Meeting of the Federal Open Market Committee

November 7, 1984

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 Wednesday, November 7, 1984, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Boehne
Mr. Boykin
Mr. Corrigan
Mr. Gramley
Mrs. Horn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger
Mr. Wallich

Messrs. Balles,1/ Black, Forrestal, and Keehn, Alternate Members of the Federal Open Market Committee

Messrs. Guffey, Morris, and Roberts, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, 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. Burns, J. Davis, Kohn, Lang, Lindsey, Siegman, and Stern, Associate Economists

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

1/ Left meeting before action to adopt domestic policy directive.

size of their reserves and figuring 10 percent on that and the troop payments, they should be selling much more. That's really what their principle is.

MR. CROSS. Well, they don't sell only on those celebrated occasions when they have come in and hit the market, of course. They do put some of this in over time. For a long period of time they had followed, in varying degrees, the practice of putting these amounts in during periods when it seemed sensible to them or when they wanted to do it. They don't follow and have not followed, as far as I know, the practice of consistently putting these amounts in the market on a regular basis.

VICE CHAIRMAN SOLOMON. If I remember correctly--Ted Truman might know--when I was at the Treasury the amount of the two items that Henry mentioned was $1 to $2 billion a year. And we did not urge them to follow a policy, Henry, of immediately selling it out as they got it in, but they did try to follow an overall, longer-term policy of averaging out that way.

MR. CROSS. They've been doing this for many years and have always done it in this way. The amounts I think are larger than--

MR. TRUMAN. It sticks in my mind that troop payments were somewhat less than $100 million a month. That would be somewhat more than $1 billion just on that score alone in a calendar year and then they would have a couple of hundred million in income.

MR. CROSS. Troop costs certainly used to be at least that much; that may have declined.

CHAIRMAN VOLCKER. Any other discussion? Well, I take it that there is a willingness to renegotiate all the swaps or to renew them for another year. There is not much renegotiation involved.

VICE CHAIRMAN SOLOMON. Do we need a formal vote?

CHAIRMAN VOLCKER. I guess we don't, do we?

MR. CROSS. I will assume the Committee agrees and will proceed accordingly.

CHAIRMAN VOLCKER. We'll approve them when they are done. We have to ratify the transactions.

MR. MARTIN. So moved.

CHAIRMAN VOLCKER. Without objection. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Questions?

MR. WALLICH. On this foreign issue: If the spread first went down and then went back up to where it was at the time of the issue, is there any justification for any bank to say that they would have lost money had they gone in on that and that they were smart not to go in on it?

MR. STERNLIGHT. Well, I think some who went in on it felt that it was worth something, just for the prestige or the advertising factor. One had that sense on the bids that came in, and I think that some modest losses probably were taken in the course of doing that. Certainly, one hears that the next time around the spread is not likely to be as large as that 32 basis points--that maybe half that would be justifiable. That was the feeling I was getting.

VICE CHAIRMAN SOLOMON. The Japanese felt an obligation to cooperate. I think that was a significant factor that wouldn't necessarily be there in the future to such a degree.

MR. GUFFEY. I would like to inquire, Peter: When did we drop the borrowing level from $750 to $700 million? I must tell you as a preface that I was surprised. The first time I realized it was from the Bluebook, which I thought was a mistake; I went back to the daily wires and there was no indication that I could find that the borrowing level had been dropped.

MR. STERNLIGHT. Just a week ago, I believe. I am confident it was mentioned. Well, I can't say I read the wire of the call. I know that it certainly was reviewed at the conference call.

MR. AXILROD. If it wasn't in the wire, it should have been. It must have been an oversight.

MR. STERNLIGHT. Last Thursday or Friday.

MR. GUFFEY. I think I went back over [the wires of] the last week.

MR. AXILROD. It was right after that first week of the two-week period. We ended up at $700 million right about that time for the average borrowing level and it seemed sensible to make it $700 million, given all that had happened. It should have been in the memorandum of the call. If it wasn't, it was certainly an oversight.

MR. GUFFEY. Well, I could be mistaken, but I don't think so.

VICE CHAIRMAN SOLOMON. It has been an interesting market. I think that the range of short-term interest rates is predicated more on a market anticipation of a fed funds rate closer to 9-1/2 percent than the 10 or 9-7/8 percent that it has been averaging lately. So, there is a question--not that we're getting into that now--but assuming there's some further easing, the question is whether markets will assume that's the last; I doubt that they will. They'll probably assume there will be a discount rate cut later on and the markets will then take it even further and we may continue to get some lower rates than the projections.

CHAIRMAN VOLCKER. Any other comments? We have to ratify the transactions.

MR. MARTIN. So moved.

CHAIRMAN VOLCKER. Without objection. Mr. Kichline.

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

CHAIRMAN VOLCKER. You say the economy was expanding more rapidly in September and October. This is what the employment figures for October show as I understand it. That does not seem to be matched by industrial production or by consumption necessarily.

MR. KICHLINE. We said more rapidly in October than in September.

CHAIRMAN VOLCKER. In employment.

MR. KICHLINE. That's true. The gains in employment in October were rather spectacular; it's the highest increase in over a year. I think that's unsustainable. It looks a little odd.

CHAIRMAN VOLCKER. I understand the number. How do you interpret the unemployment claims figure?

MR. KICHLINE. To start out I mentioned conflicting signs, and that indeed is one of them. Initial claims for unemployment insurance have been edging higher, including those for the week after the labor market reports were taken. We are estimating, as I noted, that industrial production was up about a quarter of a percent in October and that's better than a 0.6 percent decline. But the October level of production is still below what we saw in the summer. There are many what I would view as conflicting indicators of what is happening.

MR. PARTEE. Well, a lot of that increase in employment in October was in nonmanufacturing.

MR. KICHLINE. The bulk of it. I think industrial production is related [more] to the manufacturing employment. But for some reason, people are going out and hiring lots of new employees in services and trades.

CHAIRMAN VOLCKER. To unload the imports and sell them!

MR. PARTEE. To get them off the docks? Well, that could be.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I met yesterday with the chairman of the I asked him about the October retail sales. He said that their sales were lower than they expected and as a consequence that their inventories are up about 5 percent from where they thought they would be. He attributes it largely to the fact that October weather was unusually warm and that people just don't buy winter clothing until the weather turns cold. He is expecting a very strong Christmas selling season. That, for whatever it's worth, is the view.

MR. PARTEE. He does recognize that he had a very soft October?

MR. MORRIS. Yes. But he thinks he knows why--the weather factor. It wasn't something that alarms him.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. I just want to underline some of the mixed signals, Jim. I note that the Michigan consumer confidence measure was off a little in October. I don't put a big weight on that. The hours worked quantum always puzzles me a bit, but I notice the hours worked were down in October according to the Labor Department. The Chairman has mentioned that initial claims for unemployment were up. The purchasing agents survey is not a good quantitative measure--it was revised three times ex post out of the [unintelligible] data--but for whatever it's worth it shows reductions in new orders, delivery speed, inventories, and payrolls, and less price increases. I think perhaps more important were the preliminary indications that the third-quarter real GNP may be revised downward due to the merchandise trade deficit number. If that is 1.7, not 2.7 percent, it may require a rethinking of some of the inventory changes. It already has been revised down once from 3.6 percent. I don't know what a soft landing is, but an 80 percent decline from the first half, when we had GNP growth of 8.4 percent--I don't know how soft that landing is. The undercarriage of the vehicle may be slightly bent in that kind of [scenario].

MR. PARTEE. Well, it's still above the runway.

MR. MARTIN. It's above the runway but perhaps without any wheels! At any rate, your comment with regard to oil prices, food prices, and other indications of inflation out there in the future is reassuring. Imports are still soaring--I'm tying onto the Chairman's comments as usual here--but those imports are having employment and income effects in U.S. firms. We know that. It seems to me that there is a risk of a growth recession in the first and second quarters of next year. I too have talked to retailers who feel they will get through the holiday selling season well and then have very quiet first and second quarters. And I see the risk of a growth recession, with rising unemployment and very low real growth taking off from that 1.7 or 1.5 percent. I saw one model's output that had 1.2 percent for the third quarter, which I don't believe, but it begins to get your attention, I think. The consumer comes into the first and second quarters with all those new cars bought on credit and all those other consumer durables and is paying the kinds of real interest rates one pays today, and I don't know whether that adds up to a snapback or not. It doesn't to me. I think that the risk is so high that we should be very concerned about it. If we get your [projected] 3.5 percent real [GNP] for the fourth quarter and run along at about 3 or 3-1/2 percent for 1985--given the margin of error, no disrespect intended--it seems to me that again gets to be a precarious position to be in with a substantial downside risk. If we get one or two exogenous factors in there when the economy is hovering around a 3 percent level, unemployment can get started up again. The foreign competitor is still cutting into those employment rolls. So, I think the margin of error is substantial. I would hate to see the Congress come back into this town, this font of all the wisdom in the universe, facing a 1 percent real growth figure and rising unemployment. We would just get some dandy decisions in the fiscal area in that circumstance. I think we are facing an increasing downside risk.

MR. PARTEE. Jim, the last time you talked some about the probabilities. May I ask whether you have anything new to say about that? That is, have you increased the probability of something around zero compared with six weeks ago or whenever we met last?

MR. KICHLINE. There is a probability of negative growth in the fourth quarter of 19 percent.

MR. BLACK. Are you rounding, or is that--?

MR. MARTIN. Jim, what about the probabilities in the first and second quarters?

MR. KICHLINE. This comes out of the econometric model exercises we performed. The model said 19 percent for the fourth quarter and 15 percent for the first quarter; then it drifts in the range of 25 or 30 percent, let's say, in the latter part of 1985.

MR. BALLES. Have you checked it with [Jimmy] the Greek?

MR. KICHLINE. No.

MR. GRAMLEY. What is the probability of two consecutive quarters of negative growth?

MR. KICHLINE. Two consecutive quarters is very low--1 to 2 percent.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, Governor Martin said a good part of what I had in mind except that I don't expect a growth recession in the first half of next year. I don't have any major argument with the staff forecast. But I am more comfortable with the longer-term part of the forecast than I am with the forecast for the current quarter. As was pointed out in the briefing, the performance of the current quarter is very sensitive to the increase in consumer expenditures; we have to get a substantial increase--on the order of 5 percent plus in this quarter--in order to get the projected growth for this quarter. In addition, even if we get this substantial increase in consumption expenditures, the stimulus to GNP depends on the distribution of these consumer expenditures between imports and the rundown of inventory. So, the net stimulus to real GNP may not be as strong as projected. On the other hand, it may well work out that output does increase in the range of 3-1/2 percent. My only point is that for this quarter we should be prepared to see an increase in real GNP of significantly less than 3-1/2 percent.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Perhaps in line with previous comments, I'm beginning to sense what I think is quite a different tone in our area than what I reported at the previous meeting. I have suggested in the past that the Middle West has not participated very fully in the recovery and expansion, and that continues to be the case. But some things may be developing that signal broader problems. The bad business has continued to be bad. The backlogs of orders are running down. But those businesses that have done better than others are beginning to feel the slowdown. One CEO that I talked with who works with what he calls pressure curves, which are some kind of regression analysis on the rate of incoming orders, says those are beginning to indicate to him that we are heading into a downturn. Specifically: The appliance business is noticeably weaker; heavy trucks, which were

very strong early in the year, are now turning down; and the truck trailer business market was up because of a legislative change but is clearly turning around and slowing down.

CHAIRMAN VOLCKER. What business?

MR. KEEHN. Truck trailer.

MR. PARTEE. That means double trailers.

MR. KEEHN. There was a legislative change that provided for double bottoms and that really ballooned the market. That is coming down.

CHAIRMAN VOLCKER. Let me just interrupt for a second. I had the impression that heavy trucks were doing well--that they had gone down and then gone up.

MR. KEEHN. Orders booked for very heavy trucks, Class 8 trucks, are down substantially and their production is down. A large retailer--which is frankly a euphemism for

MR. MARTIN. Let's see if they told you the same thing they told me!

MR. KEEHN. We had a meeting of [local] economists a week or so ago and their representative, who had been quite optimistic about the Christmas outlook, is now a lot less optimistic.

MR. MARTIN. They did.

MR. KEEHN. They are expressing some doubts about the outlook for retail sales. This suggests that while we thought the soft landing--or the reduction from the very high first and second quarters--was a welcome thing, it may be something a bit more fundamental. I'm beginning to wonder about that. I don't disagree with the staff forecast, but it tends to be a little on the high side, to me at least. The GNP numbers look high both for this quarter and for next year. Housing starts and auto sales look a little high. So, consistent with [the views of] Governor Rice and Governor Martin, I think there is an increasing risk of low or perhaps even negative growth rates.

I just can't let the moment go by without commenting that conditions in the agricultural sector are continuing to deteriorate. What has been a very difficult situation has only gotten worse with the passage of time. The rains are now complicating the harvest season; commodity prices are down; meat prices are down; and land values are continuing to decline. [The latter] is particularly true in Iowa where admittedly they have come down from pretty high levels, but they are in a decline that's very significant. This is beginning to back up even more with regard to nonperforming loans in the agricultural banks. The banks keep saying that their problems are manageable; nonetheless, these are the kinds of things that can turn around pretty rapidly. Based on the calendar we are at a time of the year when for the next few months things [should] only get better. They ought to be better now than they are. And the fact that they are bad would indicate that in the next few months things are going to get

worse. Agricultural equipment manufacturers are continuing to go through just a very dismal period. The outlook is poor and they are pulling down their production schedules very significantly. There is plenty of tractor and combine equipment at the retail level, so production is going to be very weak well into 1985. Our agricultural economist, who is a pretty conservative guy not given to extremes, said that in his view we are facing the worst set of circumstances in this area that he has known in his whole experience at the Bank. I don't think that we are at a turning point here, but I would certainly think that the odds have changed significantly and that the probability of going into a period of lower rates of growth than we thought in the past is increasing. It is certainly higher than it was at the past meeting or two.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. In my District if you talk to people who are running companies, they still have fairly good expectations for 1985 but are less sure. Some doubts are beginning to creep in and I think we're in a period where expectations could change. The current results are quite mixed. Manufacturing tends to be flatter. In retailing, I find that we talk to one retailer and things look good in October and we talk to another retailer and things were pretty flat. So, the current indicators are rather mixed. I do think, however, that if we continue to get these mixed current indicators, the longer-term expectations are going to shift. If you start out with really good feelings about 1985, I think uncertainty tends to undermine them. So I think, as has been said around the table starting with Governor Martin, that there has been a change. I don't think it is a definite turning point but it's a period of increasing doubts. And if we don't begin to see some pickup very soon, attitudes about 1985 will shift significantly. If you felt strongly a month ago that we were having a snapback, you have to be a lot less sure about that now. If last month you were leaning toward [an expectation of] a growth recession, you have to be leaning more in that direction. My own view is that I'm fairly uncertain. There is a high degree of uncertainly about where things are going, but I think the risks have shifted toward a slower economy than I, at least, would have thought a month ago.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, I approach this with a little different view from the other speakers this morning. That's primarily, I suppose, because of where I live and work. To be sure, economic activity in the Atlanta District did go through a period of moderation in the summer but we have seen some pickup. Generally speaking, I think that economic activity is fairly healthy. Most of the indicators show strength, although there are some weak areas. We have heavy defense spending, particularly in the electronic and aerospace industries; oil and gas [activity] is even picking up in the Louisiana area; and the carpet industry, construction, and housing are picking up. In fact, housing surged by about 52 percent in the Southeast in the month of September. Tourism continues to be good. The weak spots are forest products and textiles and other export-related areas. Now, retail sales have been off even in our area; they picked up in September and fell off again a little in October. All of the retailers I speak to are experiencing downturns from their projections; their sales are not up to plan. They attribute this, as

others have said, to the unusually warm weather in October. They are a bit cautious about Christmas, although I think most of them are fairly confident that they are going to have a good Christmas season. Agriculture is a mixed bag because of a number of factors, including drought followed by very heavy rain in early November.

