Meeting of the Federal Open Market Committee

July 9-10, 1985

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, July 9, 1985, at 3:00 p.m., and continuing on Wednesday, July 10, 1985, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Balles
Mr. Black
Mr. Forrestal
Mr. Keehn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger
Mr. Wallich

Mr. Guffey, Mrs. Horn, Messrs. Melzer and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, 1/ General Counsel
Mr. Oltman, 2/ Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Broaddus, R. Davis, Kohn, Lindsey, Prell, Scheld, Siegman, and Ms. Tschinkel, Associate Economists

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

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1/ Entered the meeting after action to approve minutes for the May meeting.

2/ Attended Wednesday session only.

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Messrs. Balbach, J. Davis, T. Davis, Ms. Greene, Messrs. Lang, Rolnick, and Syron, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Cleveland, Kansas City, New York, Philadelphia, Minneapolis, and Boston, respectively

Messrs. Judd, Pearce, and Scadding, Vice Presidents, Federal Reserve Banks of San Francisco, Dallas, and San Francisco, respectively

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

Meeting of the Federal Open Market Committee

August 20, 1985

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, August 20, 1985, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Balles
Mr. Black
Mr. Forrestal
Mr. Keehn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger
Mr. Wallich

Mr. Guffey, Mrs. Horn, Messrs. Melzer and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

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

Messrs. Broaddus, R. Davis, Lindsey, Prell, Scheld, and Siegman, Associate Economists

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

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1/ Entered the meeting after action to approve minutes for the July meeting.

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Jack Guynn, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Balbach, T. Davis, and Lang, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, and Philadelphia, respectively

Messrs. McNees, Miller, Pearce, and Beebe, Vice Presidents, Federal Reserve Banks of Boston, Minneapolis, Dallas and San Francisco, respectively

Mr. Stevens, Assistant Vice President, Federal Reserve Bank of Cleveland

Ms. Meulendyke, Manager, Securities Department, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
July 9-10, 1985

July 9, 1985--Afternoon Session

CHAIRMAN VOLCKER. We need to approve the minutes.

MR. MARTIN. So moved.

MR. PARTEE. Second.

CHAIRMAN VOLCKER. We'll turn to foreign currency operations.

MS. GREENE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Comments or questions?

MR. WALLICH. Gretchen, when you say that people holding dollars have many alternative techniques to protect themselves and so are encouraged, is it to be understood that the cost of that does not fully account for the difference in interest rates?

MS. GREENE. Well, they can manage this hedging quite aggressively and they can select, if you will, the term of their insurance protection against an adverse exchange rate move. So, they can pay the price of this insurance for relatively short periods of time. We believe, or at least we have heard, that in many cases during the spring money was made on these so-called protective hedging operations when the dollar came down earlier in the year.

CHAIRMAN VOLCKER. No other comments, observations? You provoked nobody! Domestic operations, Mr. Sternlight.

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

CHAIRMAN VOLCKER. Comments?

MR. MARTIN. Move approval, Mr. Chairman.

MR. PARTEE. Second.

CHAIRMAN VOLCKER. Without objection. We'll see whether the economy sparks any more [comment].

MESSRS. KICHLINE, PRELL, and TRUMAN. [Statements--see Appendix.]

CHAIRMAN VOLCKER. Are there any comments or questions?

MR. FORRESTAL. Could I ask a question about these consumer and mortgage delinquencies? While we have had some better experience recently, they are still very high on balance. Does that conflict with what we are seeing in higher net wealth or is there an explanation due to distribution of income? How do you explain that apparent conflict?

MR. PRELL. Well, it is very, very difficult. In a sense it conflicts with the wealth figures; on the other hand, one of the

things that has prevented wealth from growing so fast has been the mild increase in housing prices, which had been a significant ingredient earlier in wealth growth. It appears that there is a combination of factors involved in mortgage delinquencies. One is that unemployment is still quite high in an historical sense, and considerably higher than the average in some locales. Income growth obviously varies across individuals, so those who took on mortgages earlier perhaps with adjustable rates or with very aggressive underwriting terms--graduated payments or whatever--may find themselves with a greater burden than they can handle readily. The fact that the equity in their homes has not built up appreciably or could even be negative, where there is negative amortization, has led them not to fight too hard to hang onto their homes. So it is a very complex matter, but those all seem to be ingredients in this picture. On the consumer side, the ratio is still fairly low historically but it could easily move higher, given what appears to be rather aggressive lending and very aggressive borrowing in many cases.

CHAIRMAN VOLCKER. My impression is that it is moving higher quite rapidly. You have the first-quarter figure here, right?

MR. PRELL. That's right. We don't have any anecdotal evidence that would suggest that the second quarter is going to look worse. We polled the senior loan officers at commercial banks last month and they suggested that the first quarter run-up had a bit of a seasonal in it and that they weren't seeing a further deterioration. In fact, they did not seem to be very concerned about delinquency rates.

CHAIRMAN VOLCKER. That's the trouble with senior bank lending officers!

MR. PRELL. We talked to the auto finance companies and they suggested that the next figures may look a little better than the last figures. So, we don't see a reversal of the upturn, but there doesn't seem to be a continuing deterioration.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. You gave passing mention to the consumer installment debt burden which, as I recall, is high cyclically and is high over a much longer period of time. Has that not been a fairly reliable indicator not only of consumer spending but of the length of business expansions? I guess I was a bit surprised that you did not spend a little more time on it. Or is it not all that important in the flow of the business cycle?

MR. KICHLINE. Do you want two opposing answers? If Mike answers, you'll hear something very different from what you will hear from me. I would be concerned about it. Mike and a number of other people are less concerned about it. It has been a topic of great debate among the staff looking at this. At least two things are a bit different now, allegedly. One is that a portion of the increase is associated with a supposedly growing use of credit cards for convenience purposes; those balances get built into the numbers but, indeed, are paid off monthly and are presumed not to be a problem--just a shift in means of payment. The second argument is that the outstandings were so depressed in 1980, 1981, and 1982 that,

basically, repayments have been lagging. And if that view is correct, with the strong debt taken on in 1983-84 and so far this year, repayments ought to be rising and, therefore, we ought to be seeing very limited further growth. If you go back historically, I think it's hard to isolate that factor as one element, but it did peak in late 1978 or early 1979 and things got worse from there on. But lots of things were going on in that period of time. I would say that there are really differing views on this whole issue--certainly among the staff.

MR. PRELL. I might say, as a cyclical indicator, that many times in the past one of the elements in the downturn of consumer borrowing and of activity in general was a constraint on the supply of credit. As rates went up, usury ceilings began to bite and the supply of consumer credit began to diminish. So it is a very complex issue, looking at the cyclical history.

MR. BOEHNE. I might just comment on your comment. There is some merit to the argument that credit cards are being used more as a convenience. The actual numbers escape me at the moment but in talking with several bankers I was told that a very, very high percentage--an overwhelmingly high percentage of people--do not pay off their credit cards in full when the bill comes. So that would suggest that, yes, there may be some convenience; but there is also some debt in the true sense of the word there. So, I would not put a whole lot of weight on that as a reason to downplay the importance of the numbers.

MR. PRELL. We felt it was sufficiently important to mention it.

MR. BOEHNE. But not have a chart.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Mike, I have a question with regard to labor productivity and unit labor costs. With productivity continuing to increase and with compensation continuing to be fairly level through '86 [in your forecast], I am a little surprised that the unit labor cost doesn't show more improvement than it does or, in fact, come down a bit. If these numbers are right, I'm also a bit surprised that your expectation regarding inflation isn't a little higher. Can you rationalize that?

MR. PRELL. The arithmetic is that we have compensation per hour rising a fraction over 4 percent from here on and we have productivity growing at something over one percent on average over the next six quarters. So, net, you come out with unit labor costs rising something over 3 percent on average. It's conceivable that price movements would move closer to that of unit labor costs and thus give us a bit better inflation performance. On the other hand, to the extent that the depreciation of the dollar permits businesses to improve their margins a bit, that will tend to maintain some spread over that period. In general, we have things moving fairly closely together--a fairly normal cyclical path.

MR. PARTEE. Could I just add on here? That is a very sharp rise in non-oil import prices on that chart, Mike. Is that an 8

percent rate of depreciation of the dollar plus a rate of inflation for imported prices in foreign currency terms? It seems an awfully sharp increase to me.

MR. TRUMAN. It is in fact somewhat less. It is an annual rate of something like 4 percent over the four quarters of 1985 and about 9 percent as it [unintelligible] over the four quarters of 1986.

MR. KICHLINE. It is 3 percent in 1985 and 9 percent in 1986.

MR. TRUMAN. But it is the combination of the dollar--

MR. PRELL. The dollar is depreciating at an 8 percent rate and you are getting an additional price effect. You are getting something less than that reflected in import prices.

MR. PARTEE. Something less than that?

MR. TRUMAN. We assume that only half of the depreciation shows through, in and of itself, to the level of inflation. Looked at another way: you have an 8 percent decline of the dollar but only 4 percent added on to inflation.

MR. PARTEE. You have about a 12 percent rise [in import prices] over this forecast period?

MR. PRELL. About 12 to 13 percent.

MR. TRUMAN. But on a quarterly rate [basis] it is about a 2 to 2-1/2 percent rate.

CHAIRMAN VOLCKER. I'd be surprised if there were 4 percent inflation abroad in the kinds of things they export to the United States.

MR. PARTEE. A lot of people say profit margins are going to decline on shipments to the United States and this does not seem to allow much for that as the dollar drops.

VICE CHAIRMAN CORRIGAN. I think at this point you can make a pretty good case that that could happen, even to the extent of neutralizing a small 8 percent change in the exchange rate completely on domestic prices.

MR. MARTIN. It would still leave margins very, very wide for those sellers into the U.S. market--into the most exciting market they could have market share in. They'd absorb it all.

CHAIRMAN VOLCKER. Going back to this chart that Mr. Keehn referred to: Is that a 1 or 1-1/4 percent difference between the red line and the compensation line?

MR. KEEHN. That is the question that I asked.

MR. PRELL. Between compensation and labor costs? Yes, approximately.

CHAIRMAN VOLCKER. If we had a 10 percent decline in oil prices--you have more than that in here--how much does that lower GNP prices? What is oil, 5 percent of the GNP?

MR. PRELL. A 10 percent decline in oil prices beyond what we have already built in?

CHAIRMAN VOLCKER. No, no--a 10 percent decline.

MR. PRELL. We estimated that a $2 to $3 a barrel decline in the oil price could have an effect, over a couple of years, of about one-half percent on the consumer price level.

MR. KICHLINE. In this forecast, if you were to exclude energy prices, for example--there are some lags in this--in 1986 you would get a fixed-weight price index that would rise three-tenths faster. So what we have built in amounts to about a quarter of a percent or more impact on prices in the GNP accounting sense.

CHAIRMAN VOLCKER. Excluding energy.

MR. KICHLINE. Right.

CHAIRMAN VOLCKER. I think what Mr. Prell just told me is that if the energy price goes down that much you would have a slower rate of increase.

MR. PRELL. We have a decline in the oil price of $2.75 a barrel. That is worth three-tenths of a percent in the inflation rate next year. That's not inconsistent with what I was saying, given the lag structure--about one-half percent for two years.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Mr. Chairman, I have a question, if I could, to ask Jim. With respect to this overall forecast, Jim, how do you think it will be affected by the threat--or the prospect, as the case may be, depending on the standpoint of the viewer--of tax reform?

MR. KICHLINE. Well, we have not made an explicit assumption in terms of passage of a tax reform proposal. We tried to capture as best we could in a variety of sectors the expectational effects that might be there. Our sense is that in the business fixed investment area--and this certainly is supported by the results of the Reserve Banks' poll of corporate executives--they are probably offsetting. There is some incentive for firms perhaps to speed up their plans in the hopes of being grandfathered, given existing depreciation rules. On the other side, the general issue of uncertainty about a change in depreciation laws might well hold some back. So, net, we don't think much is going on there. In housing we have a sense that the Administration's proposal is on balance a negative feature and that it is probably not a large issue in the short term. I would think on average uncertainty about changing taxes is probably a small negative.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Mike, you made some reference to pent-up demand on the part of the consumer and I think indicated that this probably

was largely behind us. I would like some elaboration on that because, as I recall the [staff's] February presentation, there was some considerable discussion about the continuation of pent-up demands--the average age of cars on the road, household formation and home ownership, and those kinds of things.

MR. PRELL. I guess I nailed myself! I think we are being fairly consistent. I showed last time, for example, that the stock of non-auto durables for households had fallen off during the early 1980s and had come back considerably through 1984. And in the first half of this year we had continued very strong durables spending. So, we think we're pretty near the historical trend line, if that's any indicator of those pent-up demands. On the auto side, it is very hard to read. It looks like the age of the auto stock has leveled off. The level of auto sales that we have in the forecast is historically quite high. We have almost 11 million units in total this year and we have it going down to about 10-3/4 million units next year. While that does not imply growth in consumer durables spending, it does mean that some of the aging of the auto stock will be reversed probably to a slight degree. But we are not seeing any likelihood that supplies are going to be such that we could have very much stronger auto demand. And given the income growth that we are projecting, we don't see the basis for projecting very much stronger spending on consumer durables. But it is simply a question of how much is behind us. Our judgment is that a good bit of that durables pent-up demand is behind us now.

