had a similar situation whereby the large banks were constrained by Regulation Q, we saw a big ballooning in open market borrowing by the corporate sector.

MR. PARTEE. But they were constrained week-by-week by Regulation Q. This capital ratio is going to be imposed periodically. The first thing I think I would do if I were a big bank would be to be over until the time of the calculation of the ratio and I could adapt and bring it down. I think it would take a while to catch up with that. I agree with you as to the direction, but I think it will be much less marked than the Regulation Q ceiling was.

MR. MORRIS. But it could still change the percent of credit raised through the banking system as against the open market.

MR. AXILROD. One could have argued in that period, equally convincingly, that it was the control of M1 also--it went to almost no growth--that got interest rates up. As interest rates went up, what happened in the financial markets in the distribution of credit between banks and others was determined by the Reg. Q ceilings, which were an impediment to banks competing. And then that credit got pushed off into other sectors. Something like that could happen with capital controls; possibly there could be some degree of rationing there. But look, what causes the interest rates to rise? That might be a question one would have to argue about. It might be that the control of money, somehow defined, causes the interest rates to rise.

MR. CORRIGAN. I'd just make a brief comment on this M1 issue. A fellow who works for me did basically the same analysis that Mr. Lindsey did, approaching it in a completely different way, and came to the same conclusion: that he could explain the growth of M1 by interest rates and income and all the rest of it. My problem is that I don't believe either one of them. Just to approach it a slightly different way--admittedly, this is a very crude measure--we took the experience of the Ninth District on the Super NOW accounts and extrapolated it nationwide. We said: What would M1 growth look like if the average dollar value of Super NOW accounts had stayed just where the average dollar value of NOW accounts was, at roughly \$5,000 as opposed to \$16,000? When you do that calculation, at least on this crude extrapolation that we did, you end up with the implied M1 growth rate, excluding that marginal savings associated with the higher Super NOW account balances, of 5 or 6 percent over the first half of the year. That probably understates it too. But I just cannot believe that one can explain what we've observed in M1 by simply assuming that the new shifts into Super NOWs and into MMDAs account for all that moving around. I just can't accept it.

MR. AXILROD. Well, we have our estimate of the amount of money that goes into the Super NOW accounts from outside M1. We put it most recently at about 35 percent. The latest Michigan survey, the one we have through May--and they are very variable month-by-month given that it's a small sample--[puts it at] 40 percent; the earlier ones had a lower number. So, we said somewhere around 35 percent. If you take 35 percent of something a little over \$30 billion and take 3 or 4 percent of something over \$300 billion, you tend to get offsetting numbers. That's how we're stuck.

MR. CORRIGAN. I have about as much faith in those numbers as you do. But even if they offset, it seems to me that you have to concede that a \$15,000 average balance has substantially more of a savings component than a \$5,000 balance, much less the balance of an old demand deposit. And that's why I have a great deal of difficulty with Dave's and my staff's analysis.

MR. AXILROD. Well, you're left thinking that 65 percent of the money shifted from regular NOWs and demand deposits and sort of skimming off the top.

MR. CORRIGAN. Yes, but that implies that the underlying--

CHAIRMAN VOLCKER. I think we will have to continue this discussion at a later date and resume tomorrow at 9 a.m. in executive session.

[Meeting recessed]

July 13, 1983--Morning Session

CHAIRMAN VOLCKER. We can proceed as expeditiously as possible. When I look at these longer-term ranges, the staff has not given us much alternative for M2 and M3. If one takes that as the point of departure, in the interest of moving reasonably rapidly, first let me ask the question, just for 1983 now--and I will leave M1 until later where undoubtedly there will be some differences: What about the proposition of just keeping the same target ranges for M2, M3, and total credit? I understand that we're [near] the top of the M3 range now but within it; I don't know whether we're at the top or not but we're now basically at the top. We're at about the middle of the M2 range. The staff analysis says it's all right. Is that acceptable? Is it that simple?

SPEAKER(?). Yes, maybe.

MR. MARTIN. They're wide ranges.

CHAIRMAN VOLCKER. All right. Why don't we just go to 1984, again forgetting about M1. Here the staff has given us a massive choice, if we take them literally, of a 1/2 percentage point difference in the ranges. I take it the difference here is mainly whether, in terms of consistency, our long-term posture of pulling them down by 1/2 percentage point or whatever is worth doing or not.

MR. WALLICH. I think we ought to keep pulling them down first, because according to the staff nominal GNP growth is slowing and second, just as a general anti-inflationary action.

MS. TEETERS. That's fine, Henry, if we don't respond to them when they go over the ceiling because if we do, we're going to have to keep the interest rates up.

CHAIRMAN VOLCKER. Not theoretically, if nominal GNP growth is slowing.

MR. BOEHNE. Just as a point of fact: Doesn't M2 grow between 9 and 10 percent almost no matter what we do?

CHAIRMAN VOLCKER. That has been true for the last few years; it's certainly true as an empirical observation.

MR. WALLICH. That [reflects] the amount of interest added. If people sit there [earning] 8 percent interest and do nothing, that's how much it grows.

MR. RICE. I think that makes sense. I think Henry is right because it would be consistent with what I'd like to see over the long run when we look at what happens out to 1986. We seem to get the best results, from the point of view of both real growth and price performance, if we slow growth in the first two years--that is, the latter part of this year and next year--and permit somewhat faster growth in the last two years. And reducing the top side of the ranges would indicate our intention to reduce money growth during this early part of the cyclical expansion.

CHAIRMAN VOLCKER. What is the nominal GNP growth projected-- I didn't bring those figures--for 1984?

MR. KICHLINE. The staff has 8-1/4 percent [fourth quarter-to-fourth quarter].

MR. MARTIN. But under the unchanged alternative [shown in the Bluebook] nominal GNP is 8.7 percent for 1984. In other words, we're giving up 1/2 point of nominal growth if we follow the configuration of reducing that aggregate.

MR. KICHLINE. No, we had an M2 that was about in the middle of that range to begin with.

MS. TEETERS. Which range?

MR. KICHLINE. For M2 we have 8-1/2 percent, or in the 8 to 8-1/2 percent area for 1984.

CHAIRMAN VOLCKER. The 6-1/2 to 9-1/2 percent--

MR. MARTIN. So, we're giving up about 1/2 point of both real growth and nominal growth if we adhere to alternative I for 1984, right?

MR. KICHLINE. Well, I think the alternative ranges for M2 have [nearly] the same numbers, don't they? It's a matter of where you might place it in the range. Perhaps I am not--

MR. AXILROD. Well, we allege that the long-run ranges for alternative II are consistent with the staff's GNP projection. So, it would be a dropping of M2 roughly--

CHAIRMAN VOLCKER. Roughly to the midpoint of that.

MR. AXILROD. The midpoint of that, we allege, is consistent with the staff's [nominal] GNP projection of 8.3 percent. As Jim was pointing out, the Committee's GNP projection is somewhat stronger than this 8.3 percent.

MR. WALLICH. Isn't the projection going through 1983-84 and then 1985-86 for the unchanged [alternative] 8.5 percent for M2? It seems to produce a so much better result that I think it is somewhat implausible. Doesn't that reflect the low sensitivity of the model, which throws all the weight on a reduction in real income and gives very little to a reduction in inflation?

MR. AXILROD. That's right, Governor Wallich. Actually, I hesitated a lot about whether to present these strategies in these quantitative terms, which are simply the model's extrapolations from a baseline forecast. I had hoped they would be useful in terms of general direction but, as we say in the text, there is not much price effect from carrying on at 8-1/2 percent [for M2]. And, possibly, the model also is underestimating the sensitivity of decisionmakers in the economy.

MR. MARTIN. That's an appropriate caveat but, nevertheless, for 1985 you have a real growth differential there of 100 basis points. Is that not right? Our expectation is 100 basis points--

MR. AXILROD. Yes, if you are comparing strategies 1 and 2.

MR. MARTIN. The difference in the real growth of [strategies 1 and 2] is 100 basis points.

MR. AXILROD. Oh, sure, off the models.

MR. KICHLINE. I'm sorry, yes.

MR. MARTIN. That's what we're dealing with. You might not believe it, Henry, but that's what we have; that's where we started.

MR. AXILROD. Well, these are model results, that's right. I didn't realize you were comparing those, Governor Martin.

MR. MARTIN. I'm just looking at page 11, 1985 real GNP.

CHAIRMAN VOLCKER. 1985?

MR. MARTIN. Yes, the percent increase for 1984 and 1985. Comparing the model's output, which we've been properly warned has a dispersion around it that's considerable, under the two alternatives for 1985 the model produces 4.1 percent real versus 3.1 percent-- comparing [strategy] 2 with [strategy] 1. And for 1984 the model produces 4.6 percent versus 4.2 percent. Also, as Governor Wallich has pointed out, the model is showing that there's not as large an impact on the deflator as there is on the real GNP growth. And if that's quite right, we must accept the caveat that this is the output of the model.

CHAIRMAN VOLCKER. Yes, but wait a minute. If I read this right--I hate to put all this weight on these things--for 1984 there are two rows that are consistent with alternative II, right?

SPEAKER(?). The ones through 1984, yes.

CHAIRMAN VOLCKER. At least through 1984 you're talking about 8-1/2 percent [growth in] M2, if I understand correctly.

MR. BLACK. That's the one.

MR. AXILROD. In 1984 we're talking about 8 percent for M2 and that's consistent with alternative I.

CHAIRMAN VOLCKER. I thought Mr. Kichline said 8-1/2 percent.

MR. KICHLINE. I'm sorry, Mr. Chairman.

MR. AXILROD. But the one row also assumes further reductions thereafter. So, it's a much more restrictive policy going out.

MR. BALLE. It's down 1/2 percentage point each year.

MR. RICE. Steve, in your judgment, would it be correct to say that you get these results from the model in part because of the phase of the cycle that we're in? In effect, what seems to be the outcome is that if you start to slow money growth in the expansion phase and speed money growth just before the rate of real growth begins to slow down, you get the better result.

MR. AXILROD. That's right.

MR. RICE. So, if we are in a period that is just on the edge of contraction, we'd get better results if we increase the rate of money growth.

MR. AXILROD. Well,--

MR. RICE. I'm just accepting the [model] outcome; this is not my view.

MR. AXILROD. Basically, Governor Rice, the problem with using the model--and what has always given me some pause at least in presenting the results the model gives to the Committee--is that the model has embedded in it a long lag in price effects and a short lag in output effects. And it's not at all clear that that is the way the world works at this very time. That's essentially why every time we present [an alternative] that says money growth is going to be stronger, [the economy] will always look better over the near-term horizon. Output will always react faster than prices. And, of course, the nearer we are to high levels of unemployment, in practice one would think that's the most sensible thing. So, that is one of the problems in presenting these results; it always looks more favorable in the near term to raise money growth. I would point out strategies 3 and 4. Strategy 3 slows M2 growth even more than any of the alternatives presented and then speeds it up in the latter part of the 4-year period. That, according to the model, has a very favorable effect on prices by 1986 relative to speeding up now and slowing later.

MR. RICE. Right.

MR. AXILROD. And output is no worse off by the end of '86 than [under strategy 2], which was a somewhat surprising result to me.

MR. MORRIS. I'd like to suggest, Mr. Chairman, that the model has one basic flaw and that is that the character of M2 in 1983 and the years to come is radically different than the character in the years before. And we have no reason to think that we can anticipate how the relationship of M2 is likely to behave relative to nominal GNP. That is the thrust of Mr. Lindsey's memorandum. We could very well see a situation in which we push interest rates up and M2 responds by rising, depending on whether the banks want to fund themselves through money market accounts or large CDs. It seems to me that the model simply doesn't have any rational basis.

MR. GRAMLEY. I just wonder if we're not taking this setting of the target for next year a bit too seriously here. We're talking about 1/2 percentage point on a 3 percentage point range with a variable whose linkage to GNP is rather uncertain. I think mainly what we should be concerned with is the cosmetics of this. We're not

setting policy here for the next 3-1/2 years; we're setting the target for M2 for next year.

MR. MARTIN. Well, that is--

MR. WALLICH. If that is the case, don't you think we should have a declining target?

MR. GRAMLEY. I'm inclined to go in that direction, yes. I don't think the difference between 7 to 10 percent and 6-1/2 to 9-1/2 percent is going to be all that constraining in terms of the course of policy. We could change it next February if we wanted to.

MS. TEETERS. We never do, though.

MR. GRAMLEY. Oh, we're changing them right now as a matter of fact. That argument is quite incorrect.

MR. PARTEE. Nancy is right; we have never increased them.

MR. GRAMLEY. We did last year.

MS. TEETERS. Last February was [unintelligible].

MR. GRAMLEY. We had a target of 6 to 9 percent and this year we have 7 to 10 percent. So, I'm reasonably sure that if we have to change it, we could change it in the future.

MR. MORRIS. Yes.

VICE CHAIRMAN SOLOMON. My thinking also is that this is tactical. No matter what we do on M1--whether we raise it, rebase it, or suspend it--there's going to be a certain amount of unhappiness. Therefore, it's probably just as well to reduce [the M2 range] 1/2 point for next year on account of [unintelligible].

CHAIRMAN VOLCKER. Let me raise a question about total credit. We have this figure running higher than GNP--I forget by how much--at least in the projections for this year; but it's peculiar in terms of history. And we have a relatively high total credit target this year. It may be appropriate or it may not be, but we maintain that relationship next year if we only reduce that by 1/2 percentage point along with everything else, assuming we do that. Is that really appropriate? I guess I'm looking at the staff. Wouldn't you expect credit to move more in line with GNP over time?

MR. AXILROD. Do you mean should you reduce it even [more]?

CHAIRMAN VOLCKER. Reduce it, say, by 1 point or something instead of 1/2 point.

MR. AXILROD. Well, in establishing the [M2] range for this year, the Committee had raised it a point from what the staff had [suggested] and the aftermath of it is that it looks rather wise to have raised it since we are running in the middle of the raised range [and above the midpoint of] what the staff originally had.

CHAIRMAN VOLCKER. Either that or we've got the wrong policy.

MR. AXILROD. So, I personally would recommend a bit of caution and I would recommend lowering it by the same 1/2 point that you're going along [with for the other aggregates] at this point. It is running a bit strong and I have no reason to think it will drop substantially. It ought to drop some.

MR. MORRIS. I would agree with that; I think that 11-1/2 percent is too high for 1983.

MR. PARTEE. I agree with Paul that it ought to be a point.

CHAIRMAN VOLCKER. What do you agree with, [Frank]?

MR. MORRIS. I agree with lowering it for 1984 to 11 percent.

MR. PARTEE. He wasn't quite sure if you wanted to lower it a half or a full point.

MR. MORRIS. I think a 1/2 point.

MR. PARTEE. I agree with Paul that it ought to be a point because I think we want a smaller growth in nominal GNP.

MR. MARTIN. I'm delighted to hear you mention nominal GNP or something relating to the real world rather than the Ms. It seems to me that the tactical discussion has had to do with how we appear with regard to targeting on the intermediate basis of the Ms. If there is any strategic aspect through the model's output as delineated on page 11 [of the Bluebook], it is that our objectives are nominal GNP and the other general output data rather than the Ms. So, I go back again to the aggregates [relating]--however weakly in the model--to economic activity, not the Ms. And I suggest that we look again at those aggregate figures for nominal GNP.

MR. PARTEE. Well, my point was simply that the staff's forecast from fourth quarter-to-fourth quarter for nominal GNP is 9.6 percent this year and 8.3 percent next year. That seems like a pretty favorable outcome. In any event, that's a drop of more than a point in nominal GNP and I think there ought to be a similar reduction in the credit aggregate itself. So, I think a point [reduction] is the proper amount rather than a half point.

MR. MORRIS. But I think we ought to give some weight to the fact that we have a very optimistic inflation forecast in '84.

MR. PARTEE. Well, if you thought inflation was going to be [higher], would you want to be easier or tighter?

MR. MORRIS. Well, I think one has to make a judgment as to whether a 4-1/2 percent real growth rate would be excessive for '84 or whether we should allow perhaps for a little less favorable result on inflation than we're forecasting.

MR. PARTEE. Well, I have a little less favorable forecast and it still works out with a point reduction in the credit growth.

MR. RICE. If the exercise is cosmetic, basically, I think a half point is as good as a point.

MR. PARTEE. Well, a point would change it from cosmetics to real policy.

MS. TEETERS. What do you propose to do with that credit aggregate if it doesn't fall within the range? What action would that trigger?

MESSRS. PARTEE and MORRIS. A change in interest rates.

MS. TEETERS. I'd put it down to [unintelligible]; suppose it falls at the bottom annually.

MR. PARTEE. Lower them.

MR. RICE. I don't think you would.

MS. TEETERS. I don't think you people know what the relationship of the credit aggregate is to GNP, quite frankly.

MR. MORRIS. I think we know a lot more about that than we do about the new M2 to GNP.

MS. TEETERS. That may be, but I think we know an awful lot more about [the relationship of] interest rates to GNP than we do anything else.

MR. MORRIS. The demand for credit is directly related to the level of interest rates. The level of M2 may or may not be.

CHAIRMAN VOLCKER. I don't think we know a lot about the relationship of interest rates to GNP. We didn't have a very good forecast six months ago.

MS. TEETERS. I did.

CHAIRMAN VOLCKER. You would have thought it wouldn't come out.

MR. RICE. Well, I don't think we would take any action at all on the basis of the credit aggregate alone.

MS. TEETERS. If we lower these targets at this point in time, we're going to give the impression that we're going to tighten next year. And I'm not sure that that's a good psychological thing to dump on this society at this point.

MR. RICE. Psychologically, I think it's a good thing.

MR. WALLICH. It's hard for me to believe that a more anti-inflationary posture should have a long-run effect of raising interest rates. It might have an immediate market effect, but the setting of these targets isn't really an immediate market factor.

MR. BLACK. I agree with all this talk about cosmetics, but I certainly would like to see somebody say something about taking the ranges seriously, too, along the way.

VICE CHAIRMAN SOLOMON. Why don't we use the word tactical instead of cosmetic?

MR. MARTIN. Why don't we use the word tactical and concentrate on the strategic aspects of it?

CHAIRMAN VOLCKER. Well, I don't think it's just tactical or cosmetic. It depends upon, at least to some extent, indicating one's concern about pulling these [ranges] down over time and whether we're interested in moving toward price stability or not.

MR. BLACK. I'd like to see a large element of that in the talk. But I do think it has a cosmetic or--

CHAIRMAN VOLCKER. We don't discuss that subject much, but I think it's going to be coming up. To what extent do we really want to get to price stability in the fullness of time?

VICE CHAIRMAN SOLOMON. Coming back to the question of whether to lower the credit target 1/2 point or 1 point: If we are lowering the M2 and M3 ranges 1/2 point and we lower the credit target more than 1/2 point, it implies a precision and knowledge on our part whereby we can differentiate between 1/2 point and 1 point. And I'm a little worried about that.

