Meeting of the Federal Open Market Committee

August 23, 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., on Tuesday, August 23, 1983, at 9:30 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, Black, and Ford, Presidents of the Federal Reserve Banks of San Francisco, Richmond, and Atlanta respectively

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

Messrs. Eisenmenger, Prell, Scheld, and Zeisel, Associate Economists

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Promisel, Associate Director, Division of International Finance, Board of Governors
Mr. Kohn, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Lindsey, Deputy Associate Director, Division of Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Fousek, Executive Vice President, Federal Reserve Bank of New York

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

Messrs. Burger, and Soss, Vice Presidents, Federal Reserve Banks of St. Louis, and New York, respectively

Ms. Clarkin, Assistant Vice President, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
August 23, 1983

[Secretary's note: The Committee members convened on the afternoon of August 22, 1983 in a session not considered part of the formal FOMC meeting. In that session, the group held an exploratory discussion of issues relating to the way the Committee conducts its business. The transcript of the discussion is included in the Appendix.]

CHAIRMAN VOLCKER. Mr. Cross, proceed.

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

VICE CHAIRMAN SOLOMON. What remaining foreign currency balances does the Treasury have now after paying off the Carter bonds?

MR. CROSS. It's about $3-1/2 billion.

VICE CHAIRMAN SOLOMON. That's all?

MR. CROSS. Yes.

MR. TRUMAN. Yes, that's right. The total for all currencies is $3 billion at current rates and $4 billion at historical rates.

CHAIRMAN VOLCKER. Do you have a question?

VICE CHAIRMAN SOLOMON. Well, I have a general comment to make. I think there are two types of intervention: One is [based on] the modest, narrow concept of countering disorderly markets; the other is when one wants to lean against stronger trends. And the second really should be done not only in concert with other key central banks but in a package approach in which other actions--not just intervention--are taken. I think what was done fell between those two schools. Now, it still had a useful purpose. I wouldn't agree with some of the public comment that it was a complete failure. It had the politically useful--and I use the word politically in the very broadest sense of the term--function of demonstrating that the United States was willing to meet its Williamsburg Summit commitments of cooperation. And it certainly checked for a few days the very strong upward trend that seemed to be out of all proportion to the upward movement in U.S. [interest] rates. It's quite clear that it didn't leave a good taste in people's mouths, although some people in the market thought it was a useful thing to do. On balance, I think the general consensus was that it didn't turn out to be very effective. Secondly, I think there was some irritation on the part of European central banks that on the key night, a Thursday night, we did not follow through and do any intervention in the Far East--we had no authority to do that--when there was a very major movement. And this followed a day on which the Bundesbank on its own had asked the central banks of many small European countries to join in on the intervention. And, therefore, it left a rather bad taste in their mouths and they later came out with this statement that Sam referred to, and I think that just about finished the possibility of any really effective concerted intervention. I only make these comments to give you my perspective--a report card, so to speak, of this particular incident. I don't know whether Paul agrees or not.

MS. TEETERS. I didn't realize we didn't have the authority to intervene in the Far East.

VICE CHAIRMAN SOLOMON. We're kept on a very close leash. When I first became Undersecretary of the Treasury and we had the need to intervene, Arthur Burns also would keep the New York Fed on a very close leash. That went on for a week or two. He would say that [the Desk] had $25 million and when they used it up they had to come back. And then there would be a consultation with the Treasury. I was following it very closely and I felt policy with that close a leash didn't make any sense. So, I said to Arthur Burns that if we were serious about it, we had to give the New York Desk more room; and he agreed finally. The Desk ended up having a very substantial amount of discretion, including in the Far East, and also with not too small a dollar amount. Frequently there was not a dollar limit as such. Just the process of consultation alone [is cumbersome]. If we need to intervene and are getting close to the end of the money authorization for the day--[which might be] $25, $50, or $75 million depending on the market--by the time we get through to the Treasury and the Treasury consults with the Chairman and then they get back to us, at a minimum that will be 20 minutes; sometimes it can be an hour or two. So, I personally feel that if it's a serious concerted intervention, we have to give a little more discretion to the Desk. I don't think that view is very popular, certainly not in this Treasury. John?

MR. BALLES. I saw at least one press report that indicated the initial intervention by the Treasury was unilateral and did not involve coordination with any foreign central bank. I was just going to ask, Tony, if it's a fair question: Is that true or not?

VICE CHAIRMAN SOLOMON. No, I don't think that's true.

MR. CROSS. The first day that we intervened, which occurred rather late in the afternoon, it was intervention by the United States [only] but we had talked with the other central banks about what we intended to do. Then, subsequently, we were acting more or less in concert.

MR. BALLES. Well, as usual, the press got things screwed up.

MR. CROSS. Yes, I saw some reports that were wrong.

VICE CHAIRMAN SOLOMON. Now, what was a little unusual was that the Treasury went out and made an announcement. In hindsight, I'm not so sure that was a great idea. Normally that isn't the way we would do it unless we were planning a very major effort, which we used to do by activating swap lines, taking a monetary policy measure--what I call a package approach. Then when we make an announcement, we get more credibility. Anyway, that's a minor point. They announced it, or simply after a couple of days answered questions.

MR. ROBERTS. Question: Did I hear that the historical cost of the currencies we own [is $4 billion and] the current value is $3 billion? Does that mean an unrealized loss of a billion dollars on currencies?

MR. TRUMAN. No, those are the Treasury's losses.

MR. ROBERTS. I mean for the United States.

VICE CHAIRMAN SOLOMON. Yes. But on the other hand, Ted, we had made an enormous amount of money in our intervention. Just on the Carter bonds alone--selling those, which is done to get foreign currency--not only was there a large interest rate savings but there was also a big profit.

MR. ROBERTS. Where does all that flow through--the Exchange Stabilization Fund?

VICE CHAIRMAN SOLOMON. Yes, and the Exchange Stabilization Fund when I was there was in the red. By the time I left it was in the black because of the profits that we had made, even though not all of the profits went into the Stabilization Fund. Some of them ended up in the general account.

MR. PARTEE. We have some book losses, though, don't we, Tony? That's my impression.

MR. TRUMAN. The Federal Reserve has about $830 million in unrealized losses at the moment, if you want to call it that. But unrealized losses of the Treasury are about $900 million.

MR. FORD. So that I understand, I'm trying to summarize for myself what you said just now. Would it be fair to say that you're saying either do it whole hog or don't do it?

VICE CHAIRMAN SOLOMON. Well, I think in a case of countering disorderly markets, in the very narrow sense of that term, we can do that on modest basis. That involves more a quasi-continuing presence from time-to-time in the market without making a big deal out of it. The second type is concerted intervention or leaning against the wind, which was a situation that was posed to us because in the larger sense of the term one can argue that this was a very disorderly movement. The abruptness and the size of the market movement in response to a relatively modest uptick in U.S. interest rates was out of proportion. Yes, I feel that we shouldn't do that kind of major, concerted intervention unless there's a package approach and we really mean it and don't keep such a close hold on the Desk. That's my own view.

MR. PARTEE. But you would still sterilize it.

VICE CHAIRMAN SOLOMON. Oh, yes.

MS. TEETERS. Tony, what do you consider a major intervention? This totaled $3.7 billion over those few weeks.