CHAIRMAN VOLCKER. I want to return to this price issue for a moment. I cannot resist giving you this little background--and I may as well do it now--on the record of the Federal Open Market Committee's price forecasts over the last three years. In the beginning of 1983--just taking the central tendency--we estimated prices at 4-1/2 percent, and we continued with that in July; they came out at 3-3/4 percent. We started out [in July 1983] projecting prices for 1984 at 4-3/4 percent and maintained them there in February; they came out at 3.6 percent. We started out in July 1984, in our first forecast [for 1985], projecting 5-3/8 percent and then we lowered it substantially [in February].

MR. BLACK. It's about time for us to miss in the other direction!

CHAIRMAN VOLCKER. Any other comments?

MR. MARTIN. Mr. Chairman, I am struck not only by the usual difficulties of forecasting but by the degree of uncertainty--not to take away from any of the work of our colleagues on the staff here and at the banks. It seemed to me that as you worked through the presentation and the graphics today the theme could be uncertainty about non-oil imports and real GNP. Mr. Truman, in an attempt to be reassuring, said that even if we hit the higher imports--therefore the lower line relative to the GNP--it won't put us in a recession. That was an attempt to be reassuring, which I appreciate. But if you translate that into the projection of consumer spending, which over the last nine quarters has represented about 60 percent of the real GNP chain, you note the uncertainty that the import segment of that spending presents. I noted in the presentation that that was a reasonable comment: that the consumer spending element of the GNP

assumes that the domestic segment of that spending will be somewhat higher. There will be a bigger domestic share. But there again, it seems to me that the uncertainty presents itself.

In the business investment area, I have no problem with the inventory projection; but when we get to business fixed investment, I wonder whether or not the computer and the telecommunications spending are indeed going to revive or hold, or whether [such spending] really has topped out and the catch-up in that has occurred. It seems to me that there is uncertainty there. There certainly is uncertainty as to when the nonresidential building industry is going to collapse--not whether, but when. That certainly applies to the industrial buildings, which haven't gone anywhere. There are closed plants all over the United States and there is overbuilding of office buildings and shopping centers. So, that is a question of when, not whether. I don't have any problem with the rather optimistic housing projections but we certainly can have difficulties in the business fixed investment. It just seems to me that uncertainty is practically the theme of our forecast, necessarily. I am struck by the range [of uncertainty] that we have to have around any of these lines we're looking at.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. In the Greenbook you note that the capacity utilization has fallen by more than 2 percent. Labor capacity utilization--that is, the rate of unemployment--has remained almost flat. Can one put these two things together and say that there is increasing pressure against price increases: constant pressure against wage increases and more pressure against industrial price increases?

MR. KICHLINE. It is very clear that there has been a downward trend in capacity utilization and that would continue in this forecast. Basically, it reflects the strains that are being placed upon manufacturing and mining; there firms have been working aggressively to cut costs and we have been seeing declines in employment. Employment is down almost one-quarter million over the last six months in the manufacturing sector. As you know, we have continued to see further growth in service employment. Put together, we have an unemployment rate that has been stuck for virtually the last year at 7-1/4 percent. Now, we think that 7-1/4 percent is high enough to continue to exert some downward influence on price increases and we think that would persist over the projection horizon. I think it is the case that industrial prices are being constrained in part by import competition in many areas where firms are experiencing pressure. If they had the opportunity and felt they could get away with it and not lose market share, they would try to push some price increases through. But they can't. And I don't think in this projection horizon that that will change very much. So, both capacity utilization and the aggregate unemployment rate seem to me to be at levels that would be exerting some downward pressures on price increases.

MR. WALLICH. Thank you.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I would like to pick up on the uncertainty theme that Governor Martin raised. I think there is uncertainty here; but as I look through the presentation and think about the various sectors, I can visualize this forecast materializing. I can visualize something slower than this; I can even visualize a recession over this time horizon. But I find it very difficult to visualize sufficiently more rapid growth than is in this forecast that would jeopardize the outlook for inflation. As one goes through this, sector by sector, one could make a case for slower consumer growth but it's hard to make a case for booming consumer growth. In the investment sector, I think it's the same kind of outlook and it's the same in the government sector. The foreign sector may be less of a drag, but it is still going to continue to be a major drag. Even if we got somewhat faster growth, it's hard to see that bringing about a significant increase in inflation above this forecast. The major source of inflation in here comes from the foreign side. Someone made the point earlier, with which I agree, that those margins are big and fat in terms of what's being imported into this country. And this is a very lucrative market. So I am much less fearful of that kind of import inflation being as serious as is [suggested] here.

The other point I would make is about the tone that I sense out there. My District has been, I think, one of the most upbeat Districts in recent quarters. I think that has been true up and down the Atlantic coast. That area has been more upbeat than other parts of the country. I have sensed a change in that tone. I sensed the beginning of a change the last time we met; but I sense it even more strongly now that there is a definite scaling down of the outlook for the rest of the year and in 1986 by a whole range of businesses. The only strong sector in my District now is real estate and construction, and I think that has a definite time limit. Like every place else, there has been weakness in manufacturing, but it has now spread to retailing and to some of the services. So, if you look at the objective evidence that is here and at the change in the tone--even granted the uncertainty that is present--it seems to me that there is more chance that we are going to end up on the softer side of this forecast than on the too strong side of it.

CHAIRMAN VOLCKER. Let me make another comment about these forecasts [by Committee members]. If that is true, it is not reflected in the forecasts given in preparation for this meeting. They are almost invariably higher than what the staff is forecasting, sometimes substantially.

MR. BOEHNE. Well, Mr. Chairman, sometimes those forecasts have a lot more staff input than other input.

CHAIRMAN VOLCKER. I'd just make that observation. Also, they are [unintelligible]. Now, one thing may be that the staff is assuming a lower second quarter than other people may have been assuming.

MR. PARTEE. Well, I fall into that camp that you just described, and it wasn't staff input. I put in a rather higher forecast, but this chart show gives me the uneasy feeling that we are about to stall. The problem, as I see it, is in these charts that tend to be toward the bottom of the page. As I go through the forecast here, for example, you have a very sizable rise in the

multifamily vacancy rate and an increase in the mortgage delinquency rate; and I think that starts to raise some questions about whether residential construction will be all that high. I agree with Pres; I am surprised that your vacancy rate for office buildings is only a little over ten percent since I think there is hardly a place in the Coldwell Bankers survey that that's low. Maybe New York City is so heavily weighted that it brings it down. In any event, it is just a question of when there will be a collapse in office building rather than whether.

MR. KICHLINE. Governor Partee, the scale is on the left. It's the red line and the red scale, so it's about 15 percent.

CHAIRMAN VOLCKER. I am going to make a modest procedural suggestion. In the future, when you present a set of charts, you might number them so that we can refind them.

MR. PRELL. It probably has risen considerably further.

MR. PARTEE. I should have, I suppose, done the color coordination and gone to the left, but I didn't. So I see that you have a vacancy rate of more like 15 or 16 percent, which is a very high vacancy rate. One hears of concessions occurring all over the country. I am somewhat inclined to agree that consumers have been overspending; their debt has risen sharply and delinquency rates are up some in that area. You considerably restock the car inventories and durable goods inventories and, therefore, that looks sort of high. Even for the poor state and local governments, who have been spending at a very modest rate, your chart at the bottom shows their surplus dropping off to nothing in the projection period. So I tend to get the impression looking through this--and I realize it is very dangerous--that a stall is quite conceivable, particularly if one takes Mr. Truman's adverse line on imports, which is closer to what I would have expected than the one that the staff projected as their central tendency. I tend to be persuaded by this presentation that the economy is really pretty weak.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, you may rule this next comment out of order; I'm experienced in that. But I would like to raise a question about the principal assumptions. I am aware that it is necessary for the staff in its presentation of materials to make an assumption about [money growth for] the rest of 1985 and for 1986. And it is quite understandable to use an M1 growth of 8-1/2 percent for the first period and 5-1/2 percent for 1986 to hit some kind of middle point. Likewise, it is very understandable to use the assumption of level interest rates out through 1986. But given those assumptions and the others, all of which seem to be internally consistent, that produces then 2-1/2 percent real growth. As to the Chairman's comment that the numbers in the FOMC's projections tend to be a bit higher, I think that goes back to the Chairman's informal poll here in March, in which as I remember the question he asked was: Is 3 percent real growth adequate? As I recall the results--I have a rather fuzzy memory--there wasn't anyone here, among the voting or non-voting participants, who felt that 3 percent was an adequate real rate of growth. Well, if 3 percent wasn't, is 2-1/2 percent adequate for this period? Or shouldn't we in subsequent deliberations--the

Chairman hasn't ruled me out of order yet--consider the rate of growth and the level interest rates as something that needs to be debated and some decisions made, which normally would be made in our procedures here?

CHAIRMAN VOLCKER. I think that we will inevitably get to that. You are talking about the assumptions. I would have wished earlier that $50 billion [in deficit cuts] might turn out to be reasonable, or in my wildest thoughts, low. I must say right now that I think it is much too high for an assumption as to how much the budget is going to be cut in 1986. Mr. Black.

MR. BLACK. Mr. Chairman, I think there is one element of uncertainty that possibly overshadows these other uncertainties that others have mentioned and that is the issue that Steve outlined in his very fine paper: the question as to whether we have had this permanent one-time drop in velocity of money or not. The truth of the matter is that none of us knows. I am inclined to think that we have had some of that; but if we have not, then I think there is a definite risk that with this much money, we could have more growth than is being projected. I think that's the key to the uncertainty to all of this and I don't know how to find an answer to that one.

MR. PARTEE. A permanent one-time drop in velocity would be the second occasion.

MR. BLACK. The second permanent one in very few years.

CHAIRMAN VOLCKER. Do we have any other comments on the business situation?

VICE CHAIRMAN CORRIGAN. The forecast that I put in--I have to say it was my own and not my staff's--

CHAIRMAN VOLCKER. That's the way it's supposed to be.

VICE CHAIRMAN CORRIGAN. Like Governor Partee's, it is very much on the high side in terms of what I see as the consensus for 1986.

CHAIRMAN VOLCKER. My comparison was for 1985, but I guess it's also true--well, less so, for 1986.

VICE CHAIRMAN CORRIGAN. In looking at the six quarters ahead, my forecast is on the high side. Arithmetically, it has that result because of a bunch of small differences in net exports and government purchases. But the big difference is in housing where I have basically gone with about 2 million units in housing starts, and that accounts for about 3/4 to almost a full percentage point difference in real growth. I came to that view with some considerable hesitation; nevertheless, I do think that there is something to the view that pent-up demand for conventional owner-occupied housing--not second residences such as Vail, Colorado condominiums--is still pretty strong in a framework within which financing opportunities look distinctly better.

On the investment side, I don't have any real insight except to say that in recent weeks I have spoken to three CEOs of major

computer electronics companies about this question: Do we see a real turnaround in high-tech investment or some kind of short-run glitch? Their opinion is that it is more likely a short-run glitch than any kind of real weakness of a permanent nature that is setting in. I don't think it is going to make a great upside difference, but I think it does say something about the relative downside risks to the investment sector itself.

I am influenced in the outlook also by the fall in interest rates that we have seen; and while I am certainly by no stretch of the imagination a monetarist, we sure as heck have a lot of liquidity in the economy by any definition that I can think of. Having said all that, I would have to say in terms of my own forecast that I would quickly recognize that the risks are on the down side. I think the financial sector presents its own risks; the commercial real estate sector that Chuck mentioned is one that worries me enormously at this point. Indeed, when you really look through the problem of the dynamics in trying to reverse the trade balance in any significant way, it is really tough sledding. We did a little exercise that probably isn't much better than the little exercises other people do--this is not built into the forecast--but even if we quickly got something as large as a 15 percent one-time downward change in the exchange rate, the implications of that for the trade balance over this six-quarter period are really quite modest, to put it mildly. So, while one can perhaps argue with some conviction that the rate of deterioration in the trade balance should moderate and might even come close to stabilizing, producing any meaningful reversal--particularly in the face of these very, very large profit margins of foreign suppliers--is going to be enormously difficult. The long-run implications of that in terms of the current account, in terms of the capital flows from abroad, and in terms of the ultimate vulnerability to a big shock in the exchange rate, seem to be that it will get a lot worse as time goes on. I certainly don't have an answer as to what to do; but I am more impressed with how difficult it is to get ourselves out of the quagmire.

On the price side, my own forecast is somewhere around the middle or a shade on the low side. I basically have not assumed that a modest decline in the dollar will produce any further price pressures. In the face of that, the reason I have a somewhat higher forecast of price increases relative to, say, unit labor costs, is that I do have a larger spread between unit labor costs and prices built into my own mental arithmetic than the Board staff does. And that simply is a recognition of my own view that the pressure on domestic producers to seize every little opportunity, every little crack in the window, to pass along cost increases in the form of price increases, even in the current labor market capacity utilization setting, is just so powerful. That is about where I am, Mr. Chairman.