CHAIRMAN VOLCKER. I agree that that is pseudo-precision. But I think what we would say is that the credit target is a little high this year relative to its long-term trend. We did that deliberately. And it appears all right in terms of this year but we don't want it high relative to its long-term trend indefinitely. That target was temporarily high in some sense relative to the other targets and we're now putting it back more in line with what we think the long-term trend is in relation to the other targets.

VICE CHAIRMAN SOLOMON. If you feel comfortable and still [think] it is a time of--

CHAIRMAN VOLCKER. Well, it always looked a bit awkward to me. It may be right or wrong this year, but the long-term growth trends of credit and nominal GNP are pretty even, if I remember correctly. And we have a target that implies more [growth in credit than in nominal GNP]; it's high relative to the other aggregates now in terms of long-term trends, to the extent one can make any sense out of this. It's just a question of whether to say--

VICE CHAIRMAN SOLOMON. Do we know why it's high this year?

CHAIRMAN VOLCKER. Well, I asked that question yesterday. I'm not sure I got a very satisfactory answer, but--

MR. RICE. Government borrowing--the deficit.

MR. GRAMLEY. Easy money.

CHAIRMAN VOLCKER. More intermediation and more liquidity is the answer I got.

VICE CHAIRMAN SOLOMON. But bank lending has been pretty flat and we're still going to have the big federal borrowing next year. And I think bank lending may be stronger; the equity market may not be as strong next year. So, it may very well be that we will still tend to see [growth in] the credit aggregates slightly above that in GNP.

MR. MORRIS. But I think the 11 percent [top of the range] will give us plenty of leeway.

MR. GRAMLEY. Yes, 11 percent is all right; even 10-1/2 percent would be.

CHAIRMAN VOLCKER. Well, we're talking about whether to make it 11 or 10-1/2 percent at this point.

MR. AXILROD. Our point estimate, Mr. Chairman, for what it's worth, is that credit growth fourth quarter-to-fourth quarter in 1984 --with our assumption of nominal GNP growth of 8.3 percent--will be 9-3/4 percent, which follows our estimate for this year of 10-1/8 percent. So you are right: Credit growth is continuing to run about 1 to 1-1/2 points above our nominal GNP estimate. If the Committee goes with its nominal GNP [estimate], it's much more in line.

MR. MORRIS. You're right, Paul: It is high relative to the ranges for M2 and M3. But that's because we are thinking about the midpoint with respect to debt and we're thinking about the target as the upper limit with respect to M2 and M3.

CHAIRMAN VOLCKER. Well, not on the staff's forecast; it depends upon what forecast we have. But I think that is true if you take the Committee's forecast. If you take the staff's forecast, it's right at the midpoint, roughly.

MS. TEETERS. The midpoint of 7 to 10 percent is what they have?

CHAIRMAN VOLCKER. They are assuming M2 growth of 8 percent.

MR. GRAMLEY. 8 percent in 1984.

CHAIRMAN VOLCKER. Which is exactly the midpoint [of the 6-1/2 to 9-1/2 percent range of alternative II].

MR. MORRIS. Yes, but I think you overlook the fact that in the second year of an expansion the velocity of M2 normally drops.

CHAIRMAN VOLCKER. Well, let me divide it up. On M2 and M3 we go down by 1/2 point. At least nobody has talked about going down more than 1/2 point. The question it seems to me is unchanged or down 1/2 point for M2 and M3. Is the consensus down 1/2?

MS. TEETERS. I'd prefer to leave [the top] at 10 percent.

MR. MARTIN. I would too.

MR. RICE. I'd prefer to see it down on the top side and not the bottom--alternative III. [Unintelligible] tactical.

MR. PARTEE. That's a pretty good idea.

MR. BLACK. Yes, it is.

MR. BALLE. Alternative III makes a lot of sense.

MR. BLACK. Nobody says it's the level of--

MR. BOEHNE. Well, the only thing to say against that, and I don't think it's overly persuasive, is that if we narrow the range we somehow indicate that we have more confidence and more accuracy.

CHAIRMAN VOLCKER. That's a little peculiar.

MR. BOEHNE. Yes.

MR. BLACK. And it moves the midpoint only 1/4 of a point.

MR. PARTEE. Or [it suggests that] we're more worried about a rapid expansion so we show our interest by cutting the top end. In case we get a very rapid expansion, we indicate resistance. I think that's reasonable. I'll go with that.

MR. RICE. Except that I'm not worried about a rapid expansion.

MR. BLACK. What would you--?

MR. MORRIS. Some people are worried about a rapid expansion.

MR. RICE. Some people.

MR. PARTEE. Do we want to raise the bottom and leave the top the same?

CHAIRMAN VOLCKER. Well, it can be rationalized. I think it will give us a little trouble; it depends on what you think about the amount of emphasis put on this. I can see comments arising such as "Oh, you are even more intense on these aggregates because you have the range narrower."

MR. MORRIS. Mr. Chairman, in the last three expansions, in the second year of expansion the velocity of M2 declined on the average about 2.6 percent.

MR. PARTEE. Well, you were making the point earlier, Frank, that we had a different M2 than we did before. And, therefore, the velocity of M2 won't do what it did before.

MR. MORRIS. But if [the premise] is that we don't know what the velocity is today, then we shouldn't have a target for M2. And that is my position.

MR. BLACK. Frank, that's going to lead you down a primrose path on M1, to something you don't want, if you look at what it usually does.

MR. WALLICH. I think the main principle here is that we ought to bring the targets down and avoid fine-tuning. We don't know

enough about it. [Unintelligible] the lower end and the upper end, just mechanically bringing them down.

MS. TEETERS. You can take the opposite point of view. If we leave them alone, it shows we're ignoring them.

CHAIRMAN VOLCKER. I heard two people say they didn't want them changed at all. Is it only two people? Well, it seems that it's only two people. And I haven't heard anybody say he or she wants the tops below 9-1/2 or 9 percent, respectively. Is that true?

MR. MORRIS. My position, Mr. Chairman, is that we shouldn't have a target for M2, but--

MR. BOEHNE. My position is that I don't think it makes a lot of difference.

CHAIRMAN VOLCKER. I think we are between Bluebook alternatives II and III at this point. There are pluses and minuses for both of them. The idea of narrowing a range here doesn't particularly appeal to me but I guess it can be rationalized.

VICE CHAIRMAN SOLOMON. It doesn't appeal to me either for the same pseudo-precision reasoning that seems to be implied.

CHAIRMAN VOLCKER. I think we can justify it intellectually and say that we don't really conceive of it being below 7 or 6-1/2 percent, or whatever, and we're worried on the up side. But it does have this feeling of more precision. I don't feel strongly one way or the other.

MR. GUFFEY. I'd prefer to go down on both ends; there's some comfort in using the [wider] ranges.

MR. PARTEE. Well, if you don't have any strong preference, Paul, why don't you get a show of hands?

CHAIRMAN VOLCKER. Let's have a show of hands. Who would prefer alternative II? I'm just talking about M2 and M3--moving them both down by 1/2 point. Well, I'm not counting; I don't know whether you're counting. There seem to be quite a few hands up. How many want it down 1/2 point on the top and nothing on the bottom? That seems to be a clear minority.

Now, let me turn to total credit. Nothing here is settled finally. Just forget about alternative III for the moment. For total credit, if we're consistent--well, we don't have to be completely consistent between the two, I suppose--the question is whether to go down 1/2 or 1 point.

MR. AXILROD. Mr. Chairman, I would reiterate the point that in evaluating this it might depend on what GNP forecast the Committee chooses to go with for 1984, because by going down 1 point the midpoint would be below the present Committee forecast for 1984.

CHAIRMAN VOLCKER. [Unintelligible] gives you 9 percent as the midpoint. I don't know how all these forecasts will come out, but we're going to publish these forecasts as modified in the next day or

two along, [although there are some] people who wouldn't want to modify them. They must average about 9-5/8 percent or something like that for nominal GNP.

MR. AXILROD. No, that's right; I miscalculated or something.

MR. WALLICH. Well, if we don't lower credit by a full point, we're not lowering it relative to the other aggregates. I thought we had--

CHAIRMAN VOLCKER. I think that's the question. Do we want to lower credit relative to the other aggregates, given that in some long-term sense it's high now relative to the other aggregates?

MR. WALLICH. That is, I think, the logic of the situation.

MS. TEETERS. We haven't had deficits of this size as a long-term trend before.

CHAIRMAN VOLCKER. Well, I don't know whether that's the right interpretation. It may be that these numbers are high because of the big deficit and that in a sense we're accommodating some of the consequences of the deficit. If that's the reason that they're high, then the policy question is whether we want to accommodate that.

MR. PARTEE. I think the analysis is that we get less kick for the debt than we ordinarily do. That is, the relation between debt and GNP is off.

MR. RICE. Also, there won't be much growth [unintelligible] next year, if we get it all this year.

MR. MORRIS. But in any case we wouldn't want to see the rate of growth of debt exceed 11 percent in any scenario I can think of.

VICE CHAIRMAN SOLOMON. I don't think we have enough confidence in what the future trends are going to be--not only the large deficit, but also the changing institutional arrangements in the markets. So, it seems to me that the question we again come back to is: Why do we imply that we have that much [omniscience] to differentiate an extra half point on credit?

CHAIRMAN VOLCKER. I don't think this is too big a deal. What we would say is the opposite--that we implied [omniscience] in saying credit was going to be relatively high this year, which may be right, but it's not going to continue next year.

MR. WALLICH. Some people think it doesn't make much difference; other people think it does. So, I think those who think it does should be allowed to set the--

CHAIRMAN VOLCKER. Well into a recovery--I forget--should credit cyclically be rising faster or slower than GNP typically?

MR. MORRIS. In the second year in the last three expansions the velocity of debt declined by 1.2 percent and then it approached zero thereafter.

MR. GRAMLEY. What happens to interest rates, of course, is critical. And it will work primarily in the areas like the mortgage market, where you can have a substantial degree of variance between the amount of borrowing and the amount of residential construction. But I think your reasoning is sound, Mr. Chairman, that the range for debt is high relative to the broader monetary aggregates and that one would expect those things to converge eventually. And, therefore, we could go a percentage point now without too much damage.

CHAIRMAN VOLCKER. Well, who wants to reduce it by a half point, the same [amount] as the others? Who wants to reduce it by one point?

SPEAKER(?). We have nonmembers voting here, so you're confusing--

MR. MORRIS. I think one point would be acceptable.

CHAIRMAN VOLCKER. Well, let's leave that just for the moment and we'll get to M1. Let me approach M1 by indirection. There's a question of what weight to put on M1 and, whether or not it's in the directive, what we would say about it in the Humphrey-Hawkins report. It may be helpful to approach it in reverse. Look at 1984 first. This proposal of essentially 4 to 8 percent again, which is what we have now and are widely exceeding, would imply unchanged or a small increase in velocity to a sizable increase in velocity but less than typical.

VICE CHAIRMAN SOLOMON. The midpoint implies plus 2 velocity.

CHAIRMAN VOLCKER. It implies plus 2 or a little more on the staff forecast. It would imply more on the Committee members' forecasts, which are somewhat higher than the staff forecast.

MR. BOEHNE. Are these numbers in the context of giving the importance to M1 that it has been given the last few months or elevating it somewhat?

CHAIRMAN VOLCKER. Well, we're going to have to discuss that, but I--

MR. PARTEE. The 8 percent on M1 seems to me a little high, I must say. Didn't we add to that range in order to allow for special adjustments this year?

CHAIRMAN VOLCKER. I don't remember.

MR. PARTEE. I think we did, for Super NOWs and [unintelligible]. Well, we certainly didn't add enough. Now, we could say the relationship has changed and, therefore, we have an entirely different ball game.

CHAIRMAN VOLCKER. Well, with any of these I think we have to say the relationship has changed; we're uncertain about the degree. But even with the 8 percent we are implying a little increase in velocity. That wouldn't be unusual during this period. But I--

MR. PARTEE. No, it's an unusually low increase in velocity.

CHAIRMAN VOLCKER. With 8 percent, but not with 4 percent.

MR. WALLICH. It seems to me that under alternative I we're saying we're not going to pay attention to it because we can't get it back into the 4 to 8 percent range this year, so we have to monitor it, not target it. If we set it at 7 to 11 percent or something like that, we do something that has to be changed sharply for the following year and brought back to 4 to 8 percent or even lower, and I would prefer lower for '84. Now, wouldn't it be possible to rebase instead and not have these vast changes in targets?

CHAIRMAN VOLCKER. Let's discuss it together. I guess that is one alternative. We can start out again on M1 and then have the same target for the next year that we have for this year.

MS. TEETERS. May I ask you a question, [Steve]? I got the impression yesterday when you were talking about the developments in M1 that you don't really expect the rate of growth to slow down very much. Rebasing would get us out of this trap, but it's not necessarily going to get us back onto a 4 percent rate of increase from this period on, given the nature of the M1.

MR. AXILROD. Governor Teeters, we do expect the growth of M1 to slow down. The various models I've looked at all suggest that in varying degrees--some more rapidly than others. But we had been expecting it to slow down in May and June, so I felt somewhat cautious in light of that behavior. But the models--because the interest rate effect has worn out and there is some slight increase occurring and because nominal GNP growth is slowing--all would have slower M1 into an area reasonably [consistent] with these targets.

MS. TEETERS. So, rebasing would be one way of coping with the 1983 problem as well as the 1984 problem.

MR. AXILROD. Technically, yes.

CHAIRMAN VOLCKER. If he's right, it will all work out nicely. If he's not right, then we will have rebased and be over [the rebased range]. I think if we rebase it looks as if we're attaching more importance to it somehow.

VICE CHAIRMAN SOLOMON. My concern is that, as we've seen in the last couple of months, the markets have once again attached enormous importance to M1. All the speculation that the Fed is going to have to tighten is really coming from the M1 figure because even if there's a justification for some modest tightening from the broader aggregates, it's M1 that has been the discussion point, contrary to the period right after the initial Humphrey-Hawkins testimony in February. I think putting a numerical target on M1 [is unwise], whether we call it 8 to 12 percent, 7 to 11 percent, or rebase, although I would agree that rebasing may give a shade of nuance of extra [emphasis] compared to simply moving up to 7 to 11 percent. I think there's much to be said, in view of the arbitrariness and the unpredictability of what it's telling us, for suspending the target for M1 for the rest of the year and not at this time coming up with an '84 target range for M1. We would continue to monitor M1 and when it becomes a little more predictable then come in [with a range] at that point. I don't know how one gets around that problem.

CHAIRMAN VOLCKER. That's the extreme view of what we could do--not have any target for this year or next year.

MR. WALLICH. Well, another alternative would be to widen the range even further. We have widened it from 3 to 4 points; we could go from 4 to 5 points. I agree with you when you say that whatever we do, we are increasing the emphasis if we change it from 4 to 8 percent. If we rebase we may be increasing the emphasis beyond what we would if we went to 7 to 11 percent. Widening the range I think offsets that.

VICE CHAIRMAN SOLOMON. I think that's true.

CHAIRMAN VOLCKER. So, it's not just what we say [via] the numbers, it is what we say. We can say it's a target but we are giving it whatever weight we want to say.

MR. PARTEE. It seems to me that there has been some fear in the market about the need to come [down] toward the target range. Therefore, people are saying well, even if it were one or two [unintelligible] for the year. So, doing away with the notion that we're going to make up the overshoot, if that's our decision, would be a constructive thing for the market.

MR. BALLEES. I think that's a very good point, if I can break in and support Chuck's position on that. Moving to the alternative II range for M1 shown in the Bluebook for the balance of this year would make a lot of sense, because that range of 7 to 11 percent would accommodate about a 6 percent growth rate or a little better in M1 from June to December which, according to our San Francisco model at least, would provide sustained economic growth and no increase in inflation. We'd come in with over 5 percent real growth, based on our models, for both years. So, I would feel a lot more comfortable, and I would think we might defuse some of the market fears about what we're up to, if we were to adopt that. We realize what has gone on this year so far in M1 and we can't undo that; that would be totally unrealistic. I think we should defuse some of the market fears about what we may be doing by forthrightly coming out for a range of 7 to 11 percent, which in my view would accommodate the approximately 6 percent growth rate in M1 that we happen to think would be about optimal for the balance of this year and through 1984.

CHAIRMAN VOLCKER. Just to be sure: That 7 to 11 percent implies 6 percent from now on to hit 11 percent [M1 growth] for the year?

MR. BALLEES. Yes, a little better than 6 percent. That's shown on page 6 in the Bluebook in the final column to the right.

MR. GRAMLEY. That's June to December, not second quarter [to fourth quarter].

MR. BALLEES. Eleven percent for the year would allow 6-1/2 percent from June to December.

MR. BOEHNE. What about from July, since June--. Oh, June is the base.

CHAIRMAN VOLCKER. Yes.

MR. PARTEE. Well, I must say that I think there's something a little unfortunate about the numbers 7 to 11. Also, it sounds awfully high. My instinct would be to rebase.

MS. HORN. I favor rebasing, not only because I think it indicates some additional emphasis on M1, but also because it seems to me to indicate the Committee's recognition of what we've learned about velocity. It may or may not be the start of a rehabilitation of M1 in that we say we do look at M1; we do take it seriously, but we make corrections for velocity from time to time until we're a little more sure of our velocity forecast.

MR. GRAMLEY. A range of 4 to 8 percent rebased gives you about the same as 7 to 11 percent.

CHAIRMAN VOLCKER. Presumably, it's 8.1 percent on a second quarter-to-fourth quarter basis, which is exactly the--

MR. AXILROD. In response to Governor Gramley's comment, it depends on how you rebase. It doesn't quite [correspond] if you use Q2 to Q4 1983, because of the high growth that has already happened. The rate [of growth] from Q2 to Q4 is 8 percent--

MR. GRAMLEY. With an 11 percent--?

MR. AXILROD. That's right. So, if you rebased and said--

CHAIRMAN VOLCKER. As I understand this, if we rebase at Q2, the 8 percent would be the same as 11 percent for the year.

MR. GRAMLEY. I calculated the fourth-quarter levels using 11 percent from the fourth quarter of 1982 and 8 percent from the second quarter of 1983 and I got within \$1 billion.

CHAIRMAN VOLCKER. Well, it's 8.1 percent.

MR. BLACK. Mr. Chairman, I had in mind figures very similar to what John Balles mentioned, but I think the real issue is how the market will react best to what we do. My feeling is that it's better that we not rebase, although I understand fully the argument for it. Since you said you thought this would imply more emphasis on M1, which is what we also had concluded before we came here, that does argue in favor of [rebasing] from my viewpoint. But I believe the market would react a little better if we kept what we have and you just said that we doubt that we will hit it.

CHAIRMAN VOLCKER. Well, let me try this: Suppose we rebase and use 4 to 8 percent and say that we think velocity has changed some but we don't know how much. The 8 percent would allow for very little increase in velocity, which is possible, given what has happened. The 4 percent would allow for an almost normal increase in velocity from here on out. So, we're encompassing that kind of range. We're still quite uncertain about it and--this will be the tricky part--we're not putting full weight [on M1], certainly. Just how much weight we say we are putting on it is the fuzzy area, I suppose. We could go all the way to saying that we're monitoring [M1] but putting very little

weight on it. That's one extreme. Or we could say we have a pretty wide range and we would get concerned if [M1 growth] was too far outside that range in either direction, but we're not following it mechanically. Some place in that range of--

VICE CHAIRMAN SOLOMON. Could we have some further discussion of Bob Black's suggestion? I find myself in a strange alliance with him in favor of saying that clearly M1 growth is going to be way over our target because of velocity and not offering a rebased or raised target for this year.