Looking beyond the Southeast, which is perhaps not typical [of the nation], I tend to agree with the staff forecast of renewed growth in the fourth quarter and in 1985, particularly because I think that we have not yet seen the effects working through the economy of the lower interest rates that we've recently experienced. On the inflation side, I am a little less confident about the staff's projection. I still think that is a problem that we really have to keep our eye on. I think the dollar is going to come off although, like everybody else, I won't be very quick to say when that will happen. But I think we are going to see the dollar coming off, with its implications for inflation. Also, the numbers that I have seen suggest that wage settlements in the service sector have not been nearly as low as they have been in manufacturing. And, of course, we have the fiscal stimulus, which I don't see being removed very quickly when Congress comes back. So, on balance, Mr. Chairman, I think we can expect reasonably good growth in 1985. I view the risk not as one of negative growth but rather of renewed inflation. Even if we didn't get 3-1/2 percent real GNP in 1985, I think that even 2-1/2 to 3 percent growth would still be fairly decent and not anything to be terribly worried about. At this point, I am not concerned about recession or any kind of negative growth in 1985.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Well, the staff's projection for the fourth quarter is about in line with what most private forecasters have been saying; it's certainly plausible and maybe even the most likely forecast. But I have to agree with Preston Martin and Emmett Rice and Ed Boehne and Si Keehn: I believe the risk has shifted to the low side since we last met. As Jim Kichline pointed out, there are certainly some statistics that suggest that growth picked up in September--the employment figures and the figures on retail sales. But I think we have to bear in mind that given the export/import picture, even if final demand strengthens, that doesn't necessarily mean that we are going to have equivalent strength in domestic employment and demand. People may, as you said, Mr. Chairman, be lining up to unload those imports. Moreover, the lack of growth in M1 since midyear certainly makes it less likely that there will be any sustained resumption in growth any time soon. In short, I see some serious risks in the near-term economic future and I think we ought to keep those in mind as we address policy today.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I am agnostic on the outlook. I think it has deteriorated somewhat. I made a list for myself of strong and weak factors and I stopped when I reached 12 on each side and had a number more. But I think the nature of the choices that we have is a little different. Expansions don't go on forever; at some point there will be a pause--a growth recession, hopefully not a real recession. If we had the choice of a growth recession in the near future or a real recession a year later, for instance--

CHAIRMAN VOLCKER. What's a growth recession?

MR. WALLICH. When unemployment rises but GNP still rises--in other words, growth below potential. If we had that and it were reversed subsequently, that to me would be a less ominous thing than a new real recession. And that might well be a choice because the things one would have to do in order to make sure that there is no growth recession may very well generate imbalances or maladjustments and set in motion [forces] that a year or two later might produce a real recession. They might also, of course, get us back into inflation. Starting from 5 percent inflation, it seems to me one ought to use special caution in dealing with that prospect. It's not as though we were starting from close to zero.

CHAIRMAN VOLCKER. It's not exactly at 5 percent either.

MR. WALLICH. I think the underlying inflation rate is of that order if one removes all the temporary [influences]. If we look at the probabilities of what is going to happen, they may be evenly balanced between a resumption of the expansion or a growth recession. I doubt that it would be a real recession. If we look at the risks that lie beyond that, action to keep [the economy] growing at all costs might produce a much worse situation later and might conceivably relaunch us into inflation. I think those possible costs are much higher than if the economy wants to take a short pause and then resume [growth] again.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. As I look at the numbers coming in, I am inclined to agree with the staff that they do suggest there is some improvement in activity going on. When I think of how the numbers were coming in a month or two ago, the recent figures look to me a lot more optimistic. The last figure on new orders for nondefense capital goods was up after a couple of months of decline. Shipments were up quite strongly. The last figure we had for retail sales was up; we don't know what October will bring. I read the Beigebook and I thought it was saying that the gains we had in September seemed to be sustained in October even though that doesn't seem to be confirmed by department store sales.

MR. PARTEE. Nor by the comments around here.

MR. GRAMLEY. Well, we haven't heard from everybody yet. But certainly, the comments in the Beigebook did not reflect what we're hearing today.

MR. PARTEE. I think somebody else wrote the Beigebook!

MR. GRAMLEY. We're now looking at a period of rising auto production--increasing availability of models instead of the reverse that was going on in the summer. The last figures on housing starts and new home sales were up in contrast to earlier weakness. The October employment data were considerably stronger than the data coming in during the summer; indeed, we had a turnaround in manufacturing employment from a rather sizable decline in September to an increase in October. In a period like this there is bound to be uncertainty. As Henry mentioned, you can list a dozen factors on the

positive side and a dozen on the negative side, and there is room for doubt among reasonable people as to where things are going. We've been through this sort of pause many, many times in periods of economic expansion. If you asked what basic factors were driving the economy during the first six quarters of recovery--strong fiscal stimulus, a lot of consumer confidence, low inflation, the technology driving business fixed investment--I think those factors are still there. And I'm about 75 percent certain, personally, that the incoming figures a month and two months from now will show a more positive trend. I do not worry about the possibility that third-quarter GNP growth will be revised downward. I don't doubt that at all. That is what happened in the past. Indeed, if it turns out that the downward revision reflects a lower rate of inventory investment, that would be on balance a plus and not a minus. I agree with the staff forecast. I think we will see some strengthening in activity. I don't know whether it is going to be in the fourth quarter and I don't really care. It's a question of whether or not it comes along soon enough, as I think it will, to generate the kind of growth that the staff is forecasting for 1985. And I think they are about right on the button.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. In the Twelfth District, the pace of economic expansion really has slowed dramatically. We just haven't seen the bounceback in sales that is reported in some Districts. One thing that is going quite strongly in our District is nonresidential construction; in some of our leading cities it's almost of boom proportions. But it's certainly clear that the reduction we've seen so far in mortgage rates has been insufficient to prevent both the construction and the sale of new homes from falling further. That's a weak area. And as I've been reporting for a long time now, the strong dollar and the situation with foreign imports are hurting a good part of Western industries such as forest products and primary metals, and that is reducing the overall growth of manufacturing employment to a crawl. The agricultural situation is pretty grim in a good many of our states. In sum, I think the balance has changed toward the engine stalling here. If the plane is still in the air, it's about to make something worse than a soft landing. I agree with much of what was said by Governors Martin and Rice and Presidents Keehn, Boehne, and others. Monetary policy is supposed to be flexible and I think the time has come to err a bit on the side of ease unless the situation clarifies.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. My own view is that the staff forecast is probably about on the mark. In fact, I still very much lean to the view that in the next two or three quarters as a whole, there is a good chance that the economy will be stronger than the staff forecast rather than weaker. I may be a little less certain about that now than I was six weeks ago, as are other people; nevertheless, that's still where I'd put the probabilities. The uncertainty factor clearly does reflect the very, very near-term outlook. What is this mishmash of statistics and anecdotes really telling us? On the retail sales side, we had meetings last week with the CEOs of all the big companies in Minneapolis--and there are two very sizable retailers headquartered there--and they,

remain extremely bullish about the outlook for retail sales in the near term notwithstanding this pronounced slowing in the last two weeks of October.

On the other side of the picture, a couple of the companies in the Twin Cities that are major manufacturers and suppliers of electronic gear and happen to be thought of as computer companies--in fact, they make lots of components that go into both commercial and residential construction--reported a surge in industrial bookings in October. That was the word that they used. Insofar as the equipment that they manufacture and sell is associated with housing, they don't know whether it's related to new housing or renovation, of course. But in October, or I should say the 30 days ending last Thursday, they had an all-time record 30-day pace of activity for bookings and shipments of electronic components that go into residential units. Maybe that's consistent with the view that the decline in interest rates that we've seen is beginning to take hold a little. While the housing sales figures in the last set of numbers were somewhat mixed geographically, there was some spark at least for one month evident in those statistics as well. When I put it together, again, I would agree with many of the comments that the immediate situation is harder than usual to read. I personally do not see a recession in sight or anything that would remotely qualify as a recession.

I have two quick comments on imports and agriculture. This import phenomenon, as I think I said once before, is really off the chart. There is no doubt that that makes it extremely difficult to figure out where the driving forces are, but I will just try to put that in perspective with a couple of concrete examples. For example, one of these companies told me that just in the past six or seven months they have started buying disk drives for floppy disks for smaller computers from a Taiwanese supplier. They are delivered in Minneapolis for $60 a unit whereas the cheapest they can make them with no markup--the cheapest they can manufacture them themselves anyplace in the United States--is $140 a unit. Another very large high-tech company reported to me that within the time frame of this year they started buying transformers for their medium size main frame computers from Far Eastern sources. Again, the price delivered to them in the United States is one-third of the cheapest price they can manufacture that type of component. Indeed, one of these companies reported to me that the situation has reached a point where, no matter what one assumes about exchange rates or anything else, from the point of view of their corporate long-term strategic planning they have now found themselves forced for the first time to consider seriously going into off-shore supply in a major way through their own facilities. They find that very distasteful but the economics of it are such that they find themselves compelled to think in those terms.

On the agricultural situation, I would just echo what Si Keehn has said. It is not pretty. And I think it is now starting to back up in a way that you can see the implications of it on the small banks--all these darn small one-bank holding companies that are sitting out there and are leveraged to the hilt. It could be very troubling.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. The situation from the vantage point of the Cleveland District isn't much different from what has been expressed by a number of people around the table. The Fourth District's difficulties are probably due to a [concurrence] of circumstances. First, there are the ongoing structural problems and the intense import competition, which we feel so strongly, together with the pause in economic activity. Most of our capital goods industries, excluding machine tools, have noted a flattening in orders and shipments. In steel we've had a few more furnace shutdowns. Housing in the District has been flat at best for several months and our bankers continue to comment on the difficult income situation that farmers find themselves in and the problems they will have servicing their debts. The result, as has been pointed out, is increased uncertainty about the outlook for next year. In our District we still have the basic view that the consumer will lift the economy into growth next year; around the District a strong Christmas is widely expected. Expectations are also for a continued thrust from business investment, although presumably at a slower pace. We have a basically positive outlook but a lot of concern is expressed; I think the concerns of many people arise in part because of how discouraged they are with the very strong import competition. Others focus on the long-term problems of the economy: the need for fiscal policy changes, the inflation problems, and so forth. Also, expectations are generally damped by the pause that we see. Although expectations are for growth next year, they are very shaky, and sometimes I wonder if they are held with enough confidence to get us over a few disappointments that we might see in the coming months.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I think it is fair to characterize the situation in the Eleventh District as one where we are continuing to see some improvement. Employment is increasing, industrial production is still moving up, and retail sales look fairly good. I will say that we have had slowdowns from earlier in the year. Weakness, of course, continues in the energy industry, and that might be getting a little worse. We also have had a downturn in construction but, as I indicated last time, I really don't think that's all that bad. I would pretty well agree with the Board staff's forecast. I would expect the fourth quarter obviously to look a little better than the third quarter. At least from the people I've talked to down our way, I have not picked up any real concern about a recession on the horizon as we go into 1985. The confidence factor, at least my own confidence factor, is not quite as strong as it was earlier. So, I'm not really complacent. On the other hand, my degree of discomfort, if you will, is probably not as great as that expressed by a number of people here. It seems to me that we're just coming into a period when there is uncertainty and when decisions become very difficult. I think there is an awfully great risk of overreacting to what might or might not happen.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. I have been somewhat concerned about slowing business conditions for several months and I still am. I won't repeat all the signs; I heard them earlier and you have also. I will just

add two things that I haven't heard mentioned so far. One is that in talking with a number of business economist friends who are neither kooks nor politicians I sense a big change in their attitudes in the last six weeks or so. In general their confidence in their forecasts for next year seems to have diminished. Frankly, if I had to point my finger at one factor that is responsible for this, it would be the signals that we have been sending from this building. They are looking at the slower monetary growth in the last four months and as a group are not interpreting that as poor marksmanship or the inability to hit our targets. They are interpreting these numbers as an actual tightening, particularly when they saw the fed funds rate shoot back up in August. So, I think that has led to some of the changes in attitude. Secondly, I was talking to a top economist for one of the Big Three auto companies who said that when they were doing their modeling and trying to forecast auto sales for next year they looked at the usual relationships among employment, income growth, credit availability and all the things that they know influence auto sales. They came up with a particular forecast, yet because of their lack of faith in that number, they peeled off about 300 to 400 thousand units from that because in the pit of their stomachs they didn't think they could hit the number that came out of their model. I am mentioning this to suggest that if there is a risk, I think it is that these numbers [forecast] for the fourth quarter and for 1985 will be too high rather than too low. I am not saying that there is a recession around the corner; I am not that good a forecaster. But I think there is the risk.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. One thing that worries a person who looks at the business statistics all the time is a situation that can't very well be explained on the basis of past experience. And I can't very well explain why business is as weak as it has been in the last few months. That makes for considerable discomfort in a professional economist. I am very nervous at the present time. I felt confident that there would be a resurgence in the economy this fall because, like Lyle, I thought that we had just a temporary spell of reduced consumption. I thought the economy would come along in the fall because incomes and expectations and confidence and the real financial value of assets were all there to support strong consumer spending. I guess I still feel that. I am closer in view to the guy from than I am to the guy from in thinking that we're going to have a good Christmas. Nevertheless, there is no real indication of such a resurgence in attitudes of manufacturers and business people generally. The one thing that I have never dealt with is the problem of a steadily rising proportion of total markets being taken up with imports. Because we haven't had that in the 35 years that I have been an economist, it does occur to me that it's possible that retail sales can look good and strong and that plant and equipment spending can look good and strong and it won't do anything for the domestic economy if an important increment of that demand is going into imported goods. Therefore, it is quite possible that we could have strength in the indicators of the kind that Bob Forrestal talked about--retail sales and so forth--but weakness in the underlying performance of the economy. I think that's a big change from the past, and it seems to be a trend that is still persisting.