VICE CHAIRMAN SOLOMON. Our share was $300 odd million.

MR. CROSS. Our share of the intervention was $250 million.

MS. TEETERS. But the total intervention was just over $3.7 billion. That looks big to me and just not on the proper scale.

MR. CROSS. Intervention by the Europeans and others was $2.4 billion.

MR. RICE. What was the total in 1978?

VICE CHAIRMAN SOLOMON. I can't give you a gross figure for all central banks.

CHAIRMAN VOLCKER. The United States alone did billions.

MR. PARTEE. Yes. Of course, the dollar was weak.

VICE CHAIRMAN SOLOMON. We started off without foreign currencies so we had to activate the swaps, and I suppose we got in hock by about as much as $8 billion. Sometimes we have to stick with intervention. It's not an easy, simple, black and white thing. For example, when we announced that big dollar rescue package on November 1, [1978], even though we had a whole package of measures and even though there was worldwide consultation and even though the dollar turned around very sharply on the first day, we had to make it stick and make the markets believe we meant business and that [what we were doing] was credible. To give time for the fundamental improvement in our balance of payments to become more and more apparent, we had to stick with substantial intervention all through November and December. On January 2 the markets turned around on their own and then there was such an inflow that we were able to repay our swaps and over the year to begin accumulating foreign currencies because the dollar was rising too fast. That was a situation where we had very effective concerted tactics and yet still needed intervention. Sometimes I hear the argument that [if] it is an effective concerted package which involves domestic monetary policy, then intervention isn't needed at all. That was a case where we did need it.

CHAIRMAN VOLCKER. [We need to] ratify the transactions.

MS. TEETERS. So moved.

CHAIRMAN VOLCKER. Without objection we will ratify the transactions. Mr. Sternlight.

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

[CHAIRMAN VOLCKER. Questions?]

MR. BALLES. Yes, I have one, Mr. Chairman. I'd like to get Peter's perspective on the new wrinkle added--or should I say reintroduced--at last month's meeting of the Committee, which was to pay attention not just to borrowing but to excess reserves as well. In other words, we were going back to a free reserve or net borrowed reserve concept if I understood that correctly. Just from your perspective, how if at all does that new wrinkle affect your ability to carry out the Committee's instructions or goals?

MR. STERNLIGHT. Well, I think it worked satisfactorily in this period. I don't know that it will always be that satisfactory. It depends on the behavior of excess reserves, which tended not to be as high this last period. They averaged a little over $400 million, and we were pretty much programming them in our path-building at the $350 million level. One week we moved that up to $400 million. If we

were to get weeks when there was a much stronger demand for excess reserves, it could be more troublesome to operate on that basis. But it has not been a significant problem.

MR. BALLES. The reason I raised that question, Mr. Chairman, is that if you go back and look at the history of the relationship of excess reserves to the economy, it appears to me at least to be trendless and erratic. I would have to judge that any sustained move to instruct the Desk to follow free reserve or net borrowed reserve targets would be counterproductive, and I would advise against it.

CHAIRMAN VOLCKER. Well, I don't know what the basis for that is. I don't know whether one would get any better results following borrowings alone; I would suspect not.

MR. BALLES. Pay your money and take your choice, I guess. Personally, I'd have more faith in just following the borrowing.

MR. STERNLIGHT. I think there has been some rise [in excess reserves] this year; it abated a bit in just the last month or so. We essentially have somewhat higher levels of excess this year than earlier; and I tend to relate that to some of our Reserve Bank operational reviews of overdrafts and things like that, which I think have made some bankers want to hold higher levels of excess reserves.

VICE CHAIRMAN SOLOMON. On another matter, in view of the experience we've had in the last few weeks in the way the markets absorbed this large U.S. Treasury borrowing: You said earlier that there had been some econometric analysis indicating that if there were substantial reductions in the deficit, interest rates might be, say, a couple points lower. Was that analysis done on the basis of current conditions in the economy or was that analysis based upon a more robust economy or higher utilization of capacity?

MR. KICHLINE. It was done taking the quarterly econometric model and keyed off what was the equivalent of the staff's forecast--the one that we had prepared in July--and then taking a $50 billion expenditure cut. We also did it with a $50 billion tax increase. Essentially the starting point, the initial conditions, would be the July staff forecast.

VICE CHAIRMAN SOLOMON. So, common sense would tell me that if a year from now the economy were functioning at a much higher level of utilization of capacity and you did the same econometric analysis--and at that time we got a major move to reduce the budgetary deficit--we would get an even bigger impact in terms of interest rate reduction. Is that a sensible conclusion?

MR. KICHLINE. I think, unfortunately, that's right.

VICE CHAIRMAN SOLOMON. Why "unfortunately"?

MR. KICHLINE. One of the problems with these exercises is that they are all dependent on the structure of the model one is using. Use a different model and get a different answer. It also depends on initial conditions. In our model it's a non-linear relationship so that we get a bigger bang for the buck as we get closer to potential or full capacity utilization.

CHAIRMAN VOLCKER. Why is that?

MR. KICHLINE. It has to do with the non-linear demand for money function, essentially. The elasticity of money varies over time, and in that model as we get closer to capacity utilization, short-term rates would be rising substantially. And if you take the heat off in absolute terms--and this is done absolutely, the number of basis points involved--short-term rates would drop more than they would otherwise.

VICE CHAIRMAN SOLOMON. Peter may not agree with me, but what the experience of the last few weeks--with this very large Treasury borrowing in the markets--indicated to me at least is that the other factors swamped, or were more important than, the size of the borrowing in ultimately determining the level of interest rates in the markets. So, even though in the early stages of the borrowing there were considerable interest rate pressures geared to the size of the borrowing, the whole amount got digested very easily with interest rates ultimately coming down somewhat because of other factors. It wasn't the size per se that caused that much of a problem in the overall context of current conditions and perceptions about monetary policy. I don't know if you would agree with that or not, Peter.

MR. STERNLIGHT. I don't entirely. I think the size was a factor in the extent to which the market backed up. It came down again very fast, but I think it may be premature to say that the market has really digested this; it may be regurgitated again, too.

MR. PARTEE. Of course, we're talking about a very large financing. I guess it's true of the particular set of financing that occurred, but my recollection of the statistics is that both the month of July and the third quarter show substantially reduced federal financing compared to the second quarter.

VICE CHAIRMAN SOLOMON. The third quarter is going to be about $50 billion, isn't it?

CHAIRMAN VOLCKER. It is reduced, seasonally adjusted, from the very high seasonally adjusted amount in the second quarter.

MR. PARTEE. It was $65 billion or something like that in the second quarter. And as a matter of fact, total credit expansion in July, for which the Bluebook reports a number, is down considerably.

MR. GRAMLEY. Generally speaking, $50 billion a quarter is what we'll be looking at.

CHAIRMAN VOLCKER. That is because the second quarter was so high; I think that's an illusion.

MR. PARTEE. Well, that may be because they also had all that tax-exempt financing that went into governments.

CHAIRMAN VOLCKER. No other questions? We'll ratify the transactions. Without objection. Mr. Kichline.

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

CHAIRMAN VOLCKER. [The floor is] now open for questions and comments and disagreements and alternative scenarios.