MR. RICE. You see the risks on the down side of the staff forecast or the down side of your own forecast?

VICE CHAIRMAN CORRIGAN. Well, the down side of my own forecast.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I guess I am the optimist in this crowd. The degree of pessimism I have heard around the table surprises me. I think that what we have been seeing in recent months is fairly typical of what we see toward the end of the second year of expansion: housing has run out of gas, insofar as an upturn, and we have had an inventory adjustment. Go back to years like 1962, for example. I remember; I was at the Treasury. There was real concern that we were going into recession. For some reason, after the Cuban missile crisis, consumers decided to up their spending. Maybe they were happy to be still alive. I don't know what the connection was, but the recession of '62 disappeared very rapidly. I am encouraged by signs that I see in the financial markets in response to what we have done already. There is strength in the stock market; I am very impressed at the response in the long-term bond market, where we have gotten more bang than I expected we would get. And so far as the consumer sector is concerned, the Michigan Survey of consumer confidence, which had been tending to show some deterioration in the last six months, turned up again pretty substantially in the month of June. So, it just seems to me that the level of pessimism around here is a little beyond what the situation merits, and that is one reason our forecast is significantly higher than the Board staff's forecast.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, without getting into the issue of whether or not 2-1/2 percent growth is enough or whether or not we can do anything about it, our forecast is quite parallel to the Board staff's--a touch on the higher side. The unevenness that we have had in the District continues, and at this point there is no reason to expect any fundamental change in that between now and the end of the current cycle, particularly in light of the high value of the dollar. Many of the companies that are in the heavy capital area really don't think that they are going to get back to the levels of 1978 and 1979. But there are other parts of the economy--autos, for example--that are doing well and as I talk to people about next year they continue to think they are going to have a good year next year. Residential building is going to be strong. Many retail people think that this year will continue to be good and that next year will be good. There are some risks out there. I won't belabor the agricultural problem, at least at this point. But I do think that as we look at it, the opportunity for a continued expansion at about the rate that is forecast is entirely reasonable. We are doing this against the background of a highly stimulative fiscal policy and a monetary policy that I think is at least accommodative and, as a consequence, at this point the risk of a recession or any significant downside run from the forecast is somewhat unlikely. Therefore, I agree with Mr. Morris that the opportunity is for a continued expansion, perhaps at about the rate that is suggested.

CHAIRMAN VOLCKER. You have a forecast very close to the staff's on real GNP; you're quite a lot higher on prices.

MR. KEEHN. Right. If we have any bias, it's that the inflation rate will be higher than the staff is suggesting. Our GNP number in terms of real growth is just a touch on the higher side.

CHAIRMAN VOLCKER. Why are you pessimistic on prices?

MR. KEEHN. Well, I think the exchange rate situation is likely to turn around a little; it seems to me that there are some underlying pressures there that will add to prices. And, frankly, it does seem to me that we have a monetary policy that provides a background in which the opportunity for price increases is really there. Over the last two or three months we have put a lot of money into the system and, if history is any guide, that ultimately ought to result in a higher level of prices.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Well, I agree with the more positive tone that seems to be developing. Our forecast is for more rapid growth than the staff has for both this year and next. While it differs in various bits and pieces, I think the critical difference is in the consumer sector, in consumer spending. Underlying that is the fact that I am impressed by some of the things that we have already talked about: the wealth effect stemming largely from the run-up of stock prices; the effect stemming from declines in interest rates; the pent-up demand that may or may not be satisfied. My own view is that I doubt that the last couple quarters have gone all that far in eliminating a lot of that [demand]. So I come out on the more positive side, largely because of those things and because I think that we have been reasonably accommodative as well.

In the District, there seems to be very little that's new. The two-tiered economy continues with a vengeance. The one thing that is new, and does concern me, is that the preponderance of the anecdotal evidence does seem to be becoming more negative, and it's not confined entirely to agriculture and mining. If it were confined to those sectors, I would certainly expect it and believe it. But some of that negative tone in the anecdotal evidence, I think, is a bit of something that feeds on itself. You hear about layoffs in high-tech companies or one or two of the computer firms and you get the impression that employment is dropping, net; and yet you look at the data and [don't see it]. I know of at least one firm where, yes, they have laid off some people in their peripheral operations but their total employment is up because they have a main-frame operation that is doing very well. What gets covered and what gets commented on are the layoffs; and what gets lost is the growth that is occurring elsewhere. So I am inclined to temper that somewhat more negative tone to the anecdotal evidence a bit, based on the numbers. The unemployment rate in the Twin Cities is 3.8 percent. Everywhere you go there are help wanted signs up. That [area] accounts for about 1/4 of the people in the entire District and certainly more than that in terms of non-agricultural economic activity.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Well, with regard to the outlook, our staff is also somewhat more optimistic than the Board staff, starting with the second half of this year and running all through 1986. We would expect, starting with the quarter we are now in, that the growth rate of real GNP would be something over 3 percent and that 1986 would come in at 3.4 percent. Certainly, we are not great optimists because somewhat over 3 percent isn't exactly something to write home about in terms of rates of growth, but at least it is not quite as bearish as the Board staff's forecast, which may still turn out to be correct. I

am just giving you what our staff thinks. The differences, with which I concur, seem to be that our staff is expecting a somewhat stronger picture both in consumption as well as in business capital spending, in large part because of the lagged effects of lower interest rates and greater availability of money and credit. Time will tell whether this modestly more optimistic view is right or not.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, our forecast is pretty much the same as the Board staff's; I don't know whether that puts me in the optimistic or the pessimistic camp. I guess I am a little confused because I think that there is more uncertainty in the economy now than we have seen in a while. Talking to people around my District, I sense that while the situation continues to be pretty good in everything except the manufacturing and agricultural areas, there is a perceptible change of attitude toward more uncertainty and more apprehension of a downturn. I cannot quantify why that is taking place, but that is clearly a sentiment that is coming through to me. If anything, as I indicated before, I am concerned about the growth of debt and delinquencies. I also think, if we are going to face lower capacity utilization in the economy, that we could very well get less business-fixed investment than has been forecast. So I think the risk is perhaps on the down side. I would be surprised if economic growth turned out to be much higher than my forecast and the Board staff's forecast. On the inflation side, again, we are not terribly far off. Frankly, I don't see--outside of an abrupt change in the exchange value of the dollar--where inflation is going to come from in the near term; so my concern about inflation has abated to some extent.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I am glad to be at or near the end of the ones to speak because I was a little depressed with the earlier conversations, and I was delighted to hear Frank Morris and others come forth with a little more optimistic view. Our forecast is very close to the staff's forecast. My staff would suggest that the risks are more on the down side than the up side and I guess I don't totally share that view. It seems to me that the two-tiered economy that has been spoken about--not only in Gary Stern's District but in mine and others that are predominantly agricultural and mining-related--is certainly there. But looking on a national level, I am more inclined to believe that we have experienced a pause in the first and second quarters. With what the Federal Reserve has done in conjunction with the very stimulative fiscal package, it would seem to me that we could look forward to some better growth in the latter half of this year and well into 1986.

But I don't want to minimize the impact of the two-tiered economy. It seems to me that one of the greatest risks that we may face is the instability in the financial system. As Jerry has noted, there is a lot of liquidity; but when you look at agriculture and mining and the prospects for a further drop in oil prices, which impacts the producers in the United States largely in the Texas, Oklahoma, and Wyoming areas, the prospects for financial instability that can throw this forecast askew seem to me to be very great. And that is one of my greater concerns--not whether 3 percent is right or 2-1/2 percent is satisfactory, but what may happen in these other

areas, particularly in the financial area. I am not at all convinced that what we have done up to now isn't about enough to stabilize the situation; to do more may translate into prices rather than stability to that system. In other words, I am not sure that the Committee can do a lot to fend off those kinds of uncertainty.

MR. PARTEE. Would you think things are still deteriorating in agriculture?

MR. GUFFEY. Indeed they are, Chuck. As a matter of fact, if I may, let me give you some facts. As far as the crops, wheat is being harvested now and is largely out in the mid-section, going on north. But the commodity prices are falling. For example, the commodity price of corn was some 21 percent below the price of a year ago; the price of soy beans is down 15 percent from a year earlier; winter wheat, which is just now being harvested, is down 9 to 10 percent from a year earlier; fat cattle are down 18 percent from a year earlier. It's these falling commodity prices that are worsening what has happened in the farm credit area, which has been fairly stable over the last month or two. You haven't heard much about it. It's simply because they are in the field and the real crisis isn't going to surface until the fall. But my own view is that that crisis hasn't passed and is indeed going to worsen as fall and winter approach. We are going to find that growing back in spades in the financial sector, particularly in agricultural banks and the Farm Credit System.

CHAIRMAN VOLCKER. Mr. Boykin, you can tell us about the energy business.

MR. BOYKIN. Well, [when Roger] was talking about commodities, he didn't mention cotton. We grow a lot of cotton down our way, but the price of cotton is down from 70.6 cents a pound in May of last year to 49 cents a pound.

CHAIRMAN VOLCKER. All those inflationary pressures!

MR. PARTEE. That's a big drop.

MR. BOYKIN. That is a big drop. On the energy side, the rig count numbers were down about 25 percent from a year ago, which is fairly significant. I noticed in the staff's forecast [an oil price drop from] $26 to $24 a barrel. The talk among the bankers--those who are lending in the energy business--is that they think they could manage fairly well down to $25 a barrel or possibly $24 a barrel. Now, last year they were saying that was extreme--that they'd have a hard time going down that far. Now they have decided that they could manage a little better going down there. But the energy side is very, very uncertain. My own view is probably a little more optimistic than the Board staff's. I am inclined to line up more with Frank Morris; I don't know whether it's just out of habit! Our problem is that we are adjusting mentally--or I am adjusting--to what's happening in the rest of the country. We are about where the rest of the country is, which puts us in a rather unusual position--at least for the last ten years or so.

I think a lot has been done in terms of interest rates and in terms of money growth. I personally don't have a great deal of

concern that we are going to fall into a recession. What is an acceptable rate of growth? I know we are not debating that, but 3 percent or so certainly by historical standards has been close to the long-run trend. It seems to me that, given where policy has been, the Board staff's forecast is reasonable. As I say, I'd probably put it slightly higher and I think most of the reasons already have been stated, one way or another. I still have some confidence in the consumer; I have confidence on the housing side.

Now, commercial real estate construction I obviously have a lot of concerns about. All I know is that I still see holes being dug--figuratively speaking, probably. I hear about the concessions that are being made in real estate. We have been sampling the local market because we are going to have to lease some more space. At least on the first go-round, it doesn't seem that optimistic when we talk to them. Now, we haven't gotten down to horse trading, so that's probably different. I remember we were looking for space this time last year and we will be for a number of years! [Laughter.] Last time, I made three final decisions! When you talk the first time, everybody tells you what their deal is; then when you tell them you are not going to take it and you are ready to take another deal all of a sudden they say: "Yes, but you haven't heard the best deal." We finally had to shut it off because we had to go ahead and make a commitment. I do agree that there are going to be some serious problems. But at least in terms of construction activity, it is continuing to show some strength. If you talk to an individual developer, he will tell you his project is all right: There is a lot of equity in it and his firm is prepared for the long term and he is worried about the fellow down the street. And I haven't run into the fellow down the street yet!

CHAIRMAN VOLCKER. What equity in it? The equity is a loan from the bank! We have a strategy for you, Mr. Boykin: You are going to take one of those deals where you get three years called "free rent" and then we'll let you build a building three years from now!

MR. RICE. Well, Mr. Chairman, I agree that there seems to be some conflict between the anecdotal evidence and the figures as you try to make some sense out of them. On the anecdotal side, most of the people I talk to and most of what I read suggest that the economy is a lot weaker than one would expect. On the other hand, trying to make some sense out of the figures, one gets the impression of less weakness and some improvement, at least in the short run. While my forecast is on the weak side of the range, I should explain that it does hide what I see going on between [now and year-end]. My forecast was influenced by what happened in the first part of this year: the first two quarters of the year came in very low. But in the second half of the year, I see the economy expanding at least at a 3 percent rate and maybe as high as 3-1/2 percent. The reason for that is that, looking at the numbers, it appears to me that it is hard to find any large component that is going to be weak for the next six months. The business fixed investment outlook is pretty good for the rest of the year. Business plans seem to be pretty firm, from 9 to 10 percent nominal. Despite the overbuilding in office buildings, the numbers for non-residential construction are strong and contracts for non-residential construction seem to be holding up their strength. So apparently growth in that area is going to continue at least for another six months. And I am not at all convinced that consumption

expenditures are going to slow down to the extent that the staff forecasts; I am not entirely convinced that the pent-up demand has been entirely satisfied. There has been a very strong increase in employment in the first half of this year and that may well influence consumption expenditures through the rest of the year, so consumption may well hold up higher than the staff forecasts. So, my forecast is upbeat for the second half of the year. Averaging it with the first half of the year brings it out on the low side. And this strength in the second half, in my view, carries over into the first half of 1986. But then as 1986 proceeds, I [would expect] increasing weakness because (1) the expansion matures, and (2) as time goes on consumption expenditures are more likely to fall in line with disposable income, which has been declining and probably will continue [to decline]. Eventually, non-residential construction is going to peter out as we move toward the second half of 1986. And in the absence of any stimulus--and of course the net new fiscal stimulus gets weaker and weaker as time goes on--it is hard to see where stimulus for continued growth along a 3-1/2 percent path will come from, especially in the last half of 1986. So, I would expect the economy to be expanding in the 3 percent range in the first half of 1986 and petering out very noticeably in the second half. Again, averaging the two halves, 1986 comes out low as well. So, my overall forecast for 1985 and 1986 looks low, but it does mask fairly credible performance for the second half of this year and the first half of next year.