The other thing that may have occurred--and it's very, very hard to know--is that, in fact, inflation expectations may have subsided over the last six months. We are getting some indications of that from these horseback surveys that people do on inflation. But I don't think they are much good; they really just reflect what has happened most recently. But it may be that we've had a period of low increases in wages and low increases in profit margins for a long enough time that people are now beginning to believe that by golly inflation isn't going to go back to 7 or 8 or 9 percent! You may remember in the spring that it wasn't hard to find outliers like Milton Friedman who thought that inflation would be at double digits by the end of this year. That has disappeared entirely. That also is something that could affect attitudes and the speed with which plans are put in place in order to beat price increases, because now people don't expect the price to increase whereas before they did.

I would point out that the staff forecast is nothing to write home about in terms of great strength. The forecast is for a little over 3 percent real growth over the next five quarters. That's not a high number. I would also point out to you that there is an important presumption in that forecast and that is that real imports go no higher than they are now--that the whole import thrust is behind us. In the Greenbook, if you look at constant dollar net imports on a GNP basis, there has been a deterioration of $35 billion over the past four quarters. Over the next four quarters there will be none whatsoever, if that forecast is accurate. And that goes into the GNP forecast. If you don't believe that the import surge has ended, then you can't really believe a forecast as strong as the one the staff has shown. I don't know what you think, but I think that imports are still rising pretty darn rapidly and that the growth in imports will not be over until we can change the terms of trade in which the United States deals. So, the forecast of a little over 3 percent assumes that net imports stopped growing as of the third quarter, which is already behind us. That's not such a very strong forecast.

Henry speaks about inflation. He says a base rate of 5 percent; I would say 4 percent. It is [not] zero. But unemployment isn't zero either. As a matter of fact, we have 7-1/2 percent unemployment; it has been hanging at that number, Henry, and I would argue that a 7-1/2 percent unemployment rate gives us room for further growth in the economy in the sense of looking at the performance compared with some kind of norm--what we would like to see ideally. The unemployment rate is about as distressingly above where it ought to be as the inflation rate is above what it ought to be. As I see it, it's a situation in which one can say inflation has done better than one would expect based on recent track performance. Unemployment is worse than it ought to be at this stage of a cyclical recovery. Therefore, although I'm not sure what is going to happen in the immediate future, I think that the economy is not going to go into a great resurgence in terms of output and employment and I think there is room for some more growth than seems in prospect in the numbers that we have.

MR. TRUMAN. May I just correct one comment on the forecast? I don't want to dispute the basic thrust of your argument, but on the import side we have identified a couple of areas--textiles and steel--where it is pretty clear that there was a buildup in imports in anticipation of trade policy actions that did occur and are going to,

at a minimum, put us back toward the trend of where those imports were relative to GNP. It is partly because we have taken out that small piece--$2-1/2 billion in 1972 dollars--which is not trivial in terms of the numbers we are looking at. It's 2 or 2-1/2 percent, essentially, in current dollars. We have taken that piece out and allowed some payback of it so that we get the absolutely flat picture that you so accurately described. So we do have a continued rise in imports at least to the middle of next year absent that factor, which tells us the dollar's depreciation, putative depreciation, takes effect. But the reason you get the picture in the Greenbook is largely because we have that offsetting payback in the short run on imports.

MR. PARTEE. Well, am I looking at this table correctly?

MR. TRUMAN. No, that's right.

MR. PARTEE. A year ago you had a plus $12 billion; in the third quarter of this year it's a minus $22.6 billion. That's a change of $34-35 billion.

MR. TRUMAN. No, no--

MR. PARTEE. And now, with this little $2 billion difference, you have essentially stability from now on out?

MR. GRAMLEY. Is this imports of goods or goods and services?

MR. PARTEE. The only one they have in constant dollars is goods and services. I am looking at page I-21.

MR. GRAMLEY. But I think the staff's forecast is for some increase in the constant dollar value of goods counterbalanced by a decline in the services component, which largely reflects reduced investment income.

MR. TRUMAN. Well, but the basic story is correct. Third-quarter [imports] of goods were something around $100 billion 1972 dollars, which is close to $20 billion higher than it was a year ago. [Unintelligible] another $3 or $4 billion in goods because you have oil in there over the forecast period. So, imports of services decline somewhat and that gives you the flat number on a GNP basis.

MR. PARTEE. And that is in the GNP forecast. Am I right, Jim?

MR. KICHLINE. Correct.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. I am seeing in my District some of the change in attitude that has been commented on by others. I had a meeting with about a dozen chief executive officers of large companies last week and their consensus was that business had turned toward the soft side. They were generally concerned about inventory levels; it was not that inventories had gotten out of control, but the focus of these CEOs had moved to the control of inventories. The retailers spoke of a good Christmas instead of their previous very optimistic

expectations about the Christmas season. They are reassessing their prospects in the retail area, and this group included four national retailers who had a pretty good feel of conditions nationally. They were focusing particularly on [sales in] recent weeks. In the manufacturing sector, one thing that struck me was that without exception, none of them sees any inflation anywhere either in what they buy or in their ability to change prices of what they sell. They relate this principally to the import competition, which seems to be pervasive. All of them one way or another seem to be experiencing that across the board. The other thing that impressed me was that they all felt that wages were under complete control--that settlements that had occurred were very modest indeed, and their expectations about wage settlements were of the same variety.

The housing area has been fairly stable; we have had some softness in single-family starts offset by multifamily starts. In the appliance manufacturing area, we have seen specific reductions. For example, the GE manufacturing facility in Louisville has just announced another 1400 layoffs, including about 300 white collar workers. In the textile area, where import competition has a big effect, four plants in Arkansas have just been closed involving about 22,000 workers. The shoe industry in Missouri is in extremis, as they say, in terms of import competition. Agriculture in particular is hurting now because of rains that are delaying harvesting and causing some problems. We are getting reports that harvesting of animals is including breeding stock and that is an indication of problems there. So, when I put the whole thing together, I see a change of attitude and conditions from a slowing in the economy to an economy that has flattened out. My judgment is that the staff forecast is probably optimistic for the fourth quarter and for next year as well. My best guess is that, absent a significant change of policy soon, the next move in the economy will be down.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. On the other side of Missouri--

MR. ROBERTS. It's a very thin edge.

MR. GUFFEY. But an important thin edge. In the Tenth District there has been no improvement in those areas that I have expressed concern about before--principally agriculture, energy, and the aircraft manufacturing industry. There are a couple of factors, however, that may influence the future. One, in the agricultural sector, is the Administration's program that was announced a month or so ago for delaying or setting aside some of the debt of the producers. That is now being put into place and they hope to have it operational by January 1. For your information, it involves among other things setting aside 25 percent of a producer's total debt up to $200,000 and delaying that for a period of 5 years with no interest and no payback. It is a guarantee program also with respect to the commercial banks that are financing agriculture, if that comes about. It's a pilot program in five states--Missouri, Kansas, Nebraska, Minnesota, and Iowa. There is some mixed reaction from the agricultural sector, but it is something positive and they are trying to assess what the impact will be. After it is in place in these five states, they expect to expand it nationwide.

With respect to the energy area, OPEC and the lowering of crude prices have damped the enthusiasm, which was not very great, in energy discovery. Another factor that has come to pass most recently was the announcement by Canada that they were going to reduce the price of natural gas imported into the United States by 25 percent. A lot of the Tenth District is very heavily engaged in natural gas production, so that could further depress any interest in discovery or exploration in that area. There is a fairly large segment of the District involved in high-tech business, particularly on the eastern slope of the Rockies. Most recently there have been rather substantial layoffs--about 2,000 people--in that area who were engaged in the production of semi-conductors. I'm told that the demand for semi-conductors worldwide has diminished but it has impacted this particular area more dramatically than I think any of us realizes. On the positive side, auto assembly [activity], in which we have a very large number employed, is going full out. Everybody is back and employed. Nonresidential construction is experiencing boom conditions in several areas in our District. Recreational activity is very high, with tourism and the ski industry looking forward to a very good year. I'd just note that in New Mexico, which is a very small part [of our District] population-wise but very important in the defense industry, is experiencing a boom particularly in the Albuquerque area simply because they are deeply involved in the production of defense equipment.

With respect to the outlook, I would agree with those who think the Greenbook is about right or maybe not optimistic enough. I don't see the dangers that everybody expressed around the table that we are going to drop into a growth recession, if you will, in the fourth quarter and the first quarter of 1985--or even if we did, that that would be all bad. In other words, I don't see the potential of recession as a very high probability or any probability at all. On the national level, I would accept the staff forecast as being about right. And if we get it, I would be delighted.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I would like to associate myself with the Lyle Gramley school of predicting where we are. I think it's very typical toward the second year of an expansion to run into a slower rate of growth in the economy as the economy shifts to a lower rate of inventory accumulation. And I think that is exactly what is going on right now. I would assess the risks of a recession as close to zero. I think the underpinnings of the economy are very strong. The most surprising statistic of the last month was the 440,000 increase in employment. That--particularly the 55,000 increase in durable goods manufacturing employment--was much bigger than I had expected. These are not the kinds of numbers that one sees associated with an early stage of going into a recession. Furthermore, we have had a big decline in interest rates. I think this economy is going to be very responsive to that. We haven't had enough time yet to assess the impact the interest rate decline that has already taken place will have. We see one sign in the increase in new home sales and another sign in the strength of the stock market. Another sign is [unintelligible]. But I think we haven't yet seen the full effect on the real economic activity of the rate declines that have already taken place. So, I find the pessimism that I have heard around the table from many sources hard to understand. And I don't think this

comes from the fact that I am living in a state that has an unemployment rate of 3.7 percent.

CHAIRMAN VOLCKER. [Unintelligible.]

VICE CHAIRMAN SOLOMON. I am living in a state which has double that rate of unemployment and yet I share your view, Frank. I don't quite understand the level of concern that I hear other than that it is the inherent nature of central bankers always to look at the gloomy side. And I think the sense of balance would be not a major shift of policy as Ted Roberts is saying, but some modest though limited easing. I won't repeat the reasons why I think the staff forecast for next year is on balance probably as reasonable as one can expect. In our view it might be somewhat weaker in the fourth quarter because of inventory adjustment. But the general feeling in my District--what I hear from business leaders and from members of our board--is that there will be good Christmas retail sales and that manufacturing is not showing the earlier growth but is not showing any significant softening either. I also share Henry Wallich's view--I don't always agree with Henry, but I must say I do this time--that the business cycle is still with us and we should not be excessively alarmed about some tapering off and moderation. And even though 3 percent isn't high, Chuck, it seems to me that that is a very appropriate level--if that is what we actually get next year.

MR. PARTEE. Well, we could easily afford more.

VICE CHAIRMAN SOLOMON. Well, I tend to assume that the dollar is going to come off more and I assume there will be inflationary pressures that will result from that--although they won't show up too immediately, I suppose. And I would be concerned about much more than a 3 percent growth rate. I think our capacity is growing around 3 percent and it may very well be that the structure of the economy and our comparative advantage has changed in the world and that we cannot expect to go back to a level of unemployment as low as we had in previous recoveries. Also, in those previous recoveries we got to double-digit inflation so we then tended to overreact the other way. It seems to me that a steadier, more prudent, balanced, calmer policy would be in the direction of easing which does not reflect as much concern about the economy as I heard around the table.

CHAIRMAN VOLCKER. Well, why don't we hear from Mr. Axilrod.

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

CHAIRMAN VOLCKER. Are there any more or less technical questions or comments?

MR. BOEHNE. I have a technical question. As you try to sort out what is behind the weakness in M1 and whether it's from the demand side or from the supply side, if you look at reserves over the last couple of months--which is on the supply side and can be viewed in some rough way as a [base] for creating money--reserve growth, as you pointed out, has been quite weak. I wonder, as we go into November and December and try to guard against the continuation of this weakness, if there's any value in looking through the nonborrowed target more to reserve growth to try to reduce the odds of continued slow growth. Now, that presumes that part of the problem comes from

the supply side. I just wondered technically if you have any reactions to that.

MR. AXILROD. Well, President Boehne, say the Committee wanted to achieve something like the alternative B path or, say, 7 percent growth in total reserves in November. [While] it's technically not impossible to conduct operations in an effort to achieve that if the Committee wanted it, it is impossible to tell you with any certainty, other than the way we do it in the Bluebook, what is likely to happen to the level of member bank borrowing. If the demand for those reserves doesn't happen to be there, we would have to keep throwing nonborrowed reserves out there until we force the demand on them--force the banks to create the required reserves. And that could take a very substantial drop in interest rates if the demand doesn't happen to be there. Our best guess, as is in the Bluebook implicitly, is that it would not take a substantial drop in interest rates, though I would [modulate] that a bit if the latest money supply figures I have seen hold up after a day or so.

MR. BOEHNE. I guess I am just getting at this supply/demand division that you mentioned. Does that give you any reading as to whether more of the problem lies with the supply side or the demand side?

MR. AXILROD. No, I think you have to look at the relationship between interest rates and velocity. Obviously, there would be more money out there, if we put in more reserves and there would be less money, vice versa. The way I would look at it would be to try to explain velocity. That is what I was trying to do. Does the fourth-quarter rise in velocity indicate that people didn't really want the money and that they are quite happy? Or does it indicate that people simply didn't get the money they really wanted and we had a temporary --in effect, arithmetic--rise in velocity and we're going to see that reflected later in income as they have to adjust to the fact that they don't have as much money as they want? I don't think just looking at the reserve-to-money relationship can tell you much about that.

MR. MARTIN. Steve, you commented on the possible impact of the MMDA alternative to less interest [on] transaction balances. I take it you were referring to the surprise in October?

MR. AXILROD. Yes.

MR. MARTIN. But why wouldn't that kind of impact occur when the rates first dropped?

MR. AXILROD. MMDAs were rising in the first four months of the year at a slightly faster rate than they were rising in October. And then they stopped rising as market rates went up and banks didn't follow them all the way up. Then, with this recent very sharp drop in short rates, banks have lagged in the extent to which their MMDA rates have dropped. And, according to the figures we have for MMDAs, after declining for several months they started rising. At the same time we are observing in the figures--although we have problems with seasonal adjustments because we don't have them seasonally adjusted--a drop in NOW accounts and in the very recent figures also a drop in Super NOW accounts.

CHAIRMAN VOLCKER. How big are Super NOW accounts?

MR. AXILROD. The level? The level of NOW accounts is $140 billion approximately.

CHAIRMAN VOLCKER. Super NOWs are what level?

MR. ROBERTS. $43 billion.

MR. AXILROD. I think I have that number. They're about $45 billion.

CHAIRMAN VOLCKER. Is that included in that $140 billion?