CHAIRMAN VOLCKER. What would you do for the next year?

MR. MORRIS. Same thing.

VICE CHAIRMAN SOLOMON. Well, my own feeling would be not to offer [an M1 range for 1984] at this point. But even if the majority of the Committee preferred to offer a range for next year, that doesn't mean we have to come up with a new number for this year.

MR. PARTEE. I have a problem with your suggestion, Tony. It's Bob's suggestion too, but I'll address this comment to you because I think Bob might like what I would see as the difficulty. What if we get a very, very low rate of money growth? It could happen. And in the context of having the 4 to 8 percent range, people would say, fine, we are getting [M1 growth] back down into the range, and yet it might be indicative of a problem developing in the economy and we might want to try to encourage a little more money growth. If we rebase, we have an opportunity to do that; if we don't rebase, people will think we're happy to see M1 growth come down into the old range.

VICE CHAIRMAN SOLOMON. Well, I don't see that as a real constraint. We are operating, at least most of us here today, on a recognition that we have [to have] some further restraint because of the strength of the economy. We're not mechanically reacting to the [monetary growth] outcome.

MR. PARTEE. Oh, I understand that, but I think--

VICE CHAIRMAN SOLOMON. And, therefore, if the Chairman keeps enough flexibility, which I think he will, we can react to nominal GNP and the real economy. It seems to me that that would not be a constraint.

MR. PARTEE. When we forecast I think we are slow to recognize a change in the inflection of the economy. We were slow to recognize the rate of increase that is now occurring and that we all see. We will be slow to recognize the slowing, I think, and I would like to guard against that.

CHAIRMAN VOLCKER. The more I think about this, I believe the simplest thing to do is to rebase, if we're going to have a target for next year, instead of having a complete hiatus. The key issue is what we say about the degree of weight that we give to M1.

MR. MARTIN. I think that's right. And I think the market-- almost regardless of what we say unless we just repudiate M1, which I

don't think is the consensus of this group--is still going to follow it, put some weight on it, and think we are putting some weight on it.

MR. BLACK. We either rebase now or, if we overshoot our target, we rebase at the end of the year.

MR. PARTEE. That's true. That's quite true.

MS. TEETERS. We may rebase now and have to do it again at the end of the year.

CHAIRMAN VOLCKER. That is correct.

MR. AXILROD. Mr. Chairman, a technical point, which I was struggling to say in response to Governor Gramley's comment, has to do in some sense with the psychology of rebasing: Unless it turns out that the numbers we get very soon show that July is extremely weak, if you rebase you still will be starting out well above that rebased range. You're above the one now, of course. But in any event, if you base on the second quarter and plot July, you will be well above the range already. That may or may not have some implications for the market, depending on how it's expressed and what you say in relation to it. But I think it's a factor that ought to be considered in the analysis.

MR. WALLICH. Rebase on a shorter period.

MR. AXILROD. Well, you would have to rebase right on June.

CHAIRMAN VOLCKER. I'm not sure, but I think what you're saying is that if we had this 7 to 11 percent or whatever it is, we'd also be above the 11 percent.

MR. AXILROD. That's right. It's not any different in fact; it's just the question of psychology.

CHAIRMAN VOLCKER. It wouldn't be as much above the 11 percent, I guess.

MR. AXILROD. But once you rebase, people will tend to look at it and think you're much more serious about it, I think.

MR. KEEHN. Steve, are you saying that if we rebased using the second quarter, July would come in above 8 percent?

MR. AXILROD. Well, we're projecting [July growth] well above that at this moment. But even if it came in around 8 percent, I think M1 would be above [the range] given the shape of the second quarter, which was very high toward the end. You are throwing yourselves into high--

MR. BLACK. The great unknown is what is going to happen to the velocity of M1.

MR. GRAMLEY. I think we ought to listen very carefully to the substance of what Tony is saying, in the sense that it would be a terrible mistake to impose too much restraint in the second half of this year because M1 is going up faster than we now think it might, if

the staff's forecast comes out right. But also, if we seem to say that we have dismissed altogether the growth of M1 that is likely to be interpreted, given the present concerns of the market, as [meaning] that we have dismissed any concern about inflation. And that would also be unfortunate. I think we ought to find some way that avoids both of those problems.

CHAIRMAN VOLCKER. I think it's also true that while the M1 velocity has been off historically, the economy is doing a lot better than any other forecast implied except an M1 forecast.

MR. GRAMLEY. Any M1 forecasts [unintelligible] would be something like 6 to 8 percentage points off on nominal GNP growth.

CHAIRMAN VOLCKER. A strict M1 forecast would have given much higher [GNP growth] than actually took place, but the fact is we are higher than other forecasts, which suggests that there's no place in [unintelligible] it.

MR. GRAMLEY. To complete my thought, what I would do is rebase and tell the market this: We are not giving M1 any more weight now than we have all year; our principal focus still is M2 because the velocity of M1 is so terribly uncertain; there is some indication of a return toward normalcy, but it is by no means clear.

MR. PARTEE. I would rebase and use 4 to 8 percent, but I would say to the market that we are still uncertain about velocity, though it looks as if it might be stabilizing and we're going to give [M1] some more weight.

CHAIRMAN VOLCKER. Stabilizing probably around a different trend.

MR. PARTEE. Probably. I agree with that very much.

CHAIRMAN VOLCKER. We don't know precisely, but what I'd be inclined to say is that the 3 to 4 percent increase in velocity that we counted on we no longer count on.

SEVERAL. Right.

MR. WALLICH. We know in any event that this is a function of interest rates; to keep emphasizing the velocity factor confuses the situation. We don't refer to the interest sensitivity.

MR. BLACK. Let me call your attention, if I might, to the last sentence in Dave Lindsey's memo in which he says it's not clear that V1 will be less predictable over time than V2 even though V1 may take on behavioral characteristics that are different from earlier postwar years.

MR. MORRIS. That's faint praise, though.

MR. PARTEE. I absolutely agree with that; I think that's just what Paul said.

MR. BLACK. It has been more predictable over most of our history; it may not be in the future, but I believe the burden of

proof is on those who say it won't be. That's a biased viewpoint, as you all probably can guess.

MR. GRAMLEY. The arrow is nice and straight; we just don't know which way it's going.

MR. BLACK. I agree with that, but the risk--

VICE CHAIRMAN SOLOMON. The basic difference, or point of departure, is that I am somewhat--in fact, substantially--surprised that we would stick our necks out with numbers where I, at least, feel that we are not stabilizing along a particular trend. The fact that velocity was not as negative in the last couple of months as it was earlier in the year, and granted all the Ms had negative velocity last year, [does not alter the fact that] the situation is so sensitive to the changing way people hold balances. I hear people talk about it in the banks and in the markets. I don't see how we have even a pretense of a scientific basis for working with and making projections on the basis of what may be a very unpredictable velocity situation. I don't understand why we would stick our necks out because we can do enough tightening based on the movements of M2, M3, and credit and the real economy without setting out a series of projections that have better than a 50-50 chance of turning out to be wrong again. I don't really understand; I guess many of you, including maybe the staff, must have much more faith that the range of predictability is going to be substantially narrowed. I don't believe that.

MR. WALLICH. I just think that there is such a thing as M1 and the market watches it. And [if] we ignore it, we're losing credibility as well as probably [unintelligible].

MR. MORRIS. The market watches it because we watch it.

VICE CHAIRMAN SOLOMON. Exactly. Market participants watch it when they think it's influencing our behavior. Secondly, we are going to lose credibility with certain kinds of people anyway if we move to 7 to 11 percent or rebase and wipe out the past. That will be giving M1 more importance, no matter what. Of course, I'll admit there is a way. Paul could go back to the Humphrey-Hawkins February version rather than the April version. But even then I think it is going to be harder to get back to the February market reaction to M1.

MR. CORRIGAN. The February reaction to M1 was at least in part couched in terms of what was going on in the economy. Most people thought the economy was still declining in February.

VICE CHAIRMAN SOLOMON. Okay. But it is still true that when you talk to market people in New York you feel that M1 is halfway back again.

CHAIRMAN VOLCKER. I think it's a combination of the economy being strong and M1 being so high. People wouldn't be so sensitive if the economy were weak and M1 were even 3 percentage points from its range.

MR. ROBERTS. I don't think it's so much that the market says we're watching it as that they say it's something that has to be looked at if the economy is strong and M1 is growing too rapidly.

Whether we're watching it or not, it has become a market influence. You talk to people, as you say; I also talk to people and I get the impression that they're concerned about what is happening to M1 whether we are concerned or not.

VICE CHAIRMAN SOLOMON. Sure, you hear various sentiments. But those whom I believe are the more astute observers in the financial community make a point of saying that we ought to be more sensitive to the real economy than to M1. There's a fear around also, and I have that fear, that we ourselves are going to feel--and the market will perceive us as being--more locked into M1 if we go ahead with it and dignify what has been happening with--

MR. ROBERTS. I think the problem is that the market fears that we are getting too far away from M1; as the economy has strengthened and as M1 has grown at too rapid a pace, that has produced fears. It's already reflected in a major change in interest rates in the market. If we were to do something to indicate that we are serious about it again, particularly if we were to rebase and have a moderate rate of growth as our target, I think we would see a constructive effect in the market.

MR. PARTEE. Well, there are all kinds of opinions. I think you are both overstating it. You have looked at the extremes. My view of the matter is that history shows that it's dangerous in an expansion to rely on setting the federal funds rate. We are now moving into expansion. We're talking about the next year and a half by which time we will be pretty well along in the expansion. The indication is--certainly over the 20 years that I've seen it--that the Committee is slow to change the funds rate if the funds rate is what the Committee is setting. So, I think there's a basic danger in not having something else. Now, something else might be nominal GNP; I don't think it's real GNP. Or it might be one of the Ms. And if it's one of the Ms, I think M1 still shows itself as better than any of the other Ms. It could be total credit, but on total credit our problem is that it's too hard to estimate the current numbers. We might use it for confirmation, but--

CHAIRMAN VOLCKER. Let me suggest something with great hesitancy because I'm not sure I like it visually but substantively it gives me an easy explanation: Make the range 5 to 9 percent and say that the 9 percent allows for no change in velocity during the expansion. Maybe that's the new trend of things and we want to allow for that possibility. The 5 percent allows for a fairly normal, or almost normal, cyclical change in velocity from now on. And that's precisely why we picked 5 to 9 percent, because the 9 percent allows for no change in velocity and the 5 percent allows for a sizable change in velocity. That still leaves open how much weight we put on it, but we picked 5 to 9 percent because that covers the probable range of uncertainty that we see in velocity.

MR. PARTEE. So, what we have in mind is a 9 percent nominal GNP, right?

CHAIRMAN VOLCKER. Yes, because it is consistent with the nominal GNP growth that we are predicting. Precisely.

MR. BLACK. Is that rebased, Mr. Chairman?

CHAIRMAN VOLCKER. [Unintelligible.] That is my starting point: We are going to be presenting a forecast of roughly 9 percent or a bit more than 9 percent for nominal GNP next year, so we relate it to that.

VICE CHAIRMAN SOLOMON. Let me ask a question. Even though I prefer 5 to 9 percent over 4 to 8 percent, certainly in terms of the immediate market effect, is it feasible to say that we're coming up with 5 to 9 percent and yet we are going to continue deemphasizing it?

CHAIRMAN VOLCKER. I don't particularly like showing this high a range and that's my reservation about it, but I can see a rather pat explanation being given--precisely: We projected, roughly, 9 percent nominal GNP growth next year, gentlemen. We think by implication that that is a satisfactory outcome. We feel that we are in the midst of velocity changes of a continuing sort that we can't quite identify--or we may say that we're not putting full weight on M1. Based upon everything we've seen so far and assuming we're in a period of expansion, we think it's likely that the velocity pattern will not change so greatly that we would actually get a bigger increase in M1 from now on than in the nominal GNP, so that's why we picked 9 percent at the top. The 5 percent allows for a less than normal, but not all that much less than normal, increase in velocity in this particular cyclical period. So, we kind of span as best we can the range of uncertainty that we have.

MR. BALLEES. That's a good idea.

MR. WALLICH. That seems to say that you are accepting that the causal influence goes from GNP to M1 and that there's no counterflow of causality.

CHAIRMAN VOLCKER. I don't think I quite said that. It may have sounded that way when I worded it. But I can word it the other way: that if there is no change in velocity, the 9 percent would be the appropriate [number]. That gets the causality the other way. And if there is a change in velocity, we would want to have a lower M1 and that's why we have the lower end [at 5 percent].

MR. WALLICH. But looking at this as a target, suppose M1 were growing at 9 percent but unfortunately velocity was growing at 4 percent, as it could. That is what I see as the problem of this target.

CHAIRMAN VOLCKER. That would be too high.

MR. PARTEE. I like that the real target is the nominal GNP.

CHAIRMAN VOLCKER. Yes, but what I would be saying implicitly is that if we have 4 percent velocity growth we may not know it until ex post. That's the problem. But if we thought we were getting that, the 9 percent is too high.

MS. HORN. We might know it ex post but at least it would only be 4 months ex post, not a half year or a year ex post. So, it's shortening the period of uncertainty.

MR. BALLEES. Paul, is this suggestion both for '83 and '84?

CHAIRMAN VOLCKER. Well, as I say, I throw it out as a suggestion. The one thing I don't like about it is that it looks pretty high on the face of it.

MR. BLACK. Particularly for next year, I think.

MR. BALLE. But was it for both years? Is that after rebasing 1983?

CHAIRMAN VOLCKER. I'm attracted to it simply because I think it's fairly easy to explain, given the GNP forecast we have--if we think that's an appropriate GNP forecast. Actually, it's going to come out 9-1/2 percent, I guess. I don't know where the central tendency is; we have these medians here. But I'm assuming the central tendency is someplace around--8-1/2 to 9-1/2 percent would be ideal I suppose--8-3/4 to 9-3/4 percent or 8-3/4 to 9-1/2 percent or someplace in that area.

MR. KEEHN. Not to complicate it, but what if we use the 5 to 9 percent for this year and then suggest that if velocity begins to return to a more normal pattern as we get into 1984 we might contemplate a reduction and go back to the 4 to 8 percent?

CHAIRMAN VOLCKER. That's kind of fine-tuning in an uncertain period.

MS. TEETERS. We could just not even mention a target for 1984 and see where we are at the end of the year because we may very well have to rebase again then if [M1 growth] doesn't come down. And certainly the velocity changes are still going on.

MR. ROBERTS. But don't we have to talk about next year, Paul?

CHAIRMAN VOLCKER. We have to talk about next year; we don't necessarily have to give an M1 target. But if we didn't give one for this year, I don't see much reason not to give one for next year. We can say we don't pay much attention to it, but--

MR. PARTEE. It seems to me that the principle is the one you state and then, of course, it's subject to review as more evidence comes in on what velocity is in fact doing.

MR. CORRIGAN. That 5 to 9 percent sounds nice but I don't like it partly because of where I think the risks are. If there is some strong sympathy that way, I'd rather see us rebase off June and use 4 to 8 percent, which would give the same practical result anyway. I really think that saying 5 to 9 percent in the context of everything that's going on, at least as I look at it, is very troubling.

CHAIRMAN VOLCKER. We are going to have great trouble getting a central tendency when I look at these numbers. We have a whole bunch at a high level and we have a bunch at a lower level and there's nothing in between. It worked out pretty well last time, but it certainly doesn't work out very well this time if my glance at these is clear. The central tendency--

MR. BLACK. What may explain some part of that is a different policy [assumption] or something.

CHAIRMAN VOLCKER. The central tendency on the nominal GNP will come out at 9-1/2 to 10-1/4 percent or maybe even 9-1/2 to 10 percent. We have 10 people between 9-1/2 and 10 percent, roughly, or 11 people between 9-1/2 and 10.2 percent. So, I guess we can say the central tendency is roughly 9-1/2 to 10 percent.

MR. BLACK. Well, you can cut that 9 percent down to 8 percent by assuming a little pickup in velocity rather than no change.

CHAIRMAN VOLCKER. I think what we would say with 4 to 8 percent in any event is that we are assuming a little increase in velocity.

MR. BLACK. You could stress the point that Jerry just made a minute ago in that way, which is not an unreasonable thing to assume.

CHAIRMAN VOLCKER. Actually 4 percent would give a 5-1/2 percent increase in velocity; that's pretty high even by historical standards.

MR. ROBERTS. I thought it was over 6 percent.

MR. AXILROD. Well, if you are talking about the second half of '83, but if you get into '84, the second year probably--

MR. CORRIGAN. It's quite high.

CHAIRMAN VOLCKER. I don't know. Maybe I'm beginning to like 5 to 9 percent.

MR. BLACK. We could go to 10 percent and assume a small drop in velocity.

MR. WALLICH. It seems to be mainly accommodative and much less leaning against the pressures.

CHAIRMAN VOLCKER. Let's look at what we're saying with 4 to 8 percent. If we take the average of these forecasts, we're saying we expect velocity to be between plus 6 and plus 2. Do you want to adjust the 4 to 8 percent or would you say between plus 5 and plus 1? That's the difference.

MR. WALLICH. This could be a period of somewhat rising interest rates, possibly, and that would accelerate velocity. The cyclical pattern certainly is one of some velocity gain.

CHAIRMAN VOLCKER. Well, all of these would allow some velocity gain. The midpoint would be a plus 3 or 4 velocity gain.

MR. CORRIGAN. Mr. Chairman, when you look at velocity historically, though, I think the potential for a rise in velocity has to be related directly to the actual decline in velocity. And there are all those balances sitting there and we can't ignore them.

CHAIRMAN VOLCKER. Are you saying velocity may rise more than the normal cyclical pattern?

MR. CORRIGAN. I think that is a very distinct possibility, yes. We just can't ignore all that money that's sitting there.

MR. BLACK. I think that is where the risks lie.

MR. CORRIGAN. That's where I think they lie.

MR. WALLICH. When this is compared with the old range of 2-1/2 to 5-1/2 percent, people aren't going to keep in mind that this is a different M1.

MR. GUFFEY. Mr. Chairman, I'm starting from the point that I'd like to preserve M1 for some time when it becomes more important informationally. But this discussion has just reinforced my view that we shouldn't rebase at the moment. We shouldn't be talking about 5 to 9 percent or anything else because it gives much more credence to those numbers than anybody around this table is able to assign to them, at least by a consensus. And thus it seems to me that we should drop back and use the 7 to 11 percent, which recognizes that we had an overshoot in the first half that we can't explain and we don't know what is going to happen in the second half. An 11 percent top suggests to anybody who chooses to figure it out--and the monetarists and market people or others will do so--about a 6-1/2 increase for the remainder of this year. And in view of the uncertainty, that isn't unreasonable. As a result, I would go to the 7 to 11 percent now without rebasing and maybe talk about it sometime in the future. And [for 1984] I'd go to 4 to 8 percent, which we established in February of this year, in view of the uncertainty. The uncertainty still exists for 1984 and we will have the opportunity to change it in February of 1984. The result, it seems to me, is that we're according less precision to M1 and it's more attuned to the discussion we just had around this table. Nobody knows. So, why should we elevate it by changing it and assigning some precision to it, even with all the language that you suggested that if velocity increases at the historical rate or if it's at zero--?