CHAIRMAN VOLCKER. I don't want to suggest that everybody has to defend their differences in forecasts here; they are all in a very narrow range.

MR. WALLICH. Having listened to the forecasts, which is the principal function, I do think that we haven't done a great deal in terms of evaluation of what these forecasts mean. The rate of growth, at 2-1/2 to 3 percent, is not great. It's not going to get us back to full employment. But it's at about our long-term potential; at that rate we are going to continue to expand more or less with a constant rate of unemployment. The rate of unemployment of a little over 7 percent is not good, but it is not very far from what most people think is the so-called natural rate of unemployment, the non-accelerating inflation rate of unemployment. We can gain maybe 1/2 or 3/4 of a point to 6-1/2 percent or so, but that is all. Now, the one number that I think is totally unsatisfactory is a 3-1/2 to 4 percent rate of inflation. That is quite abnormal in terms of the historical inflation level of the American economy. It's abnormal in terms of the inflation levels that are tolerated in industrial economies abroad, if they regard themselves successful in this respect. I think the inflation rate cannot be accepted as satisfactory--inflation simply defined as a continuation of a going rate with the going rate being, in effect, acceptable. I think the main shortfall in these three variables we are looking at--the rate of growth, the level of unemployment, and the rate of inflation--is the rate of inflation.

MR. PARTEE. A lot of people would say unemployment, Henry.

MR. WALLICH. There isn't much to be gained; unemployment is high in structural terms.

MR. PARTEE. Well, if it came down to 6-1/2 percent, we would have a very considerable increase in the number of employed.

MR. RICE. I agree with you, Henry, but what do you do about it?

MR. WALLICH. Well, we're evaluating risks. The risks on the down side seem rather impressive; the possibility of a breaking-out on the up side in real terms doesn't strike me as very likely. Nevertheless, given the unsatisfactory inflation rate, I think we should not back away from the risks on the down side in order to get a lower rate of inflation--or particularly avoid getting a higher rate [of inflation], which is likely to be the consequence of aiming for a higher rate of growth.

CHAIRMAN VOLCKER. The comment made about the budget earlier is reinforced by the fact that I now read that Mr. Stockman has resigned as Director of the Office of Management and Budget. It's not encouraging to think that we'll have striking new vigor toward budget cuts. We are going to have a difficult arithmetic job, if nothing else, to explore everybody's ideas and where all of these targets should be. There are umpteen different variations; I am a bit concerned about the time. I think perhaps we ought to spend time this evening having Mr. Axilrod explain to us all about the money supply.

MR. AXILROD. I'm afraid I may not shed any more light than was in the 40 or so pages of various documents dealing with this problem that were circulated to the Committee.

CHAIRMAN VOLCKER. [Your report] might be more condensed.

MR. AXILROD. It will be more condensed. [Statement--see Appendix.]

CHAIRMAN VOLCKER. I think that we should not try to get into a discussion of just where to set these targets for the short-run policy at the moment, given the time [of day]. But I think we have a little more time for any questions or comments people want to make about the kinds of issues that were raised in the paper that Steve distributed and touched upon in his comments as a kind of a philosophic background to the discussion.

MR. WALLICH. Could I ask a question, not having read the paper as carefully as I should have, because I just came back? The principal conclusion seems to be that we have had another shift in the demand function for money, that we have no strong reason to think that it will move back, and that we should in a sense let by-gones be by-gones. My question is: How likely is it that this was an episode such as we have had at times in the past and that from here on out there will be a higher degree of stability in the relationship of M1 to the economy--not necessarily at the old velocity, but maybe at a velocity that is rising less rapidly than before? Is it likely that we might have that so that we could go back to targeting M1 at moderate rates, or would we have to anticipate continued or repeated incidents of this kind that would make the variable quite useless?

MR. AXILROD. Well, as a minor point, I think you have to anticipate it in the third quarter, given what has happened. It's not impossible to have it, but it would take a very sharp drop in demand deposits in July or August to produce a third quarter that isn't as high as the roughly 10 percent that we are projecting. That assumes 5

or 5-1/2 percent growth, month by month. So I think you have to anticipate an unusual looking third quarter in terms of velocity unless the GNP comes roaring back. Over the long run, Governor Wallich, it is true that the paper implies that this could be a one-time drop in velocity. It didn't say for certain, obviously. And that was really on the assumption that the present level of nominal interest rates would not be reversed and that inflation wouldn't occur, which would bring them up--or in effect that the economy wasn't so strong that that would drive them up either way. In that case, there would be no reason to reverse this velocity. We would go back to trend and not to 5 or 6 or 7 percent velocity to offset that. I don't think that the trend will occur if you did that until the fourth or first quarter or some time like that; it wouldn't occur right away.

But there are two other points I would make, one on both sides. One is that it is not absolutely clear that this present level of real and nominal rates will be sustained on the high side. It could very well drop; it is hard to think of real rates of return as high as these present real market rates seem to be. On the other side, however, we have done various charts using various lags relating money to GNP showing that they correspond reasonably well; and we have had times of large money growth followed by large GNP growth. That did happen in the 1982-1983 period, but we were operating at such a low level of the economy that we had more in real GNP and very little in price. Now we are operating at a much higher level of capacity, as you mentioned or implied. If this were going to be followed by a burst, one would expect it to have a little real effect but a little more price effect. So having looked at those charts, I felt somewhat ambivalent. I would not in any way want to think that it was an absolute dead certainty that we had a one-time drop in velocity that was not going to be at least somewhat reversed. I just don't feel that certain about it in my own mind.

MR. BLACK. Just a question of clarification, Steve. I thought at first that you were referring to a shift in the demand for money, but as I read it more I thought you were talking about a movement on the existing demand curve for money, weren't you?

MR. AXILROD. That right. The models don't explain everything. In fact, if you read the residuals, you could say to yourself that there's a 2 or 3 percentage point upward shift in demand for money. But I wasn't stressing that. I was stressing the impact of the interest rate decline itself in relation to the elasticity.

MR. BOEHNE. I have just a few comments. One is that I thought the paper was excellent; it was very thought provoking. I have a couple of questions. As I read it, I came away feeling that your conclusions were more tentative than Henry implied--that you had a feeling and a fair amount of circumstantial evidence that there is something wrong with the relationship of M1 and the economy, but that is was fairly difficult to prove that with any great certainty.

MR. AXILROD. That's what I was trying to say.

MR. BOEHNE. My other comment is that you based a good bit of what you are thinking [on the view] that we are moving from one level of real interest rates down to another level and that that is affecting velocity, which is quite plausible. Is there some symmetry

to this on the other side? In other words, in the 1970s and early 1980s when real interest rates were rising did we also see movements in the opposite direction in velocity?

MR. AXILROD. Well, I am not sure it looked that dramatic. I really haven't checked it out in the detail that you are suggesting. We saw it to a minor degree in late 1983: the movement in velocity was somewhat higher because of the interest rate increase, and it was rather consistent with what our models were saying. If you look over the whole postwar period, where I feel a little more secure than the models, we tend to believe that about a point or more of the trend velocity over that period of 3 points or so is explained by the rise in interest rates over that period. They enter the model with those sorts of effects. In any particular period we'd be off because of the model misses and the shifts. But I can't really respond to the very particular period of the 1970s and early 1980s.

MR. BOEHNE. Well, my main point is not such a specific question. It is that it would strengthen the argument, I think, if there were some symmetry to it.

MR. AXILROD. I think there probably is.

CHAIRMAN VOLCKER. The model is symmetrical.

MR. AXILROD. Yes, the model is symmetrical. I was trying to think of history. The basic issue is that if you go from 10 percent price inflation to zero and the interest rates go from 13 to 3 percent consistently, you would expect a big increase in the willingness to hold cash. The question is how to satisfy those cash holders who now feel that the opportunity cost is such--3 points instead of [13]--that they might as well hold cash. It seems to be happening lumpily as we phase down. So, if we ever get to price stability--it may not happen but if we ever did--I would expect another instance or two of this kind as the nominal rates dropped down, unless in 1986 when we free up the ceiling rates on NOWs and super NOWs we get just parallel movements in those rates. They won't ever be just exactly parallel rates because of reserve requirements. But if you had actually parallel movements in the offering rates and the market rates, you might not get this phenomenon. It's that possibility that makes us think the interest elasticity will become less as you go on, so that this phenomenon might not be so pronounced when you get into that period.

CHAIRMAN VOLCKER. Mr. Melzer, first I would like to take the opportunity to welcome you to these deliberations. We look forward to some clarification of all these doubts that others have expressed.

MR. MELZER. Thank you. Steve, I had a question in terms of comparing the present situation to the 1983 period--where we not only had a decline in rates but also had the account innovation--whether that represents a substantive difference in terms of the analysis. I would think, certainly in terms of the perceptions of a rebasing, that it might be more difficult at least from a layman's point of view to rationalize a rebasing at this juncture than it was at that point.

MR. AXILROD. Well, we were closer to the account innovation that affected M1 at that time but it had gone on for some time. In

any event, now we are a little further away except for the drop from $2500 to $1000 in the minimum balance, which we don't think had a significant effect. I think the economics of it are roughly the same; whether the public relations of it are the same is [another question]. I am not sure that it is all that different, even though you probably can--

CHAIRMAN VOLCKER. We claimed at that time when there was a lot of innovation that it affected M2 and M3 more than M1.

MR. AXILROD. We had that February-March base for M2 and M3 and we said that we now had a build-up of nationwide NOW accounts and it was beginning to have this effect. This wasn't the introductory period; it already had been built up and, being there, it was having this effect. But, of course, the very latest strength in M1 is in currency and demand deposits.

MR. PARTEE. There is not much innovation to refer to this year.

MR. AXILROD. That is the point of this paper: it wasn't the [current] innovation per se that might have increased the elasticity; it was the impact [of declining interest rates] on the elasticity that could do it.

MR. PARTEE. Yes. It could just be an argument that with the rate of inflation down and inflation expectations declining, why, it is a better bet to hold money.

MR. MARTIN. And interest rates [down].

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Steve said a minute ago that these models don't explain everything. I think of that as an understatement of some proportion! I am not sure that they explain anything to me anymore. But looking at M1 right now, it seems to me, abstracting at least a little from all the models, that one can draw one of several conclusions. One is that history is history and down the road we're going to get more nominal GNP or more inflation or both; but none of us seems to see that. The second conclusion is one that Pres just mentioned: that what we are seeing is an adjustment taking place, reflecting fundamentally the shift going on in the economy to lower nominal interest rates and lower rates of inflation, which could quite conceivably be very plausible in the context that it leads to some lower secular growth of velocity. That, in turn, would mean that whatever we thought to be an optimal growth in M1 is now higher in some permanent way than it once was. The third explanation is that there is something to these technical shifts, whether due to innovation, or to changes in spread relationships, or even to something like this E.F. Hutton situation. I personally do not rule out the possibility that the Hutton situation has had an impact. I won't say that other firms' practices are exactly parallel to Hutton, but anyone who thinks that those types of cash management practices as a general thing are limited to one or two firms is being quite naive. And anybody who thinks that those firms who might have been doing the same general kind of thing are going to tell you about it is very naive. But I think that one has to allow for those types of

possibilities, whether due to financial innovation or other types of phenomena. Of course, the difficulty with those things, if they are there, is that we can't quantify them; we can never be sure what they mean. And in the short run they certainly do mean that velocity and demand for money, neither of which is quite the same thing, are going to bounce around. And at the extreme, the conclusion that you have to draw is that this velocity or money demand relationship is just shot and money is no longer any good as a policy variable. As a practical matter, I don't think we can afford that conclusion even though some of us may like it. Because if you don't like money, you have to find something else to use as a policy variable. Where I come out is that both for practical and what I at least would consider to be theoretically attractive reasons we have to work with some combination of the second and third things that I mentioned. And within that framework I agree with Tom that it may be more difficult today than it was in 1983 to make the case for jiggling around ranges or bases or something. But as a practical matter, I come out to the view that we don't have any choice but to be thinking in that broad direction, without prejudging exactly how that should be done.

MR. PARTEE. It's potentially dangerous to change the base, isn't it? If I understood Steve, we don't know that this--whatever it is that is occurring--is over. If it is occurring, it may continue; and in fact it seems likely to reflect itself in the third quarter. What is [M1 growth for the quarter], 10 percent?