MR. AXILROD. That's included; so there is $100 and some odd billion--

MR. ROBERTS. Steve, are you saying that as the differential between NOW accounts and MMDAs declines, there's a percentage that shifts [to MMDAs] instead of the contrary?

MR. AXILROD. Well, [we were] reaching for hypotheses to explain this back in the second half of 1982 when interest rates dropped sharply and there was a sharp rise in NOW accounts. At that time there were no MMDAs. MMDAs have a lower reserve requirement than NOW accounts by a lot.

MR. ROBERTS. But that's an interesting thesis: that someone who accepts a lower-than-market rate gets more interested in changing to the market rate as the spread declines instead of as it widens.

MR. AXILROD. Well, I was thinking of these as monies that are in the market now that shift back into bank deposits as rates go down. And what bank deposits do they shift back into?

MR. ROBERTS. Not from NOWs to MMDAs but from the market to MMDAs.

MR. AXILROD. And instead of going back into NOWs, as we experienced in 1982--

CHAIRMAN VOLCKER. Why would that make NOW accounts go down?

MR. AXILROD. Well, there are other things going on at the same time, obviously. But I was thinking mainly of shifts from the market and not using NOW accounts.

MR. PARTEE. It keeps them from going up. I see the point.

MR. MARTIN. But my question is: Why wouldn't that have occurred earlier than October? I am trying to figure out October and I can't.

MR. AXILROD. Well, that I really can't give an answer to. The banks' MMDA figures were running negative between 5 and 6 percent and then minus 1 percent in September. Then they rose to an 8.8 percent rate of growth in October.

MR. ROBERTS. For a while the money market funds were more attractive than the bank funds and that spread has declined more recently.

MR. AXILROD. But why banks have chosen to lag their rates at this point is hard to answer.

CHAIRMAN VOLCKER. Mr. Guffey, did you have a question?

MR. GUFFEY. Yes. With respect to the October number--and I know this won't make a great difference--do I remember correctly that last year when we did the seasonal adjustment those figures for the fourth quarter, including October, were revised up substantially? Would you not expect a similar event this year?

MR. AXILROD. What I have readily in mind is that for the second half of last year the rate of growth of M1 was raised 1-3/4 percentage points at an annual rate, of which 1 percentage point was seasonal and .7 was benchmark figures. This year, we've run through it assuming that money grew 7 percent in November and December and that changes the configuration somewhat in that the slowdown occurs more gradually over the course of the year. But you still would get, of course, a much slower growth in the latter months of the year than in the first several months of the year. But it will raise July, August, and September and make October less negative, say, by 4 percentage points depending on November-December. There's no doubt about that; it goes in that direction.

MR. GUFFEY. That's making a substantial--

MR. PARTEE. What if November-December were less than 7 percent? If, say, November and December were at 4 percent rather than 7 percent, would that have changed the seasonal distribution and in which direction?

MR. AXILROD. I assume it would. I assume a lower growth rate would tilt a little more of the growth into the second half. But I didn't run it for that.

MR. GRAMLEY. I have a question about the contention that the increase in velocity in the fourth quarter might be explained by a supply side phenomenon rather than a demand side phenomenon. I know there are differences in speeds of adjustments, depending on the models, but if you had a stable money demand function and a restriction of supply and the short-run elasticities of demand with respect to interest rates were a lot less, what you would have is a phenomenon in which interest rates rose much more than they would have to to equate money demand to money supply. Well, that's not the problem we are looking at now. Interest rates are going down, not up. It seems to me you have to argue that if we have not had a downward shift in money demand either we don't really understand the factors affecting money demand, which is possible, or that our estimated nominal GNP figure for the fourth quarter is way too high.

MR. AXILROD. The only thing I would add to that, Governor Gramley, is that apart from the fact that the model [unintelligible] relationships, one could also argue that interest rates are higher

than they otherwise would have been, obviously, if you had really forced in the money now. That's pretty much what I had in mind.

CHAIRMAN VOLCKER. Do you have something to say, Mr. Sternlight?

MR. STERNLIGHT. I was going to add a comment on the question Steve was raising earlier about why the banks have lagged in bringing down their rates on MMDA accounts. I think one reason might be that they see that as a rather easy way to get in some more retail money and lessen their dependence on day-to-day liability managed funds. I think some of them are conscious of the problems the big banks have had and wanted to strengthen their deposit base that way. That could have been a factor.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I'd just like to ask Steve a question about the use of his phrase "searching for hypotheses" here in view of the unexpected and unwelcomed decline in M1 in October, which seems to be getting worse. If there had not been a downward shift in money demand, are there alternative plausible explanations such as that we didn't provide enough reserves?

MR. AXILROD. Well, that's what I was trying to deal with. Reserves did drop somewhere around 15 to 18 percent.

MR. WALLICH. Then interest rates would have had to rise.

MR. AXILROD. Or drop a lot more to get the money in.

MR. WALLICH. I mean if you didn't supply enough money and demand was constant.

MR. AXILROD. The other hypothesis that I tried to [test] was that if the demand was weakening in any event and if you supplied more money, interest rates would go down even more.

CHAIRMAN VOLCKER. We've had enough hypotheses. We will go and drink some coffee.

[Coffee break]

CHAIRMAN VOLCKER. Let me express a few thoughts after listening to this conversation this morning, which I thought had quite a different tone than a month ago. The big surge theory seems to have disappeared or has strongly dissipated at least. Similarly, the economy has not been expanding very rapidly in recent months. We had that very large--and confusing to me--figure on employment in October. I would emphasize one point that a lot of people have emphasized already: The impact of imports on the manufacturing sector of the economy is pervasive. I won't go on at great lengths because it was explored earlier. But there are signs that what was happening earlier was that the expansion in demand was so great you could knock off 2 percent of it for imports and nobody felt the difference. Now, when domestic demand goes down, it makes a big difference. And I guess the imports actually have surged. You do get a sense of spreading layoffs among some pretty big areas in manufacturing industries right in the

middle of this expansion. You mentioned textiles, shoes, lumber, and some others. And I think that affects the manufacturers' moods anyway--not just in terms of the current competition but I think they are looking at some of their investment plans. Some shoe businesses are going out of business, for instance.

MR. PARTEE. Textiles too.

CHAIRMAN VOLCKER. And it is leading to some moderation there. But enough was said about that. As I look at the business picture, I think we have a rapid rate of inventory accumulation. That didn't look so bad when the economy was rising rapidly, but as soon as the economy stops rising so rapidly that rate of inventory accumulation has to come down. One senses that that's what businessmen feel. And I think the short-run question we have is: How will that happen? If retail sales are strong in the next few months, we can get a declining rate of inventory accumulation in a very smooth way and have a good setting for business next year. If retail sales don't pick up in the next few months, I think we have a quite different kind of problem. The GNP figure for the fourth quarter may not be a bit different in total but it's going to include more inventories and less sales, and that has quite different implications for next year. And I don't think we know. Everybody reports on talking to retailers who seem to change their minds every two weeks about their feelings about sales--for good reason, I suspect, because there is some instability in them. I surely don't know, but if I had to guess I'd say the retail sales figure in October is probably going to be weak because autos presumably were down. The explanation that there are not enough cars [in dealer inventories] is beginning to wear a little thin on me. Maybe it's all true; there is something curious in that industry. I don't think the industry wants to produce many more cars. I am beginning to think they get a nice profit margin where they are. The dealers like it, manufacturers like it, and so long as they have the Japanese shut off why take on another worker with all the pension obligations and everything else? Although we'll get some expansion in production there, I guess it will not be very much. We are in a period of great uncertainty, particularly about what retail sales are going to do. I think plant and equipment [spending] is holding up fairly well. I feel more comfortable about housing than I did a while ago simply because interest rates are going down. I would comment that I don't have any particular quarrel with the forecast, but I think we ought to put a good deal of uncertainty around any forecast. I would point out that the forecast level has been successively lowered in recent meetings at the same time that interest rates have been declining fairly precipitously. We have a lower forecast now for economic activity for the next year than we had in August or in previous meetings, with interest rates 2 percentage points lower.

MR. GRAMLEY. Is that right? I thought the level of real GNP at the end of 1985 was almost exactly what it was in the previous forecast.

CHAIRMAN VOLCKER. No. I don't know what the previous--

MR. KICHLINE. It was, but the near term--

CHAIRMAN VOLCKER. But two forecasts ago we had a 5 percent increase in the third-quarter GNP and we're now going to have 1-1/2 to 2 percent. That's a difference of almost 1 percent [in level terms] in the estimate of one quarter's change. I think it was still higher in an earlier estimate.

MR. PARTEE. Then it has been coming down?

CHAIRMAN VOLCKER. It has been coming down by whatever the right amount is. In a perverse kind of way, maybe compared to the comments that I heard from a lot of people earlier, I feel more comfortable about the forecast this month than I did last month, partly because interest rates are down and I think the housing forecast is better based. We have the exchange rate at least moving in the other direction; we are not under the same pressure. We have had some--it is so brief it is hard to tell--firming of commodity prices in recent weeks which is quite in contrast to the trend we had for several months prior to that. And we do have that surprisingly good employment figure in services and retail trade in October, which I don't understand.

Last month I saw no danger, frankly, that we could overease within the practical scope of whatever we were going to do. This time I am not so sure. Beginning at the level of interest rates that we have and given the feeling I have about the economy, I could conceive that we would get overly enthusiastic in terms of easing, whereas I didn't think that was possible last month. In terms of generally posturing ourselves, I think we are in a far better position for a variety of reasons, given all the risks that exist, to not be too far behind the curve in easing if that is the way things develop. That's partly because we have the risks of the dollar; I would hate to have to do a lot of aggressive easing in a situation where the dollar is already declining more than one would like to see. I would rather be in a position where, if anything, we have the easing done and are in a position to tighten up a little if the dollar does get in real trouble at some point. But in terms of our general posture, it's partly--and the point has been made--that there is room, obviously, for the economy to grow more than 3 percent next year. I am talking about the probabilities.

The inflation picture looks under enough control so that I don't think we have to worry about an explosion on that side apart from anything that would develop on the exchange rate end itself. It is not a current concern but could be a concern almost at any time looking to the future depending upon how things develop. And given the experience we have had, I don't feel any great sense of inability to prevent the economy from bursting out on the up side in the foreseeable future. If we had to tighten some down the road, so be it. I don't have the feeling that it would be an impossible job to keep the economy from an unfortunate and overextended surge of activity if we faced that possibility rather than the opposite one of cumulating excessive weakness in the economy, given all the risks and uncertainties that I see. And one factor I might mention in that connection is that in the rest of the world I still do not see many signs of ebullient economic activity, to say the least. The European economy still seems to me to be in a very sluggish phase. I guess the latest information from Japan is not so bad, but it's on the slower side rather than on the stronger side. And that has been the one

economy that has been showing a pretty good rate of advance. The problems in the developing world are obvious enough.

Where that all leaves us, I don't quite know. But I think we may have room for a little more formal easing here if that's what you want to do. But I don't know that we want to go overboard about it. I might say that in view of the monetary developments, I think the only question in the past few weeks was whether we should have been easier and put in more reserves and reduced the borrowing level. The reason that was not done was simply because I judged that the tone of the discussion and the instructions last time clearly reflected some concern if interest rates--and the federal funds rate in particular--were to go down around the 10 percent level or below and other rates were declining rapidly. There wasn't much eagerness for being very aggressive, so we weren't very aggressive. In fact, interest rates obviously did get to those levels and in those conditions it didn't seem all that urgent. But I don't know that I personally had the feeling that the interest rate developments were disastrously rapid in terms of lower rates, given all the conditions. And I am not sure I would want to conduct a policy that I thought would actively back them up again as a deliberate matter of policy. But with that much discussion, let us proceed.

VICE CHAIRMAN SOLOMON. I would like to propose that we move to an area between alternatives A and B. I think we get halfway there if we only bring the borrowing level down to $600 million. If the fed funds rate is running now at, say, 9-7/8 percent on average and we reduce the borrowing level by $100 million, the rate is likely to come down to 9-1/2 percent or a shade above. I think the markets then will expect a discount rate cut at some point following that; and if that were a 1/2 point reduction, that would bring [the funds rate] down to 9 percent. It seems to me that to go all the way to alternative B would be a great mistake. Therefore, borrowing somewhere in the area of $600 million makes the most sense. We probably ought to adjust the fed funds range. I forget what it is now--8 to 12 percent? Maybe we ought to make that 7 to 11 percent. For the monetary target figures I would probably take numbers halfway between the [A and B alternatives]. I don't have a clear view on M1; it seems to me less reliable than it has at other times. But the target figure is there.

CHAIRMAN VOLCKER. By going halfway in between you are making a final judgment of 1/2 percentage point on a figure that we may come within 5 percentage points of if we are lucky.

MR. PARTEE. We did this past time; it was within 5.

VICE CHAIRMAN SOLOMON. Okay.

MR. MARTIN. Within 10!

VICE CHAIRMAN SOLOMON. I am pretty limited by 10.

CHAIRMAN VOLCKER. I understand.

VICE CHAIRMAN SOLOMON. That's all I have.

CHAIRMAN VOLCKER. You mentioned something about reducing the discount rate; I have a comment on that. That may be a market

expectation, but I don't think there is anything technical that would raise the question of a decline in the discount rate if the funds rate were 9-1/4 or 9-3/4 percent or so. We can do it if we want to, but I don't see any dynamic in the situation that forces that decision.

VICE CHAIRMAN SOLOMON. But if the Board were to take the move and cut it by 1/2 point--I'm not saying that it would--the fed funds rate would go down by 1/2 point with that.

CHAIRMAN VOLCKER. I might mention: Somebody tells me that Citibank reduced the prime rate by 1/4 point--a small move on the down side, considering.

VICE CHAIRMAN SOLOMON. They're trying to influence these deliberations here!

MR. CORRIGAN. They'll [unintelligible] one way or the other here.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I don't want to put too much emphasis in our discussion on M1 in a single month, despite the magnitude of that surprise decline of 7 or 7-1/2 percent--I think that's what I heard Steve say--in October. If it carries over into this month, though, I think it deserves some weight given that there are so many uncertainties from the real economy that we've all been sharing with one another here. It's so difficult to forecast not only the fourth quarter but the first and second quarters of next year when I think there is a high probability of some difficulties. Yes, even the third quarter is still [uncertain].

CHAIRMAN VOLCKER. Let me just say a word about that M1 number. If I understand it, given the fragmentary information we now have for the beginning of the month, we would have to get a big increase in the second week of the month--

MR. MARTIN. I realize that.

CHAIRMAN VOLCKER. I will make an empirical comment that big increases don't ordinarily come in the second week of a month.

MR. AXILROD. Even before these figures, we had been forecasting a fairly big increase in the second week of the month. But that is an unusual time for that to occur.

MR. PARTEE. You have a 7 percent projection for November?

MR. AXILROD. That's what we had before the very latest figures. I feel confident it will be lower now.