VICE CHAIRMAN SOLOMON. You seem to be assuming that next year we will have a downward drift in long-term interest rates, notwithstanding the improved economy, etc.

MR. KICHLINE. That's right. The rates in the forecast are in Appendix I of the Bluebook. We do have in there, for example, in the mortgage area about a percentage point reduction in rates from the fourth quarter of this year to the end of 1984. We have had this kind of pattern for a while. We also have corporate bond rates drifting down. It comes out of our forecast; it's sort of an iterative procedure. But our major view is that inflation will still be quite mild and that indeed, with the slowing of nominal GNP growth that we foresee, we could have a little drifting down of short rates and still meet the Committee's targets and that the good inflation performance over time ought to show through in some reduction in long rates.

MR. PARTEE. Now short rates are down too?

MR. KICHLINE. That's right.

MR. WALLICH. And this would be about a constant real rate, given some decline in inflation?

MR. KICHLINE. Well, we have a decline in real rates implied because inflation this year and next year is about the same.

VICE CHAIRMAN SOLOMON. An act of faith?

MR. KICHLINE. Well, in large part.

MR. PARTEE. [Unintelligible] starting it; there's no question about it.

MR. KICHLINE. Maybe even when it's econometrically derived, it's an act of faith.

CHAIRMAN VOLCKER. Any forecast is an act of faith!

MR. GUFFEY. I'd like to step back. You spoke of next year's rates. [In the Bluebook appendix] an increase in rates is shown in the fourth quarter, which I assume is built into your Greenbook forecast. Can you comment on the background of that assumption?

MR. AXILROD. Mr. Chairman, I might note that a good part of my briefing is devoted to these questions.

MR. GUFFEY. I'll wait.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I have a healthy respect for the forecast produced by the Board staff. In light of yesterday's discussion, I feel it necessary to "fess up," as it were: We [in San Francisco] do have a significantly different forecast, though not for this year, where we come in very close to the [Board staff] forecast. By the

time we get to 1984 there is a difference that I feel compelled to comment on. I'll try to explain very briefly why. On real GNP, the Board staff reduced its forecast for the end of '83 to the end of '84 fractionally this time. They were at 4.2 percent in July and they're at 4 percent in the latest revision; so, they're down fractionally. We had already been higher than they were in our July forecast, which was a 5.1 percent increase. Our staff, rightly or wrongly, has now upped that to a 5.8 percent real GNP gain fourth quarter-to-fourth quarter. In trying to track down the differences--because what I expect every time from my staff is some explanation or attempted reconciliation of differences between their forecast and that of the Board staff--it gets down to the basic methodology. The Board staff has a model that's driven by M2 and we're old fashioned enough to be back to using M1. The reason I feel compelled to comment on this is that I have in front of me a chart that shows the relationship between M2 and personal income going back quite a ways. It tracked pretty well up until 1978 when all these things began to happen to rates paid on various components of the Ms. Since that time any relationship between M2 and income is just invisible. In fact, they quite often go in opposite directions. We have some faith that we're about to see a restoration of normal velocity patterns in M1.

MR. PARTEE. Does M1 look better?

MR. BALLES. Yes, except obviously for 1982, when it just fell out of bed and was hopeless. What we're expecting--and it's a forecast not a fact--is that we're in the process of seeing the restoration of the normal velocity trend in M1 which, if realized by the fourth quarter as we forecast, would mean a considerably faster growth of the economy going into 1984. Our specific monetary assumption is that for the balance of this year M1 will grow at the upper end of its range and that as we move into 1984 it will grow in the middle of the 4 to 8 percent range. I think your forecast, Jim, was based on M2 in the middle of the range both for the balance of this year and next year. So, it's simply the difference in methodologies. All sorts of details, of course, would have to be explored, but just in a gross sense that's why we come out with a different forecast. Since we have stronger real growth, we have less unemployment. Time will tell which of these views is correct.

MR. CORRIGAN. What does that forecast have for inflation?

MR. BALLES. It's a little more than the Board staff has. Specifically, they're expecting 4.3 percent this year, fourth quarter-to-fourth quarter, versus our 5.1 percent; next year they're at 4.4 percent and we're at 5.2 percent.

SPEAKER(?). What about the interest rates?

MR. BALLES. We don't forecast interest rates. We don't know how.

MR. WALLICH. Do you assume that velocity will grow at the same old rate hereafter or is it a reduced but stable rate?

MR. BALLES. We assume velocity will approximate its historical growth rate more than what we saw in 1982. I'm not sure--I don't think anybody can be, Henry--that it's going to come back right

on or somewhere around the historical average, but it's certain to bounce back and be reasonably similar to what it used to be--up 2 or 3 percent a year.

MR. FORD. I'm just looking at the trend for the last four quarters: Starting with the third quarter of 1982, M1 has grown by 6.1, 13, 14, and 12 percent and nominal GNP [growth] was well below it for the first three of those four quarters. Then in the last quarter, the second quarter of this year, velocity has finally made a comeback and is now running ahead. That reinforces in my thinking what John is saying about the likelihood of a rebound toward more normal velocity. What worries me was that we could really see this surge. M1 was surging way ahead of nominal GNP and now all of a sudden nominal GNP has zoomed ahead on a concurrent basis. That obviously isn't the right way to look at it, but that's the way a lot of people around here have been talking about it for the last few quarters. So, if you want to continue talking in that vein, we should now be concerned about the fact that the second-quarter nominal GNP went up by 13 percent when M1 went up by a little less.

VICE CHAIRMAN SOLOMON. Coming back to the real economy, Jim: What level of housing starts and what level of automobile sales are you assuming for the fourth quarter?

MR. KICHLINE. Housing we have at 1.55 million units at an annual rate; that would be down from our guess of 1.65 million units for the current quarter, which entails some decline for August and September. So, we have a further drop of 100,000 units in the fourth quarter. For auto sales in the fourth quarter we're assuming 9-3/4 million units in total, of which domestic sales would be 7.4 million, and that's about where they've been running in the first half of this quarter to date. We have domestic auto sales at this higher level but not rising further.

VICE CHAIRMAN SOLOMON. I would guess, although it's nothing other than gut instinct, that those levels are somewhat optimistic. Housing transactions are beginning to fall. And as the pent up demand for automobiles begins to be satisfied to some degree, I have a feeling that that's a very high level of automobile sales to be projecting for the fourth quarter.

MR. MARTIN. I would join Tony only in the comment on housing. I was convinced yesterday that the interest concessions have been so narrow in automobile financing that their removal is not going to be a material factor in the fourth quarter. But I would argue that housing in the fourth quarter will be down more likely by 200,000 to 250,000 than 100,000 units. The cancellation rates in the escrows in Dallas, Chicago, San Diego, Los Angeles, San Francisco, and Atlanta are such that the sales will not be completed. The rates are floating up 150 and in some cases 200 basis points. Those sales are just not going to be closed and that, of course, will back up into starts and other housing figures. So, as usual, I would indicate a deeper, further degree of pessimism on the housing front.

MR. ROBERTS. Are you referring to single-family primarily?

MR. MARTIN. New single-family homes primarily.

MR. ROBERTS. Isn't there some increase in the multifamily area that is partially offsetting that?