CHAIRMAN VOLCKER. Oh, I think we have to say that anyway for next year. The official is less different than--

MR. GUFFEY. To be sure, the uncertainty involved is velocity and its relationship to income. But to do the things we are talking about--one rebasing it and then establishing a 5 to 9 percent range and trying to explain it for the remainder of 1983--seems to me to be elevating it beyond the point that I'd like to see.

CHAIRMAN VOLCKER. The only difficulty with 4 to 8 percent for next year--it's not a substantive one, I guess--is that we're going to be projecting, unless these [forecasts] change, a 9-3/4 to 10 percent average nominal GNP. That projection is going to be published. And a 4 to 8 percent range says that velocity is going to increase by from 2 percent to 6 percent. Is that what we want to say?

MR. GUFFEY. Well, as I've just suggested, in February we established a 4 to 8 percent range, describing some uncertainty. And the report to Congress had nominal GNP of [7-1/4] to 11-1/4 percent.

CHAIRMAN VOLCKER. And the average of that was 9 percent, roughly?

MR. GUFFEY. 9 percent, roughly.

CHAIRMAN VOLCKER. And we said 4 to 8 percent against the background of cyclical increases in velocity of 6 percent or more in the first year recovery. Now we're in the second year of recovery, and we've had two more quarters of low velocity.

MR. GUFFEY. Therefore, it gives the background of saying that we'll just reestablish the 4 to 8 percent because we don't know what will happen and we'll look at it [again] in February.

MR. ROBERTS. We have gone from an 11 percent rate of [velocity] decrease to about a 1 percent rate of decrease in that period, suggesting that it's straightening out.

CHAIRMAN VOLCKER. Well, any of these ranges allows for an increase in velocity. And they all assume that [some] degree of normality will return; it's just a question of the degree.

MR. BOEHNE. I think there's something to what Roger says. If the conversation added up to anything around the table, it is that nobody really knows enough about M1 to be very confident. We could say for next year that the M1 range is 4 to 8 percent and that assumes a velocity of 2 to 6--and use whatever rationale you feel comfortable with to say it--and say that if that doesn't work, we'll simply have to adjust M1 again. That strikes me as conveying the notion that we have some expectation that M1 will return to a more normal path, but we're not very confident of it. And if it doesn't, we are not going to base monetary policy on something that isn't dependable.

CHAIRMAN VOLCKER. Does anybody have the figures handy as to what the velocity has been historically in the second year of expansion?

MR. MORRIS. For M1 it has been 2.7 in the last three expansions.

CHAIRMAN VOLCKER. Only 2.7?

MR. GRAMLEY. In the second year?

MR. MORRIS. That's the second year. It's higher in the first year; it's 5.2 in the first year.

MR. CORRIGAN. Well, the issue here is not to agree on how much we know about M1 for this year. I don't think we know a helluva lot about either [year]. But the problem that I think we ought to avoid is having a set of targets that won't provide the opportunity to tighten up further if we have to. And if we have targets like 11 percent or even 9 percent--

MR. BOEHNE. But remember that this M1 number can be put in the context of a reduction in the targets for the broader aggregates.

MR. CORRIGAN. But the broader aggregates don't really provide much of a mechanism--or they have not provided much of a mechanism--to permit this.

MR. MORRIS. And M1 has?

MR. CORRIGAN. We can use it; we don't have to. I'm not saying we would. But as a practical matter, it does give us the opportunity to move if we think we have to move. And that's what I'm concerned about--having a set of targets that gives us the flexibility even though we may not use it.

MR. PARTEE. I agree with Jerry. I think we ought to rebase, but then I'm scared of the 5 to 9 percent so I'd fuzz a little on the velocity but say we are keeping it open.

VICE CHAIRMAN SOLOMON. Would you base it on June, then?

MR. PARTEE. Sure. I think the concept here is that what has happened has been unusual. And now we're going to be following M1 in the expectation that there will be some small rise in velocity.

VICE CHAIRMAN SOLOMON. The whole spectrum of short-term interest rates is really behaving as though the fed funds rate were closer to 9-1/2 percent than to the 9-1/8 percent rate of the last few days. So, if we raise expectations [by] having 4 to 8 percent based on the second quarter, we are going to get even more of a reaction in the market.

MR. PARTEE. But I said I'd base it on June.

CHAIRMAN VOLCKER. Basing it on June seems awfully fussy to me.

MR. PARTEE. But it's basing it on where we are, which I would define as June.

MR. GRAMLEY. You get a lot by way of money growth; that's worth \$10 billion in M1, I think. The second-quarter average is \$505 billion and June is \$515 billion.

MR. GUFFEY. Rebasing suggests that we know more about what M1 is going to do in the future than I think anybody around the table is willing to admit.

MR. CORRIGAN. I think one can make the argument the other way around. Rebasing, depending upon how we articulate it, can be construed to say that we had this unusual period and we're recognizing that it's unusual. We are cutting the umbilical cord from it and we're going from there. That clearly leaves open the option and demonstrates our willingness to do something like that again.

MR. GUFFEY. It seems to me that the market would suggest that M1 is going to become a greater focus of policy implementation. And I'm not prepared at this moment to start looking at M1 as a policy guide because I don't think we know what is going to happen in the period ahead any more than we knew what would happen or how we can explain what happened in the last six months or nine months.

MS. TEETERS. That argues, though, for just ignoring M1-- don't set a target for this year or don't set one for next year.

MR. GUFFEY. I'd just like to clarify that point. I would not want to ignore M1 totally and not set any targets at all because I think M1 has served us very well, both politically and economically in the past and it will need to do so in the future. I wouldn't want to move totally away from it. I'd like to preserve it.

MS. TEETERS. But if we eliminate the ranges temporarily until we have a relationship back, I think that signals the markets that we're not [focusing on M1] even more strongly--

MR. GUFFEY. But then when we move back to it, it will be the sole target as far as the markets are concerned. If we eliminate it and then reinstitute it when we think it has some validity again, then the markets are going to pick it up as being the sole target for monetary policy. And in my view it shouldn't have been totally the guide in the past and shouldn't be in the future. Again, I think you're according it something that I would not be prepared to do.

MR. CORRIGAN. If M1 is growing at 12 percent, I don't care if we have a target or not, the market is going to look at it and we're going to get interest rate effects. We can't wish that away. It's just not going to go away.

MR. GUFFEY. The other approach, though, provides some flexibility to us in the period ahead when the uncertainty is still at a very high level.

MR. BLACK. A lot of the reasons for that uncertainty have disappeared, Roger. It may well behave more predictably now than it has in the recent past. I hope so and I know you hope so. Of course, none of us knows.

CHAIRMAN VOLCKER. What are the Administration's and CBO's projections for nominal GNP next year?

MR. KICHLINE. I don't know about [CBO]; the Administration's nominal GNP is 9.7 percent for 1984.

VICE CHAIRMAN SOLOMON. CBO is out of date. There isn't much--

CHAIRMAN VOLCKER. It sticks in my craw a bit--we're back at 9-3/4 percent. That's about where we will be. If we say 4 to 8 percent, we're saying velocity is going to increase by the normal cyclical amount even if we're in the high end of the range.

MR. ROBERTS. If we hit it right in the middle and have a normal cyclical velocity, we're right on.

CHAIRMAN VOLCKER. On 8 or technically 7--

MR. ROBERTS. Yes, it's just as important not to pull it back too much as it is to have the right amount.

MR. PARTEE. That argues for 5 to 9 percent, analytically--no question about it.

MR. WALLICH. Well, it gets to be very close to saying that M1 has become like M2 and M3. One reason I can see for saying that is that M1 now accumulates interest as a result of interest being paid [on NOW accounts] and so it has an upward bias that it didn't used to have. Whether that is very important, I don't know. But I think there is a difference between M1 and M2 and we ought to show that in the range.

CHAIRMAN VOLCKER. The argument that I hear against 5 to 9 percent, apart from something cosmetic, is: Suppose velocity is high and we want to tighten up and we're well within the 9 percent? I guess the answer to that has to be that if that's true, M2 and M3 and credit must be running high.

MR. GRAMLEY. Not necessarily.

MR. PARTEE. I don't see that.

SPEAKER(?). I don't think so.

MR. GRAMLEY. The argument for a big increase in velocity and slow growth in M1 is that we had this big cyclical drop in velocity, which relates to higher interest rate sensitivity in demand for NOW accounts and changes in compensating balance practices as interest rates go up. And I think the implicit argument here, which we ought to lay on the table, is that interest rates are going up a good bit more than the staff has forecast and that slows down M1 growth a lot, so we need to keep a low range for that reason. I worry about that about as much as I worry about the problem that Chuck posed earlier, which is that the economy may hit the rocks and M1 growth may slow down for that reason. I think both of those are protecting against being run over by a herd of stampeding elephants in Washington at high noon. The main problem we're going to have, I think, is that we have a fairly strong economy that's going to pull a lot of money growth out. And the question is what we want to do about that. Do we want to ignore it or not? I would be prepared to put very little weight on growth of M1, but I don't think we ought to tell the public inadvertently that we're giving up on the fight against inflation. So, I think Jerry's suggestion of basing on June makes good sense because I don't think we ought to constrain ourselves too much. Then we can use 4 to 8 percent and it sounds better. Cosmetically, it sounds better. And I think we can finesse this business of velocity in 1984; that's no problem. No one really knows what is going to happen to velocity anyway so we just make some arguments for [the possibility that] it may go up or it may not and we'll be all right.

CHAIRMAN VOLCKER. We can make some arguments that it may go up; we can't make any that it may not because then we have to--

MR. GRAMLEY. No, if we say it may not go up, we're saying in effect that we're not going to put much weight on M1 until we see normal patterns of M1/GNP relationships restored. And if, in fact, when we get to 1984, it takes 10 percent growth in M1 to have a decent economy, we're prepared to do that.

MR. CORRIGAN. I don't see that as a problem. If we're faced with the situation later this year or next year where velocity isn't growing, I think it's a fairly easy matter to make that kind of adjustment both in policy and what we say about policy. But I don't think the reverse follows. If we have a target that's 5 to 9 percent and money supply is growing at 9 percent and the economy is growing like gangbusters, how do you go up [on the Hill] and explain that we're tightening when we're within our target range? I think it's a real problem.

MS. TEETERS. We change targets.

VICE CHAIRMAN SOLOMON. We can do 4 to 9 percent based on the second quarter, which also is a practical way of showing the market that we're de-emphasizing M1 to some degree. They don't really believe as much as I think some of you people around here believe that we have de-emphasized M1. I keep mentioning this point. Sure, it has been reinforced by the strength of the real economy; I understand that. But there's a revision to the old thinking more and more.

MR. MARTIN. Jerry, I think we go up to the Congress and tell them that we're tightening because the economy is growing above the rate anticipated and we're beginning to see the first signs of inflation. I don't think we go up and make an argument based on the Ms at all. We make an economic argument.

VICE CHAIRMAN SOLOMON. But how can we say we see the first signs of inflation? What do we point to?

MR. MARTIN. Well, if the economy is growing very, very [rapidly]. That was the assumption Jerry made.

VICE CHAIRMAN SOLOMON. I don't think he has a basis for saying that.

MR. CORRIGAN. There's somewhat of an historical tendency to be unwilling to do that in this Committee.

MR. MARTIN. That was his assumption.

VICE CHAIRMAN SOLOMON. If the exchange rate--

MR. MARTIN. I'm not talking about today. I'm talking about his scenario, Tony.

MR. CORRIGAN. The problem is that there's a reluctance to do that even in the confines of this Committee, much less to go up and tell Congress that that is what we are doing. I don't give a darn about M1 in and of itself either. My concern is simply that we formulate policy in a way that it provides us with flexibility to do what has to be done, if indeed it has to be done.

CHAIRMAN VOLCKER. Gosh, I would hate to rebase on June but--

MS. TEETERS. Well, take Tony's [suggestion] and make it 4 to 9 percent and base it on the second quarter.

CHAIRMAN VOLCKER. I'd almost prefer to make it 8 to 12 percent for the year.

MR. GUFFEY. Well, 7 to 11 percent puts some restraint on M1 over the last half of the year.

CHAIRMAN VOLCKER. 7 to 11 percent is exactly the same as [8] to 12 percent based on the second quarter.

SPEAKER(?). Yes.

MR. AXILROD. Mr. Chairman, I made some calculations when I was fiddling with this. Growth of 12 percent for the year would give you about 8 or 8-1/2 percent from June to December. That's about a 10 percent rate from Q2 to Q4.

MR. BOEHNE. Does that show July above or below the target?

MR. AXILROD. I would assume it's above, but I'd have to check. Oh, I'm sure it's above.

MR. PARTEE. Of course, if it's slow in the second quarter--

CHAIRMAN VOLCKER. What has it been so far?

MR. AXILROD. For the year-to-date it's around 13 percent. As of June, from a fourth-quarter base it was running 13.8 percent. So, it's 5.8 percentage points above the June level.

MR. ROBERTS. June was 10 percent.

MR. AXILROD. I meant above the June target level. And the growth rate for M1 from the fourth quarter to the second quarter is about 13-1/4 percent. Either way it's very strong. Our projection for the third quarter, for what it's worth--

CHAIRMAN VOLCKER. If it's 13.8 percent now, we're almost at 14 percent so if we have 11 percent for the year, it has to come down to 8 percent for the rest of the year. That's simple arithmetic.

MR. BOEHNE. You are the number one salesman on this, Mr. Chairman. What do you feel most comfortable with trying to sell?

MR. BLACK. One interesting thing that makes it a little easier is that under any of these short-term alternatives, the third quarter looks fairly high in an absolute sense. Any of these short-term alternatives that we're looking at would imply a third-quarter rate that really doesn't look like much drop from the second-quarter rate. It's just pure arithmetic. If I can find the darn table--

MR. PARTEE. Lyle's helping you.

MR. BLACK. Here it is. It's on page 14 [of the Bluebook], Mr. Chairman. Under the short-term alternatives for M1, "A" gives you 10.8 percent for the third quarter; "B" gives you 10 percent; and "C" gives you 9.2 percent. That may be obfuscation to a certain degree, but it is probably a more meaningful number than the rates from June to September in a sense. I don't know whether it's a wise thing to do

or not, but I don't think anybody could deny that that's probably a more meaningful figure than the behavior over a particular month in the period. Any of those involves some deceleration but not what most people would think of as a terribly fast deceleration. I don't know what the fourth quarter looks like at this point.

MR. ROBERTS. That would be 2 percent.

MR. BLACK. That's going to be a lot less. You run into a few more problems. You assume that's within your target and then you start talking about the month-to-month--

MR. AXILROD. Well, you have very low fourth-quarter numbers [if you] believe that. Growth is going to have decelerate into the 4 or 5 percent area.

MR. BLACK. You have faith on that, Steve. I know they would be low, but I don't have those [numbers] in front of me.

CHAIRMAN VOLCKER. With that kind of increase in the third quarter, we'd have to have, say, 5 percent for the fourth quarter.

MR. BLACK. It is pretty low.

MR. AXILROD. Yes. That's what comes out of the averaging process. If M1 growth is decelerating at the end of the third quarter and continuing to decelerate in the fourth quarter, you get very low numbers. But I would be very cautious about [assuming] that will happen.

MR. GUFFEY. That's a quarterly average?

MR. AXILROD. Yes, low numbers month-to-month and a low quarterly average in the fourth quarter.

CHAIRMAN VOLCKER. And July looks as if it's going to be high.

MR. AXILROD. We will get the more recent numbers shortly. At the moment it looks that way.

MR. GRAMLEY. That makes a very strong case, if we are going to rebase at all, for rebasing on June.

MR. AXILROD. Last year, Mr. Chairman, we thought July was going to be high and it came in weak. Remember, that was the surprise last year. And August and September came in high.

MR. CORRIGAN. Another thing on this rebasing: If we don't rebase, we are going to have a target this year of 8 to 12 percent or 7 to 11 percent or something like that and then what do we do next year? We're left having to hang out a target for next year that on the surface is going to look like it's 4 or 5 percentage points below our target for this year.

VICE CHAIRMAN SOLOMON. Maybe if we talk long enough, you will come back to my suggestion.

MR. CORRIGAN. What, an easy money policy?

VICE CHAIRMAN SOLOMON. The fact that we are doing some modest tightening, [which is] probably what we're going to be doing, I don't think we ought to show that. And there's enough justification in the M2 and M3 figures to justify a modest tightening.

MR. WALLICH. We are pretty far into the expansion and it's a very strong expansion. Interest rates have gone up very moderately. Historically [speaking], I don't think it's a very tough policy that we've had.

MR. GRAMLEY. Hopefully, we're only about 1/8th of the way.

MR. RICE. Compared to what--what we've done in the past?

MR. GRAMLEY. Maybe 1/16th.

MR. CORRIGAN. If we are not careful, it may not be an eighth.

VICE CHAIRMAN SOLOMON. We don't have a typical recovery. We have a very strange world situation as you know, Henry. And yet I don't see that that whole world situation enters into our bottom line policymaking here.

MR. WALLICH. Whether that is a very major thing [unintelligible]. I wrenched myself away from that on the grounds that we're contributing a good deal more to the world expansion by having this bigger growth rate.

MR. MARTIN. But the interest sensitive sectors of the domestic recovery have not had time to react to or [feel] the impact of the slightly higher rate. A month from now, six weeks from now, we will see the interest sensitive areas, especially housing, begin to level off or decline.

MR. BLACK. That's another reason why M1 may well slow down.

CHAIRMAN VOLCKER. Well, I would suggest that we go to the short-term ranges. The more one looks at the problems in the next quarter, it bears upon the reality of any number we put down for the rest of this year. So, let us move to the short-term ranges. We can do that by dispensing with the Managers' reports at this point, to avoid any interruption in the continuity. What do we have now for the short-run ranges?

MR. AXILROD. Mr. Chairman, the table on page 13 of the Bluebook summarizes the short-term ranges. Alternative A retains the federal funds rate range of 6 to 10 percent, which was in the last directive of the Committee, but assumes in effect retaining the degree of restraint on bank reserve positions that the Committee most recently has allowed. And those money market conditions, we believe, are consistent with a slowing in M1 growth to a 7-1/2 percent range over the June-to-September period, as you see, and a slowing of M2 and M3 growth--

CHAIRMAN VOLCKER. That produces what quarterly average? It's 10 percent or something that like?