CHAIRMAN VOLCKER. Yes. A figure that pulls down growth for the month of October at the end of the month by 1 percentage point means that November is starting appreciably lower than what they were assuming.

MR. AXILROD. Yes, the level is roughly $3-1/2 [billion] lower than we were assuming.

MR. MARTIN. So the 7 percent for November in alternative A--

MR. PARTEE. It's not going to happen.

MR. MARTIN. Of course, it is now way out on the curve somewhere. I take it so is the 7 percent in alternative B.

CHAIRMAN VOLCKER. Well, it is harder to get those figures in November. I don't think there is any question about it. Of course, if we get some momentum, it's not hard to get a big one-month figure. December could be anything. But it's going to be hard to get a big figure in November.

MR. MARTIN. If it were a perfect world--which it isn't, of course--the ideal targeting would be something around the midpoint for M1 and M2. We're getting somewhat different information from M2. Maybe it is a relief in that we are not getting quite the same message as from M1. But [the midpoint] obviously is not a potential in either of the alternatives as regards what could be done the rest of the year and beginning in the first quarter in terms of getting levels up to a point that would be consonant with a reasonable rate of real growth in the economy. There is no point in belaboring the lessons from the real side of the economy. And you are tired of hearing me talk about risks in the financial system--in thrift institutions, agricultural banks, and all the rest. I won't make my usual [comments] and take up your time--all this overhead sitting around the room--with that. But still, it seems to me that we can pay some more attention valuably to the aggregates, particularly M1 and M2, now. I am not clear with regard to M3. The risk of a growth recession is greatly enhanced if M1 is allowed to decelerate sharply for the whole fourth quarter. And even if we were to set an operating procedure and some short-term targets in which we overshot the midpoint, I don't see under these circumstances--with inflation being under control, the low M1 figure we have had, and the uncertainties in the economy--that that's a substantial risk.

So, I come down for alternative A. Given what Steve and the Chairman have just discussed with regard to the growth of M1 and M2 for the fourth quarter, those are not modest figures but they're a long way from getting us to the midpoint [of our long-run targets]. As I understand it, very temporarily--hopefully very temporarily--the M1 figure is almost at the bottom of the range; it is within $400 to $600 million of the bottom. So, it seems to me that alternative A doesn't produce any kind of configuration vis-a-vis the midpoint of either of those two ranges to have any implication of overstimulation or the revival of inflation. Given what Steve and his colleagues have laid out here in terms of borrowing getting down considerably below Tony's number, it seems to me it would be well to go for the $400 to $500 million level. If that results in a fed funds rate rate below 9 percent or in the 9 to 9-1/2 percent range, that doesn't seem to me a problem. It was well said that we don't know what the implications are of the decline in interest rates that has already occurred. I agree with that. We also don't know the implications of 4 or maybe 5 months of decline in the growth of M1 particularly and to a lesser degree of M2. We don't know what the aggregates track will turn out to be going into the first quarter, so it seems to me that we are in a position of being able to change our targeting in an accommodative direction without any substantial risk of reigniting inflationary

factors. I say again, at the risk of turning you all off, that if a fiscal policy question is going to confront the nation early next year, I would hate to see that confrontation with 1 percent real growth and unemployment heading for 8 percent or something of that sort. I vote for "A," Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. I would like to reinforce what Governor Martin said. I think we are testing our luck by having had no growth in M1 for five months. And based on our inability to meet our past targets for M1 growth, I have no confidence that the projected November and December increases will occur unless we refocus our policy on reserve growth instead of interest rates, which is what I think we should have done. I think the reason M1 has not expanded is that we have been willing through our policy of targeting borrowing to resist the natural market declines in interest rates that otherwise would have occurred. I noticed that the growth in total reserves and M1 from the fourth quarter [of 1983] to October are essentially the same, for example. But in recent times we have had this precipitous drop in reserves. So my view would be that this is a time to effect a significant easing and to accomplish a growth in reserves that will result in a growth in money--without concern about the level of market rates.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I would like to make a comment on our operating procedure. It seems to me that the events of this summer uncovered a significant defect in our current operating procedure in that, as a consequence of the Continental situation, the banks' borrowing behavior was very much different than we had assumed at the time of our meeting. They had a propensity to bid up the federal funds rate rather than come into the discount window and as a consequence we had a higher level of interest rates, which also fed into long-term bond yields, than the Committee had expected at the time of the meeting. If we have an excessively--

CHAIRMAN VOLCKER. What meeting are you talking about?

MR. MORRIS. Well, it was the July meeting [or perhaps] two meetings ago. You recall we were not contemplating a federal funds rate that would go up to the 11-1/2 to 11-3/4 percent area. I don't think anyone around the table was talking about that high a level.

CHAIRMAN VOLCKER. My memory is that that happened before that meeting or very close to it.

MR. MORRIS. I would have to look back and find out which meeting it was. But I think it is clear that there was a meeting in which as a consequence of this change in behavior we got a tighter federal funds market than any member of the Committee had talked about. And it seems to me that if we have a slower economy than we want now, perhaps part of it at least could have been produced by that higher level of interest rates than we contemplated. It seems to me that is the fact, and there may be a recurrence of this kind of situation in times to come. I just wonder whether we shouldn't take that into account in how we structure the directive. Since the

borrowing [level] is not a key factor in the implementation of monetary policy, if that borrowing [level] produces unexpected results in interest rates, it seems to me that perhaps we ought to have the Committee take a look at the situation by conference call rather than just staying with it and accepting whatever rate comes out of it.

VICE CHAIRMAN SOLOMON. Frank, one of the problems was that nobody could be sure how long that unpredictable behavior was going to continue. We didn't know how long that reluctance to borrow would continue and we certainly didn't want to take care of it in the directive because then we would have ended up [targeting] the fed funds rate more narrowly than I think--

CHAIRMAN VOLCKER. After hearing the discussion last month, I was almost tempted to raise the question on the agenda: Do you want to target the federal funds rate? That is what most people seemed to want to do last meeting. I wouldn't recommend it, but that's--

MR. MORRIS. I recognize that there are a lot of hazards in targeting the federal funds rate. I think the question is whether we ought to have a procedure under which, if the borrowing level is producing a significantly different level of rates than the Committee expected, the Committee should at least take a look at it.

CHAIRMAN VOLCKER. I think you're misreading this history a bit, if I may say so. There is no doubt that the funds rate got higher than was anticipated, given any particular level of borrowings. But this happened over a period of 4 or 5 months; we had several meetings when the interest rate was higher than we expected it to be and there was a deliberate decision not to do anything about it. When it first happened, the money supply was rising very rapidly in May and June and the economy was going along very rapidly and we had quite ebullient forecasts that people weren't objecting to as to the rate of economic growth. So, under those conditions people sat there and said, rightly or wrongly: "The interest rate is higher than we expected it to be but it looks all right."

MR. MORRIS. Sure. That's precisely the point. If it's coming from a strong economy and is expected, that's one thing. If it's coming from a deviant behavior on the part of the banks, that's another thing. It seems to me that our procedures ought to be able to differentiate these.

MR. PARTEE. If we can distinguish.

MR. WALLICH. Well, the economy was visibly strong.

CHAIRMAN VOLCKER. I don't know whether you have a particular proposal.

MR. MORRIS. I have a proposal that we ask the staff to take a look at this problem--if you agree that it is one--and to design a proposal for dealing with it in the future.

CHAIRMAN VOLCKER. This is not operative for today's meeting?

MR. MORRIS. No, I'm not talking about today's meeting.

CHAIRMAN VOLCKER. Well, perhaps we can return to that point.

MR. MORRIS. Beyond that, in line with my previous comments, I would prefer to stand back at the moment with alternative B until we get further information. I would be perfectly willing to support a move to a still further lowering of interest rates if the incoming evidence suggests continued weakening in the economy. But it seems to me that we ought to stop and take a reading with respect to what impact the rate declines we have already seen will have on the economy before we go further.

CHAIRMAN VOLCKER. How long a time period are you talking about?

MR. MORRIS. A few weeks.

CHAIRMAN VOLCKER. What information are we going to get in the next few weeks? We know roughly what industrial production is going to be. The big information we're going to get is retail sales figures; there's nothing else of any significance.

MR. KICHLINE. Next Wednesday we will get the retail sales.

CHAIRMAN VOLCKER. Is there anything else? When are durable goods orders? Is there anything else big coming out?

MR. KICHLINE. No. We have personal income on November 19th; housing starts on the 20th; revised GNP figures on the 20th; and durable goods orders on the 21st, which will be the following week.

CHAIRMAN VOLCKER. So we get retail sales and durable goods orders two weeks from now.

VICE CHAIRMAN SOLOMON. We are pretty sure that retail sales will be somewhat on the weak side.

CHAIRMAN VOLCKER. I don't think the retail sales figure is going to tell us much unless it is quite strong. If it is, I would think it significant. Myself, I think it is likely to be weak.

MR. PARTEE. And the GNP revision is likely to be downward. So the first possible good-size plus number we could get would be on durable goods. That's hanging an awful lot on durable goods orders.

MR. MARTIN. And if the purchasing agents are right, we're not going to get a plus number.

MR. MORRIS. [Unintelligible] initial claims, basic commodity prices--

CHAIRMAN VOLCKER. We get commodity prices and initial claims, yes. Are you finished?

MR. MORRIS. Yes sir.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think it is important that we try to get M1 back on a moderate growth path as quickly as we can. Unless someone is prepared to make pretty heroic assumptions [about] shifts in demands for money, then it strikes me that a zero rate of growth over a four-month period is just about the maximum that we ought to tolerate. But I think we have to be very careful here and in particular take account of these lagged relationships that traditionally have existed between short-term rates and M1. We have pushed short-term rates down some 200 basis points, and in the past such a move usually has led to a very sharp spurt in money growth. It could be that this lagged response to the rate reductions we have already had will produce a fairly good pickup in M1 in November and December. I think it would be very desirable if we could finish with M1 close to the 6 percent midpoint at the end of the year. But at the same time, we have to keep in mind that the actions we take now affect reserve pressures over the next few weeks and are going to affect M1 in the early part of next year. I can see a danger that an overly determined effort to try to get near that midpoint could start us off in 1985 with an unacceptably rapid rate of money growth. But if you look at the quarterly rates of growth in M1 or the other aggregates for 1984 and see how much M1 in particular has decelerated, a fairly rapid growth in the first quarter of next year would not look all that bad to me. The bottom line is that I think our reactions should be rather cautious and measured.

I prefer the aggregate outcomes anticipated by "A," but at the same time I am not at all sure that it's necessary to push the borrowing target immediately down to $400 million with whatever reduction in the federal funds rate that might imply. I would feel more comfortable if we moved somewhat more slowly with a higher borrowing target initially for the next couple of weeks or so; if it becomes clear at that point that M1 is still below path, then I would be prepared to reduce the borrowing target accordingly. I would favor [the language in the Bluebook under] alternative Roman numeral II with certain changes in the second sentence for the wording of that and I strongly endorse Frank Morris' suggestion that it really is time for us to look at our procedures. I think everybody wants to get the money supply growing again, but we have no earthly idea how much we will have to reduce the borrowing target or how much the federal funds rate will have to come down to accomplish that. And I think that means that our procedures are pretty faulty. I doubt that I would end up with the same recommendation as Frank but I certainly do endorse his idea. In view of all these unexpected things that have happened this year, our control mechanism leaves a lot to be desired and I think we can improve it.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. From my perspective what we have seen here over the past several weeks, and indeed months, has been something that I would consider an orderly adjustment in policy and interest rates and so on. There was at least a fleeting moment when I thought it might become a little messy but that did not materialize. In the broad context of the situation that we are looking at, I would not be troubled if interest rates went down a bit more in a context not unlike what Tony spoke about earlier. But let me turn to that in a minute. My view of the economy is a little different from many others. That is a factor in my thinking. But I would also caution

against too much of a reaction to M1. We have been through M1 problems and we are going to go through them again. It seems to me that all of these fine arguments that Mr. Axilrod and others make about M1 really come down to the question of how many angels can dance on the head of a pin. I don't know how many. I do know that seasonal adjustment factors alone can make a big difference. We have looked at these data using a seasonal adjustment technique that's very respectable--I don't think it's any better than any others but it's very respectable--and it produces almost a $7 billion increase in the money supply from the first week of June to the second week of October rather than a decline.

CHAIRMAN VOLCKER. Better use that seasonal, Mr. Axilrod!

MR. PARTEE. We need to have several seasonals and we can use the one that fits best!

MR. AXILROD. 50 seasonals!

MR. CORRIGAN. The point isn't that any one is better than any other. The point is that this series is notoriously noisy and we don't really understand it in the short run, and I think to pretend that we do is a mistake. The only thing we can be sure about in terms of M1 is that if it's surprising us on the down side right now, it's going to be surprising us on the up side at some point in the not too distant future. So, while I recognize the very special psychological if not political significance of M1, I must say I would be very cautious about going too far too fast in response to it even in the context of everything else that is going on. My thoughts on specifics would be somewhere between "A" and "B." I have no great concern about the money specifications themselves. Borrowing of $550 to $600 million wouldn't bother me. I would prefer, at least for now, to leave the federal funds range at 8 to 12 percent.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, no one can take first place away from me in recognizing the volatility of the M1 numbers. And I agree, Jerry, that the best thing to expect when we get a decline is a rise in the next month. But we have been sitting here looking at surprisingly weak numbers for quite a while and I think there is a cumulative effect that most people do feel has a significance. I think enough of M1 as an indicator that I am inclined to be considerably impressed by that or I presume that I am going to be impressed by it unless someone gives me very good evidence as to why I shouldn't be. As I review it, M1 has been surprisingly weak over a period of time and probably erratically weak in October. I just don't see how we could have such an economy that would produce a 7-1/2 percent decline in money as an indication of the future. But when you put it all together, it does amount to quite a bit. Because of that and the great damage that that's going to do us, as well as what I said earlier about the economy falling short and having room for further growth, I would not be opposed to alternative A as the way to go. I think it's time for a fairly pronounced further adjustment. And it won't hurt us; I agree with Paul that if it turns out to be wrong, we can tighten up a little later on.