MR. MARTIN. Yes, but there, Ted, we have the condition of high vacancy rates for apartments in the major markets in the Sunbelt and a very low household formation rate in 1982. There is some controversy about what the formation rate was last year; some people say there wasn't any for the first time in twenty-five years or something like that. I think that's a bit too pessimistic, but the Board's staff indicated that it's several hundred thousand households.

VICE CHAIRMAN SOLOMON. Is that because of the demographics or because people aren't getting married, or what?

MR. MARTIN. The staff comment yesterday [at the Board briefing referred to] the impact of the recession. I think it goes beyond that. I think there are some changes. Some younger folks are staying with Momma and Poppa a little longer and I think there's a definite slowing in the rate of [household] formation.

MR. PARTEE. They are spending their money on a new car.

MR. MARTIN. Or a new computer. Then there's a question, of course, of the thrift industry problems, if any, at today's interest rates. We had some work done here a while back--I'm not sure that Jim would still underline that work--in which we second guessed the thrift industry economists and it came down to this: A very rough figure of 100 basis points in weighted average costs for the thrifts means a pre-tax impact of about $1 billion. If you remember the rise in rates since June, which is the month in which we received those data from the thrifts and translated that into a post-tax profitability, [it means that] they don't have any [profit]. And, of course, for the savings banks you get a figure that's in the red. But some of you in your own Districts know that picture of the savings banks a lot better than I do.

MR. BLACK. Mr. Chairman, I thought John Balles was going to make my speech for me. He started off pretty much the same way, but we come out with less real growth next year than he did, though a tad more than the Board staff is projecting. The main difference is that as we looked at prices next year, we paid right much attention to the behavior of money in recent months in addition to the effects, as the Board staff suggested, of a great firming of labor markets, a depreciation of the dollar, and the drought this year. And we believe that's going to result in somewhat higher prices than the staff is projecting. If I figured it right, they have the implicit deflator [rising] about 4-1/2 percent from the fourth quarter of '83 to the fourth quarter of '84; we think [the increase] might be near 6 percent. That's really the significant difference between us and John.

MR. PARTEE. You have prices and he has real growth.

MR. BALLES. I like mine better.

MR. BLACK. I hasten to add that I hope we [are wrong]. I thought we were going to end up the same place but that's exactly the difference.

MR. KEEHN. By way of a District report, I must say that economic conditions in the Middle West are very significantly improved and would be broadly consistent with the outline that Jim has given [for the nation]. The only point I'd make--and I think Jim used the phrase "capital goods are poised for recovery"--is that the people who are running the major capital goods firms in the Middle West really are becoming very, very discouraged by the outlook. I'm now talking about the heavy capital side: foundry equipment, railroad equipment, and heavy trucks. Though things may look a little better off a very weak base, people on that side of life are becoming terribly discouraged that 1983 is by now largely gone and the early part of 1984 is to a large extent gone as well. Most of them say the earliest they expect recovery is in late 1984. So, they continue to be very pessimistic. Perhaps that's typical for this point in a recovery but, as a consequence of all this, our outlook for 1984 would be modestly lower than the Board staff's outlook.

MR. GRAMLEY. Mr. Chairman, I sense a somewhat different tone developing at this meeting in regard to where the economy is going than I detected at the last meeting. We have seen some signs of slowing in retail sales, although it's hard to assess what one month's numbers mean. Prospectively, in housing we've heard a lot qualitatively about the slowdown in mortgage applications and so on. Still in all, I think it's wise to recall that if anyone had forecast 6 months ago that we were going to be looking at a 9 percent real GNP growth in the second quarter and 8 percent in the third, he would have been considered slightly off his rocker. [The expansion] has developed much, much more strongly than nearly everybody had foreseen. In my judgment, probably the best single analogy one can use for the economy is that of the fly wheel: What happened in this quarter is going to happen in the next one. My guess, if I had to make one, would be that we're more likely to see somewhat faster growth than the staff has forecast for 1984. And I think the big candidate for an overrun is business investment. It's something I cannot pin down except to say that the increase in contracts and orders for plant and equipment in the past two quarters has been very, very substantial, but I have a hunch that more is developing in this area than what was allowed for.

Still in all, if I had to put out a forecast, it wouldn't be drastically different from what the staff has for next year. It might be a half point more or something like that, but certainly nothing that would change in major ways the outlook for employment and for prices. One of the things that we do need to think about and concern ourselves with is what may be happening in the food area. The staff has a 7 percent rise in food prices fourth quarter-to-fourth quarter. Unless we get some rain of substantial magnitude soon, it could be a lot more than that. It would be worrisome if that got built into the underlying inflation. It's awfully hard to keep that from happening. I'm not quite sure what to do about it, but I worry about it.

MR. PARTEE. Seed the clouds.

MR. MORRIS. Some work I've done is supportive of your feeling on the capital goods sector. I've compared the current expansion to the expansion of 1975-76 and in general the broad measures show that we're tracking very closely to that expansion. One sector that is different, even though the capital goods people in the

Middle West may not appreciate it at the moment, is that capital goods orders are coming in much stronger than they did at the corresponding phase of the 1975-76 expansion.

MR. RICE. Isn't the composition different, though?

MR. KEEHN. It's a different segment of the capital goods side. I'm talking about machine tools, foundry equipment; I don't think perhaps you are.

MR. MORRIS. But doesn't that side hit the lag in any event?

MR. KEEHN. Perhaps so, but it has been lagging so long that the guys are getting awfully discouraged. For example, to give you just one quick figure: The delivery of railroad cars this year will be 5,000 units. It typically runs about 80,000 to 85,000 units and in 1980 it ran 120,000. This year's figure will be lower than any year since 1933 and I'm not sure the figures in 1933 were that good. This provides the kind of environment in which people are thinking and they've become very discouraged about it.

MR. PARTEE. Is there some increase in orders?

MR. KEEHN. No, orders have been absolutely flat. Now, there are some reasons for that; nonetheless, it provides a very difficult environment in which people are operating.

VICE CHAIRMAN SOLOMON. Union Pacific people tell me that carloadings have not gone up as much as the rest of the economy and normal relationships would indicate, although the published data don't seem to make that very clear.

CHAIRMAN VOLCKER. While I was on the phone the other day I was looking at Business Week, which has this business indicator [measure] on the front page. They compared last month to two months ago and last year, and they had a comparison with five or seven years ago. They included the steel industry, which is running 40 percent below the figures of five years ago. Every other industry they included was up 30 to 40 percent compared to whatever it was 5 or 7 years ago. There's a tremendous contrast between what is going on in steel, as reflected in that, and in the rest of the economy.

VICE CHAIRMAN SOLOMON. The barge business is also very, very bad. It has not picked up. There seems to be less movement of coal, heavy material, steel, and even of grain. But coming back to food prices: I thought we were sitting with such huge surpluses. I'm not quite sure I understand why there is such a big price impact.

MR. GRAMLEY. We are, in wheat. But the inventories of corn and soybeans are going to be quite low. If the crop forecast is reduced much further, I think we will get some liquidation of livestock herds, hogs and cattle both, and then a very large run-up of meat prices next year. That is the big risk.