MR. AXILROD. Yes, that produces a 10.8 percent quarterly average, given a high July. And I might add that I do now have very recent data and they would not suggest that July is very different from 10 percent. They tend to confirm the first couple of weeks in July that we had estimated last week. Alternative B and alternative C contemplate a tightening of bank reserve positions--in the case of alternative B, perhaps up to the 9-1/2 percent area for the funds rate and perhaps up to the \$850 million to \$1 billion range for member bank borrowing. And alternative C contemplates even more tightening. We believe alternative B is generally consistent with M1 growth, expressing it at an annual rate, in the 7 to 11 percent range and is more consistent than alternative A with the broader aggregates--at least M2--being closer to the midpoint of their ranges. We believe alternative A to be more consistent with the broader aggregates being toward the upper end of their ranges--particularly M3, but M2 would be in the upper half of its range. And for M1 we would be more comfortable, I think, with an 8 to 12 percent range for the year. The greater tightness of alternative C we believe would be more temporary even than that under alternative B because we would contemplate a more rapid downward reaction of the demands for goods and services. And that would tend to be reversed toward the end of the year and into early next year more than with alternative B and, of course, that would contemplate a greater slowing of M2 and M3.

Mr. Chairman, in view of the uncertainties, I might say that as a policy course it would not seem illogical to me to contemplate higher growth rates of the aggregates, such as those in alternative A, even if the Committee wanted also to contemplate some little tightening of the money market. If the Committee did not wish to contemplate any tightening, it certainly seems as if the higher growth rates of alternative A, or maybe even higher rates, would be necessary so far as we can see at this point.

CHAIRMAN VOLCKER. I'm not quite sure I understand what you just said. You say when you really look at it, you're not sure alternative A is inconsistent with some modest tightening of the money market?

MR. AXILROD. If the Committee wanted to contemplate no more than a modest tightening, then I think it would be more certain to get that result to be consistent with the [growth rates it adopts for the] aggregates if it raises them. If the Committee were willing to have much more than a modest tightening--quite a tightening--then, of course, a lower aggregate [figure] would work more to assure that that would develop naturally.

VICE CHAIRMAN SOLOMON. Are you talking about roughly a \$600 million borrowing assumption?

MR. AXILROD. Well, I'm not sure that that would get you a lot of tightening.

VICE CHAIRMAN SOLOMON. I think we need \$800 million to get the funds rate to 9-1/2 percent.

MR. AXILROD. Probably, although this week borrowing is running around \$400 million. Of course, in earlier weeks it had run much, much higher very steadily.

MR. MARTIN. When you associate "A" with some tightening, are you referring to a validation by us of the movement in the markets that has already occurred or are you talking about higher rates from today's level or yesterday's level?

MR. AXILROD. I was associating alternative B with some tightening, Governor Martin--perhaps I misspoke--and alternative A with about the present degree of reserve restraint, which would be a validation [of the modest recent tightening].

MR. MARTIN. Let me shift to "B" then: Are you talking about validation or further increases?

MR. AXILROD. No, I was assuming further tightening would mean a funds rate moving up at least to 9-1/2 percent.

CHAIRMAN VOLCKER. Well, you're talking about the funds rate. That might be consistent with the rest of the market being where it is, if [market participants] thought that was the end of [the tightening]. But they may not think it's the end of it.

MR. MARTIN. I wouldn't think it's the end of it.

MR. GUFFEY. Mr. Chairman, I would like to ask Steve, in response to Tony's question: If we select alternative A, what kind of borrowing level in your judgment would give us a funds rate someplace between 9-1/4 to 9-1/2 percent?

MR. AXILROD. That is somewhat tighter than we contemplated in alternative A and I would say between \$600 and \$850 million.

MR. GUFFEY. Between \$600 and \$700 million would you say?

MR. AXILROD. Borrowing has fluctuated so much that--

CHAIRMAN VOLCKER. We can't interpret the borrowing level without some allowance for excess reserves. We've had borrowing much higher but we have had a lot of excess reserves. I think the change in free reserves or net borrowed reserves is roughly what we contemplated, but we have been getting a lot of borrowing in the beginning of the week and the market gets easy.

SPEAKER(?). Because banks have so many excess reserves.

MR. GRAMLEY. Would it be better, instead of an initial borrowing assumption, to talk about an initial net borrowed reserve number?

CHAIRMAN VOLCKER. In some sense it is probably better to talk in those terms or in some combination of the two. I think of the borrowing number as shorthand for something that's associated with \$350 million or so of excess reserves, which used to be normal. For several months, at least, it has been well above that. I think the distribution of reserves results in some easing influence even though

the borrowing is high. So, implicitly I look at the net borrowed reserves.

MR. PARTEE. Alternative A on M1 would be consistent with what for the last two quarters [of 1983]?

MR. AXILROD. We thought that would be more consistent--again this is judgmental--with the alternative that isn't here; we had more like an 8 to 12 percent range for the year. Alternative B, which is the basis of the staff forecast, we thought was more consistent with a 7 to 11 percent range.

MS. TEETERS. And "B" implies a rise in rates to 9-3/4 percent?

MR. AXILROD. The way we had written "B," it assumed a funds rate probably up in the 9-1/2 percent area or somewhat higher. Again, it depends on what borrowing level the Committee adopts. The one President Guffey suggested would be somewhat lower. What we have in here is 9-1/2 to 10 percent; where it would fall in that range depends a bit on how it's toned up.

MS. TEETERS. Net free reserves, excluding the one week in the past six when it was positive, would average about \$225 million.

MR. PARTEE. Net borrowed?

MS. TEETERS. Yes, net borrowed reserves were about \$225 million. And I agree with the Chairman that that's what we should focus on--whether we want to increase the net borrowed [assumption] or keep it the same--because the week-to-week changes in the excess and borrowings are really all we have.

MR. MEEK. I think that \$225 million includes about \$150 million of seasonal borrowing.

MS. TEETERS. I thought that was out of there. It's the extended that you pushed over.

MR. MEEK. Seasonal borrowing is in.

VICE CHAIRMAN SOLOMON. But if we're going to work with the initial assumption of net borrowed reserves, then we have to make an estimate as to what the excess reserves are going to be, and I don't think--

MS. TEETERS. They are not unrelated, Tony.

VICE CHAIRMAN SOLOMON. I know that.

MS. TEETERS. When the borrowing goes sky high so do the excess reserves.

MR. AXILROD. No, that would eliminate the need to make that assumption in advance. If you gave us a net borrowed assumption, we would have a required reserve figure; under lagged reserve accounting that would disappear later and then we would know the nonborrowed reserve number by subtraction. Whatever excess is involved and

however net borrowed chooses to distribute itself between excess and borrowings, we'll work out. We will have a lot of borrowing and a lot of excess, or a little borrowing and a little excess, for the same--

MR. WALLICH. Well, you remember the old mechanism: If you keep net borrowed at a given level that the banks don't find consistent with prevailing interest rates, the money supply will get away from you as you try to maintain that net borrowed level. It's a very tricky, slippery target.

MR. GRAMLEY. No trickier than [the relationship of] initial borrowing to the federal funds rate.

MR. PARTEE. Yes. I think we've been doing exactly the same thing here in the last 6 to 9 months.

MR. BLACK. Mr. Chairman, what bothers me more than anything else is that when we stopped tracking M1 we lost a lot of that automatic correcting mechanism we had before. I don't think the figures we choose here are as important as that we agree that we are going to change the borrowing level and federal funds rate--and maybe in rather prompt steps--if the actual growth deviates from what we expect. That's the point I'd like to see us zero in on if we could, because all we can do now on the present procedures are ad hoc adjustments. That makes me a little uncomfortable.

MR. AXILROD. Mr. Chairman, I should have commented that the proposed directive alternative on the short run does include a bracketed proposal that the Committee may want to consider as consistent with this discussion. If it were included, it would imply a degree of automaticity in reaction that has not been attained for some time; if not included, we could not have the automaticity that had been in place before last October. That's another point the Committee may wish to consider.

SPEAKER(?). Where are you?

MR. GRAMLEY. Pages 21 to 22. That would go with the bracketed comment on page 21.

MR. AXILROD. I had not thought that those necessarily followed, Governor Gramley. This would be in case the Committee wished to give a little more weight to M1 and a little more automaticity, whether or not the bracketed part under the long run--. Oh, I'm sorry! You mean the second paragraph on page 21. That's right; it would go more logically with the last paragraph.

CHAIRMAN VOLCKER. Well, I think we ought to have some modest degree of tightening here, but it's a matter of degree.

MR. ROBERTS. Alternative B accommodates the present rate of growth in M1 during the third quarter.

CHAIRMAN VOLCKER. Present rate of growth? I'm not quite sure what you mean by the present rate. It would accommodate--

MR. ROBERTS. The 10 percent rate we've been seeing in M1 in the third quarter would be reflected under alternative B. It's running about 10 percent.

CHAIRMAN VOLCKER. I thought it was running above that. Oh, you mean from June. Okay.

MR. ROBERTS. [July] is estimated, I thought he said, at about the same as [June].

MR. AXILROD. That's right. But if you adopt the 6 percent and July is correct, that alternative would necessarily imply a sharp drop in August and September to about 4 percent. That would give you a high quarterly average but August and September would have to come down quite a lot to get there.

MR. MARTIN. And you're talking about [growth in] total reserves under "B" at 2-1/4 percent June-to-September?

MR. AXILROD. Yes.

MR. MARTIN. It's also substantial.

MR. AXILROD. It was because of that sharp drop implied in August and September that I suggested with a bit of caution the possibility of higher growth rates [even] if you had some modest tightening.

MR. MARTIN. What would "B" imply with regard to the prime rate--very considerable pressure upward?

MR. AXILROD. I would think a rise.

MS. TEETERS. There'd be even more pressure on the mortgage rate. Last week it was at 13.3 percent, when we had a--and I quote--"modest increase" in pressure. Apply the same modest increase in pressure and it would get over 14 percent.

MR. AXILROD. But "B" is going to a funds rate of 9-1/2 to 10 percent. If the Committee were only going to a 9-1/2 percent funds rate, things would become a little more iffy; it becomes a sort of struggle between the banks.

MS. TEETERS. But, Steve, didn't you say even alternative A implies some increase in restraint?

MR. AXILROD. Well, we were writing alternative A as if it implied bank reserve positions that would keep the money market about where it is. It's probable that short-term rates and long-term rates have anticipated a further tightening, so there is some real possibility of a little drop in rates under alternative A if it works out that the money market just doesn't tighten up from its recent degree of restraint.

MR. RICE. Alternative A does include the present degree of restraint--that is, it includes the tightening that has already taken place?

MR. AXILROD. That's what we were intending. The market is anticipating further tightening, as far as we could construe up to yesterday. But, that's what we were intending.

VICE CHAIRMAN SOLOMON. I think it's fair to say that the market, particularly after the Humphrey-Hawkins testimony, probably will not retreat and will tend to assume that this is not the last upward adjustment.

CHAIRMAN VOLCKER. That's the problem. When we get into a phase of change they keep anticipating more and more until something happens to change that, such as a decline in the money supply, a weakness in the economy, or something.

VICE CHAIRMAN SOLOMON. They are reacting now to those wide swings in weekly M1 variations as they were before we had formally deemphasized M1.

CHAIRMAN VOLCKER. You put more on M1 than I think is justified.

VICE CHAIRMAN SOLOMON. I'm talking about the swings [in M1] we're now seeing in the Friday publications.

CHAIRMAN VOLCKER. Well, what I had in mind was borrowing of roughly \$600 to \$800 million, but I assumed excess reserves of \$300 to \$400 million, say. It implies higher borrowings as it evens out if excess reserves are very high. Whether that's consistent with "A" or "B," I don't know; I guess it's someplace in between.

MR. MEEK. Let me mention one other factor that's in that borrowing number. We have a lot of nonmember banks that now have access to the discount window; they're borrowing about \$100 million. The seasonal borrowing is \$150 million and there has always been a normal frictional borrowing amount of about \$100 million. So, you're talking about a \$350 million base in some sense.

MR. BLACK. Also, borrowing has been so low that there's less reluctance [by banks] to come in, so it's probably going to be high.

MR. MEEK. I think \$600 million is probably about where we are now, but not in--

MR. PARTEE. \$600 million on borrowing?

MR. MEEK. I think \$600 million on borrowing is somewhere around 9 percent or a little higher--perhaps 9-1/8 percent.

MR. BOEHNE. So, what we need is \$800 million to get to 9-1/2 percent? Is that what you are saying?

MR. MEEK. Well, I would give a little range there, I think.

MS. TEETERS. Why do you feel we need to tighten now over and above what we've already done?

CHAIRMAN VOLCKER. The economy is moving pretty fast; we have some inflationary danger sitting out there in the future; and the

aggregates are running high. So, I'd go for a modest tightening until I see a change in this.

MS. TEETERS. What's wrong with the economy recovering?

CHAIRMAN VOLCKER. Nothing, if it does it in a sustained way --a noninflationary way.

MR. RICE. The forecast doesn't show very much inflationary danger.

CHAIRMAN VOLCKER. The staff forecast doesn't show much inflationary danger.

MR. RICE. No, the consensus forecast; I didn't hear any strong arguments against the staff forecast on that score.

MR. WALLICH. If we don't act somewhat now, I think we're repeating what we've done many times before. That is, we let it run too long and we then confront either inflation or excessive interest rate increases. Both put an end to the expansion.

MR. PARTEE. We've just had a concerted move in the market, which is the point that Pres made. Now, maybe we haven't fully confirmed that move. But I would be happy to see the private rate structure stay where it is for a while because I think it will have some effect on the very credit sensitive industries and we ought to wait and see what that is before we let this get away from us on the tightening side. But I think that's probably consistent with a little tightening.

CHAIRMAN VOLCKER. That's what I would [unintelligible] except for this expectation. We've had rates move up, and I'm not sure the market is convinced that we've moved at all. Now, when we tell them that we have--probably tomorrow--we will get another reaction.

MR. RICE. I don't understand how that tightening is consistent with steady [reserve] positions.

MR. MORRIS. There's no doubt that we've moved in the market.

CHAIRMAN VOLCKER. I don't know. What do you think? I just read the newspaper. Some say we've moved a tiny bit and some say we haven't.

MR. MEEK. Well, I think the analysts have one [view] and the traders another. I think the traders have voted with their feet and have anticipated not only 9-1/8 percent but something on the order of 9-1/2 percent. The analysts are still sorting out free reserves, borrowings, and excess reserves, and lag a bit behind.

VICE CHAIRMAN SOLOMON. If we tighten to 9-1/2 percent, the chances of the market not continuing to anticipate that there might be more tightening later on are very small. I don't think we could tighten without getting some movement in the whole spectrum of short-term rates, even though technically the 9-1/2 percent [funds rate] would be consistent with the short-term rates we've seen here.

MR. MORRIS. It would force a change in the prime rate.

MR. PARTEE. Well, the prime rate probably ought to go up a notch.

MS. TEETERS. You're going to force a change in the discount rate, too.

MR. CORRIGAN. No, I don't think that follows.

MR. MORRIS. I think we could very easily see the prime rate go to 9-1/2 percent.

MR. PARTEE. Yes, and it probably ought to. Everything else has moved and the prime has not.

MR. ROBERTS. Everything has moved 5/8 to 3/4 point except the prime.

VICE CHAIRMAN SOLOMON. The logic of that argument, Chuck, that we [ought] to wait a while before we put more pressure on the whole spectrum of short-term interest rates is that we really can't afford to push up the fed funds rate even though it would be in a technically better relationship.

MR. PARTEE. That could be. An awful lot will be determined by [events in] the next few days--the testimony and so forth.

VICE CHAIRMAN SOLOMON. I am assuming that the tone of that testimony, to the extent that it's not as completely neutral as it can be, is that it would give more [emphasis] to the question of alertness to the strength of the economy, strength of the aggregates, etc., than it would to any implication that would correct anticipation on the other side. In other words, I don't see any reason to assume that the testimony would tend to take the upward movement and expectations out.

CHAIRMAN VOLCKER. There is only one way to do that. If we in fact move a little, then we say we moved a little and leave the implication that at this point we don't see any reason to move any more.

MS. TEETERS. We've already moved.

CHAIRMAN VOLCKER. All right, we have moved.

VICE CHAIRMAN SOLOMON. Are you prepared to go that far?

CHAIRMAN VOLCKER. Well, that depends upon what we do here, I guess. I don't see how we can give that impression without moving a bit here. If we move a little here, we can leave the impression that we may have a little tightening but there's nothing else in the offing other than what we're in the process of doing immediately. That probably won't calm them down. I don't think [the market] is going to be calmed down until something happens like the money supply going down or the economy showing a bad month or something.

MR. ROBERTS. And we had the first month of a turnaround in business loan demand in June.

CHAIRMAN VOLCKER. The fact is that in a strong economy and anything like their present mood there's no reason why we should indicate a decline in interest rates, whatever we do.

MR. MARTIN. But that's one month of business borrowing and the kind of businesses that provide much of the new employment are paying 2 to 3 points over prime. If we get the prime rate up another 50 or 75 [basis] points and add 2 to 3 [percentage points] on top of that, we'll see how much borrowing we get!

MR. ROBERTS. Well, some people are still paying prime, but it's less of a significant rate in the C&I market. In New York, three-fourths of the new loans are not at prime; in Chicago, half of them are not at prime.

MR. PARTEE. They're below prime.

MR. MARTIN. Yes, but small businesses are paying 200 to 300 basis points over prime, as we all know. In construction with 100 basis point increase on FHA/VA [loans], they're back to paying 6 points again. The conventional loan points are much more, maybe 10.

VICE CHAIRMAN SOLOMON. There has been a bit of a shift back to prime as the Eurodollar and the Libor rate got lower and the banks found some of their interest is--

MR. PARTEE. Well, I think Pres is right that very few people in the construction industry pay prime. They'll be paying prime plus 2 probably.

MR. MARTIN. And then points on the mortgage.

CHAIRMAN VOLCKER. What I'd like to get to, which is a little difficult to do in the current atmosphere, is the point where we're not really tightening more than we can tighten--where the expectations in the market change and they say that whatever change in interest rates will be might have [occurred] and that the next move might be down again. We're not there; we are a long ways from there in the present atmosphere because of all the external events and the money supply. How do we get there without making things so tight? Obviously, we don't want to--

MR. GRAMLEY. Well, it's going to take a while to get there.

CHAIRMAN VOLCKER. I don't think we can do it right at the moment, but I--

VICE CHAIRMAN SOLOMON. I don't think you can do it in your testimony either.

CHAIRMAN VOLCKER. Oh, no.

MR. GRAMLEY. We're not going to get there until there has been enough evidence in the financial data and the nonfinancial data to indicate to the public that no further tightening is needed.

CHAIRMAN VOLCKER. I think that is right.

MR. PARTEE. A smaller quarter in GNP.

CHAIRMAN VOLCKER. Basically I agree with what you're saying. What we're doing here is trying to maneuver things so that indeed those things happen in two or three months.

MR. GRAMLEY. That's why I would agree that some slight further nudging up is needed. I do think it's important to recognize that we have accomplished a good bit. We have long-term rates up 3/4 percentage point, the stock market has stopped booming, and the exchange rate hasn't dropped a ton like we thought it was going to do in the past year, so we got restraint from that side too. So, we've made some progress. I think we probably need a little more.