But right now it seems to me that the risks are such that we ought to be guided to a degree by this weakness in the M1 numbers. One advantage of a Wednesday meeting--maybe it isn't an advantage--is that at least we get the most recent figures that way. And I would point out that Steve has indicated that with these most recent figures it seems very improbable that we could get the M1 specs of alternative A. So, we ought to use something like the specs of alternative B since we already have fallen well short of what was put in the Bluebook for us last Friday. I also think that means we have to go to a different kind of description of our policy than just a repetition of the past one--focusing on what we would hope to see and would be prepared to tolerate in November-December following the surprising October weakness. I guess the Roman numeral II [draft] directive is a reasonable thing to be talking about. I would reduce the federal funds rate range from 8 to 12 percent to 7 to 11 percent, as Tony suggested; and I would regard the midpoint of that range, 9 percent, as entirely acceptable for the funds rate. [On borrowing], $400 million seems a rather marked change in operational targeting. I would put it at $500 million but I would not be prepared to accept a figure as high as $600 million, as I think Tony suggested. It is time for a little "oomph" to get into monetary policy. One final point: If in fact it is true that it is becoming the very general view out there that the inflation rate is going to be much calmer than was previously expected, that, of course means that nominal rates have to drop at least as much as the expected inflation rate--maybe a little more--in order to offset the deflating effect of that change in expectations. So, I don't know that we have gone too far at all in terms of the indicative real rates that would be associated with the declines we have had in nominal rates.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, given what I said earlier this morning, it's probably not difficult to predict where I come out. Of course, this behavior of M1 throws up some red flags and does suggest a cautionary attitude. But there are a couple of mitigating factors that I would like to put on the table. One, the debt number is still relatively high and that ameliorates my concern about the M1 decline a bit. Secondly, I really don't think that M1 is yet showing the influence of the lower rates that we've had in the past several weeks. Indeed, M1 might still be reacting to the higher rates that we had during the summer. So, given those lags and my view of the economy--which is that it's basically coming down to a sustainable level and we're going to get some pickup in the fourth quarter and into 1985 as suggested by the staff--I think we just ought to pause, rest on our oars, and let the easing that has occurred filter through to the economy and the money supply. M2 and M3 are behaving quite respectably and I am not at all uncomfortable with adopting a policy that would allow M1 to be in the lower end of the range for the balance of 1984. I would be very cautious about continuing to ease too much or pushing too hard in the direction of ease at this point.

With respect to the directive, I would prefer alternative B, which as I interpret it is a status quo, wait-and-see alternative; and I would keep borrowing at $700 million with the funds range where it is. As for the directive [language] I would prefer the second alternative in the Bluebook, although in the second sentence of that alternative there is reference to M1 being in the lower end of the

range and I'm not sure that it's necessary to flag that for the public generally. The bottom line for me, Mr. Chairman, is that I think we have time and I would stay where we are.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, Bob has given my speech; I am with him. I would like to suggest that there is a case that we could look at, Chuck, where the money numbers were giving us the same kind of misinformation they are now and that was in the late spring and early summer of 1980. Now, the situation was quite different. But we were looking at very, very large declines in real GNP and so we were experiencing weak growth of money because we were moving down the money demand function. And at the same time the money demand function was dropping a ton. Signs that the economy was going to come out of recession were beginning to emerge but that was very uncertain. So what we did--and I have to say that I participated in this--is that we kept pushing the interest rates down far enough so that finally we got the money growth that we had been contemplating; but when we got it we found that the economy was roaring upward. So money growth began to take place at horrendous rates and we pushed interest rates way, way up again and got involved in a situation of volatility of money growth and of interest rates which I think was neither necessary nor desirable. Now, this is a totally different situation than that.

MR. PARTEE. You can get whipsawed. There's no question about that.

MR. GRAMLEY. Yes, and that's my point. I am optimistic that the economy is going to turn around; the signs of emerging strength are there. I am not certain, but I am reasonably confident that that's going to take place. I would not, therefore, want to see interest rates drop much further from where they are now. In this connection I would note that the staff forecast implies a federal funds rate for the end of 1985 in the 10-1/4 percent plus range and if we let the rate drop too much further, we are going to be looking at the need for a significant increase in interest rates to keep both the economy and money growth under reasonable control. One point I want to make is a more or less technical one: The staff has been telling us that seasonal borrowing is a very, very large part of the total adjustment plus seasonal borrowing. I think the number for the seasonal component is $300 to $350 million. If we adopted a borrowing target of $400 million, we are talking about $50 to $100 million of pure adjustment borrowing. I don't know where the federal funds rate is going to go but it could go down a lot further than to the 9 percent number that the staff is talking about.

MR. PARTEE. I would assume that we are dealing with a time when seasonal borrowing would drop.

MR. AXILROD. Well, my thought would be that some of it would drop. Seasonal borrowing is running well ahead of where it runs with even much more total borrowing. We don't know for sure how much of it is going to stay because it is seasonal or distress borrowing and how much really represents the response to the rate. I think it will end up a little higher than one would normally think in any event.

MR. ROBERTS. A good part of the seasonal is arbitraging the discount rate. That was certainly true in my District. People just took advantage of the opportunity and they will stop doing it.

MR. AXILROD. That [borrowing] will drop.

VICE CHAIRMAN SOLOMON. The conduct of monetary policy would be better, I think, with a mix of a partial movement in the fed funds rate and a cut in the discount rate in order not to get the borrowing levels too low. If the borrowing level gets too low, I think there are complications.

MR. PARTEE. I interrupted Lyle. I really was just thinking that we are at the time of the year when we ought to get a drop in the seasonal. That is all.

MR. GRAMLEY. Well, that could happen. I think the problems with the agricultural banks make it less clear that most of them have been playing the rate spread and that what we're likely to see is the normal seasonal decline. In any event, I would stick with alternative B. If we wanted to shave the borrowing level down to $650 million or so, that would be fine. I would want the federal funds rate to stick in the range of 9-1/2 percent plus or minus a little and wait and see what happens.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. As has been pointed out several times here, we've seen a good deal of easing since the last meeting. As a matter of fact, the easing is just about the amount that I had hoped for at the last meeting, so what has been taking place in the easing of policy is getting very close to my comfort level. I think it is important not to allow short-term interest rates to fall too far too fast. In this sense, I share Bob Black's feeling of the need for some caution in the rate at which we ease policy. Having said that, I think we have to do better than alternative B. I would hope for something between "A" and "B" and I am not uncomfortable as we move toward "A." I would be very happy to go along with Tony Solomon's recommendation of borrowing at $600 million and adjusting the fed funds rate range down to 7 to 11 percent and hope that the aggregates show some improvement.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. In view of what I perceive to be the weak spots in business that could be spreading rather than about to improve, and given the sustained undershoot in M1 since the middle of the year, I am getting quite concerned about that problem. The well known volatility of M1 on a monthly basis begins to wash out when it has had a weak performance for four months. I take no comfort in the fact that M2 has been rising steadily because it did so preceding the last major recession that we had. I would be ready to err on the side of ease for a while and if that proves to be too much, we can always correct it later. By and large the one alternative that to me at least would be unwise is alternative B, since that anticipates a borrowing level of $700 million and an expected federal funds rate of 10 percent. In sum, I would be happy to see alternative A or possibly halfway between "A" and "B." And if we were to go for "A," I would be a little cautious in going down to a borrowing level as low as $400

million right away; I would prefer to start at about $500 million for much the same reasons Governor Partee has already set forth.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. On cyclical grounds, I really find it very hard to make an argument for any kind of easing. I see the risks of making the same old mistake of easing in the latter stages of an expansion. But the discussion of M1 may provide a justification for how I can perhaps get myself off the hook of being--

CHAIRMAN VOLCKER. I didn't know we had that problem of easing too late in an expansion.

MR. WALLICH. I think that has been what has often happened.

CHAIRMAN VOLCKER. We always got accused of the opposite.

MR. WALLICH. Cyclically, I see--maybe it's inadequate tightening. But your remark, Mr. Chairman, that if we overshoot on the down side we could catch it again and tighten, does encourage me a little in a different interpretation of the situation. We obviously have very high real interest rates. As Chuck said, each time inflation expectations come down real interest rates go up. Over time we have to bring these down. The main way of bringing them down is to reduce the budget deficit. But I think it also has something to do with monetary policy in the sense that there isn't enough money in the economy to allow interest rates to be lower. Now, the difficulty is getting that money into the economy without going to a very high growth rate of the aggregates--which looks terrible, sends the wrong signal, and may never be caught up with and never be stopped. When you have a temporary reduction in demand for M1, or maybe a permanent reduction, that does provide an opportunity without seeming to gun the aggregates to increase the amount of money in the economy in a limited way and thereby put pressure on real rates. So, with that analysis, I could go somewhere between "A" and "B." I think $600 million would be the maximum, given the danger that borrowing could become too low and the funds rate might be destabilized.

CHAIRMAN VOLCKER. [You mean] $600 million would be the minimum.

MR. PARTEE. That's as far as you would go?

MR. WALLICH. That would be as far as I would want to go. And for the funds rate range, if this is an effort to bring rates down by increasing the stock of money and not the rate of growth of money in the economy, 7 to 11 percent would be acceptable.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Although there is some uncertainty as to where the economy is going, from the earlier comments it does seem to me that on balance the tone has changed very substantially from our past meeting and that we are in an environment where some easing is a reasonable expectation. I wouldn't make too much of the M1 number for one month but, as has been pointed out, this [weakness] has been persisting for some period of time now and just maybe it's telling us

something. I would not in turn overreact, but as I look at the dots on the charts it seems to me that neither alternative A nor alternative B is an overreaction. Rather, I would think we ought to be aiming toward the middle of the range over a longer period of time as we look into the next year. And that leads me to alternative A. I would reduce the federal funds range to recognize a reduction that has taken place in the market--not so much because I think that 7 percent would be an operative rate. But if the federal funds rate were to get back into the 11 percent area with any persistence, I certainly think that would be an opportunity for a telephone call. With regard to the borrowings, I think going down to the level suggested in the Bluebook under alternative A is pretty severe; therefore, I would think a borrowing level of, say, $500 to $550 million would be appropriate.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I am voting for alternative A for two basic reasons. One, of course, is what I see as the slowing in the economy and the sobering of the moods out there in the business world. Secondly, although I am not obsessed with what happens to M1, I am depressed with what has happened to M1 growth in the four months from July to October. In fact, what is shown even under alternative A for the final quarter this year does not look like red hot growth. Also, looking at M2, whose expected growth in the fourth quarter is 7-1/2 percent, which would be the midpoint of the long-term range, that doesn't seem excessive either. And then getting to where this would put us at year-end, we would be below the midpoint though within the long-term ranges for both M1 and M2. So, this doesn't strike me as easing irresponsibly. Also, when I look at the reserve figures, I am not surprised that monetary growth was as slow as it was in October. I guess I am surprised it wasn't slower when I see the dive in nonborrowed reserves and total reserves. So, I would vote for alternative A. In terms of the directive, I would use the number II alternative. I don't feel that the relationship between borrowing and the fed funds rate is clear enough to me to know what kind of borrowing numbers would come through. It seems to me this is somewhat of a crap shoot; there is obviously a number out there some place that is the right one, whatever that is, and it will give us fed funds in the range of 7 to 11 percent and would satisfy me.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. In my opinion the pause in the economy and several months of flatness in the money supply argue for active support of growth in the money supply. Both "A" and "B" accept a shortfall in money, which I favor, but of the two I would favor moving toward alternative A. I would like to see that kind of growth rate in November and December. I think we ought to move carefully toward that. I wouldn't want to jump to a $400 million borrowing level. And as we test borrowing levels below $700 million, I would like to see a 9 percent plus federal funds rate and something around 9 percent triggering a call. I am assuming something quite far toward alternative A. In that assumption I assume no change in the discount rate. I am sympathetic with the people who have said that we have come a long way with regard to interest rates; they are down considerably and we ought to wait and see [the impact of] what we have already done. In addition, I still believe that the long-term underlying problem in the economy, and our top priority, is inflation.

So, if we adopt something toward alternative A, we may have to reverse our actions if the recovery comes on as strongly as I think it might or if the growth in money resumes. But I prefer to take the risk of the reversal to the risk of waiting. That's where I come out.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With respect to the difference between alternatives A and B, given the money numbers that we have looked at, clearly a move to alternative A would suggest some further easing immediately after this meeting. We don't have a lot of hope, judging from the comments around the table and from the staff, that we will reach the level of money growth that is incorporated in alternative B; therefore, if we move to alternative A, we are going to be easing more aggressively immediately after this meeting. The second point is that in accordance with the staff's projection, alternative B suggests a federal funds rate in the neighborhood of 10 percent with a $700 million borrowing level. I think there is fairly good evidence that there has been some shift in the demand for borrowing and, therefore, the relationship between the borrowing level and the federal funds rate is perhaps less precise than in the past. Let me just make two points in that regard. One is that, clearly, the unwillingness of large banks to borrow following the Continental situation has reversed itself. They don't seem to be experiencing that unwillingness and as a result have come back to the discount window. The second and more important thing is what Lyle Gramley has spoken of and that is the relationship of the borrowing level to the federal funds rate when you incorporate seasonal borrowing into that borrowing level. Traditionally, seasonal borrowing has commenced growing around the first of the year, grows through August, and then declines to almost zero by the end of the year. This particular year that pattern did hold, but at a much higher level. Seasonal borrowing has been much higher than in the past. And there has been little or no decline from August forward, as we would have experienced in the past. We're now in the $300 to $325 million range for seasonal borrowing; if you consider that that has become less sensitive to interest rates, there is very little room. If you take that away from the total borrowing level of $700 million, we are at a frictional level, it seems to me; adjustment borrowing would be virtually nonexistent if we go to the $400 million level and at the frictional level if we remain at the [current] level.

The conclusion that I would draw from all of this is that I would opt for alternative B because we don't know what relationships will come to pass as the result of the interest rate drops that have already taken place. I would consider those fairly aggressive--1-1/2 to 2 percentage points over the last five weeks. Secondly, I would also anticipate that if we adopted "B" as specified in the Bluebook with a $700 million level of borrowing, we would see some further easing in interest rate levels, maybe to the 9, 9-1/4 or 9-1/2 percent area. It would seem quite appropriate to me that we get to that 9 to 9-1/2 percent area, but I think we can achieve it with a $700 million borrowing level.

VICE CHAIRMAN SOLOMON. Why do you say that, Roger?

MR. GUFFEY. Simply because a good part of the seasonal is inelastic now or unresponsive to interest rate levels, which I think

the record would reflect. Then you're really operating on a borrowing function of something in the neighborhood of $400 million and that is closer to a 9 percent federal funds rate than a 9-1/2 percent rate, as suggested by the Bluebook. Alternative A would get you there with a $400 million borrowing level.

VICE CHAIRMAN SOLOMON. Well, I agree with you on the $400 million. I am just a little surprised that you said to continue the $700 million level would bring fed funds down to about 9-1/2 percent.

MR. GUFFEY. I think fed funds right now are probably at the 9-1/2 percent level or thereabouts. If we don't do anything, I think we will see them come on down to that level. The last point I want to make is that if I were running policy by my own prescription, I would rather take "B" and a $700 million borrowing level for the reasons I have just expressed--expecting fed funds to come down to the 9-1/2 percent area. Then, if we saw a need for further easing, I would do it with a discount rate decrease rather than letting the fed funds rate run down to 9 percent or maybe even below 9 percent and then making a 1/4 or 1/2 point cut in the discount rate, which could push [rates] down to a level that I would not want to see occur.

MR. PARTEE. May I just ask Roger a question?