MR. AXILROD. Yes, that is in large part a carry-over of the second quarter.

MR. PARTEE. I understand that. And then it could be much higher.

CHAIRMAN VOLCKER. I don't want to get too deeply into those precise questions now. Mr. Balles.

MR. BALLES. Mr. Chairman, I would like to set forth the case for rebasing--and I think there is a pretty good case for it--and then ask Steve a question. Admittedly, the circumstances are different now than they were in 1983 and the technical justifications for the rebasing may be somewhat different, but I think it is still pretty solid. We have had extraordinary circumstances here; in part, the rapid growth that we had in the first half of this year in M1 could be viewed as a catch-up from unusually low growth in the second half of 1984. Certainly, in the case of the San Francisco analysis, the drag on the economy caused by the net imports was much bigger than we had anticipated. That, in turn, has depressed activity and required, I think, an extra surge of money to take care of it. But given that set of biases or set of preconceptions that I have and given the tough job that you have--you would have to explain to the Congress and hence to the whole world why we are rebasing or raising the range--I would like to put a question to Steve. If it is putting you on the spot, Steve, just say so. In terms of the adverse risk of either raising the range or rebasing--adverse in the sense that it might cause some people in the country such as savers, investors, and so forth, to view the Fed as now off on a kick of monetizing the federal debt or giving up somewhat on its battle against inflation--which would you view as having the least risky impact?

MR. AXILROD. I found it impossible to try to discern a big difference in public psychology. I think the main risk is in doing either and not hitting it. Just to remind the Committee: In 1983, the [range] at the beginning of the year was 4 to 8 percent; growth in the first half was 11.9 percent; it was rebased to QII to QIV to a 5 to 9 percent growth rate and that was hit. By the time we reseasonalized and everything, the growth in the second half was 8.4 percent and for the year was 10.4 percent. Then, the next year, the range of 4 to 8 percent was hit. So, the Committee wasn't repeating the experience after the mid-1970s where it was rebasing every quarter and the range was missed every quarter. To me, the main problem wouldn't be whether to raise the range or rebase; the problem would be that it would be very desirable to hit it if you do [either], so that it does not set in motion--

CHAIRMAN VOLCKER. We said that was only a monitoring range.

MR. AXILROD. Yes, but it was hit nonetheless.

MR. MARTIN. I think it has been very well said by Tom and others that we do not have quite the rationale in this period of time that we had in 1982-83 with regard to the number of new instruments, new minima, new rates, and less rate control. On the other hand, we have had the passage of time and we are aware that cash management techniques continue to be employed--perhaps some ways outside the three sigma limit, as in Hutton's case. At any rate, those institutional commentators who are likely to react to a rebasing, I argue, are themselves cash managers, and they themselves are shifting funds, even as individuals, between and among their firms' interest-bearing or noninterest-bearing accounts. So, I think there is a chance to appeal to the day-to-day experiences of the financial managers and the financial commentators that there is indeed this relationship between the holding of assets with varied degrees of liquidity as a characteristic and the changes in the levels of interest rates. Furthermore, I think there is the Hutton phenomenon that is more widespread than perhaps is obvious. I agree with Jerry in that regard. Furthermore, we rebased to take into account changes in institutions and interest rates once before, in very recent experience. This rebasing was not followed by an augmentation of inflation; indeed, if anything, there has been a little--I'm agreeing with Henry that it's unsatisfactorily little--disinflation that followed. So it seems to me that there can be an appeal made to what people and institutions and financial managers are doing themselves following changes in interest rates. There is a common sense kind of [case] that can be made to justify and explain and communicate the rebasing that I think is necessary here. And I think it is important that that be done because I am hopeful that there will be additional changes in the interest rates. While the elasticity may diminish--I have no problems with that as the spreads and the increments get smaller--nevertheless, there may well be an additional impact upon V1 and the other velocities, which we will be able to explain if we are successful in this rebasing.

CHAIRMAN VOLCKER. We have someone distributing some pretty little charts here; I keep expecting someone to comment on them.

MR. MORRIS. That's me. You didn't call on me. Norm was supposed to tell you.

CHAIRMAN VOLCKER. Perhaps I can call upon you and we can pronounce the benediction.

MR. MORRIS. I'd like to refer first to the table at the rear.

MR. PARTEE. When I first saw that table, I figured these were your charts.

MR. MORRIS. We have been trying to describe the deviation of the aggregates from their traditional historical behavior in terms of two things: one, financial innovations; and two, the decline in the interest rates. This table suggests to me that there are other factors of major consequence involved in this situation that we don't understand. I refer you to total liquid assets, L, and call your attention to the fact that the behavior--the deviation from the 1970-1980 trend--is very similar for total liquid assets as it is for the monetary aggregates.

CHAIRMAN VOLCKER. I can't understand what these numbers are; perhaps you can explain.

MR. MORRIS. This is a cumulative deviation of the velocity of these various aggregates.

CHAIRMAN VOLCKER. Cumulative deviation from the trend line established earlier?

MR. MORRIS. Right, from the 1970-1980 trend line. Now, total liquid assets should not be affected by financial innovation because all of these new instruments are presumably included in the aggregate and switches among them really don't have any effect. Secondly, I have not been able to figure out any reason why a decline in interest rates should lead people to want to hold more liquid assets relative to nominal income. In fact, I think you could argue--thinking back to my investment days--that you would get the opposite effect; that is, the decline in short-term rates should lead people to push into longer-dated assets in order to try to maintain their yields. But the fact is that the movement of M1 velocity, although the amplitude is greater, is year to year very similar. We have, I think, in the case of total liquid assets a deviation from historical experience that cannot be explained by anything that I have been able to think of, which suggests to me that from a philosophical point of view, something is going on here that we don't know much about. This should lead us to conclude two things. One, I think, is to try to explain to the public that we can't run a sensible monetary policy by blindly following any of these [monetary aggregates] because we don't know what rate of growth in them is going to be compatible with a reasonable economic performance. The second is, that if we have to publish ranges, we should have a propensity to broaden the ranges, because I think quite clearly that we have a problem in trying to use any of these, blindly, as a guide to monetary policy.

Now, my second point: Steve's paper--and I thought the paper was very well done--argues that super NOW accounts have tended to reduce the interest elasticity of M1. My conclusion is quite the opposite: that the way the banks have priced them in fact has led to super NOW accounts increasing the interest elasticity of M1. The

first graph shows that the banks have been fairly responsive in adjusting the money market deposit account rates to changes in the market rate. I'm comparing them here to the money market mutual fund rate. Therefore, I think you can conclude that M2 is now much less interest sensitive than it used to be. And I think the behavior of M2 recently has suggested that. If you look at the way the banks have priced super NOW accounts, you would have thought there was a Regulation Q ceiling of 7-1/2 percent on super NOWs because there was no response to this big run-up in interest rates. Now, if the banks are going to continue to price super NOW accounts in this fashion, then you can expect that the super NOW is going to increase interest elasticity of M1. If you look at the last chart, the top shows the interest rate spread between super NOW accounts and money market mutual funds and the bottom shows the growth rates of super NOW accounts. During the summer of last year the spread had reached around 3 percent against the super NOW; super NOWs were priced about 3 percent below money market mutual funds and the rate of growth of super NOWs dropped to a 3 percent annual rate. These are over three month spans. When the spread closed up again, with a decline in market rates, the rate of growth of super NOWs moved from a 3 percent to a 45 percent annual rate. I submit that, at least until the banks start pricing their products differently, the super NOW account is going to increase the interest elasticity of M1 rather than reduce it.

CHAIRMAN VOLCKER. You're permitted a brief rebuttal, Mr. Axilrod.

MR. AXILROD. Well, we're in some sense talking about the long-run not the very short-run elasticity. In the very short run, there are obviously lags. Secondly, they have been adjusting the rate downward even though they don't adjust it upward and I don't know what point they are going to get. Thirdly, they are adjusting it and that is different from the NOW account ceiling rate, which isn't adjusted, so you get a bigger impact on that, which compares to super NOWs.

MR. MORRIS. But if they were only adjusted downward, the effect is going to be much like the old Regulation Q ceiling. If they don't respond when market rates rise, we should expect that the regular super NOW will drop very sharply.

MR. AXILROD. I do not know what would happen if market rates began rising from the current level. I suspect that might be.

CHAIRMAN VOLCKER. You are permitted to discuss that between you men. I would like to make one observation in closing for the evening: What we are struggling with is not exactly unique in the central banking world these days, or recently. In many ways our situation resembles what the Swiss had in 1978 when they said the Swiss franc, in their judgment, was getting way overvalued. And finally they said: The heck with monetary targets; we will operate under the exchange rate. M1 went up 21 or 23 percent that year; I am not sure whether they are happy in retrospect or not. They still have a pretty good inflation record relative to others. I am sure there is no cause and effect but the Bank of Canada, for the inverse reason I guess, gave up monetary targeting a couple of years ago and their inflation rate promptly sank for the first time in 10 years. The English are apparently debating right now whether to abandon the monetary targets or not, again in favor of the exchange rate. This

debate is proceeding on an international scale. We will see you at 9 o'clock in the morning.

MR. BERNARD. 9:30 a.m.

CHAIRMAN VOLCKER. I think we better make it 9 a.m.

[Meeting recessed]

July 10, 1985--Morning Session

CHAIRMAN VOLCKER. As I sat here and listened yesterday, I did not detect enormous differences about the short-run outlook, although I think there are a lot of uncertainties. I do think that we somewhat neglected in our discussion the rather large problems of why, as a practical matter, we have some enormous disequilibria in the economy that we are dealing with. We can't save enough to finance all of our investment and we have a government deficit; we are buying abroad much more than we sell. I don't think either of those phenomena can last forever, and all of these nice projections that we have assume that the expansion is going to go along rather smoothly without any great discontinuity. That may be right for the next year and it may be right for the next 18 months. I don't think it'll be right forever and I wouldn't count on it for the next year.

We face a very sluggish picture abroad, as near as I can see, with no great growth. I think we will see some growth, but not enough to reduce appreciably their unemployment or increase appreciably our exports. I don't see many signs of change in policy there. We have a lot of financial strains around, whether internally or externally, and they are going to take a long time to cure. We may even break an axle as we proceed in the financial markets. Henry Wallich tells us we still have an inflation problem. People from the farms tell us we have deflationary problems. In the oil area, we have a deflationary problem. Mr. Corrigan tells us we have lots of liquidity. When I look around at all the figures, it looks to me like we have a lot of bankruptcies, which isn't exactly consistent with overflowing liquidity in the economy.

MR. PARTEE. Bad distribution.

CHAIRMAN VOLCKER. Wild distribution; I think that's right. Everybody, seat of their pants, was telling me that the economy isn't going anyplace. The M1 figure tells you it is going to zoom, if you believe M1. So, we have a lot of questions and I don't know how we contribute to the answer to all of these problems. I think the answer is that we don't. We can't magically deal with the budget problem, the trade problem, and the financial problems and cure them all very easily. We can maybe avoid aggravating them. But when I look around and think about what to do in the short run for the moment, I am not sure that we can do much differently than what we have been doing. And I approach the long-run targeting from that standpoint. I would suspect, from what I heard yesterday--you tell me if I'm wrong--that I am not going to be hearing any proposals for radical changes in operations in the short run.

MR. BLACK. How do you define radical, Mr. Chairman? I would like to see that M1 slow down a little.

CHAIRMAN VOLCKER. We would all like to see it slow down. The question is whether anybody wants a tightening action to slow it down. These long-term ranges all depend upon the unknowns of M1 in the short run. If we had one month of zero [M1 growth], it would look better. But we are entering [the third quarter], as you know, at a very high trajectory off of June; and any number we put down is going to be above [the long-run range] in the short run. Well, that's a fact we face. So long as we don't have the base as June--we could do

that, I suppose--we wouldn't be above in the short run. I don't know as anyone proposes that. We could have a base of two months, I guess.

MR. WALLICH. The logic of Steve Axilrod's paper--that there may be successive future bursts of M1--suggests that even if we somehow got around the recent bulge by rebasing, the same thing may happen again. That suggests that we should put M1 back where it was a year or two ago, on sort of a probation status.

MR. MARTIN. A probation status after rebasing as we did just a couple of years ago?

MR. WALLICH. I would just suspend it, so to speak, because there is no point in rebasing M2 and M3 and we are almost forced to give those more weight, even though we don't think very highly of them, because of the failure of M1.

MR. MARTIN. I think if we put M1 in the penalty box now, we will have difficulty getting the door open to extricate it.

CHAIRMAN VOLCKER. Well, I am a little uncertain as to whether we should discuss the short run or long run first because obviously they are interrelated. Let me just test my assumption that nobody wants any radical changes in the short run--maybe Mr. Black is an exception. A radical change I assume is a change in the borrowing target by more than $50 or $100 million.

MR. BLACK. I could probably live with $100 million.

CHAIRMAN VOLCKER. Well, we will have you on the other side; you want a change. Does anyone else want a change of that magnitude?

MR. RICE. I would like to see the borrowing number raised. I could live with less than $100 million, but I would like to see it go up.