MR. BLACK. And M1.

VICE CHAIRMAN SOLOMON. Do you consider the exchange rate progress?

MR. GRAMLEY. Well, progress in achieving a--

CHAIRMAN VOLCKER. Would you like to quantify your view? We'll start backwards: start with that view and then translate it into the right numbers and then go back to the long term. How do you quantify your view?

MR. GRAMLEY. Well, I would go for a borrowing figure of somewhere around \$800 million probably, or \$850 million. I'd like to see the federal funds rate hit around 9-1/2 percent. I wouldn't want it to go up high into the 9-1/2 to 10 percent range. I would go basically with the specs of "B." That's where I'd be. I want to do this cautiously. I would not wish to go in the direction that the bracketed language in the directive suggests, with a lot of automaticity in response. I think automaticity in response ought to be avoided like the plague because we just don't know what these money numbers mean. Until those numbers begin to make more sense, I think we ought to use a judgmental approach rather than an automatic response.

MR. PARTEE. Well, those specs aren't bad. I'd be close [to that]. I'm not sure I agree with the last point, although I certainly lean away from automaticity. But I feel that we would need to rebase M1 in order to show the market that we're not going to be trying to get it down in the range.

MR. GRAMLEY. I agree with that too; for the long-run range I would use 4 to 8 percent based on June.

MR. WALLICH. I could go with alternative B shaded a little on the low side--not as far as \$1 billion of borrowed reserves or 10 percent on the funds rate. I'd use lower limits--\$850 million and 9-3/4 percent.

MS. TEETERS. Are you going to show the 7 to 11 percent range [for fed funds]? That is going to come out as a very strong signal: that we're raising rates by a whole percentage point and the range by quite a bit.

MR. WALLICH. Well, we're supposedly now in the 6 to 10 percent range and funds are at 9-1/4 percent.

MS. TEETERS. Well, I just find it very difficult to accept any tightening. I didn't approve a tightening last time and I just don't think we need any more at this point. We haven't had time, as has been pointed out, to get the effect on the mortgage market and the automobile industry of what we have done already. And the economy, which has had only two quarters of recovery, doesn't strike me as one that needs a lot of restraint. And it's also one which is fairly typical. We typically get a quarter like this. We should get some recovery before we start tightening again; we should let it get back to something close to normal. I'd go for alternative A and keep the free reserves minus the special factors like the seasonal in a range of maybe \$200 to \$250 million dollars net borrowed.

MR. RICE. I would support that. I think we've already had a good deal of tightening. I know some people think it's minuscule; I think it's significant at this point in the recovery. I would not at this time want to damp the recovery because I'm not yet sure it is all that strong. It may well be as strong as many of you think it is, but I would like to be surer than I am now and I would want to wait a bit before I tighten any further. I'd want to wait at least another month or two.

VICE CHAIRMAN SOLOMON. Well, I'm closer to Emmett and Nancy's view, but I think it would be perfectly reasonable to compromise at something in the neighborhood of an initial borrowing assumption of, say, \$700 million. I don't see that expectations are going to change, and that [borrowing] would we give us some modest further lift in rates and I think would be consistent, as Steve pointed out--at least I think he expressed this view--with the targets of alternative A. I don't think the funds range is significant; the way we're running monetary policy these days, we're not going to touch either extreme anyway. So, I don't think it's important whether we leave it at 6 to 10 percent or not. I think we might as well leave it.

MR. GUFFEY. I would join that view for a borrowing level of \$700 million or thereabouts. That suggests to me that we validate what has happened in the past; a funds rate roughly in the 9-1/8 to 9-1/4 percent range with a potential high of 9-1/2 percent might fall out of the \$700 million borrowing level. I would oppose going much higher than the \$700 million at this point.

MR. KEEHN. I'd be more inclined toward alternative B. I'd feel more comfortable with a fed funds rate of 9-1/2 percent or maybe a touch higher. And if a \$750 to \$800 million borrowing level would accomplish that, I think that's where I'd be comfortable.

VICE CHAIRMAN SOLOMON. You and I ought to change Districts! The theory of this regional system is that we reflect the view of our Districts. We do not.

MR. ROBERTS. I think Si's view is about where I would be. Alternative B is closer to what I would like to see: a funds rate of 9-1/2 to 10 percent and the borrowing somewhere around \$800 million if excess reserves are going to be around \$400 million.

MR. MORRIS. I would support the status quo policy of alternative A.

MR. BOYKIN. I would support "B," pretty much for the reasons that have already been set forth. I won't bother to repeat them.

MR. FORRESTAL. We would support alternative B, Mr. Chairman. We would look for something perhaps at the lower end of that range for the reasons you've already expressed--namely, that we're looking at a much more robust recovery than we had anticipated and monetary growth is very strong. The major question facing the Committee, it seems to me, is how long we can allow the monetary aggregates to continue to grow without raising inflationary expectations. So, it's a question of how much restraint needs to be put into the system. Our view would be that a little more tightening is required at this time, and the alternative B specifications would fit that. I would say we would look for borrowing at around the \$800 million level, with the funds rate somewhere between 9-1/2 and 10 percent.

MR. BOEHNE. My preference is alternative A, for the reasons stated. However, I would find acceptable an "A minus," which would be \$700 million on borrowing and 9-1/4 percent on the funds rate.

MR. MARTIN. I would support the Chairman's \$600 to \$800 million range, anticipating that \$700 million would be the midpoint of that. I would like to see fed funds at no higher than 9-1/2 percent. In other words, I'd support some verification on the interest rate side of what has already occurred, for the reasons I have mentioned too many times at this meeting. And I would move for the deletion of the automaticity embodied in the language in the two paragraphs that have been called to our attention.

CHAIRMAN VOLCKER. Who else has something to say? Are we supposed to be having coffee? If nobody else has anything to say, why don't we have coffee quickly?

[Coffee break]

CHAIRMAN VOLCKER. Let me try to summarize this as nearly as I see it. I am impressed, first of all, by the fact that our forecasts, I assure you, will receive much more prominence [than usual] in testimony and congressional discussion. I got a request from Mr. St Germain that the first page of the Humphrey-Hawkins testimony be nothing but a table of economic forecasts so they can concentrate on that. I don't know whether I'll do that or not, but--

MR. PARTEE. Our forecasts?

MS. TEETERS. Identified?

CHAIRMAN VOLCKER. The Committee forecast. So, it's going to be sitting right out there on the front page. I calculated that the central tendency averages roughly 9-3/4 percent. They go up as high as 11-1/4 percent and the lowest is 8.9 to 9 percent, which rounds off to 9 percent.

MS. TEETERS. You're talking 4th quarter over 4th quarter?

CHAIRMAN VOLCKER. I'm talking 4th quarter over 4th quarter for 1984. Now, wait a minute. No, there is someone who is as low as 7 percent. Yes, the low is 7 percent. But still, I think this would be 9-1/2 to 9-3/4 percent, just to cite that as background. But it bothers me in rationalizing--

VICE CHAIRMAN SOLOMON. How is that lower one split between real GNP and prices?

MS. TEETERS. About even.

CHAIRMAN VOLCKER. Well, I don't know how to answer that because the way I have it arrayed it goes from high to low on each of these, so it doesn't add up. They are all higher than the staff. Or rather, the tendency is to be higher than the staff on the GNP deflator. There's no question about that; that's where the difference from the staff forecast is. The staff forecast is 8.3 percent [on GNP] and on the deflator it's 4.1 percent. The central tendency on the deflator is going to be 5 percent or something like that on the Committee side. Now, it can be changed. But it will be sitting there and much more than before we're going to be asked: Is this desirable? Is this what we really want? Is it consistent with our policy? And so forth and so on. Let me just cite that as background.

For the short run, after listening to you and considering the desirability from my particular point of view of a little flexibility, I would still say something like \$600 to \$800 million, assuming that [excess reserves] are around \$300 to \$400 million, which means net borrowed reserves of \$300 to \$400 million. In fact, borrowings would be higher than that if excess reserves show this recurrent tendency to be much higher. But I detect a lot of sensitivity, which I can well understand, to the federal funds rate moving above 9-1/2 percent, and I think that flexibility would be partly associated with a tendency for the federal funds rate to move and stay much above 9-1/2 percent. As for the aggregates, in the sense of being a little more conservative in terms of what actually has been happening in M1-- Well, it looks like we're going to have a high M1 in July, judging by the way it's starting out. Of course, it doesn't make any difference for the June-to-September figure but for the quarterly average we're starting high. I'd be somewhat inclined to take the specifications of alternative B for M2 and M3 and use 7 percent or something like that for the M1 specification. So much for the short run. We have to discuss precisely what to say in the directive and I would make some changes in what has been proposed.

For the longer term, there's no perfect way. I must say that I don't feel comfortable with rebasing on June. It looks like too much fine-tuning. I can see everybody saying: Gee, they just take the highest number they got recently and they are fooling around. I would put in either 7 to 11 percent or 8 to 12 percent for this year, and I take it there's agreement--well, we'll get to it--for 5 to 9 percent or 4 to 8 percent for next year. But if it's 4 to 8 percent, I really have a problem in terms of our forecast. It seems to me the implication of that is a lower GNP forecast. And I would feel much more comfortable if we decide on 4 to 8 percent, if people would say that in the light of all our policy decisions these things were reviewed and we got a somewhat lower GNP forecast for next year and maybe a lower inflation forecast. It can be on the inflation side

rather than the real side. But I feel a little uncomfortable about rationalizing 4 to 8 percent with a forecast of almost a 10 percent nominal GNP increase next year. I don't feel uncomfortable in rationalizing it with the staff's GNP forecast; the staff's GNP forecast is more than 1 percent lower than the Committee's GNP forecast.

I guess there's agreement not to change the M2 and M3 ranges for the rest of this year and to reduce them by half percentage point for next year. Credit could either be reduced by 1/2 or 1 percentage point. Looking at the numbers now for credit: On the average, though not in every expansion, [nonfinancial] debt has increased a little faster than GNP in the second year of recoveries. I think it's true in all but one case since 1954. The first year it increases more slowly. Now, it has been increasing more rapidly this year; so I don't know what that tells us for next year. So, that probably is where I would be.

Now, we have to divide it up in terms of arriving at a conclusion. Let's take the short term first. To repeat: Some degree of flexibility in [borrowing of] \$600 to \$800 million, interpreted partly as net borrowed of \$300 to \$400 million, but with some sensitivity to the federal funds rate getting above 9-1/2 percent.

MR. MORRIS. So this is more generous than alternative B?

CHAIRMAN VOLCKER. A little more generous, yes. It's pretty much between--

MR. MORRIS. Alternative B is 9-1/2 to 10 percent.

CHAIRMAN VOLCKER. Yes, it's between "A" and "B," I think, and in broad terms is confirming where the market is now, except that I agree the market just might anticipate more [tightening]. I don't know how to deal with that. The market will anticipate it at some point whether we do anything now or not, unless we try to hold it down by--

MS. TEETERS. A lot depends on the testimony.

CHAIRMAN VOLCKER. Well, I think in the testimony I would not try to give the impression that we just embarked on this; the testimony would say we've tightened already. I'll probably say that tomorrow because I don't feel I can avoid it. I will try to say as little as possible about the future until next week.

VICE CHAIRMAN SOLOMON. Do you feel that you can say we've tightened a bit and that for the time being we want to wait and see the results of that tightening and other factors on the growth of the economy?

CHAIRMAN VOLCKER. I'd like to be able to say that, but if right in the midst of when I'm testifying we are tightening a little more I don't know that I can really say we are going to wait and see. But I'd like to give that impression to the degree that I could. I think I can say we don't see anything here that says we need any drastic action. The emphasis would be on a relatively modest move.

We don't see anything right now to require anything more drastic than a slight action. I'm not sure I can say this is over now.

MR. MORRIS. We're already up to 9-1/4 percent on the funds rate, so you're only talking about 1/4 point and that I think could be encompassed within the statement of no significant further move.

MS. TEETERS. We only intended it to go to 9 percent last time.

MR. PARTEE. They're going to be watching.

CHAIRMAN VOLCKER. As much as possible I would give the impression, without denying that some tightening may be going on, that a really drastic move is not what the doctor calls for.

MR. GRAMLEY. You just have to convince them that we've moved enough to choke off inflation and not enough to hurt the economy.

CHAIRMAN VOLCKER. Thank you. Just in the interest of clarity, when I say "sensitive" to a federal funds rate of about 9-1/2 percent, that doesn't mean that the federal funds rate couldn't be above 9-1/2 percent on particular days or for several days. What I do mean to say is that if it got up there, then we wouldn't be moving aggressively toward the higher borrowing numbers but the reverse.

MR. RICE. We would be trying to bring it back down to 9-1/2 percent?

CHAIRMAN VOLCKER. I don't want to make the target and then set--

MR. RICE. Well, if it happens to drift up to 9-3/4 percent, it could stay there.

CHAIRMAN VOLCKER. It could stay there, but it would only stay there if the borrowing number tended to be on the low side of this range that we're talking about.

MR. PARTEE. Well, I think it's a tad of tightening, but just a tad.

CHAIRMAN VOLCKER. I don't represent it as anything other than that.

MS. TEETERS. Yes, but suppose it goes up to 9-3/4 percent. Then you'll come back next time and argue that we're just validating what the market has already done.

CHAIRMAN VOLCKER. At that point either we would want to validate it or not or go further, depending upon what evidence we have at that time. I would be delighted to get in a position where because of something we saw in the aggregates and the economy or whatever, we could say "Let's ease up a little bit." I'd be delighted to be in that position, but I don't think we're there.

VICE CHAIRMAN SOLOMON. I'm not sure that I understand the importance of the targets for M2 and M3 and that for M1. I'm not sure

I understand their importance if we're having that narrow a view as to where we expect the fed funds rate to be. Do you want to--

CHAIRMAN VOLCKER. Well, this gets to the question of what we say in the directive. I don't feel particularly strongly about this but I think it might be useful to have something along the lines of what [the Bluebook] is proposing in the brackets, but I'd modify it. Let me say one other thing: In the long-run targets--but it would have a pale reflection in this operational paragraph--I could see some merit in trying to handle this M1 issue by presenting our targets, when we present them statistically, in a little table. I'd put down M2 and M3 as a target and put down M1 and total credit--I don't know what term to use--as a monitoring range or an associated range, so we have a two-tiered kind of target.

MR. GRAMLEY. Would that be demoting M1 further from what it was?

CHAIRMAN VOLCKER. I would not interpret it as demoting it further but making it clear that it has been demoted. It doesn't get the same weight as the other two.

MR. BLACK. Are you talking about the short run still?

CHAIRMAN VOLCKER. I'm talking about the long run when I say that, but [it is reflected] in the short run. I had a piece of paper where I scribbled something for the operational paragraph: "The Committee seeks in the short run to increase slightly further the existing degree of reserve restraint. The action is expected to be associated with growth of M2 and M3 at annual rates of about 8-1/2 and 8 percent respectively from June to September." And then, though I am not sure I thought this through, I'd pick up that bracketed sentence [in the Bluebook] but modify it to take out the "in part." I'd say "Depending on evidence about the strength of economic recovery and other factors bearing on the business and inflation outlook, lesser restraint would be acceptable in the context of a significant shortfall, while somewhat greater restraint would be acceptable should the aggregates expand more rapidly. The Committee anticipates that a deceleration in M1 growth to an annual rate of around 7 percent will be consistent with its third-quarter objectives for the broader aggregates."

VICE CHAIRMAN SOLOMON. Could you expand that sentence and put in something about total credit in the same sentence?

CHAIRMAN VOLCKER. We could, except that we don't have a figure.

MR. AXILROD. Evidence comes in later. In terms of the statistical evidence available, it's shakier and comes in later [than numbers] for M2 and M3.

VICE CHAIRMAN SOLOMON. But it would be helpful, I think, to carry through the concept of the two tiers with the associated ranges, if there's some way of doing that even without putting numbers on it.

CHAIRMAN VOLCKER. It's not very meaningful if we don't get the figures in.

MR. PARTEE. We have a third-quarter projection as I recall; I read it someplace.

MR. AXILROD. We couldn't put that in.

MR. PARTEE. It's rather low because the government borrowed so much in the second quarter.

CHAIRMAN VOLCKER. We could put in a figure but I don't think it would have much, or any, operational significance. It might have some operational significance by the time we get to September.

MR. PARTEE. Yes, it's very difficult to have any number there until the very end.

CHAIRMAN VOLCKER. We could say that the Committee anticipates that deceleration in M1 growth to an annual rate of blank would be consistent with its third-quarter objectives for the broader aggregates and that total domestic credit would remain within its range for the year or something like that. It could be a little broader--"will remain within the established range for the year."

MR. PARTEE. That is true, isn't it?

MR. AXILROD. Yes, it's hard to get out of that range.

CHAIRMAN VOLCKER. I wonder whether it's worth putting that in up above, too, just to emphasize that in these respects, anyway, we're within the targets. "The action is expected to be associated with growth of M2 and M3 at annual rates of about 8-1/2 and 8 percent respectively from June to [September], consistent with the targets established for the year." I didn't say anything about the range for the federal funds rate. I don't have any strong feeling about that one way or the other. If we leave it at 6 to 10 percent, we are telling the market a month from now--I don't know how meaningful that is--that we didn't want or were worried about the federal funds rate going above 10 percent.

MS. TEETERS. It has been in there for quite some time; if we take it out, it's going to cause comment.

CHAIRMAN VOLCKER. We'll get comment a month from now but I don't know whether it will make any difference. It's a little artificial at the low end, particularly now, but--

MR. MORRIS. But if we really would be concerned to see the rate go above 9-1/2 percent, it seems strange to me to raise the upper limit to 11 percent.

CHAIRMAN VOLCKER. One can argue it either way; it seems strange not to change it because we're nowhere near the middle. And it would seem strange to raise it if we want to reflect that concern. So, I come out neutral.

MR. MORRIS. A skewed median.

CHAIRMAN VOLCKER. Yes, I think I'm neutral on the subject.

MR. GUFFEY. We're still on the short-run directive?

CHAIRMAN VOLCKER. Yes, we're on the short-run ranges.

MR. GUFFEY. I have a question about putting in the bracketed sentence. I don't know that it adds anything and I would opt to remove it.

VICE CHAIRMAN SOLOMON. Well, it gives us a little more flexibility, Roger.

MR. GUFFEY. I don't know that it does, Tony. We can operate policy and this is a record that is essentially meaningless when it's released.

VICE CHAIRMAN SOLOMON. Basically what it's saying, though, is that our judgments about movements in the real economy will temper that earlier sentence. And I think that's consistent.

CHAIRMAN VOLCKER. I think it says more accurately that judgments about the real economy and inflation and so forth will temper our judgments about the aggregates.

MR. MARTIN. I think it's well to say that; I'd suggest leaving it in.

VICE CHAIRMAN SOLOMON. I agree.

CHAIRMAN VOLCKER. But it's also a warning that if the aggregates really went in one direction or another we would pay some attention to that, but how much attention we would pay would depend upon what we thought was going on in the economy and exchange rates and other things.