MR. GUFFEY. Yes.

MR. PARTEE. Roger, I've never looked all that closely at these seasonal borrowing arrangements. Do they have a terminal date?

MR. GUFFEY. Yes, there should be a terminal date on seasonal borrowing; it can run out as far as 11 months, Chuck.

MR. PARTEE. And you said it started in April?

MR. GUFFEY. Historically, such borrowings start at the first of the year. Just to give you the figures from '81 to '83: On average, they would go up to a $250 million peak level in July and then decline back down to about $60 million in December. The pattern this year was that they started out at about $80 million in January, progressed up to a $350 million peak in August and are currently in the $310 to $325 million range; we don't see that falloff in the last half of the year.

MR. PARTEE. That was why I asked that question. I just wondered whether there would come a point where you would want to clean up and call them off and say the year is over.

MR. GUFFEY. If you consider that it is inelastic and that there has been a shift in demand for borrowing, then those banks that run out of their seasonal privilege are going to come back in for adjustment credit or they are going to be illiquid.

MR. PARTEE. Then it will be adjustment credit at that point.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I came into this meeting with a lot of uncertainty about the economy and the outlook and, as it draws to a

close, I really don't feel as though I have been overwhelmed by an abundance of clear vision.

CHAIRMAN VOLCKER. The clearest vision we may have is that we're uncertain.

MR. BOEHNE. I think we are all pretty much in the same boat of uncertainty. It really comes down, then, to how you posture yourself when you aren't sure and where you have more room for error. I think there is considerably more room for error on the expansion side than on the slowdown side. So, for all the reasons that have been given in support of that position, I come down on the side of alternative A. I think it is easier to undo a mistake on the stimulative side at this point than to undo a mistake of not being stimulative enough. I do think $400 million on borrowing is a little low; $500 million makes sense to me. Initially, my main concern is that it is a long time between now and the next meeting. If we tack on to the four months or so of slow growth in the economy and slow growth of the money supply, we could end up with six months of the wrong kinds of numbers. I am not a great fan of money but I think it does tell us something when it begins to cumulate like this. So, I think we ought to be awfully careful as we go through the intermeeting period. And if it turns out that the incoming figures on the economy are weaker and money continues to be weak and we don't have any really good reasons to explain it other than a weak economy, then I think we may have to become increasingly aggressive as we head toward the end of the year. I don't have strong feelings on the directive language; I have a slight preference for alternative I.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, as I indicated a little earlier, my view of the economic outlook is not quite as pessimistic as some. I find myself in a dilemma because I find myself agreeing with the last speaker regardless of what he has said! Intuitively, the uncertainty that we all share, which is obvious, tells me that we shouldn't do very much that is different from what we are doing at this point. I really agreed with Karen Horn's description of the situation except that I come to a different conclusion about what to do about it. I would remain where we are, alternative B as prescribed, and then as events unfold move to a little more ease if necessary as opposed to going the other way to a bit more ease now in the recognition that we could move policy back. I would not go that way. On the borrowing assumption, however, I would not feel as strongly that it has to remain at $700 million. I rather agree with Roger: Alternative B as prescribed but with an initial borrowing assumption of $600 million would be all right with me.

CHAIRMAN VOLCKER. Since I have not looked at these directives very closely, the first one is just like last time, right? We would have to put in different numbers.

MR. PARTEE. We are going to have to put in a lower M1.

CHAIRMAN VOLCKER. I ordinarily have a strong bias toward not changing these directives in mid-quarter, but this time we are so far off on M1 that maybe it would be better to change the whole thing than to put in a funny number, which leads me to alternative II. A number

of people, but not everybody, mentioned II. Let me ask whether we should work from II. I am not saying every dot and tittle of it, but the difference is that it involves saying something special about M1. That's the substance of it.

MR. WALLICH. I see a case for alternative I because I don't think we want to show a very high rate of money growth. If we do ease some, we would be doing enough. I don't think one would want to signal on top of that that something is being done that is really irrelevant [to our decisions], which is the sense [of the difference] between alternative I and alternative II.

VICE CHAIRMAN SOLOMON. I am a little concerned also about the market speculating as to why we gave two-month instead of three-month growth rates. A lot of [market observers] will presume there are reasons; and if so, I wonder if they're worthy ones. If the numbers add up to what they add up to, then I don't see why we should put ourselves in the position of treating M1 specially in order to come up with a higher-sounding number when anybody who really is a Fed watcher is going to know exactly what it will mean and that it will say the same thing for the quarter as a whole. I have a mild preference for alternative I.

CHAIRMAN VOLCKER. I have not really examined this closely but the thought just occurred to me: Suppose we combine alternative I and II and avoid the two-month number. It may be a bad precedent since we haven't the vaguest idea whether we are going to come close to it for two months and part of the two months is already over. But suppose we said something like: "This action is expected to be consistent with growth of M2 and M3" at whatever [rates we decide]. Those rates are not changed in substance or even not changed at all. Maybe we could even say "as indicated last month." However, then we'd put in a special sentence about M1. "In view of the shortfall in M1 in October it is anticipated that the quarterly figure would be"--whatever. And then maybe we should pick up this part "More rapid growth would be acceptable in M1 in view of the substantial decline of M1 in October which brought that aggregate in the bottom half of its long-term range." Or we could leave that last part off. Maybe that's the way to do it: Just put in a quarterly figure and a sentence on M1 and then say, just as you say here, that more rapid growth would be acceptable in view of the substantial decline. Make that the third sentence of alternative I.

MR. PARTEE. My objection to leaving it the way it is is this: It seems to me that either we make a mockery of having had targets or we have to ease an awfully lot more to get growth up to 6 percent. How can you reduce it from 6 percent to 2-1/2 percent just because you have had a bad month? Paul's way of dealing with that at least makes it understandable, I think.

CHAIRMAN VOLCKER. At least we are admitting--

MR. MARTIN. That's right.

MR. GUFFEY. But the number that we will put in there with that change will be something in the neighborhood of 1-1/2 to 2 percent for M1 growth in the fourth quarter.

MR. PARTEE. It will be pretty small.

CHAIRMAN VOLCKER. Well, I don't think it is going to change whatever we put in anyway.

MR. GUFFEY. That is the reason I would opt for alternative II, so we don't have to deal with it in mid-quarter.

CHAIRMAN VOLCKER. I presumed we were going to put in 2-1/2 to 3-1/2 percent or compromise between them and put in 3 percent.

MR. AXILROD. Well, alternative II is only focused on the two months for M1.

CHAIRMAN VOLCKER. I know, but I presume that's the same as some quarterly figure.

MR. PARTEE. Yes, it's 2-1/2 or 3-1/2 percent, depending on--

CHAIRMAN VOLCKER. Well, it's going to take 1/2 percent bigger growth for the two months because we are one percent lower in October than we thought we were.

MR. PARTEE. So we can't really put in more than 3 percent.

CHAIRMAN VOLCKER. Three is a nice round number and that implies a little over seven percent, I take it, for November-December. I don't even know what you have. What are you intending to put in here on the two alternatives? You said 7 percent for "B." What was it for "A"?

MR. AXILROD. "A" had 8-1/2 percent.

CHAIRMAN VOLCKER. [Unintelligible.] So, it is 8 or 8-1/2 percent, I guess. For "B" you had 7 percent and for "A" you had 8-1/2 percent and it is starting out a little low so that adds another 1/2 percent. So you would have 7-1/2 [and] 9 percent for those two months. If we put in 3 percent--if I'm doing this arithmetic right--that implies 8 to 8-1/2 percent for--

MR. GUFFEY. Something more--

CHAIRMAN VOLCKER. Well, 3-1/2 percent presumably implies 9 percent. If my arithmetic is right, it comes out about 8-1/4 percent.

MR. AXILROD. Yes, it's about 8-1/2 percent.

MR. PARTEE. Yes, that's right; you need 8-1/4 percent for November-December to get 3 percent for the three months.

MR. AXILROD. Well, our numbers are 3-1/2 percent for September to December and 8-1/2 percent for October to December.

CHAIRMAN VOLCKER. With the new October figure?

MR. AXILROD. No, I am sorry. That's with the old October [unintelligible].

MR. BLACK. Mr. Chairman, if you haven't written off alternative II altogether, I think you can do essentially that same thing fairly easily if you change the second sentence right after the semi-colon and say something like "which would partly offset the unanticipated decline in October."

CHAIRMAN VOLCKER. There isn't that much difference between these two [alternatives]. The only difference is that one sentence really. It's a question of whether we state it as a quarterly figure or as a two-month figure.

MR. BLACK. That's exactly right.

CHAIRMAN VOLCKER. The rest of this is all open.

VICE CHAIRMAN SOLOMON. Well, not only have we used quarterly figures but, as I said before, Fed watchers are going to come out with the same arithmetic. Thirdly, if we do fall short of this 8 to 9 percent growth in November and December--

CHAIRMAN VOLCKER. I don't know how you got that figure.

VICE CHAIRMAN SOLOMON. --it clearly makes it even fairly obvious to non-Fed watchers and casual Fed watchers that there was this enormous shortfall. I just don't see why we want to play around with moving away from the quarterly numbers. The minute we do that they are really going to take out their pencils and do all the arithmetic.

CHAIRMAN VOLCKER. I think the only issue here, which is not a substantive issue but a cosmetic issue, is precisely that: whether we want to cite a two-month number--whether that's a good policy on balance or not. I have some sympathy for saying it's not. We've pretty consistently used quarterly numbers.

MR. MARTIN. We don't have any real reason for the shortfalls and how to read them.

CHAIRMAN VOLCKER. I guess I am saying that we might as well stick with the quarterly figure. In either event, I would make a special sentence about M1 and say whatever we want to say about a shortfall in it.

VICE CHAIRMAN SOLOMON. Let me ask a minor question, Steve. If my recall is correct, and it probably isn't, didn't we always use the word "reduce" rather than "decrease" existing pressures on reserve positions?

MR. AXILROD. Oh heavens, I don't remember.

MR. GRAMLEY. You think there's a difference?

VICE CHAIRMAN SOLOMON. Yes. People are going to wonder why.

MR. AXILROD. I can't imagine that they will.

VICE CHAIRMAN SOLOMON. But am I correct that we always used "reduce"?

MR. AXILROD. I don't know. I can check.

CHAIRMAN VOLCKER. Well, let me try to resolve the problem we have here and then we can come back and try to write something. Again, I don't think there is a substantive difference. After "This action is expected to be consistent with growth of M2 and M3" why don't we put in the same figures we had before. We're within a half percent of them, aren't we?

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. Let's say "growth of M2 and M3 at annual rates of 7-1/2 and 9 percent." All right?

MR. AXILROD. That is, we are projecting to be within that; we are not actually--

CHAIRMAN VOLCKER. What do you mean?

MR. AXILROD. Well, the October figures are quite different: 6 percent for M2 and 10 percent or so for M3.

CHAIRMAN VOLCKER. It's still a reasonable target, right?

MR. AXILROD. Yes, that's right.

CHAIRMAN VOLCKER. Shall we stick a phrase at the end of that such as "as indicated at the last meeting" or something like that? Then go with another sentence on M1? Well, maybe we don't need that "as indicated at the last meeting."

MR. AXILROD. You could say "continue to be consistent."

MR. PARTEE. Except we're changing the specifications, though. So, "continue to be consistent"--

MR. GRAMLEY. No matter what we do, they are going to grow at those rates.

CHAIRMAN VOLCKER. "M1 is expected to grow over the period by" whatever. Let's say 3 percent tentatively, which is halfway between and a round number. We could just put a semi-colon and then say "more rapid growth would be acceptable in view of the substantial decline of M1 in October." Or we could say "M1 is expected to grow over the period by 3 percent, less than anticipated earlier in view of the shortfall in October."

MR. AXILROD. That's better.

MR. GUFFEY. What period are we speaking of?

MR. AXILROD. From September.

MR. GUFFEY. Oh, September to December.

CHAIRMAN VOLCKER. And then we could go on to say "In the light of that shortfall, more rapid growth in that aggregate would be acceptable."

VICE CHAIRMAN SOLOMON. Do you want to say "In view of the negative number in October" rather than "the shortfall"?

CHAIRMAN VOLCKER. I think "decline in October" is all right. Then we're going to say more generally "Lesser restraint on reserve positions would be acceptable in the event of significantly slower growth in the monetary aggregates." I sure don't know whether we need that greater restraint sentence.

MR. PARTEE. The whole thing starts out with "decrease somewhat." I wonder whether we want the "somewhat."

CHAIRMAN VOLCKER. Let's get to that point. Is that general framework of the directive--just in terms of the language--all right?

SPEAKER(?). Mind over matter.

CHAIRMAN VOLCKER. Let me take the funds rate first; that seems to be easier. Most people have said 7 to 11 percent, which makes sense to me. It's more centered and we raised it not so long ago. I think after all this period of time it might be appropriate to have some gesture toward reducing it.

VICE CHAIRMAN SOLOMON. It's a lucky number.

CHAIRMAN VOLCKER. Generally, we are at 7 to 11 percent?

MR. MARTIN. Yes.

SPEAKER(?). I guess so.

CHAIRMAN VOLCKER. The critical figure will be the borrowing assumption. There we are dealing with a great deal of uncertainty. I think all these comments about the seasonal borrowing are relevant but also I suppose it's possible that the seasonal borrowing will decrease now that market rates are so low. We had an experience recently with a big bank waltzing in for a large amount of borrowing for no apparent reason. And if one or two big banks waltz in during a reserve period, that uses up all our borrowing here and we're left in a peculiar position. We have a full range of proposals here--from $400 or close to it to $700 million, which averages to $550 million.

VICE CHAIRMAN SOLOMON. You may have two groups of dissenting votes.

CHAIRMAN VOLCKER. I do think there is some danger in easing too aggressively here. I don't think that analogy in '80 is a terribly good one to give because we had those credit controls and other factors that were driving down M1. But we have had a pretty good decline in interest rates. I personally feel a little more comfortable about the outlook simply because interest rates have declined. I think we have to show some motion here and that seems to be the prevailing sentiment. What anything means I don't know. As a practical matter, I take it nobody would be very happy at this stage, contrary to a few weeks ago, to see the rates backing up appreciably in the market; the bill rate can go up a little from where it is today and so forth. But I don't know what borrowing level provides assurance against that.

VICE CHAIRMAN SOLOMON. I'm afraid that at $700 million there might very well be some backing up.

CHAIRMAN VOLCKER. I agree with that. We don't know that, but I would agree that the odds are substantial in that case. It could happen with $600 million but that is less likely, depending upon where you think it is now. Driving it down to $500 million seems to me a bigger step than is appropriate at the moment. Maybe it will be appropriate in a few weeks. My view is that that could put the funds rate at 8-1/2 percent, given--

VICE CHAIRMAN SOLOMON. If we have a volatile--

MR. PARTEE. I thought we had a staff projection that $400 million would be consistent with 9 percent.