MR. KEEHN. I would like to see it up.

MR. PARTEE. I think it ought to be higher.

CHAIRMAN VOLCKER. You all want to tighten policy right now?

MR. MARTIN. I think it should be the same.

MR. RICE. Whether the policy is tightened depends upon what happens.

MR. PARTEE. Well, my observation is that we are getting far too much money with the borrowing number we have and, therefore, we ought to nudge it up a little.

VICE CHAIRMAN CORRIGAN. You don't like to talk about these things, but in some ways the best of all worlds would be to find an opportunity to lower the discount rate and then raise the borrowing up a little.

MR. PARTEE. There almost would have to be an announcement on that--that would be such an extraordinary thing to do.

VICE CHAIRMAN CORRIGAN. I wouldn't do it quite as boldly as I just stated it.

CHAIRMAN VOLCKER. You really don't want to tighten.

VICE CHAIRMAN CORRIGAN. That's right.

MR. RICE. Well, I don't want to tighten either. I want to slow down the rate of growth of M1. I don't want to tighten in the sense of raising interest rates. I don't think raising the borrowing level somewhat at this time actually would have much effect on market rates in the short term.

MR. BLACK. Actually, the level has been above our target for some time.

CHAIRMAN VOLCKER. The actual level has been way above the target a good part of the time. So have free reserves. Who could say that wouldn't happen if we did the same thing again? I've heard from three people saying that they would like to tighten. Does that mean that the other nine don't want to?

MR. MARTIN. I don't want to.

MR. FORRESTAL. I certainly wouldn't want to tighten at this point. In fact, I would tilt a little on the other side.

MS. SEGER. I would too. I would tilt toward something to reduce rates below where they are now.

MR. MORRIS. I think we are in a situation similar to 1982 where we looked around the economy and the only thing that we could find that was really strong was M1. We concluded at that time that M1 was not giving a proper signal and it seems to me that we ought to draw that same conclusion today.

MR. PARTEE. We have had a very considerable increase in business activity [since] then.

MR. MORRIS. We wouldn't have if we had followed the M1 target.

MR. PARTEE. That's true.

MR. MORRIS. We would have had a world depression.

MR. PARTEE. That's true. But the question is: Can we afford that much of an increase in business activity now?

MR. MORRIS. I think we can afford quite a bit.

MR. MARTIN. With 2 percent real growth, we could afford something, surely.

MR. PARTEE. Well, that's certainly true. Can we afford 10 percent?

MR. MARTIN. A 10 percent increase over the two percent? Sure. That gets you to 2.2 percent!

CHAIRMAN VOLCKER. I would not have thought anyone would think 10 percent was likely.

MR. PARTEE. I don't think it's likely. It's very difficult. One would have to disregard M1 altogether.

MS. SEGER. That's a good idea.

MR. PARTEE. No, I don't think it is a good idea. I don't think the experience of the postwar period suggests that it is a good idea.

MR. MORRIS. I question the relevance of the experience of the postwar period. I think the experience of recent years shows that it has taken more money, more liquid assets, and more debt to generate one dollar of nominal GNP. The old relationships are not holding up, and at some point in time we've got to recognize that.

CHAIRMAN VOLCKER. First of all, I would say that I don't know what the answer is. Obviously, we went off course in May and June from what was expected. Maybe that will continue and maybe it won't. The best staff input that we have says that roughly unchanged reserve paths will be reflected in a markedly lower M1 growth rate.

MR. RICE. It's still unacceptably high.

MR. MARTIN. I think we have to be very careful with May and June, particularly June. We go back and revise, revise, and revise. My goodness, that June could be like May or whatever it was last year: it could come down when we revise.

MR. PARTEE. What's the first six months: 11 percent?

MR. AXILROD. 11-1/2 percent from December to June.

MR. KEEHN. What's the outlook for, say, July?

MR. AXILROD. Well, our estimate--and it is subject to quite an instant revision because we are getting more data here very quickly--is on the order of 7 percent. A range of 6 to 7-1/2 percent or something like that is a good way to think about it, given what I know about the very first week. But I will know more shortly.

CHAIRMAN VOLCKER. The fact is that we don't know; we never know. But it would not be unlike all experience if we had a month here of something [near] zero at some point. I don't know why demand deposits are so high; it's the most intriguing part. Good ole demand deposits seldom jump around that much. I don't know whether it has anything to do with E. F. Hutton or not. There is no evidence for it, but one wonders a little. If it does, we ought to allow for it. If it doesn't, past experience would suggest that it is going to go down at some point.

MR. RICE. Didn't that happen in 1980?

CHAIRMAN VOLCKER. Didn't what happen?

MR. RICE. Well, we had this big jump in the money supply and then we said it couldn't possibly slow down enough. I may be wrong on this but, as I recall, money started expanding very rapidly.

MR. GUFFEY. That was when we had credit controls--in the spring of 1980, I think.

MR. RICE. Yes, we did have credit controls.

CHAIRMAN VOLCKER. The latter part of 1980 was certainly a period where we kept underprojecting the money supply; it kept rising more rapidly in the latter part of the year than we anticipated. There's no question about that.

MR. RICE. That's right. It was the opposite. We said that it couldn't possibly increase at the rate it turned out to increase.

CHAIRMAN VOLCKER. That is correct. Last fall it kept increasing less than we anticipated. So you can take your pick of experiences.

MR. BOEHNE. One prudent way to move forward, if we really don't know quite what to do, is to go forward staying about where we are, keeping a very open mind about what we do three, four, five weeks from now, depending on how the economy comes in and the money numbers come in.

CHAIRMAN VOLCKER. That's about the way I would read it, yes.

MR. MARTIN. I'd certainly concur.

MR. WALLICH. I would agree with that. It seems to me it's a mistake to chase half-heartedly after M1. If we really believed in it, we would have to do something very drastic. If we don't believe in it, it makes no sense responding to it at all. The other two [aggregates] and debt are still high, so maybe a little firmness is justified; but I think that it would be a mistake to subject ourselves to the need to work off the overshoot at a time when the economy is clearly not very strong.

CHAIRMAN VOLCKER. I didn't hear any suggestion yesterday--now, I'm just reading into the comments--that anybody was talking about working off the overshoot.

MR. BLACK. I think the best solution, Mr. Chairman, is to rebase this. It probably surprises a lot of people that I say that. But I'd rebase, in a sense forgiving part of this on the basis that there is probably some substance in what Steve is saying. If we were to rebase, for example, and keep the 4 to 7 percent range and hit the top of that, that would result in an 8.9 percent rate of growth in M1 for the year, which seems adequate even if M1 has changed in meaning. I would think that would be enough liquidity to keep the economy going pretty well.

MR. PARTEE. My problem with rebasing is that we don't know that we have run the end of this string.

MR. BLACK. No, we don't.

MR. PARTEE. If we could rebase on the third quarter--.

MR. BLACK. That's one thing--delayed rebasing--that we haven't considered.

MR. PARTEE. But I think there is a very great danger that if you rebase, it sounds as if you are serious.

MR. BLACK. Of course, that's part of my motive.

MR. PARTEE. And it very well may be that we'll start right out on the high side of any rebased numbers, assuming we rebase on the second quarter.

MR. WALLICH. That is why I think we not only have to rebase, but in some sense qualify [M1] or suspend it because this may repeat itself.

MR. STERN. Yes, why not put M1 back on a monitoring status? In a sense, I would argue that that is where it has been the last couple of months anyway, looking at the directive and the way we have not responded. It's already there, essentially, in my mind; and I suspect market participants have reached that conclusion as well.

MR. BLACK. It would be hard not to; it grew over twice as fast as our target. Of course, they don't know what the target was.

MS. HORN. I would support the point of view also that we put M1 on a monitoring basis. That may come as a surprise to some of you who know that I believe in targeting M1 and in its relation to prices and in its usefulness in the past. I also think it will be very useful to us in the future in the long run in the fight against inflation. But I do think that rebasing or revising the current targets is an indication that we are serious about pursuing those targets. Or at least I believe that when we do set targets for M1, we ought to be serious about them because I think it's that important. And at this point, at least speaking for myself, I don't know where I would like M1 to be in the fourth quarter of this year. It is too early, I think. We don't have the kind of information I would like to have to set the serious M1 target that I would like to set. So, it seems to me that it is most appropriate to say M1 is a monitoring variable right now. The rest of what I would like said is that we are serious about the long-term battle against inflation and about coming back to M1 as soon as practicable. Our experience the last time we did this was that it was after something like a year that we found we could indeed reemphasize M1. We could indicate that we would hope that at least by the fourth quarter of this year we might have enough information to then reemphasize M1 and conclude on that. For that reason, I would not do anything with the 1985 targets but for 1986 I would reduce the target for M1 to a range of 3-1/2 to 6-1/2 percent, slightly below the 1985 range, to indicate our seriousness in coming back to this kind of strategy as soon as we have some more information.

MR. BALLES. Before we go too far down the road on monitoring, I would just like to raise the question: What do we do

instead? What kind of guides do we have? Are we going to start following M2? Or are we going back to taking the funds rate or relying on money market conditions or--going back 30 years--the tone and feel of the market? We have to have something in lieu of M1, and I think that question needs to be answered before we make a decision on just monitoring M1.

MS. HORN. Isn't the answer "All of the above," John?

MR. BALLES. I'm not sure.

MR. BLACK. Of course, we are not going to know whether M1 really has lost its meaning until several quarters down the road anyway. I think there's a good possibility that it has lost a good part of it, so my inclination is to hedge the bets and assume it has lost some but not all of it. That gets me to this rebasing. But if we are wrong and it means what it used to mean, then we are in for a lot of trouble. I hope it has lost a lot of its meaning.

CHAIRMAN VOLCKER. Let's do the easy part first. What do we do with M2, M3, and debt? The obvious thing is not to change the ranges for this year. The argument, I guess, revolves around M2 and whether we give ourselves a little more room on M2. We're a few tenths above the range now.

MR. MARTIN. We are not above the parallel lines. We are above the cone. We are something like $11 billion under the parallel lines.

MS. SEGER. But our forecasts are running 1 to 1-1/2 percentage points below what we were talking about back in February. If we thought then that these targets were appropriate, then don't they look sort of out of line?

MR. MARTIN. My only comment about February is that I think the Greenbook had the federal funds rate rising to 9-1/2 percent by the end of the year. And 200 basis points does make a bit of difference in growth rates of the aggregates. Was the funds rate 9 or 9-1/2 percent by the end of the year in our February Greenbook? We had the federal funds rising over the year.

MR. KICHLINE. In February, yes.

CHAIRMAN VOLCKER. Oh, six months ago! You're not assuming that now.

MR. KICHLINE. We are assuming interest rates are about flat at current levels. That's the current assumption.

CHAIRMAN VOLCKER. Then that's theoretically consistent with M2 being within the target and M3 being within the target.

MR. MARTIN. My only point is--given the high level of real rates and the difficulty of forecasting the rates and a caveat from Steve's excellent paper--that from time to time there is at least the prospect of real and nominal rates coming down. I think that argues for more flexibility--that is, rebasing to, let's say, a 4 to 8 percent range rather than a 4 to 7 percent range.

CHAIRMAN VOLCKER. I'm on M2 and M3 and debt at this point.

MR. MARTIN. Okay. Sorry.

MR. PARTEE. If we are giving any serious thought to putting M1 on standby, I think it would be a serious error to raise the targets on the rest of the aggregates, which have been reasonably well behaved. Dropping M1 and then raising M2 and M3 would certainly give the impression that we are letting [monetary policy] go to the winds. I think the only way we could possibly say that we are going to watch M1 carefully and do that credibly--and we don't know what all that has been going on means--would be to hold to the [ranges for the] other aggregates that have been expanding reasonably. It's true that credit is above its range; I believe it hasn't increased its excess above the range. And the projection has it generally coming down in the next year.

MR. AXILROD. Our point estimate for credit for the year is 12.1 percent. The range is 9 to 12 percent.

MR. PARTEE. And about 1 point of that is the merger--

MR. AXILROD. Whatever it turns out to be by the time the year is over; it may be less.

CHAIRMAN VOLCKER. We're having a little more of that, I think, than we assumed at the beginning of the year. Does anyone strongly object to that conclusion?

MR. MARTIN. I certainly don't object strongly to that.

MR. WALLICH. No.

VICE CHAIRMAN CORRIGAN. No.

MS. SEGER. Can we ignore, though, the changed forecast for this year? The staff has cut its estimate of real growth from 3.6 percent down to 2-1/4 percent for 1985 and has cut it slightly for 1986 from 2.7 percent to 2.5 percent. And comparing the estimates of the Board members and the Presidents in February to today, those also were cut rather significantly. It would seem to me that we would have to take that into account: that what was appropriate for monetary targets back in February ought to be reexamined if we are perking along that much more slowly and the expectation is for continued sluggishness, using our own numbers here.

MR. WALLICH. In my numbers I took the first quarter as a loss but then pretty much went on with the old quarterly figures I had; I think that is what the staff did too. You could argue that, even so, the economy is somewhat smaller because it did not grow in the first quarter and, therefore, with regard to the money supply that there is more money relative to economic activity. That doesn't seem to me to argue that we should further increase the amount of money--M2, M3, debt, etc.--relative to this smaller activity.