MR. GUFFEY. I guess my point is that, at the time this record is released, that's a meaningless expression.

VICE CHAIRMAN SOLOMON. You think we're being too heretical? "Depending in part on evidence"--

CHAIRMAN VOLCKER. I took out the "in part" deliberately.

VICE CHAIRMAN SOLOMON. --"about the strength of economic recovery both domestically and in the world." Something like that would show that we are aware of what is happening in the world economy.

CHAIRMAN VOLCKER. Well, if we get the right words, "Depending on evidence about the strength of the domestic economic recovery and other factors bearing on the business and inflation outlook, including...."

MR. GRAMLEY. We're talking about the operating directive. It's getting somewhat absurd.

MR. PARTEE. Yes, this is the instruction to the Manager.

MR. GRAMLEY. It's getting somewhat absurd. The whole idea of providing a little broadening is fine, but you are throwing in the monitoring of the credit aggregate and you are throwing in the international situation. This is--

MR. MORRIS. Yes, that ought to come in earlier in the introductory paragraphs, not in this paragraph.

VICE CHAIRMAN SOLOMON. The short-term directive--

MR. GRAMLEY. We can list these things in the Chairman's ear. I agree with flexibility, too. [Unintelligible] between now and the next meeting.

MR. PARTEE. It's not so much the world economic recovery as it is international debt. It's really the international financial conditions.

VICE CHAIRMAN SOLOMON. It's also the industrialized countries.

CHAIRMAN VOLCKER. Probably the right answer is not to complicate it. I may have complicated it too much, but let's not go any further. We can put somewhere else in the record that among these other factors we're looking at are international financial markets, the credit situation, etc. Well, I think the primary question, so modified, is: Do we leave that sentence in or not? Let's deal with that question.

MR. PARTEE. Would you read the sentence again the way you now have it?

CHAIRMAN VOLCKER. The way I now have it is: "Depending on evidence about the strength of economic recovery and other factors bearing on the business and inflation outlook" and the rest of the sentence is as it is.

MR. WALLICH. Well, that is an instruction to the Manager whereas it is an expression of the intention of the Committee subject to our evaluation--

MR. PARTEE. We will instruct the Manager as to the economic conditions and--

MR. WALLICH. That's right. I think we should deburden--

MR. PARTEE. I have a feeling the Chairman will have a view on these matters.

CHAIRMAN VOLCKER. I think that's fair. In or out?

SEVERAL. In.

MR. WALLICH. I would say out.

CHAIRMAN VOLCKER. Well, let me have a show of hands. How many say in?

MR. PARTEE. Are you talking about everybody?

CHAIRMAN VOLCKER. Just members of the Committee. That's 1,2,3,4,5,6,7,8, without me. Tentatively, we leave that in. Now, what about the numbers? I put in here 8-1/2, 8, and 7 percent and put in at the end of the sentence on the broader aggregates that they are consistent with the targets established for the year. That's just advertising. We say in the other sentence, which would follow this sentence we just discussed, that the Committee anticipates that deceleration of M1 growth to that area will be consistent with its third-quarter objectives for the broader aggregates and that total domestic credit expansion would remain within the range established for the year. Let's just look at that part, both the wording and the numbers of 8-1/2, 8, and 7 percent.

MS. TEETERS. That assumes borrowing and [unintelligible]?

CHAIRMAN VOLCKER. I'll get to that in a minute. But that's what I'm going to assume so we can vote on it explicitly. Is that all right? We'll get to the funds range but we're not there yet. We're voting on the 8-1/2, 8, and 7 percent with the language that I suggested. All right.

SPEAKER(?). I think I'll go with that.

CHAIRMAN VOLCKER. Now we get to the funds range. We have a choice of 6 to 10 percent or 7 to 11 percent; I'm happy with either one.

MR. GUFFEY. 6 to 10.

CHAIRMAN VOLCKER. How many want 6 to 10 percent?

MR. GRAMLEY. What has it been?

CHAIRMAN VOLCKER. 6 to 10.

MR. GRAMLEY. Well, then, leave it there.

CHAIRMAN VOLCKER. Who is for leaving it at 6 to 10 percent? 1,2,3,4,5. Who is for making it 7 to 11? 1,2,3. How many are left? Some people aren't voting again.

SPEAKER(?). I don't care. As long as you're planning on somewhere between 9-1/4 and 9-1/2 percent, I'm for either.

CHAIRMAN VOLCKER. Well, I wouldn't like to see a lot of disagreement just about that number, but I guess we have more for 6 to 10 percent in an indifferent situation than we have for 7 to 11 percent. All of this is associated with \$600 to \$800 million on borrowing, interpreted as \$300 to \$400 million of nonborrowed reserves and sensitivity to the federal funds rate being above 9-1/2 percent-- meaning that we would lean toward the lower side of this degree of pressure either in net borrowed reserves or borrowings or both. That's all I have to say. If nobody has any other particular improvement on that formulation, I'll just assume that's it.

MR. GUFFEY. I'd just like to ask: When you are talking about \$600 to \$800 million and \$300 to \$400 million, I assume you are

looking at \$700 million [on borrowing] with about \$350 million on net borrowed. Is that at least the way we start in theory?

CHAIRMAN VOLCKER. I think that's--

MR. PARTEE. It's certainly within the range.

CHAIRMAN VOLCKER. Okay, I guess we ought to vote on this unless somebody has some question. Is it all clear?

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Guffey	Yes
President Keehn	Yes
Governor Martin	Yes
President Morris	Yes
Governor Partee	Yes
Governor Rice	Yes
President Roberts	Yes
Governor Teeters	No
Governor Wallich	No

SPEAKER(?). A bell shaped distribution!

CHAIRMAN VOLCKER. Now we turn to the longer-term ranges. Let's dispose of this total credit figure to get it out of the way. Do you want to go down a half point or one point next year? How many vote for going down one point? [Six.] How many want to go down a half? Five. That certainly settled that one!

MR. PARTEE. How about one point on the top and a half point on the bottom?

CHAIRMAN VOLCKER. Well, before we get to what is acceptable and what is not, let's assume for the moment that it's down one point, subject to change. Everybody is in favor of down a half point for the other aggregates, M2 and M3. Now we're on M1 again, our famous M1. I feel just as I expressed it. I'm willing to go to 4 to 8 percent, but it makes me very uncomfortable with the GNP projections as high as they are. And I would like to have a feeling that if we arrive at 4 to 8 percent people might think that that's a little restrictive-- enough to justify some shading of their GNP projections.

MR. PARTEE. Do I take it that you mean that you don't think we ought to attempt to restrain GNP at 10 percent? That's an acceptable growth in the economy?

CHAIRMAN VOLCKER. My gut feeling is that if we say 4 to 8 percent, we are assuming that GNP ought to be restrained from 10 or 11 percent. I think that's what I am saying.

MR. PARTEE. Whereas 5 to 9 percent is pretty neutral.

MR. ROBERTS. You could have, could you not, a 10 percent nominal GNP, 4th quarter over 4th quarter? I think that could still be consistent.

CHAIRMAN VOLCKER. Well, it could be. I can't put it that sharply. I can't say that with 8 percent it is impossible to have an 11 percent [nominal] GNP, but I think that's coming back to pretty much saying that velocity patterns haven't changed at all.

MR. GRAMLEY. What is the staff--

CHAIRMAN VOLCKER. In a word we're saying this is our central feeling about the GNP and the central feeling is that velocity patterns probably haven't changed at all. That's what makes me uncomfortable.

MR. ROBERTS. If we had 6 percent growth in money, which is right in the middle of our range, and got a 10 percent middle range nominal GNP, assuming 3-1/2 percent velocity--

CHAIRMAN VOLCKER. That's what you have to assume--a 3-1/2 velocity, which would not be outrageous but is higher than the average somebody gave me for the second year.

MR. ROBERTS. Higher than the 2.7 we heard.

CHAIRMAN VOLCKER. That's what bothers me about it, just in terms of explaining it. It seems to me that we'd have to say that for all this talking we've been doing about velocity changing, our forecast and our policy is based upon the notion that velocity hasn't changed. That's what bothers me.

MR. BOEHNE. It seems to me this is not an issue that's worth getting hung up on in testimony. Around a 10 percent nominal GNP has a nice ring to it; it's fairly close to what seems to be the conventional wisdom, right or wrong. For that reason, I wouldn't want to risk a major disagreement or being beat up on because of it.

CHAIRMAN VOLCKER. I'm not sure what you're saying.

MR. BOEHNE. I'm for 5 to 9 percent is what I'm saying.

CHAIRMAN VOLCKER. Oh.

VICE CHAIRMAN SOLOMON. Then maybe you ought to find out whether today's discussion could cause some of those who came in with higher projections to feel justified in somewhat lower ones or not.

CHAIRMAN VOLCKER. That would solve the problem, if it did. I guess that's what I'm asking, particularly in the light--

MR. BOEHNE. Well, it solves the problem of numerical consistency, but I don't think it solves the broader problem of the Fed somehow finding 10 percent growth unacceptable and wanting to restrain it. That strikes me as an uncomfortable position to be in.

MR. PARTEE. Well, I think it's a very big growth. I must say I had 9 percent and I guess I'd be inclined to raise it, hearing what I've heard around the table.

VICE CHAIRMAN SOLOMON. We had even lower--

MR. PARTEE. We're not talking about any restraint at all.

MR. MORRIS. We have second-year velocity expansion as high as 4.3.

CHAIRMAN VOLCKER. Well, I have a list here of what everybody projected on everything and I'm looking for Governor Partee's name and it's not here.

MR. KICHLINE. If you're looking at annual averages, I think he abstained.

MR. PARTEE. I didn't give annual averages.

CHAIRMAN VOLCKER. Oh, I'm sorry. Have I been looking at the wrong numbers all along? I didn't mean to look at these annual averages.

MR. PARTEE. There still is quite a range, according to this chart that was passed out yesterday, for the year from the fourth quarter. The low I see is 7 percent and the high is 10-1/2 percent. No, there's 11-1/4 percent from somebody.

CHAIRMAN VOLCKER. The high is 11-1/4; the low is 8.3. But there are 8 people at 10 percent or higher. Did we present this as Committee members or everybody last year?

MR. KICHLINE. Everyone last year.

CHAIRMAN VOLCKER. Half the people who vote are at 10 percent or above.

VICE CHAIRMAN SOLOMON. Paul, I'd say 5 to 9 percent. Unless there is going to be a major review and change from a substantive point of view I'm happy with the 5 to 9 percent.

MR. MARTIN. I think the 5 to 9 percent is easier to explain. You're the person who has to be the expositor here and I think we should go along with your--

CHAIRMAN VOLCKER. When I sit here, it seems to me easier to explain without much question. On the other hand, it's shocking psychologically perhaps.

MR. GRAMLEY. Well, that's the part that bothers me. We start out with an M1 target for this year of 4 to 8 percent and then we are going to allow an overrun and raise it for next year. And what is going to happen is that people are going to say the Fed [is not] fighting inflation. I think you are making a lot more of this velocity point than is necessary from the standpoint of consistency with GNP projections. If you're talking about the midpoint and the average, fine. But there's no reason at all why if we have a target of 4 to 8 percent, we can't let the 8 percent happen. If 8 percent happens, 10-1/4 or 10-1/2 percent is easily a reachable measure for nominal GNP.

MR. BOEHNE. But M1 is going to be in this associated range below, and we're going to show in the M2 and M3 ranges a drop of 1/2

point, and the companion associated range for total credit is going to go down 1 point. It seems to me that we have three of the four down, which indicates concern about inflation in terms of the long-run goals. And the fact that M1 has to go up and down and all around simply conveys the uncertainty that is characteristic of that aggregate.

MR. ROBERTS. Well, that isn't exactly right. We've had an excessive rate of growth here for a long period of time; it's continuing at a little more moderate pace. Normally in a business expansion we would moderate that; it's time that we signal that to the market very clearly. And I would be in favor of the 4 to 8 percent.

MR. WALLICH. Historically, M1 has been about 3 percentage points slower than the other two. Now that velocity has changed, it may be 2 percent slower, so that 8 and 10 percent are still reconcilable.

MR. PARTEE. Well, that's arithmetic.

CHAIRMAN VOLCKER. At the margin 8 and 10 percent are reconcilable. It is pretty hard to reconcile 4 and 10 percent.

MR. PARTEE. I think what you want is 5 to 9 percent.

VICE CHAIRMAN SOLOMON. But if you take Paul's reluctance to base it on June, then you tell the markets that you are going to do 4 to 8 percent based on the second quarter.

CHAIRMAN VOLCKER. Well, I am thinking now of using the annual figures--using either 7 to 11 percent, which is equivalent to 4 to 8 percent, or even 8 to 12 percent.

VICE CHAIRMAN SOLOMON. Well, you're thinking of using annual--

CHAIRMAN VOLCKER. So, it would be presented as: Look, M1 is off this year; we are going to attempt to slow it down. That's true with even the 8 to 12 percent range; 7 to 11 percent is a slightly different coloration. Next year we expect it to be lower by a significant amount. What I would say is just what we said before: that it does assume some slowdown in velocity from past trends, but not all that much at one end of the range. At the lower end of the range we've allowed for a full, or more than a full, cyclical rebound in velocity.

MS. TEETERS. We are dealing with a very different aggregate. And this whole discussion is [based] on the assumption that it is still the way it was for 20 years. It's a new aggregate. It's going to behave very differently. And we ought to give ourselves plenty of room to let it operate and find out what it does.

CHAIRMAN VOLCKER. I don't want to make too much of the difference between 5 and 9 percent and 4 and 8 percent. But it also comes to: What are our chances of getting within it? It's awfully nice to be within these numbers instead of making excuses for being outside. The down [side] is explaining why they've gotten that high in the first place.

MR. GRAMLEY. If we go to 5 to 9 percent, isn't there a reasonable argument for rebasing on the second quarter for the second half of this year also?

CHAIRMAN VOLCKER. Oh, I don't mind rebasing on the second quarter, but I don't like rebasing on June.

MR. GRAMLEY. If we go to 5 to 9 percent, I think we could do that. Maybe the staff could give us estimates of what 9 percent would be. What would a range of 5 to 9 percent give us if we hit the upper end of that range?

MR. AXILROD. By the fourth quarter?

MR. GRAMLEY. Yes.

MR. AXILROD. You have to give me some time to make that calculation.

MR. GRAMLEY. The only question is what the year-over-year growth is. I think it'll be close to 12 percent.

CHAIRMAN VOLCKER. It's going to be one percent higher than where we are now. That will be an easy calculation.

MR. PARTEE. Is June [adding] about 1 percent in the second quarter?

CHAIRMAN VOLCKER. 1/2 of a percent.

MR. GRAMLEY. 1/2 of a percent, yes.

CHAIRMAN VOLCKER. It's 1/2 percent higher than whatever.

MR. AXILROD. Yes, it should be around 11-1/2 percent. If it grows 9 percent Q2 to Q4, just extrapolating from what I have here, that ought to be about 11-1/2 percent for the year. Is that what you're asking? If it grows 8 percent, it looks like it's about 11 percent for the year. So, if it grows 9 percent, it ought to be around 11-1/2 percent for the year.

VICE CHAIRMAN SOLOMON. The argument against rebasing as opposed to giving an annual number is that it might look as if we're giving M1 more importance than we want to convey. But I think that's a bit offset by putting in M1 and total credit as associated ranges.

CHAIRMAN VOLCKER. I would not argue against rebasing on the second quarter; it just looks a little flimsy to me to rebase on June.

VICE CHAIRMAN SOLOMON. Yes, that's what I'm saying. In other words, I'm addressing why we were moving away from the rebasing approach earlier. In general it was because it might give the impression that we were attaching more importance to M1 than we wanted to convey. But maybe we're offsetting that now by putting in M1 and total credit as associated ranges. So, therefore, I think we can rebase on the second quarter.

CHAIRMAN VOLCKER. Well, I'm perfectly willing to rebase on the second quarter, if it sounds better to say 5 to 9 percent beginning in the second quarter.

MR. PARTEE. Really, it's for this period out ahead--the next 18 months. We don't have much distinction between the second half of 1983 and the year 1984.

VICE CHAIRMAN SOLOMON. And we shouldn't have a distinction because that would imply a knowledge on our part about velocity, which we don't have.

MR. PARTEE. Yes, and I'd say we don't have a distinction in the GNP forecast either. So, I think it makes sense to talk about the period ahead.

MR. BLACK. If we rebase and take 5 to 9 percent for '83, it looks to me as if we ought to go a little below that for '84.

MR. PARTEE. We're talking about a block of time and we are not distinguishing one part of it from another.

MR. BLACK. But if we really look at our ranges for '83 and a rebased 5 to 9 percent for M1 from the second quarter looks appropriate, then I'm just saying the targets for next year--

CHAIRMAN VOLCKER. If we go for 5 to 9 percent particularly, we have to say in the statements that 9 percent is not appropriate if we get a normal velocity recovery. We just say that very strongly. That's why we have a range, and we could well be low in the range if velocity is normal. But we have some great doubts about whether velocity will be normal. We're going to have a downward movement in M1 next year without a doubt, but it's going to be 11 percent this year or something like 10 or 11 percent.

MR. GRAMLEY. That's a lot of progress, Bob.

MR. BLACK. Well, looking at the year as a whole. But from the last half, if we come within a 5 to--

CHAIRMAN VOLCKER. From the last half there wouldn't be.

MR. BALLE. The latter half will be about 6 or 6.5 percent.

VICE CHAIRMAN SOLOMON. Yes, but on our principal targets, M2 and M3, we would be showing a reduction.

MR. BLACK. The difference is that that's not my principal target, Tony.

VICE CHAIRMAN SOLOMON. Well, it is the Committee's.

MR. BLACK. Yes.

MR. BALLE. Mr. Chairman, I'll come back and support the words of caution that Lyle threw out here, wisely in my opinion, a few minutes ago. We are not debating the course of policy; we're debating broad ranges that have a public announcement effect and certain

perceptions. To go up to 5 to 9 percent in combination with what we've already done--or let happen--in M1 this year because of some very unusual circumstances, I think has some real risks of adding to perceptions that the Fed is giving up on the battle against inflation. I would be very leery of that. I'd rather live with some inconsistencies that we can straighten out or worry about later on. This is, after all, just a tentative, provisional indication of our 1984 plans subject to the usual more thorough review around yearend or early next year.

MR. PARTEE. Of course, we're not really using the M1 number as a range with a midpoint. We're talking about a true range of 5 to 9 percent and we're expressing hope, I would presume, that it could be more toward 5 percent, but that depends on the rate of increase in velocity.

MR. MARTIN. This isn't a statement in isolation; this is a statement made at a time that interest rates have firmed and are continuing to firm a little.

VICE CHAIRMAN SOLOMON. We could underline the uncertainty of the velocity projection by making it 4 to 9 percent.

MR. MORRIS. We could underline it even better by eliminating M1 guidelines.

MR. GRAMLEY. We could put it in the list below the credit aggregate: M2, M3, credit aggregate, and M1.