MR. RICE. Yes, that $400 million would be 9 percent.

MR. AXILROD. We think that borrowing of $400 million will keep the funds rate slightly above the discount rate. And it might go below that; I don't think it will. A lot depends on how we manage operations and the signals given. In general, that's probably right.

VICE CHAIRMAN SOLOMON. But, if the markets think that we're going to be easing aggressively, they will go even further, Chuck.

MR. PARTEE. They probably won't cut it much below the discount rate.

MR. AXILROD. Well, I ought to add a caveat, Governor Partee. With this two-week reserve period what President Solomon mentioned is perfectly right. If we have to push reserves in aggressively to get the borrowings down or if some big bank comes in early and creates a lot of excess reserves and the funds rate tends to go down, anticipations of a discount rate decrease will come into play and the actual funds rate may actually fall below the present discount rate. Now, I can't imagine that the borrowing will be particularly high in those circumstances, but there is some give there.

MR. PARTEE. It would be pretty eccentric to have the funds rate much below the discount rate.

MR. AXILROD. Yes, not for any sustained period. But it has been for a few days; it was on Monday and Tuesday.

MR. PARTEE. Maybe we just ought to provide some reserves and forget about this borrowing number.

CHAIRMAN VOLCKER. We could do that, but we're going to get the--

MR. PARTEE. We don't know what will happen then.

CHAIRMAN VOLCKER. If the money supply is weak, we are going to drive [the funds rate] way down and then you get into the '80s [situation]. That's what we did in 1980--

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. --until we finally stopped and the funds rate got way below the discount rate. Maybe that's what we want to do at the next step but I am not sure we want to do it right now. Given the way this market has been acting, my gut feeling is that we ought to be in the $550 to $600 million range. And if the rate shows signs of backing up at that level--unless we get some really good business numbers--we ought to let borrowing go down further pretty promptly but do it over [a few weeks]. We have one two-week reserve period and then we have another two-week reserve period. I'd do it by the next reserve period maybe, but not all at once. Are we in the first week of a reserve period? No, we're just ending a reserve period.

SPEAKER(?). It starts on Thursday.

MR. AXILROD. The reserve period starts tomorrow.

CHAIRMAN VOLCKER. Well, by the beginning of the next reserve period we will have the retail sales and the durable goods orders figures and some more data on unemployment claims, won't we?

VICE CHAIRMAN SOLOMON. We will have more flexibility and more options to move or not to move on the discount rate if we go down to the $600 million, or possibly the $550 million, level. I think the $600 million level is better, because otherwise we are going to have real problems with what may be a psychological situation in the markets where the expectations are so heavy for a discount rate cut and so affecting behavior that we may feel that that's what we want to do if conditions indicate further easing.

MR. PARTEE. That second reserve period, if I am reading it correctly from the calendar, starts with Thanksgiving. Is that a problem?

VICE CHAIRMAN SOLOMON. We serve pressed turkey here!

CHAIRMAN VOLCKER. You have a thing for pressed turkey.

MR. MARTIN. We don't want to end up being the turkey!

MR. PARTEE. That second period may be eccentric because of the holiday.

MR. STERNLIGHT. There might be reserve problems because of the holiday then, but I don't think it presents any problem for edging the borrowing down.

MR. PARTEE. Yes, particularly--

MR. CORRIGAN. --particularly at the beginning of the period. It could at the end of the period.

CHAIRMAN VOLCKER. I don't want to be too arithmetic about it, but the great majority of the Committee is within $50 million of $550.

MR. PARTEE. I could accept $550 million as a first step.

MR. MARTIN. What would the second step be?

MR. PARTEE. Well, it would depend on whether we had to go further. We would have to go down toward $400.

CHAIRMAN VOLCKER. If the money supply is weak and the economy is weak and so forth--

MR. PARTEE. If everything is still weak, probably.

VICE CHAIRMAN SOLOMON. Or a discount rate cut rather than go completely down to $400 million in the second step.

MR. PARTEE. Maybe both.

VICE CHAIRMAN SOLOMON. But that would be a half-point cut.

MR. GUFFEY. I would just remind you that the borrowing level was just reduced from $750 to $700 million this week. And federal funds today--although to be sure it's Wednesday--are trading below the discount rate. I don't know what all of that means and the funds rate shouldn't remain there, obviously, but we've already taken one cut from $750 to $700 million that the market doesn't know about. Now you're suggesting cutting it another $150 million.

VICE CHAIRMAN SOLOMON. But at the conference call, you remember, there were some people who wanted to ease aggressively and some of us--and I was in the other group--wanted to ease only to a point where we avoided going down to 9-1/2 percent [on the funds rate]. We thought that the Chairman and the Open Market Desk might go as low as $650 million on the borrowing assumption. Some of us hoped the rate would not go much below 10 percent. I think they stayed very faithfully within the spirit of the consultation by bringing borrowing down only to $700 million. And the average fed funds rate recently has been a shade under 10 percent. So I think it was a perfectly appropriate move; I was a little surprised it didn't come earlier because the market situation was very strange. In a sense, that's past history almost, Roger, and I think--

MR. GUFFEY. Let me be sure to be understood. I am not critical of having moved to $700 million. I am just noting the fact that we very recently moved to the $700 million level and to talk about taking it to $550 million seems to me to be a rather large change in policy.

CHAIRMAN VOLCKER. You have a pretty good microscope if you can tell the difference between $750 and $700 million.

MR. GUFFEY. Well, to be sure.

CHAIRMAN VOLCKER. It was a feeble gesture to--

MR. GUFFEY. I cannot tell the difference, but the fact of the matter is that there has been an overt move and we don't know what the result is.

MR. CORRIGAN. I personally think that whatever we do the market is at a point where it is likely to try to run beyond it, which is another reason I would favor a more conservative approach. I think the market psychology is a big factor here.

MR. ROBERTS. There is the possibility, of course, that the market, having already discounted a discount rate decrease and a move [by this Committee], might react adversely if we didn't move enough.

CHAIRMAN VOLCKER. If they did, then we ought to move more; I don't think anybody is talking about a backup.

VICE CHAIRMAN SOLOMON. I still feel that $600 million gives us the maximum flexibility to respond to any changing circumstances either in the market psychology or in the real economy or--well, I don't think we'll see much change in the money numbers in the next few weeks.

CHAIRMAN VOLCKER. Frankly, the difference between $550 and $600 million is not going to be visible in anything we do. It's within the range of error that we hit anyway.

MR. CORRIGAN. [It's not] the difference between $550 and $600 million. I think the only thing that matters is the extent to which there is an implicit automatic assumption that you'd go down further to $500 or even $400 million.

CHAIRMAN VOLCKER. I don't think the assumption is that we would automatically go down; the assumption is we would go down if the money numbers come in weaker than anticipated and if the business and general news is biased on the less strong side rather than the strong side. If we come up with a positive retail sales figure in October and a strong new orders figure and the money supply is up $3 billion in the week of the 15th and another $2 billion in the following week, the 22nd, I don't think there's any assumption that we'd do anything.

MR. MARTIN. Would it be at $550 million then?

CHAIRMAN VOLCKER. If we start at $550 million, it would.

MR. PARTEE. We also ought to take a look at this seasonal question. I don't know whether we'll get all that much detail but I have a feeling that we may get the decline mainly from the seasonal dropping off. I'd forgotten about it until it came up today that this seasonal borrowing must be running toward the end of its period and that, therefore, there will be a drop in seasonal borrowing.

CHAIRMAN VOLCKER. Why won't they just renew it for the following year?

MR. PARTEE. Oh, I don't think they can; it's not really done that way. They have to have a time when they're out of debt, I believe.

MR. AXILROD. It may be a big factor this year. Normally it's not a big factor because the variations in the other borrowing and the errors in their relationship swamp it. But we're getting so close to it now that it may very well be a factor and we would certainly want to look carefully.

MR. CORRIGAN. It has been a factor, hasn't it, Steve?

MR. AXILROD. Well, it's a factor technically in the intercept, not necessarily in the slope of the relationship.

VICE CHAIRMAN SOLOMON. Why don't we compromise by saying the initial borrowing assumption is in a range of $550 to $600 million and leave it [to you] as you feel your way over the next couple of days?

MR. PARTEE. How about $500 to $550 million?

MR. GUFFEY. $600 to $700 million.

CHAIRMAN VOLCKER. We're getting pretty narrow. From my standpoint, if you want to make it $550 to $600 million, it's fine with me. I'll make it whichever I feel like.

SPEAKER(?). That's the actual state of the art, I guess!

CHAIRMAN VOLCKER. I think everybody is saying we play this a little [flexibly]; we've been playing it this way anyway. It depends upon what happens in the market. If the market gets way ahead of it, we go slower; if it doesn't, we go faster.

MR. MARTIN. I'd just like to see you have the flexibility to go to $400 million if the market conditions and the economy dictate.

CHAIRMAN VOLCKER. I think that is within this anyway. You can have an argument as to whether the market conditions and the economy dictate it but it's certainly within the range of where we can go as I understand it.

MR. PARTEE. I would like to think that we're doing this within the context of alternative A, but we're--

CHAIRMAN VOLCKER. Well, I don't know what alternative A means. That's just a question of the number to put in, isn't it?

MR. PARTEE. I just say that to give a sense of--

CHAIRMAN VOLCKER. Frankly, the number that I thought of putting in there--but it's not going to make any difference to me--is the round number that is halfway between "A" and "B." If we do it on a quarterly basis, I'd put in 3.

MR. PARTEE. I have no problem with 3.

VICE CHAIRMAN SOLOMON. There's a danger in the sense that the market is so bullish that they are going to seize on almost anything. We're getting a very significant bond market rally; I don't know that we've seen evidence of it in the stock market. Whatever we do they're going to do more, if they think there's more to come.

CHAIRMAN VOLCKER. To some extent that doesn't bother me because I don't think the general business picture is very risky on the up side. And if it gets moderately risky on the up side, we can tighten up. I don't want to get the money supply [expanding so rapidly] in the next few months that we've got a problem, but--

MR. PARTEE. It gives you one more chance to adjust the portfolio if you're an FCA or something like that.

CHAIRMAN VOLCKER. [Steve], did you write down the language that we had? I'll fill in some numbers as you go along.

MR. AXILROD. Maybe Normand has been writing.

CHAIRMAN VOLCKER. In sentence number one, I don't care whether it says "reduce" or "decrease." We'll take a vote on that. "In the implementation of policy in the short run, the Committee seeks..." "To reduce" is a better Anglo-Saxon term; no they're both Latin, aren't they?

MR. AXILROD. The staff sees no difference, but--.

CHAIRMAN VOLCKER. "Reduce" sounds better to me. "...seeks to reduce somewhat existing pressures on reserve positions. This action is expected to be consistent with growth of M2 and M3 at annual rates of around 7-1/2 and 9 percent during the period from September to December." We're putting in there the same figures we had before; we're not very far away. Now I don't remember what I said before.

MR. BERNARD. "M1 is expected to grow over the period at a rate of around 3 percent...."

CHAIRMAN VOLCKER. 3 percent semi-colon.

MR. BERNARD. Or [comma] "less than anticipated earlier in view of the decline in October."

VICE CHAIRMAN SOLOMON. The unexplained decline.

MR. BERNARD. And you thought about possibly putting in there "In light of that decline, more rapid growth would be acceptable."

CHAIRMAN VOLCKER. In light of that decline more rapid growth of M1 would be acceptable.

MR. PARTEE. And then "More generally..."

CHAIRMAN VOLCKER. Yes, and then it would go on to say "More generally lesser restraint..." Instead of "acceptable"--we just used the word "acceptable"--let's say "Lesser restraint on reserve positions would be sought in the event of significantly slower growth in the monetary aggregates, evaluated..." etc.

VICE CHAIRMAN SOLOMON. Well, if you go that far and use the word "sought"--which is all right with me--then I think we ought to leave in the counterbalance sentence. Otherwise, if we leave that out too, then it's really going to look silly.

CHAIRMAN VOLCKER. Well, it's all right with me. The other sentence says "acceptable," which is weaker than this other one. If that sounds generally all right, we're still left with what level of borrowing we're starting off with. I am perfectly happy with an understanding of $550 to $600 million that would be played in the first week depending upon how the market conditions look. We'll stay

there if things are very equable. If things come out on the strong side, well, we'd stay for a while; if things come out on the weak side, we'd make another step downward.

VICE CHAIRMAN SOLOMON. And if you have to make a very substantial step downward, we could have a consultation unless you decide to do it through a discount rate.

MR. PARTEE. I think the second step is to go down to $400 million.

CHAIRMAN VOLCKER. We might well want a consultation staying within this, but we will have to see how obvious or clear it is. Is that reasonable? Let's see whether we've got the votes.

MR. MARTIN. 7 to 11?

CHAIRMAN VOLCKER. And 7 to 11 percent on the funds rate.

MR. KEEHN. Not to stir the soup but--

SPEAKER(?). But it will.

MR. KEEHN. On this M3 number of 9 percent, I'd ask what the basis for that is. Neither alternative A nor B would suggest that.

MR. CORRIGAN. It's the one we had the last time.

MR. KEEHN. The fact that we had it the last time I don't find necessarily compelling.

CHAIRMAN VOLCKER. You're quite right, neither "A" nor "B" has that, but they are within 1/2 point of it and I think that's--

MR. KEEHN. Just to carry over the language doesn't seem to be a clean way of developing a directive.

CHAIRMAN VOLCKER. We've typically done that, or tried to, when it's very close.

MR. AXILROD. Looking back, the Committee has accepted pretty much staying there when the expectation was within a percentage point.

CHAIRMAN VOLCKER. Actually, M3 is running a little high and M2 is running a little low. But gosh, we should be so close on these things ordinarily!

VICE CHAIRMAN SOLOMON. If we end up with interest rates [down] much further with your second or third step, there's going to be absolutely no incentive in the Congress to do anything about that deficit.

CHAIRMAN VOLCKER. It works the other way if the economy is slowing down so much.

MR. MARTIN. That's the problem.

MR. BOYKIN. Governor Partee's comment that this would be done in the context of alternative A disturbs me a bit. I can probably agree to what you're saying in the context of alternative B.

CHAIRMAN VOLCKER. I don't know what "in the context of" means and I don't think I understand Governor Partee's comment.

MR. PARTEE. I'll retract it.

CHAIRMAN VOLCKER. It's in the context of what we're talking about, which is a figure of 3 percent for M1 and 7-1/2 and 9 percent for M2 and M3 and these general borrowing numbers. It is talking about going to, say, $400 million, without making a great deal of it, if there is a succession of weak economic or monetary numbers.

MR. BOYKIN. I just could not let his comment go without additional comment.

MR. BLACK. You just have a short-term attitude ever since you got through--

CHAIRMAN VOLCKER. If no one has a better proposal at the moment, I think we ought to vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	No
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. We are finished.

END OF MEETING