MR. PARTEE. With the same amounts of the aggregates, Martha, and the smaller GNP, one would expect lower interest rates.

MR. WALLICH. Which is what we got.

MR. PARTEE. And that could continue. You could argue that if we have smaller GNP growth, we don't need as much credit as we did before. We get these lower rates, which brings the GNP back up and brings the aggregates up to our previous ranges.

One other comment I would like to make, if I could, Paul: I know we haven't talked much about 1986, but I do want to remind everyone that Reg. Q goes off entirely in the spring of 1986. The staff has said that they do not think it will have much effect. But, boy, it is a pretty wild environment out there when you don't have any limits on anything! All NOW accounts would become super NOWs, by definition. Savings accounts would come back into their own. Who knows what might happen to savings accounts? So, I think we have to have a certain amount of diffidence in talking about what might happen in the aggregates in 1986 because of that event.

CHAIRMAN VOLCKER. Well, let's very tentatively assume that we are not going to change M2 and M3 and debt--we'll go back to look at them--as background to the discussion of M1. Does anybody want to change the range for the year? I haven't heard any sentiment of that sort: to go back to the beginning of the year and just raise the range for M1 for '85.

MR. RICE. Yes, rather than rebasing. I wouldn't want to rebase at the present time for reasons that Chuck stated. I would prefer, if we are going to ignore M1, to just ignore it.

CHAIRMAN VOLCKER. I'm not saying that now. That is another option.

MR. RICE. Another option--

CHAIRMAN VOLCKER. Change the range through the year.

MR. RICE. Yes, change the range for the year.

MR. MARTIN. Without rebasing.

MR. RICE. Without rebasing.

CHAIRMAN VOLCKER. That's not ignoring it.

VICE CHAIRMAN CORRIGAN. Well, there's still the question of how much weight to give it.

MR. PARTEE. I think I would agree with that. I would like to raise the range on the basis of the experience that we have had.

VICE CHAIRMAN CORRIGAN. Steve, I want to make sure that I understand. I know these numbers are very slippery, but in light of your best estimate for July--

CHAIRMAN VOLCKER. Subject to change in an hour.

VICE CHAIRMAN CORRIGAN. If you were thinking in terms of changing the ranges and not rebasing, what kind of growth would you

have in M1 over the balance of the year, taking account of July as best you know it? Would it come in, say, within 9 percent or 8 percent?

MR. AXILROD. What would the growth for the year be?

VICE CHAIRMAN CORRIGAN. The second half of the year.

MR. AXILROD. The second half would be close to 7 percent--6-3/4 to 7 percent.

MR. BLACK. 7.1 percent is the way I figured it.

MR. AXILROD. What we have here is Q2 to Q4, assuming a 5-1/2 percent growth from June to September--and we think that is consistent with July coming in around 7 percent and growth phasing down from there. Then growth goes down from September to December to 3-1/2 percent, and that would only be if interest rates didn't go down any more and the effects of the drop since May had worn out. Then the growth for the year, Q4 to Q4, would be 8.8 percent; and the growth for the second half, Q2 to Q4--on that kind of averaging basis--would be 6.9 percent. That then assumes that the average growth, month by month, is roughly 4 percent over the balance of the year.

VICE CHAIRMAN CORRIGAN. In June and July you are using something like 7 percent?

MR. AXILROD. Yes, something like 7 percent for July. Now, if we had a very weak July like we did last year when we had almost zero [M1 growth] in July, and these demand deposits came running off--we have no evidence that that's occurring yet, except a little in the very first week of July--then you could get a more favorable picture, in a sense. You would get a much weaker third quarter than we are assuming, as the demand deposits unwind, which would make the fourth quarter look a bit better. But we have no basis for that yet. So our median assumption is the one I just gave you.

VICE CHAIRMAN CORRIGAN. In the end, I might be agnostic; but I guess I have some sympathy for changing the ranges rather than rebasing.

MR. AXILROD. I might add, Mr. Chairman, that all the models that we look at would say that growth in the third quarter, month to month, will be more like 7 percent. We have taken 1-1/2 points off that because of the thought that this bulge of demand deposits in May and June simply has to unwind. So if that doesn't happen, there's more danger of greater growth.

MR. WALLICH. I don't quite see the consistency of saying that we suspend M1 in some sense and then we fiddle around with the upper margin by 1 percentage point. I think it is better to leave it and say it was a bad job.

VICE CHAIRMAN CORRIGAN. I blow a little hot and cold too, Henry. But the other side of it is that rebasing carries with it this implication that the problem is behind us.

MR. WALLICH. I wouldn't rebase it either; I would just give up on it for the time being. When we reinstate it, which I hope we do someday, then it ought to be on a rebased basis--after proving itself.

VICE CHAIRMAN CORRIGAN. That scares me a little.

MR. BLACK. You get very different conclusions because of the arithmetic in this too. If we did raise the upper limit to 9 percent, if I figured right, from the second quarter to the fourth quarter the growth rate would be around 7 percent; I think Steve's [estimate] was slightly different. If you look at June to December, you are looking at the 5 percent; but if you look at the growth on a quarterly basis, it does not look like that much deceleration from the 10-1/2 percent or whatever it was in the first half. The arithmetic can always be so troublesome on this; I don't know whether it's better to look at it on a quarterly basis or not. I guess I would like to look at it in a chart and put least squares to it; that's the way I tend to think.

MR. PARTEE. I wasn't thinking of raising the upper limit 2 points.

MR. BLACK. No.

MR. PARTEE. You said 9 percent; I was thinking of 4 to 8 percent. And I would do it on the grounds that there is a great deal of uncertainty about what may happen. Zero is not the only possibility for a month; we may have a month that is negative. We might find ourselves back within [the range] but running high because we have had a cumulation of such high numbers. It seems to me that simply a recognition of the fact that it has run so strong thus far this year and that there seems to be a changed relationship would lead us to say that we would raise the limit because of that. As Henry said, we have M1 on probation because we really don't understand what is going on here. It could come down within the ranges--and it could in August, say. I don't think July is a likely month, but August is a possibility. If that should happen--

MR. BALLES. The same point, of course, holds if we go to eight percent. The second quarter to the fourth quarter would be, if I figured it right, about 5.3 percent and June to December would be 2.8 percent. The fact that June is so high is obviously the reason.

MR. KEEHN. As I hear the numbers, it appears that if we rebase--and I think there are some compelling reasons to rebase--and maintain the same 4 to 7 percent range, there is a high probability that we would be about in the range. Or a possibility--

MR. PARTEE. Yes. I wouldn't say a high probability.

MR. BLACK. What bothers me about raising the upper part of the range as opposed to rebasing is that when we get to next year and we want to work it down a little--if indeed we want to, and certainly over the long run we have all agreed that we want to--if we start with 8 percent, we have to work it back down to where it once was before and then down beyond that. And in this political environment in which we live, if we had 4 to 7 percent on a rebased basis, it is easy to work it down, if that is what we want to do then. If we had a 9 or 8 percent top, I think--

MR. BALLES. I would like to support Bob Black's point on that. I think [there is] the historical continuity factor as perceived by the public when we have to announce not only '85 but tentative '86 targets. We might get to the same end results by raising the range to 4 to 8 percent or even 5 to 9 percent versus rebasing and keeping 4 to 7 percent but I think it would make the 1986 rationale a lot harder to establish, whatever range we decide on. Either keeping them the same as they were or cranking them down a notch would be my preference. So that led me, Mr. Chairman, to favor rebasing over raising the range.

MR. PARTEE. Well, I don't see anything wrong with it. What we would be doing is raising the spread too, Bob. If we take it to 4 to 8 percent, I don't see anything wrong with 3 to 7 percent next year. And I think [M1 growth] might well be very low [next year] because of Reg. Q ending, which I think is going to lead to transfers from checking-type to savings-type instruments.

MR. BLACK. That is a good point. I think we probably will end up about the same place at the end of the year, in terms of the level, regardless of which course we take. The important thing is what we do in the shorter run.

MR. PARTEE. Well, I can't speak with certainty, but it just seems to me that as a result of Reg. Q we can get some rebirth in the kinds of instruments that we classify as M2 rather than M1.

CHAIRMAN VOLCKER. Anybody who is going to move out of savings deposits already has.

MR. PARTEE. But I am talking about moving back in, with new attractive instruments.

CHAIRMAN VOLCKER. How can you make an instrument more attractive than a money market deposit account already is?

MR. RICE. No minimum balance.

CHAIRMAN VOLCKER. There's no minimum balance on the MMDA now, is there?

MR. AXILROD. Well, a thousand dollars.

MS. SEGER. There's a limit on withdrawals.

MR. PARTEE. Well, it is hard to say. NOW accounts could get the expansion, too, because there would no longer be the 5-1/4 percent [rate] limit on NOW accounts. As I say, I just have no idea. But it is conceivable that M1 could come out low in the range next year.

CHAIRMAN VOLCKER. The principal change next year will be to take the ceiling off the [interest rate paid on] NOW accounts so that it will increase the transactions--

MR. PARTEE. Well, that is a possibility, too.

MR. MELZER. One problem that I have in terms of thinking about rebasing--and yesterday I thought that was the appropriate way

to go--is not knowing whether the problem is behind us. That concerns me. On the other hand, putting M1 on a monitoring basis also troubles me. As I reflected on some of the activity in terms of the foreign exchange markets and also what is happening to the growth rate in GNP here in the United States versus overseas economies, I could see a substantial shift in psychology in terms of what has been driving some of the capital flows in this direction. None of us really knows how the dollar is going to correct. We have assumed an 8 percent depreciation for next year, but it seems to me that if we got a more dramatic weakening of the dollar--not even a precipitous one, but a more dramatic one than that--that is going to feed back pretty quickly into inflationary expectations here, certainly amongst market participants in the domestic credit markets. At the same time that will affect feelings about the ability to continue to finance the deficit through foreign investments. And at the same time we have what we were talking about yesterday, in terms of a less favorable outlook on the budget deficit. It just seems to me that if we were to put M1 on a monitoring basis against the backdrop of all those potential developments, people could question our resolve in terms of dealing with inflation in the long term. And it could have a very significant impact, particularly in terms of the shape of the yield curve, I would say. So, as between monitoring or one of the other two options, I would do one of the other two. And, as I say, I am troubled about rebasing because that implies that we know the problem is behind us. As I said yesterday, I think it is a more difficult argument to make in terms of the rationale than it was two years ago.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, there has been a good deal of discussion about the uncertainty of what M1 is going to do. I would start from the premise that M1 has a value in that it has informational content even now when we are uncertain about it. We have seen it return to more normal relationships in the past and I would hope that would occur in the future. As a result, I would not want to do away with M1 totally. But in view of the uncertainty, it would seem to me that it makes no sense either to rebase or raise the top limit for the reason that that uncertainty suggests: that we don't know whether we can hit the target if we raise the top, for example, or if we rebase. To be sure, it improves the chances. But it also implies to the market, it seems to me, a precision that nobody around this table believes--that we know what is going to happen to M1 in the period ahead. Therefore, I come to the conclusion that we should do nothing with M1 other than to move it to a monitoring status. We should let you describe in the upcoming testimony that velocity and demand for money have created the uncertainty; that M2, M3, and debt are all within their boundaries; that the economy is chugging along--maybe not to the level that we want, but chugging along nonetheless; and that looking at all things we are setting aside M1, which we don't understand, to a monitoring status but are not totally doing away with it because it does have some information content as to direction if nothing else. So up or down, if you will, on M1 I would describe what has happened in the past and the uncertainty, and rely upon the other touchstones--and I am talking about the aggregates, principally, as well as the economy and the level of the dollar. I would not want to raise the upper limit or rebase because either one implies precision that we don't have.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, I certainly share the uncertainty that has been voiced around the table about the performance of M1. But I am a little concerned about moving it to a monitoring position at this point. If we do that, in light of what happened last year, I think the public is going to come to the conclusion that we, in effect, are setting it aside. We moved it into a probationary status and then we moved it back to a regular target status; now if we turn around and do it again, I am a little concerned about the public's perception about that. While there is uncertainty, I think there is some evidence, and some possibility, that M1 will return to more normal levels. I am inclined to believe, although there are uncertainties, that this is a one-time shift and that we will get more normal relationships in the future. For that reason, I think that rebasing is supportable; and for that reason I would like to suggest that rebasing is probably the better way to go. Again, I think it is premature to put M1 on a monitoring status at this time. If we rebase or if we raise the targets without rebasing and find out on the basis of subsequent experience that M1 is not in fact returning to a more normal level, then I'd move it to a monitoring status or set it aside completely. I would prefer to rebase and leave the target essentially where it is, at 4 to 7 percent.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, I don't think anybody around the table feels terribly comfortable with any of the suggestions that have been made.

MR. GUFFEY. That's not true! [Laughter.]