VICE CHAIRMAN SOLOMON. I see. So, it's meat prices rather than corn that you think--

CHAIRMAN VOLCKER. Just the feeling that everybody buys, including the Russians.

MR. GUFFEY. Just to follow up on that comment: Our people had [forecast] an increase in food prices in 1984 of about 5 to 6 percent until this drought really hit the corn and small grain crops; now they've moved it up to 7 percent or a little over. And the reason the rise is only that modest is the fact that in the early part of 1984 there will be a liquidation of red meat [animals], both hogs and cattle. As a result there will be a depressed meat price and the impact on food prices won't occur until later in 1984. So, the yearly contribution to inflation [from the food] price increase will be modest--in the 7 percent range. But by the end of 1984 quite likely we'll see food prices rising much more rapidly than 7 percent.

CHAIRMAN VOLCKER. Well, they'll get that new crop in by the end of 1984.

SPEAKER(?). Yes.

MR. PARTEE. Then people will stop liquidating their meat animals and that will really push meat prices up.

MR. GUFFEY. As somebody observed, the PIK program was ill devised but what they also missed was Mother Nature being a participant in it. It essentially has been much more effective in bringing down the excess stocks of corn and other crops that normally would be harvested in the fall than anybody ever imagined.

MS. TEETERS. Mr. Chairman, I have a different forecast, which I've had since February. I did have growth of 8-3/4 percent for one quarter, but I think interest rates at these levels will calm down the economy, bringing it to the levels we had previous to the last run-up during the fall. And my real [GNP] forecast for next year is at the bottom of the FOMC [members' range]. I think [GNP growth] will probably slow down to below 4 percent, fourth quarter-over-fourth quarter, which will both reduce the inflation rate and increase unemployment next year. We don't have a stable relationship on velocity. It may return. Until it does, it seems to me that what is more important is the level of rates and what that does to economic performance. So, I'm anticipating a much slower recovery, with all the consequences that go with that slower rate of growth.

MR. ROBERTS. Since that hasn't been true up to now--real rates have not slowed the growth at all--why will it be true later in the year?

MS. TEETERS. I think there was a great deal of pent up demand, particularly in the housing and automobile areas, that came out in the early parts of the recovery. As that pent up demand is met and as the rate [increases are felt]--obviously, [housing] is very sensitive to a mortgage rate somewhere between 12-1/2 and 14 percent--we also are going to run out of people who qualify for mortgages at this level or even at 12-1/2 percent as we move further into the recovery. So, I think that we will see a moderation in housing demand and that automobile demand probably will moderate also. GM, as you know, raised its prices about 2 percent today. Well, 2 percent, given the level they're starting from, makes the real cost of owning an

automobile very high and rising. And I think people are responding to that in a very economic way.

MR. ROBERTS. We should keep in mind, though, that the housing recovery started at a higher level of mortgage rates than you're suggesting would be a problem.

MS. TEETERS. Well, it means that more people who could qualify have been wiped out already.

VICE CHAIRMAN SOLOMON. Did you really have an 8 percent third-quarter projection back in February?

MS. TEETERS. No, for the second quarter.

VICE CHAIRMAN SOLOMON. Even when you were so worried about interest rates back in February?

MS. TEETERS. Yes. It was obvious what the inventories were going to do.

MR. PARTEE. I sort of agree with Nancy but for different reasons. And that is--though I realize Jim has put the saving rate back [up] some--that I just think the projected saving rate is too low. For the projection period it's around 4-1/2 percent as we go through 1984. I think that's an extraordinarily low rate. And it's not consistent with all the incentives to save that the government has provided with IRAs and deferred compensation. I'm not sure whether the problem is that income is being understated--it could be--in the forecast. But that means stronger plant and equipment or something to provide the income that will make for a higher saving rate. Or maybe consumption is too high. I realize that people, because of pent up demand, can go in and use credit actively and draw down their financial assets in order to take care of their needs; [but] as soon as that's over, I should think that the saving rate would be around 6 percent. Therefore, I would come in with a little lower forecast for the year from the fourth quarter of '83 to the fourth quarter of '84--certainly lower than John Balles has, and lower I think than Lyle has.

VICE CHAIRMAN SOLOMON. How much of the increased spending do you attribute to the stock market and bonds?

MR. KICHLINE. I can't answer explicitly in terms of a number. I don't know what the model has on that; I don't remember. I do think that part of what we saw in the second quarter was a wealth effect, and that was important in the kind of forecast that we have. It's hard to see stock prices zooming on up in the near term; that market has cooled a bit. So, I would use that wealth effect argument as helping to explain the second quarter. And that [effect] is weakening now, given what is happening in the market.

MR. MARTIN. Jim, in terms of wealth effects for middle income consumers, their assets are tied up in a single-family residence, which they can't sell. In city after city those people are sitting there with a number on paper or in their minds as to what the equity in their home is and they can't realize it. So, I wonder how important the stock market is to the middle of the pyramid.

VICE CHAIRMAN SOLOMON. Peter Fousek from New York has some projections, which I forgot. I don't have any here. You can answer it, can't you?

MR. FOUSEK(?). [Unintelligible] impact of the total rise in consumer spending, 30 percent is attributed to the stock market.

MR. FORD. Nationwide?

VICE CHAIRMAN SOLOMON. The change from the second quarter of 1982 was a rise of some 57 percent in the stock market.

SPEAKER(?). What was the 30 percent?

MR. FOUSEK. Of the excess increase of the--

MR. FORD. It seems high.

CHAIRMAN VOLCKER. What's this excess increase?

MS. TEETERS. Yes, what's this excess?

MR. FOUSEK. Well, all our past relationships would have suggested about half--

MR. MARTIN. And what was the offsetting decrease? I don't have our [forecast] here so I can't--. There was a decrease in the value of the equity of housing of $30 to $40 billion for households. Is there an offset? They have a perception of a decrease in their wealth.

CHAIRMAN VOLCKER. Why?

MR. PARTEE. That's not in this period, I think.

CHAIRMAN VOLCKER. They have a decrease in their rate of return.

MR. MARTIN. They've had a decrease in the real value of their housing and, therefore, their equity. They're heavily borrowed.

VICE CHAIRMAN SOLOMON. Not for the second quarter of '82 to the second quarter of '83.

MR. MARTIN. I believe that's exactly--

VICE CHAIRMAN SOLOMON. Housing prices [were] firm.

MR. GRAMLEY. I think the statistics show that household wealth has gone up somewhere between 3/4 of a trillion and a trillion dollars in the past year, taking the two things together. Now, the distribution of this is another question. But certainly the household wealth statistics have looked much, much better in the past year. How much of that one can really expect to influence consumption is hard to say because it is rather narrowly distributed among a small--

VICE CHAIRMAN SOLOMON. You have to look at the volume of refinancing of existing house mortgages to begin to get some kind of clue as to whether it influences consumer spending or not.

MR. PARTEE. And there you're talking about 14 percent interest rates.

CHAIRMAN VOLCKER. We've had a number of different views expressed here about the outlook. Out of curiosity, how many people would have a forecast significantly higher than the staff forecast? I will define significantly higher as roughly 1/2 percent or more on the rate of growth over the next 18 months. [Secretary's note: Messrs. Balles, Black, Gramley, Ms. Horn, Mr. Morris, and perhaps a few others.] How many would have a significantly lower forecast? [Secretary's note: Messrs. Partee, Rice, and Ms. Teeters.]