CHAIRMAN VOLCKER. That doesn't--

MR. MARTIN. Or a footnote.

VICE CHAIRMAN SOLOMON. Oh, we forgot it!

MR. BLACK. Or put the footnote on another page where nobody could find it!

MR. PARTEE. Or we could have another paragraph--associated with the particular increase in bank credit and M1.

CHAIRMAN VOLCKER. Well, this is all a question of nuance. If we have 4 to 8 percent, then I think a statement has to say pretty clearly that we're counting on regular velocity movements and if they don't happen, we're going to have to increase the target. Now, if we emphasize that less--

MR. PARTEE. I certainly don't want to do that.

MR. GUFFEY. I would prefer doing that and coupling it with going to 7 to 11 percent for this year and thus not building any certainty on the M1 target.

VICE CHAIRMAN SOLOMON. We can have a new category for velocity-sensitive associated ranges!

CHAIRMAN VOLCKER. Well, you've heard all my doubts on either side. Who wants the 4 to 8 percent next year?

MR. GRAMLEY. I'd prefer 4 to 8 but I could live with 5 to 9.

CHAIRMAN VOLCKER. One, two, three, four, five. Who wants 5 to 9 percent? One, two, three, four, five.

MR. GRAMLEY. Well, I'd rather switch than fight.

CHAIRMAN VOLCKER. Who wants 7 to 11 percent this year as opposed to either 5 to 9 or 4 to 8 percent for the remainder of the year?

SPEAKER(?). I don't think we can have 4 to 8 percent for the remainder of this year and then say next year is going to be 5 to 9 percent.

MR. PARTEE. That has to be 5 to 9 percent.

MR. GRAMLEY. It could be 5 to 9 percent and then 4 to 8 percent, but not the reverse.

MR. PARTEE. Either [unintelligible] or we're going to rebase.

CHAIRMAN VOLCKER. Yes, I agree with that.

MS. TEETERS. And the question is whether we want to rebase or not.

MR. PARTEE. Yes, that's it.

CHAIRMAN VOLCKER. Yes, one or the other. Just let me put it that way. Do you want to rebase or not? Seven. Well, that isn't a very healthy [margin] but I guess we rebase. Having rebased, what is the preference between 5 to 9 and 4 to 8 percent?

MS. TEETERS. 5 to 9.

VICE CHAIRMAN SOLOMON. You already asked that, didn't you?

CHAIRMAN VOLCKER. I asked for next year; now I'm asking for this year.

SEVERAL. It's the same.

CHAIRMAN VOLCKER. Everybody is going to have the same.

MR. CORRIGAN. We could have 5 to 9 percent this year and 4 to 8 percent.

MR. KEEHN. Yes, 5 to 9 and 4 to 8--

SPEAKER(?). How many people have that?

MS. TEETERS. Listen, you lost that argument.

MR. CORRIGAN. Heck, I want 4 to 7 percent next year.

CHAIRMAN VOLCKER. Well, we could have 5 to 9 and 4 to 8.

MR. GRAMLEY. That would be my preference.

MR. KEEHN. That would be my preference.

CHAIRMAN VOLCKER. Well, let's see how strong the support is for that: 5 to 9 percent for the rest of this year and 4 to 8 percent for next year.

MR. GUFFEY. Assuming rebasing?

MR. BALLE. This would be from June or the second quarter?

SEVERAL. Second quarter.

CHAIRMAN VOLCKER. A second-quarter rebasing. That isn't tremendous [support]. Who wants 4 to 8 and 4 to 8?

MR. WALLICH. I'm willing to rebase on June.

CHAIRMAN VOLCKER. That's a bigger increase than what you indicated, Henry. That's a triumph of cosmetics over substance.

MR. BLACK. That is right.

MR. MARTIN. Hope over experience.

CHAIRMAN VOLCKER. That leaves us with 5 to 9 percent for the remainder of this year and 5 to 9 percent for next year.

MR. PARTEE. Well, the whole period could be spoken of as 5 to 9 percent. I wouldn't make that much of a distinction between the second half and next year.

MR. BLACK. You have to rewrite this.

CHAIRMAN VOLCKER. Well, I'm not quite sure what you are saying. Are you saying when people look at it in these cone terms that the cone begins in the second quarter and goes through 18 months and we get a big cone then 19 months later?

VICE CHAIRMAN SOLOMON. Oh, you're not suggesting that?

MR. PARTEE. I hadn't even thought of a cone. No, I was thinking that I did not want to distinguish. The reason I didn't vote with Lyle on reducing it to 4 to 8 percent is that it seems to me to be fine-tuning because we can't make any distinction between the rate of progress on the economy now for the second half of this year and for next year. And our forecast is very close to assuming that. So, it seems to me we ought to talk about a 5 to 9 percent rate of increase as being consistent, depending on what is going to develop in velocity, for this period ahead. I see your point because the Humphrey-Hawkins Act asks us what our targets are for [the next year, which is] 1984.

CHAIRMAN VOLCKER. I don't think it makes much difference, and I don't think we have to face this at this stage. We set it this way and say 5 to 9 percent for the end of this year. The assumption

would be that the second 5 to 9 percent started out where we were at the end of this year.

MR. WALLICH. It can't go above 9 percent.

CHAIRMAN VOLCKER. It can't go above 9 percent in either case; it can only go below. Well, I recognize the psychological difficulty of this. It's a question of a kind of realism and of the initial psychological [effect]. I have to think of how that could be worded.

MR. AXILROD. You have indicated no change in the range for next year. You could say "extending 5 to 9 percent over the balance of this year and indicated no change for the range for next year."

MR. PARTEE. And "tentatively for next year as well."

MR. AXILROD. Yes, indicating that its base is wherever it ends up.

VICE CHAIRMAN SOLOMON. When you do the Humphrey-Hawkins testimony, do you actually release the directive language on the long-range targets or do you simply use your own wording?

MS. TEETERS. It has been worked into the text in the past.

CHAIRMAN VOLCKER. It shouldn't; the wording appears--

MR. PARTEE. It is not set.

MS. TEETERS. It's not set in; that's correct.

CHAIRMAN VOLCKER. It's not set in as a directive.

VICE CHAIRMAN SOLOMON. But I assume on the wording that the associated range type of language would be placed around the sentence on M1.

CHAIRMAN VOLCKER. "At this meeting the Committee reaffirmed the longer-run ranges established earlier for growth in M2 and M3 and total domestic nonfinancial debt." I don't know that we want to say "with growth in the broader monetary aggregates expected to be in the upper part of their ranges."

MR. AXILROD. No, not with the short-run policy; it's not consistent. That was just in case a different short-run policy--

CHAIRMAN VOLCKER. That M1 sentence has to be changed quite a bit. We have to write an M1 sentence; that's where we are.

VICE CHAIRMAN SOLOMON. An M1 and a total credit sentence.

CHAIRMAN VOLCKER. Why don't we take out the total domestic nonfinancial debt from the first part and just say "reaffirmed the longer-run ranges established earlier for growth in M2 and M3."

MR. GRAMLEY. We could leave the total nonfinancial debt in 1983 in that sentence, take out the next bracket and the following bracket, and then change it to the second half of this year.

MR. CORRIGAN. Would it be too much of a break from precedent to have it structured so that we have in effect two votes--one on M2 and M3 and then a separate vote on the associated range for M1 and total credit?

MR. PARTEE. Well, it certainly would set a precedent.

MR. MORRIS. It would be too much.

MR. PARTEE. We already have the difficulty of inconsistency.

VICE CHAIRMAN SOLOMON. I think it gives more importance to the associated ranges if we have a separate vote on them.

MR. CORRIGAN. Maybe.

CHAIRMAN VOLCKER. Maybe it should be what you were saying, Lyle. "At this meeting the Committee reaffirmed the long-term ranges established earlier for growth in M2 and M3 for 1983." And then go immediately to "The Committee also agreed to tentative growth ranges for the period from the fourth quarter of 1983 to the fourth quarter of 1984 of" whatever they are. What are they?

MS. TEETERS. 6-1/2 to 9-1/2 percent--

CHAIRMAN VOLCKER. 6-1/2 to 9-1/2 percent for M2 and 6 to 9 percent for M3.

MR. PARTEE. I thought we were cutting them a half point.

CHAIRMAN VOLCKER. That is cutting them a half point. "The Committee considered that these ranges"--that's referring to M2 and M3--"would be consistent with growth...."

VICE CHAIRMAN SOLOMON. I think it should be the reverse. In other words, say that the associated ranges of X and Y are consistent with the principal targets. It's not that the principal targets were designed to be consistent with--

CHAIRMAN VOLCKER. All right. "At this meeting the Committee reaffirmed the longer-run ranges established earlier for growth in M2 and M3 for 1983. The Committee also agreed on tentative growth ranges for the period from the fourth quarter of 1983 to the fourth quarter of 1984 of 6-1/2 to 9-1/2 percent for M2 and 6 to 9 percent for M3. The Committee considered that growth of M1 in a range of 5 to 9 percent"--if that's the number--"in the second half of 1983 and during 1984, taking a base of the second quarter of 1983, would be consistent with these ranges. The associated range for total domestic credit was reaffirmed at 8-1/2 to 11-1/2 percent for 1983 and tentatively set at 7-1/2 to 10-1/2 percent for 1984." Now, I used a full percentage point reduction there, if we use the 5 to 9 percent. If we use the 4 to 8 percent, I think we'd use the higher total credit number. We could say 4-1/2 to 8-1/2 percent.

VICE CHAIRMAN SOLOMON. What would you do then about the next paragraph?

CHAIRMAN VOLCKER. That's the operating paragraph; nothing on that.

VICE CHAIRMAN SOLOMON. In the second sentence we ought to say "the behavior of M1 and total credit."

CHAIRMAN VOLCKER. Yes, I think that will do. "The behavior of M1 and total credit will be monitored, with the degree of weight placed on M1 over time dependent on evidence of velocity characteristics that are resuming more predictable patterns."

MS. TEETERS. Take out the bracketed sentence?

CHAIRMAN VOLCKER. Leave out the bracketed sentence. And then we don't need the next sentence either, I don't think.

VICE CHAIRMAN SOLOMON. Well, wouldn't you want to say the degree of weight on both in leaving out the next sentence?

MR. PARTEE. The degree of weight on both placed on the velocity characteristics of M1?

VICE CHAIRMAN SOLOMON. No, the degree of weight on M1 and on the [debt].

CHAIRMAN VOLCKER. I don't know.

SPEAKER(?). It's clear now; you can't--

VICE CHAIRMAN SOLOMON. You're right; I'm sorry.

MS. TEETERS. You can't.

MR. PARTEE. We haven't got velocity on total credit.

CHAIRMAN VOLCKER. Is that wording acceptable, leaving open for the moment the numbers on both credit and M1?

MS. TEETERS. Did you take out Tony's change?

MR. PARTEE. It's a just an expression of what we did without any real analysis. We will have to rely on the statement for that analysis. But it's so complicated that I think that's the way to go.

CHAIRMAN VOLCKER. Well, what would appear on the table is the M2 and M3 targets and the associated ranges, or whatever other euphemism is used, that we have for M1 and total credit.

VICE CHAIRMAN SOLOMON. I think that's a more clean-cut way of doing it.

CHAIRMAN VOLCKER. Hearing no comment, it leaves us still with this 5 to 9 or 4 to 8 [decision]. I can live with either one; I don't want to make too much of it. I would say if we have 5 to 9 percent, we ought to go down 1 percentage point on the credit range;

if we have 4 to 8 percent, I'd go down 1/2 point on credit. I don't know; as a matter of fact we could have 4-1/2 to 8-1/2 percent. We have halves in all the others.

MR. GUFFEY. For '83 and '84?

MS. TEETERS. No, it's too restrictive for '83.

MR. PARTEE. Well, it seems awfully fine.

SPEAKER(?). Yes.

MR. GRAMLEY. We've done it before [unintelligible] M1.

MR. PARTEE. [Unintelligible] compensating with regard to--

VICE CHAIRMAN SOLOMON. The fact that we already used multiple--

MR. GRAMLEY. Our range for 1981 was 2-1/2 to 5-1/2 percent.

CHAIRMAN VOLCKER. But we weren't protesting then that we didn't know anything about velocity.

MR. GRAMLEY. We should have. We knew as little then as we do now.

CHAIRMAN VOLCKER. I guess the more obvious compromise is 5 to 9 percent this year and 4 to 8 percent next year. The only thing that bothers me is the height of those nominal GNP [forecasts].

MS. TEETERS. What's wrong with just leaving it 5 to 9 percent for the whole period?

MR. GRAMLEY. I think we're much better off to have it somewhat lower; I would worry very much about just the announcement effects of numbers like 5 to 9 percent continuing through 1984.

MR. BALLE. Amen.

MR. GRAMLEY. It's not that it's going to affect policy at all; I don't think it will. But I think the announcement effects could be unfortunate. It's not the market effects but the announcements effect that I'm worried about.

MR. BALLE. I'll support that.

MS. TEETERS. I think we'd get unfortunate announcement effects just by showing that we're going to tighten up again.

MR. ROBERTS. We're telling the market that we accept this bulge that has taken place--that we are not going to do anything about trying to get rid of it. That ought to be a positive influence.

MR. PARTEE. Yes, I think that would influence their thinking.

VICE CHAIRMAN SOLOMON. Well, I'll switch my vote and accept 5 to 9 percent for the remainder of the year and 4 to 8 percent for the next year.

CHAIRMAN VOLCKER. I would do that, but I think we have to say in the statement that if the next six months show no return to [normal patterns of] velocity, 4 to 8 percent is probably too low.

MR. ROBERTS. It's subject to a resumption of normal velocity.

MR. GUFFEY. There's a potential rebasing every year.

CHAIRMAN VOLCKER. All right. Let's vote on that particular variant, understanding that I will cast some doubt if pressed on this consistency. I'll say we are assuming that it will return to normal velocity patterns. If that doesn't happen--if we don't see further evidence of that in the next six months--we're going to put that target higher when we come back in February. After all that, are we ready to vote? Now, where do we put the credit range then?

MS. TEETERS. Down 1/2 point. That leaves--

CHAIRMAN VOLCKER. It's down a 1/2 point on the credit. If you are going to vote for it--

SPEAKER(?). Make it 2 to 11!

MR. PARTEE. I thought we took--

MR. BALLE. I thought we already had decided down a point on credit.

CHAIRMAN VOLCKER. Well, I guess we did have a majority there.

SPEAKER(?). No one feels all that strongly about it.

CHAIRMAN VOLCKER. Well, let's take it again. Assuming we have 5 to 9 percent and then 4 to 8 percent, who is for down 1 point on the credit aggregate? Who is for down 1/2 point? I guess we have a trade here for the 4 to 8 percent. So, we are at 5 to 9 percent. I have to change the wording slightly here from what I wrote, reflecting that. Understand that that's done. We are down only 1/2 point on credit.

MR. WALLICH. From 1983 to 1984?

CHAIRMAN VOLCKER. Yes, for credit. Now all the numbers are reduced by 1/2 point.

VICE CHAIRMAN SOLOMON. Excepting M1.

MS. TEETERS. Except M1, which is down by--

CHAIRMAN VOLCKER. M1 will be 5 to 9 percent; the borrowing--

MR. GRAMLEY. The 5 to 9 is just for a half year, Nancy. That's annualized.

MS. TEETERS. Come on! It goes down a whole point.

CHAIRMAN VOLCKER. Ready, aim--

VICE CHAIRMAN SOLOMON. It would be ironic if the markets interpret the 1 point reduction in M1 as against a 1/2 point reduction in the other three as in some way giving more importance to M1 again.

SPEAKER(?). Let's take a vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Guffey	Yes
President Keehn	Yes
Governor Martin	Yes
President Morris	No, on the grounds that I
don't think we ought to have	guidelines for M1 and M2
Governor Partee	Yes
Governor Rice	Yes
President Roberts	Yes
Governor Teeters	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. Now I think we have reports from the Managers.

MR. GRAMLEY. Somehow they seem rather anticlimactic.

MS. HORN. We'll be fascinated by everything they have to say!

SPEAKER(?). Make it short.

CHAIRMAN VOLCKER. I think it is abbreviated.

MR. MEEK. Yes, very abbreviated. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions?

CHAIRMAN VOLCKER. Is still borrowing?

MR. BALLE. No, they've stopped the borrowing now; they have repaid the whole thing. That final week before the consummation of the mergers it got up to a daily high of \$960 million and a weekly average of \$800 million. We gave them a week after the consummation of mergers to repay the whole thing and they have done it.

CHAIRMAN VOLCKER. Did lend to them?

MR. BALLE. Yes, really raised the funds in the market to do it. We didn't want to have a disruptive situation, so we talked about cranking it down to about \$300 million a day. And they paid off late last week and got it down to zero.

CHAIRMAN VOLCKER. Any other questions? Mr. Cross.

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

CHAIRMAN VOLCKER. Mexico, as I understand it, would prepay at least part of these but they can't do it because their agreement with the commercial banks doesn't permit them to repay the official [borrowing] in advance. So, we are exploring some kind of deposit arrangement or something.

MS. TEETERS. I move we accept both reports and ratify the transactions.

CHAIRMAN VOLCKER. Without objection. I'd say the Brazilian thing has been very disturbing; it's promising if they act. They're in the clinch this week--today, tomorrow. The latest report seems somewhat promising. It's a terrible problem.

MS. TEETERS. What is the political situation in Brazil? Is it like Chile? You know, Chile blew up last night. Is Brazil in that sort of situation?

CHAIRMAN VOLCKER. Chile blew up last night?

MR. PARTEE. Well, it didn't blow up.

MS. TEETERS. There was a big riot in Chile last night.

CHAIRMAN VOLCKER. Well, there have been some riots in Brazil, too. But it's complicated. The President has heart problems and is coming to the United States. They are in the throes of trying to pick a successor for the President--pointing a finger in the right direction. Apart from the economic problems and difficulties, which are very evident, time is running out in terms of patience by the banks and the BIS and others. And it's either going to come together this week or we're going to be in the soup.

MR. ROBERTS. There was a reference to our guarantee of the BIS credit. Is that a full or a partial guarantee?

CHAIRMAN VOLCKER. That's a mistake in the papers. It is the United States but it's Treasury, not us. It's shared among the various central banks and--

VICE CHAIRMAN SOLOMON. We have about 47 or 48 percent.

MR. ROBERTS. "We" meaning the U.S. Treasury?

SPEAKER(?). The Treasury.

SPEAKER(?). About \$200 million.

MR. CROSS. The Treasury has \$500 million out of \$1250 million.

MS. TEETERS. Isn't the Brazilian guarantee the one that involves

SPEAKER(?). No.

CHAIRMAN VOLCKER. No, that was

VICE CHAIRMAN SOLOMON. And that didn't go through.

SPEAKER(?). They never drew on--

CHAIRMAN VOLCKER. No, this doesn't have any of the real security. The Brazilian problem is very troublesome; it's troublesome whatever happens. If they act, they're going to have problems at home and they already have them. The Mexican situation, on the other hand, looks pretty good. From an external standpoint they still are not growing. With that, I guess we can conclude.

END OF MEETING