VICE CHAIRMAN SOLOMON. There are a couple of us left who more or less agree with it.

CHAIRMAN VOLCKER. Well, I think that's quite possible. Why don't we turn to Mr. Axilrod.

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

MR. BOEHNE. Steve, what has been the pattern of growth for the old M1A?

MR. AXILROD. The quarterly figures, starting with the third quarter of 1982 are: 2.4 percent; 7.8 percent; 5.6 percent--held down by shifts, I think, but I don't know the exact amounts--and 6.7 percent. And it looks like Q3 1983 will be 6.9 percent.

MR. BOEHNE. Thank you.

CHAIRMAN VOLCKER. Any other questions? Mr. Axilrod answered all the possible--

MR. BALLES. Steve, may I ask: What is your velocity forecast or expectation for M1 for the fourth quarter?

MR. AXILROD. It's around 2 percent or that order of magnitude for current M1.

MR. BALLES. The historical average was how much higher?

MR. AXILROD. Well, if you use M1 without NOW accounts, which is what we used to have, the history is that in the fourth quarter of a recovery, its growth is around 7 percent or something like that. Take out [unintelligible] and it'll be lower--more like 6 to 7 percent.

MR. BALLES. True, but is that a fair comparison? That is kind of old M1 with--

MR. AXILROD. No, that's what I was trying to say. I don't think it is. I don't think you would then reason that the 2 percent is too low.

MR. BALLES. What I'm trying to get is: What would be the comparable figure of the old M1 velocity given the new M1 content? Would it be 3 percent or 2 percent or what?

MR. MORRIS. We don't know.

MR. BALLES. I'm just trying to smoke out, if we can, what Steve meant by "velocity is recovering but it will remain low." I think those are the words you used.

MR. AXILROD. What I meant was, if you go back to history when M1 had a different composition, the numbers in the fourth quarter of a recovery run around 5 or 6 or 7 percent. What we have now, based on our current estimates, is something on the order of 2 percent, which will mean GNP doesn't pick up and M1 doesn't pick up with it. If you use the old M1A, you'd have something like 4 or 5 percent, which would be more in line with past cycles. It just says it's some sort of a residual transaction element if this keeps up and old M1A is moving like it used to. One conclusion I drew from that is that the new M1 does have this additional element, which is holding down its velocity. So, one might not want to extrapolate from that to higher nominal GNP a few quarters ahead. Velocity is behaving a little differently; that could change.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. Since you asked yesterday for some comparisons: I don't know how many of the models you follow, but we do that all the time. And I feel great listening to Steve and Jim and so on, if one can only believe all this. The others that we track, such as Townsend-Greenspan, DRI, and Harris--your alma mater is forecasting even lower rates, as you must know--and Chase all are giving forecasts very similar to what the staff has. So, that kind of alternative makes one feel better. I think it would be beautiful if it comes true, but--

VICE CHAIRMAN SOLOMON. It could just be that everybody is wrong.

MR. FORD. That's what worries me.

MR. ROBERTS. But so far the consensus is better than the individual forecasts; that's been the experience of this guy out in Arizona.

MR. RICE. But isn't it true that the majority of outside forecasters expect higher interest rates?

MR. FORD. No.

MR. RICE. Don't they expect higher long-term rates in 1984?

MR. FORD. Well, I just have the T-bill and the prime rates. All four of those outsiders expect, by the second quarter of 1984, the prime to be the same as it is this quarter on average and T-bill rates to be maybe 1/2 percentage point or more lower. I don't know about bond rates; I didn't get that.

CHAIRMAN VOLCKER. Are there any other questions addressed to Mr. Axilrod?

MR. PARTEE. Did I understand, Steve, that you were expressing the view that foreign demand for U.S. investments affects U.S. interest rates rather than U.S. exchange rates?

MR. AXILROD. I think they are probably not unrelated. I was assuming that the large capital inflow we've had this time, without a sharp depreciation in the dollar so far, reflected a willingness of the foreigners to put their money here not [wholly] independent of interest rates but more or less independent of interest rates--that is, there is a wide range of interest rates that wouldn't have mattered. But that willingness really meant that the exchange rate stayed higher than it would otherwise be instead of depreciating. That kept our prices from being higher than they would otherwise be and it was the price effect in my mind that kept the interest rates from being higher. It's somewhat like in the olden days of fixed exchange rates when we could run big balance of payments deficits and lose [foreign] exchange reserves and in some sense have bigger domestic purchases without getting right away the inflationary impact of the purchases. And in my head, subject to Ted's contradiction, something like that has been going on--

CHAIRMAN VOLCKER. Why wouldn't it have a direct effect on interest rates as well?

MR. AXILROD. Well, yes. One would think so.

MR. PARTEE. I'd understood this as a circularity question. I'd really dismissed foreign demands ebbing and flowing as having an effect on U.S. interest rates because of the circularity of flow.

MR. TRUMAN. It depends a bit on what you--. You get the same results as Steve's--

CHAIRMAN VOLCKER. There isn't circularity when you're running great big current account deficits.

MR. GRAMLEY. If you think [unintelligible].

CHAIRMAN VOLCKER. That may be caused by the exchange rate.

MR. TRUMAN. It's a question of how you break into the circle. If you think the current account deficit to some extent has been pushed by fiscal policy or an increase in aggregate demand in the United States, then to the extent that you can open as opposed to not being able to open up a current account deficit, in effect the saving that comes in does damp the rise in interest rates that a given impetus to domestic demands would give you in a closed economy context. That's a slightly different way of putting the same point that Steve was making, though you obviously know, Mr. Chairman, that one has to say where one is going to start the circle.

CHAIRMAN VOLCKER. If there are no other questions, we'll go and have some doughnuts.

[Coffee break]

CHAIRMAN VOLCKER. We've had some differences of opinion expressed about the business outlook. There are some indications of a little slowing [in the recovery] from the pace to date. Differences of opinion on the outlook seem to be rooted in [unintelligible]. There are some tentative signs of a little slowing in M1; M2 and M3 are doing pretty well in terms of the objectives. It doesn't necessarily strike me as a time for pronounced moves, but I'm open to comments.

MR. PARTEE. Let's vote on alternative B and go home!

SEVERAL. I'll second that.

MR. ROBERTS. Well, I'd like to suggest that alternative C would be no change. We agreed last time that we wanted 7 percent growth in M1 and alternative C would take us there. I think the economy is doing great and we shouldn't change what we're doing, which is working. And I would recommend that we go to alternative C.

VICE CHAIRMAN SOLOMON. Well, I don't think we have to argue really about whether it's "B" or "C." We maintain the same operational paragraph and simply say we maintain the existing degree of reserve restraint. And we assume [borrowing of] $700 to $900 million. I guess that's the difference between us. If we go all the way down to alternative C, that assumes a borrowing range as high as $1 to $1-1/4 billion, and then we would be pushing up the federal funds rate to 9-3/4 percent plus, whereas if we stick with $700 to $900 million, then it's about 9-1/2 percent.

MR. PARTEE. You're objecting to the M1 number, isn't that right? You would rather have the old M1 range. That's all he's talking about.

MR. MORRIS. I would remind you, Ted, that we're not targeting M1; we're only monitoring it.

MR. ROBERTS. It seems we could use our monitoring a little more sensitively, though, which I'd appreciate.

VICE CHAIRMAN SOLOMON. The operational paragraph says 8-1/2 and 8 percent for M2 and M3 and it says 7 percent for M1. I don't see that we have to change any language, but I feel very strongly that we not go higher than $700 to $900 million on the initial borrowing.

MR. GUFFEY. I would agree.

MR. ROBERTS. Well, I don't know what the right level is. You remember the discussion the last time; we were so panicked over going to $400 million and nothing dreadful seemed to have [happened] in the market when we went to $900 million. In fact, the rates have subsided here. I'd let the borrowing go up if necessary to maintain the path.

MR. PARTEE. Well, the rates did go up a half point, Ted.

MS. TEETERS. Including long-term rates.

MR. MORRIS. Net, I don't think it's a half point except for the prime rate and the funds rate; the bill rate went up 25 basis.

MR. WALLICH. This isn't the time, really, to make a change. Two weeks ago, I must say, I would have thought we should tighten up a little, but the data that have come in have made me think we'd better wait--as Steve said in his final remarks, wait and be cautious. It looks almost too good to be true that we can get off this bulge of M1 with no further increase in interest rates. And, if true, it makes me think that something is happening to M1 in that it fails to send us a very useful message. But both from the point of view of the monetary aggregates and the point of view of the economy, the right thing to me seems to be to go with "B," leave things as they are, and hope that [the forecast] as projected here is true.

VICE CHAIRMAN SOLOMON. I think that's reinforced by the fact that we're getting credit--I'm not sure we deserve it--in that there's a widespread perception in the financial community that it was our tightening that started correcting that bulge. Whether it's true or not true, we're getting the credit for it.

MR. PARTEE. We deserve anything we can get!

MR. GRAMLEY. I think Henry is probably right and that things aren't really as nice as they seem, but I'd just like to relax and enjoy it awhile.

CHAIRMAN VOLCKER. Well, I don't know whether these views that are expressed are the consensus, but I have a certain aversion to making unnecessary changes in these targets in the middle of the quarter. That appears to be an extreme fine-tuning. All we really have to do, if this is the course we want to go, is say "The Committee seeks in the short run to maintain the existing degree of reserve restraint." We'll discuss how that gets interpreted. Maybe we say that the action is expected to be associated with growth in M2 and M3 at around 8 percent--that's about what we have--and leave in the 7 percent for M1.

MESSRS. GUFFEY, FORD, and CORRIGAN. Yes. Let's go home.

CHAIRMAN VOLCKER. Well, we have to discuss just precisely what we mean by the borrowing assumption. As Steve suggested, all things considered, the $700 to $900 million might be appropriate. It is $100 million higher than we set before, but it encompasses the range that we've actually had.

MR. PARTEE. It's $100 million higher? Is that because you think that the demand for borrowing is a little higher?

MR. AXILROD. It has been running, generally, quite a lot higher. This week it's running over $1 billion; even taking out a couple of what I think are special cases it would be running $800 to $900 million. And the federal funds rate is at 9-1/2 percent. It seems that the demand for borrowing is running a little higher than we thought.

MR. WALLICH. Would that be matched by higher excess reserves than usual?

MR. AXILROD. I was looking at the $350 million; I was not necessarily assuming that, Governor Wallich. I assumed that the range would encompass some variation in excess reserves.

CHAIRMAN VOLCKER. I think we're still talking specifically of excess reserves in the $350 to perhaps $400 million area when we make that borrowing assumption.

MS. TEETERS. Well, they've been running $650 million in the last two weeks on the chart.

CHAIRMAN VOLCKER. What--excess reserves?

MS. TEETERS. No, the net borrowing ran about $650 million.

CHAIRMAN VOLCKER. This would imply [excess reserves of] $350 to $550 million.

MR. BOEHNE. What set of numbers would keep the funds rate more or less around 9-1/2 percent?

MR. AXILROD. I would say somewhere between $700 and $900 million on borrowing, but one can't be absolutely certain. Mr. Sternlight?

MR. STERNLIGHT. I agree with that. And I agree with some looseness of that relationship, because we seem to be getting borrowing a little over $1 billion and yet the funds rate looks as if it's going to average a little under 9-1/2 percent. When I look back at some rough equations I tried to draw up, $700 to $900 million might suggest to me 9-1/2 percent or a little higher on average, but it--

CHAIRMAN VOLCKER. Where the funds rate is in the short run, I suspect, is partly affected by whether the market thinks interest rates are going to go up or down. If they think they're going up, the funds rate will be higher; if they think they're going down, the funds rate will be lower.

MR. BOEHNE. Borrowing of $700 to $900 million seems like a reasonable starting point.

CHAIRMAN VOLCKER. Also, we have a fairly long time before the next meeting. I thought we ought to have some sort of a consultation in between.

MR. BOEHNE. It's October 4th, I think. Yes.

MR. PARTEE. I think it's an ordinary six-week interval.

CHAIRMAN VOLCKER. We have the question of the federal funds rate range. We left it at 6 to 10 percent last time and I don't know if there's any great reason to change it. I think its only relevance will be when it is published.

VICE CHAIRMAN SOLOMON. I'd leave it alone.

CHAIRMAN VOLCKER. Well, I don't want to conclude the discussion prematurely.

SPEAKER(?). That's a blessing!

MR. BALLES. I'll start an argument here, just so that we can have something to do between now and lunch time.

CHAIRMAN VOLCKER. We have some other things we can talk about, though. I don't want to encourage it unnecessarily.

MR. BALLES. Based on the San Francisco money market model, we do not share the view that M1 is in the process of slowing down. Therefore, that leads me to wonder whether the 10 percent funds rate is going to be enough to contain M1 anywhere near the path that we have set for this quarter. We've already overshot as it is and I would expect some further overshoot based on our analysis. That leads me in the direction of at least "B-" if not all the way to "C."

VICE CHAIRMAN SOLOMON. But how can you get that significant a move upward for it to go over 10 percent if we're running policy as we are and interpreting it as maintaining the existing degree of reserve restraint? That's the operative sentence.

CHAIRMAN VOLCKER. Well, if the aggregates ran high, we could tighten up on this.

MR. PARTEE. But our main aggregates are M2 and M3, which are within their ranges.

MR. BALLES. I guess I'm quarreling about whether "existing degree of reserve restraint" is in fact what we need or whether we need a bit more restraint.

MS. HORN. It comes down in part to whether we trust ourselves to deal with the problem you raise when it happens, doesn't it, John?

MR. BALLES. That's right. We have two choices: We can put our confidence in the forecast, which may be wrong, or wait to see what happens, in which case it may be too late.

MR. PARTEE. Well, since you're the one who has that forecast --Steve doesn't have the same forecast--it's putting our trust in your forecast as against Steve's forecast.

MR. AXILROD. That was one of the two models I referred to that did run higher.

MR. GUFFEY. I would just change the focus a little. It isn't clear to me what establishment of a borrowing figure by this Committee really means. We've been operating on nonborrowed reserves or net borrowed reserves. It appears to me that what we're doing is simply pegging the funds rate at some level and turning over to the Desk and in a sense to you, Mr. Chairman, where that funds rate will rest on a week-to-week basis. I guess I'm raising a question on the operational procedures that are being followed. If we're following a regime of merely pegging the funds rate, then establishing a borrowing level isn't very meaningful because it all cues off of what Peter and Steve believe will give us a 9-1/2 percent funds rate. And then it is

adjusted from there depending on, I guess, their judgment and the Chairman's judgment.

VICE CHAIRMAN SOLOMON. Well, there is some variation.

CHAIRMAN VOLCKER. How much weight you put on the funds rate is in our minds when we make the decision. And we're obviously constraining the funds rate in some sense but we're not aiming at a particular funds rate. The funds rate came out a little higher--a quarter point maybe--than we anticipated at the last meeting.

MR. GUFFEY. Well, to illustrate the point, the fact is that the funds rate ran up in the last two weeks; it then came back down, to be sure. It may have been affected by technical considerations of the [Treasury] refunding and other things. But as a member of this Committee, I have a very difficult time saying that $700 to $900 million is the right borrowing figure when it is meaningless after the first day, if you will, after the paths are built. I'd rather talk about some appropriate funds rate.

CHAIRMAN VOLCKER. Well, you can talk about what you want to talk about or what you want to aim at, but I don't think it's meaningless after the first day. We haven't basically changed that. We could change it in light of all these factors mentioned here.

MR. GUFFEY. When borrowing ran at the $900 to $1 billion level, we did not follow the regime of earlier days by adjusting the nonborrowed reserve path.

VICE CHAIRMAN SOLOMON. But in planning the nonborrowed reserve path you still have been using the assumption for everything you've said, haven't you, Peter?

MR. STERNLIGHT. Yes.

VICE CHAIRMAN SOLOMON. Irrespective of the fact that some weeks borrowing comes in higher or lower.

MR. GUFFEY. [Unintelligible] and then you accommodate that borrowing.

MR. ROBERTS. Well, it looks to me as if we've had a constructive effect. The policy has resulted in a path that has slowed the [growth of the] monetary base, which is getting reflected here in a slowing in the stock of money.

VICE CHAIRMAN SOLOMON. That's a larger question. He's talking about a narrower question.

MR. GUFFEY. Yes, I am.

VICE CHAIRMAN SOLOMON. I'm not on the phone every day, but my understanding--if I'm wrong, Steve or Peter ought to speak up--is that they are following the Committee's guidance in calculating the nonborrowed reserve path. They are not adjusting the nonborrowed reserve path to the actual borrowing that happened to occur in a particular week.

CHAIRMAN VOLCKER. Except that, as kind of a footnote, they have had these weeks when [borrowing] came in very high early in the week and the market may get pretty [unintelligible]. We get a lot of excess reserves as a result. The Desk hasn't been driven to supply a lot of money to get the borrowings way down to balance off what happened in the first half of the week on some occasions.

MR. GUFFEY. But those weeks have followed one after the other; that is my point. It's not just one week in isolation.

CHAIRMAN VOLCKER. No, there were several weeks.

MR. STERNLIGHT. We got a lot of borrowing early in the week. There was one week when we were just about explicitly making the kind of adjustment that President Guffey referred to. We were prepared to accommodate--to make some allowance for the high level of borrowing in that week, as it closed out. We were going to make an allowance for high excess reserves as we were closing out the week but then it turned out that the reserve factors caused a big miss that pretty much offset the kind of allowance we thought we were making there.

MR. PARTEE. Consider that confirmation!

CHAIRMAN VOLCKER. I think it's clear that members of the Committee, in varying degrees, have the level of the funds rate in mind when they think about the borrowing level. But we're not strictly adjusting the operations so that we are aiming at a particular federal funds rate.

MR. GUFFEY. Well, you try to hit a net borrowed reserve figure that will give you a [particular] funds rate, though, if I understand the way you've been operating most recently.

MR. STERNLIGHT. Right. But that net borrowed reserve figure comes out of the Committee's discussion on borrowing and--

MR. PARTEE. I guess, though, that I can understand Roger's point. Another way to put it, precisely, is that you think $700 to $900 million is closer to giving us a 9-1/2 percent funds rate than $600 to $800 million was. So, Roger's point is: Well, why not just specify a 9-1/2 percent funds rate and forget about the borrowing number? There's some logic to that, I think.

CHAIRMAN VOLCKER. We can do that, but that's not what we are doing.

MR. WALLICH. It is true that we don't operate on the automatic system where a rise in money supply and, therefore, demand for reserves automatically leads to a rise in the funds rate.

CHAIRMAN VOLCKER. That is correct.

VICE CHAIRMAN SOLOMON. That's why we changed the paragraph to put emphasis on the degree of tightening--or maintaining or loosening, even--of reserve restraint.

MR. WALLICH. I think that is what Roger is saying, if I understand him correctly.

MR. GUFFEY. That's correct.

VICE CHAIRMAN SOLOMON. It certainly limits the amount of variability in the fed funds rate. There's no question about that. But I think it's also correct to say that we're not pegging it. We've seen within a week a considerable movement in the funds rate.

CHAIRMAN VOLCKER. With that clarification or lack thereof, I guess where we are specifically is that we replace "increase slightly further" with "maintain the existing degree of reserve restraint." I would just summarize that 8-1/2 and 8 percent by saying 8 percent [for both M2 and M3] and take out the "respectively." We leave in the 7 percent for M1 and I guess we're leaving in the 6 to 10 percent for the federal funds range. And we are assuming a borrowing level of $700 to $900 million, unless these other factors suggest that that should be changed.

MR. GUFFEY. And this implies a funds rate of around 9-1/2 percent?

CHAIRMAN VOLCKER. That's where they are guessing, that's right.

MR. GUFFEY. Or a little less. [Laughter.]

CHAIRMAN VOLCKER. Shall we vote? Somebody is pointing something out. What is this about?

MR. BERNARD. The interest rate sentence.

CHAIRMAN VOLCKER. It's not true, is it? Mr. Bernard is looking at the last sentence of the boilerplate on interest rates. "Interest rates rose appreciably through most of the intermeeting period but recently market rates have retraced much of their rise." We should just be putting in "all of their rise." Is that correct?

SPEAKER(?). Yes.

MR. MARTIN. Some, but not all.

CHAIRMAN VOLCKER. Well, "much" is the way it is now.

MR. AXILROD. Much or most?

CHAIRMAN VOLCKER. We'll make it "most."

MR. PARTEE. It depends on what rates did in the last few days.

CHAIRMAN VOLCKER. That gives us two "mosts" in that sentence. Say "through much of the"--

MR. AXILROD. I would say it is more than a large part, Governor; in many cases they're within 5 basis points. It really is the bulk or something--

CHAIRMAN VOLCKER. Where it says "most" up above we'll change it to "much." We'll reverse the "most" and "much."

MR. MARTIN. Give them something to work on, right!

CHAIRMAN VOLCKER. Okay. I guess we'll vote.

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	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. All we have left is the confirmation of the date for the next meeting, October 4. And we may have a consultation before then.

END OF MEETING