MR. BOEHNE. It seems to me that when you find yourself in

MR. GUFFEY. I would share that [view]. I think proposal number 2 does capture what I have in mind: put M1 on a monitoring status but don't do away with it.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I won't reiterate the reasons I expressed earlier for favoring putting M1 on a monitoring status. But if it is on a monitoring status, we do need some range; at least in the past we have had that. And whether we rebase or not I would prefer that we widen the range a little, maybe to something like 4 to 8 percent. The real reason for doing that, in my mind, is that it gives us a little more flexibility going into next year. And given all the uncertainties both about the economy and about deposit flows and asset holdings, and given further the elimination of Reg. Q, that flexibility strikes me as desirable. For that reason, looking ahead to 1986, I would want to take this opportunity to broaden the M1 range. It seems to me it would be on the side of prudence.

MR. PARTEE. If it were 8 percent, Steve, what could growth be from June to December?

MR. AXILROD. Recognize that a lot depends on the pattern of the months. Assuming essentially a straight line after whatever happens in July, for 8 percent for the year you would have month-to-month average growth of roughly 2-3/4 percent--not much.

VICE CHAIRMAN CORRIGAN. And what would growth over the second half of the year be?

MR. AXILROD. Growth from June to December, as I said, would be 2-3/4 percent; on a Q2 to Q4 basis it would be around 5-1/4 percent, again depending on how the months bounce around. That, by the way, given the staff GNP projection and the way the quarterly averages work out, still would give you a negative velocity in the third quarter and then a very strong positive velocity in the fourth quarter.

MR. MARTIN. Considering the difficulty in predicting velocity so far in this expansion and considering the difficulty in projecting interest rates, real and nominal, so far in this business expansion, it would seem to me that we would want to give ourselves the flexibility that has been alluded to several times here and that rebasing gives us that flexibility. It also recognizes the unusualness of recent events with regard to both velocity and, therefore, on the other side of that coin, the growth of the aggregates. Why not give ourselves the operational flexibility that rebasing presents and indicate--to work a word to death--the uncertainty associated with these relationships at the moment? Maybe we ought not use the term "monitoring" and so forth if our goal here is [unintelligible]. Let us not call it "monitoring;" let us call it "bananas" or something else. But let's give ourselves some operational flexibility. We don't know what will happen to interest rates; we don't know what the public's attitude is toward holding various kinds of assets.

MR. KEEHN. While the objective in proposal 2 as stated--that we would expect M1 growth to slow down in the second half--is

obviously something we desire, that proposal seems a bit on the vague side. Perhaps we do need to be just a bit more specific about what we plan to do and how we plan to do it. Just to say it again: It seems to me that the arguments for rebasing are compelling and I would be in favor of rebasing; I quite recognize that this may not be the last time that we have to do it. I don't think we ought to get into the business of rebasing every other meeting--nor would I expect that to occur--but I don't see anything wrong with rebasing now and perhaps having to rebase some time in the future if there is a recurrence of some of these events. But I do think that we need to be a little more specific as to how we are going to be conducting monetary policy. I think rebasing is a way of recognizing that something has taken place that we need to deal with. Reestablishing a range provides some guidance as to what we plan to do, though always being able to use judgment as we go along. So I would be in favor of rebasing, reaffirming the ranges at least for this year, and going into next year very likely with the same ranges in place for next year that we have for this year.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Gary expressed my view pretty well. It seems to be me that raising the upper limit to 8 percent simply recognizes what has happened already. But at the same time, it puts us in a position to be flexible.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, I am having a little difficulty following some of the discussion from the standpoint of rebasing or raising ranges, and so forth. I still don't have a sense --maybe I am missing it--of whether or not we want to address this very large growth in M1 and address it forthrightly. I am leaning in that direction in my own view. It seems to me that once that basic point becomes clear, how we structure our ranges then becomes a little easier. I am not comfortable at this point in knowing where we really stand in terms of: Are we going to try to do something about M1 or are we going to accept it the way it is and just let whatever happened happen? And based on what we think [the answer to] that might be, then decide to rebase or change the range? I guess what I am saying is that I would like to see, however it is constructed, some movement to reduce the rate of growth in M1.

CHAIRMAN VOLCKER. Would you like to see some reduced growth in M1--just for instance--if trade problems continue to get worse and the dollar goes up and the economy is in recession?

MR. BOYKIN. To some extent, I would be inclined to do that looking longer term, because I have a very uneasy feeling that we are building major problems as opposed to the difficult problems that we have right now.

CHAIRMAN VOLCKER. What major long-range problem will you be adjusting by curtailing M1 with the dollar strong and the economy in recession?

MR. BOYKIN. The major problem, it seems to me, would be the possibility of inflation coming back and coming back very strongly.

MR. MARTIN. In a recession?

MR. BOYKIN. Yes.

MS. SEGER. Recession/depression?

MR. PARTEE. Well, I think the argument is that you have built in excess liquidity that then becomes uncontrollable.

MR. BOYKIN. Yes.

MR. PARTEE. Boy, that's a tough belief to follow right into a recession.

MR. BOEHNE. Fundamentalist economics!

MR. PARTEE. I am sure that Friedman would say that if he were sitting here.

CHAIRMAN VOLCKER. That's not what he said ex post in 1933.

MR. BOYKIN. Don't misunderstand me. I am not talking about [unintelligible] it. I am just talking about moving in the direction of some restraint.

CHAIRMAN VOLCKER. We can conclude that everybody would be delighted if M1 subsided without doing--

MR. BLACK. And was accompanied by declining interest rates.

CHAIRMAN VOLCKER. We will stipulate that.

MR. BOYKIN. Well, I don't think we're coming to a recession.

CHAIRMAN VOLCKER. I think it is a heck of a lot more important what we do than what numbers we put down here, myself.

MR. BOYKIN. Well, that is what I am searching for--not how we present it. In the final analysis it will become rather transparent. I think the big question out there--at least in the layman's mind--is that we have had this excess of M1 money growth and are we going to do something about it or not?

CHAIRMAN VOLCKER. I don't think that's a question in many laymen's minds.

MS. SEGER. [Their question is:] Do they have a job?

MR. BOYKIN. Well, quasi-laymen.

MR. MARTIN. Interest rates are all they care about.

MR. BLACK. Well, I sense that the Chairman felt somewhat like that in posing the question first as to what we do in the short run. I think he was saying something perfectly compatible with what you are saying, although his answer might not be the same as yours. But I think he was saying that's where one ought to start.

MR. BOYKIN. I agree. All I am saying is--and maybe you got ahead of me--that I didn't sense that that really had been answered.

MR. BLACK. No, I agree with you. It's just that I didn't want to be associated with you in any way, so I didn't say that! I did really; I thought that was your best statement to date, as a matter of fact.

CHAIRMAN VOLCKER. Well, the sense of this, I guess, is that if we don't do anything other than keep the numbers the same, we probably ought to rebase. We can pick numbers that are the same arithmetically and that are a more forward-looking, easier translation of what we intend, rather than changing the range for the whole year to take account of what took place in the first half of the year.

MR. GUFFEY. Doesn't that imply to the markets that we are intending to hit those targets if we rebase, or if we raise them?

CHAIRMAN VOLCKER. If we change the existing targets, it also implies that to the market. It depends on the language surrounding it.

MR. GUFFEY. That's exactly my point. If we either change the target or rebase, it implies that we are going to hit it. And I might just observe that there is a possibility that if we rebase we won't even hit the bottom end of the target. That's an outside possibility, to be sure; nonetheless, the possibility exists. And certainly it's going to put us to the test to hit the top of the target if we rebase. Therefore, I would opt not to do either of those two things, but describe what has happened and describe what we think will happen in the future and put M1 on a monitoring basis.

CHAIRMAN VOLCKER. Well, an alternative is not saying anything about M1, in effect. I think that that does suspend it. But that does not reflect the desire that everybody would like to see it lower.

MR. PARTEE. I think we do maximize our problems if we rebase because if things continue as they are, we are going to be over the top; and if this was some kind of a strange aberration that is reversed, we are going to be below the bottom of a rebased number. I think Roger is right: that possibility increases. That exposes us to the maximum danger of missing it utterly on either side.

MR. RICE. It doesn't increase that danger if we just simply move the range to take into account what already has happened.

MR. PARTEE. It's obvious that that's my preference.

MR. FORRESTAL. If you keep missing the target on a continuing basis, isn't that the time to set it aside?

MR. PARTEE. We surely have missed it.

MR. FORRESTAL. But we haven't rebased. Why not try the rebasing and then--?

MR. PARTEE. Because we don't know why it is down. We don't know what accounts for what happened in May and June.

MR. GUFFEY. And we don't know whether it is over or not.

MR. PARTEE. We don't know whether it is over; we don't know if it is reversing. We don't really know anything about it.

MR. FORRESTAL. Well, I would be willing to take that chance: rebase and then see what happens.

MR. GUFFEY. I don't share that.

MR. FORRESTAL. I gathered you didn't.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I would associate myself, at least in part, with Tom Melzer's remarks that the frequency with which these problems come up--no matter how we deal with them--inevitably will raise questions about the philosophy and the practical approach to policy that we are taking. Somewhere out in the future--I don't think that we are there now--there will be at least a perception, or maybe even a danger, that we could kind of slide into a degree of indifference about the speed of money and credit growth, however defined. There could be that danger. Primarily for that reason, I don't want to end up in a position of altogether disregarding M1, which I think, Roger, is the logical conclusion of your position. Then, looking between rebasing and raising the range, I would have a modest preference for raising the range; I'd put it at 4 to 8 percent or something like that, with some language about probation, as opposed to rebasing. But in the end, [Mr. Chairman,] you are the one who is going to have explain it. I wouldn't go to war over one or the other, but I do think the integrity of the process, in a context in which the importance of M1 for the time being is reduced, is preserved a little better by raising the range rather than rebasing.

MR. MARTIN. I would like to make the argument for rebasing on a slightly different basis. It is certainly important that the financial markets accept what we do here as being operationally dictated and not an abandonment of disinflation as a primary goal of this institution. On the other hand, it seems to me that the operational considerations are important here and that we should attempt to adopt those features of a policy which are most likely, with all the difficulty of forecasting, to be attainable. We rebased in very recent history. There was not a reinflation following those actions, and it seems to me that operationally we would have a little more flexibility [by rebasing]. We can be careful with the language in which we ascribe weight to M1, but nevertheless I think it is important to reiterate that M1 is an information variable. It does have content; most of the time it does have information that is valuable in the implementation of policy. I think that rebasing and the right language accomplish this. Why not pick the alternative we are most likely to succeed in?

CHAIRMAN VOLCKER. Well, you can make them arithmetically equivalent.

MR. MARTIN. But we have to raise the top limit so high if we don't rebase, Mr. Chairman. To be pragmatic, we really ought to use a 10 percent top for that range and who wants to go to 10 percent? I don't.

MR. WALLICH. I wouldn't rebase. I wouldn't change the M1 range. I would just let M1 sit there with a statement that it is not more than a monitoring--whatever the word is--variable. I wouldn't change any of the other ranges. That makes for a--

CHAIRMAN VOLCKER. It's not even a monitoring range if you don't expect to make it.

MR. WALLICH. Well, we can eliminate M1 totally, but I don't see any purpose in doing that.

CHAIRMAN VOLCKER. The hardest thing to explain is why we wouldn't change the range and yet expect to be over it. I can see where one can abandon the range. That's easy to explain. If it's wider, that's another question. But I don't know how we can sit there and say we reaffirmed the range for M1, but expect to be well over it.

MR. MARTIN. By 300 basis points.

MR. RICE. How much over we don't know, and that's why raising the range somewhat gets--

MR. PARTEE. I am rather impressed with the integrity argument that Jerry just gave. People who have been around here for some years know that we are often accused of rebasing any time we get into trouble. That has been a constant source of friction and difficulty in discussions of these matters. I think we can rebase if we have a good argument for rebasing. My problem with rebasing now is that we don't know what has happened. In 1982 it was a stab, but it sure looked as if [M1 growth] was running way off. Right now we don't know. What we really have is a couple of high months, which happen to be the months just right now, and we don't know what is going to happen. And when we rebase, it looks like we are rebasing to make it easier. That's the old complaint about rebasing.

MR. MARTIN. Chuck, we have had interest rates come down 400 basis points from their peaks and, in somewhat more recent time, 200 basis points. That must have some relationship.

MR. PARTEE. I think that's a reason for raising the range.

CHAIRMAN VOLCKER. I must say, I don't see much difference between rebasing and raising the range.

MR. PARTEE. I do.

MR. BOEHNE. Well, there is a cosmetic difference and I think Pres has put his finger on it. It's just the numbers you look at.

CHAIRMAN VOLCKER. Cosmetically, I don't see any substantive difference; arithmetically it is equivalent.

MR. PARTEE. I think the majority have indicated that they are not prepared to wring out the high M1 numbers. So we are only talking about cosmetics. We have given up on substance here.

CHAIRMAN VOLCKER. Well, I just don't see the cosmetic difference in your own terms between saying we are raising the range or we are rebasing. They both amount to the same thing.

VICE CHAIRMAN CORRIGAN. Arithmetically, obviously you can make them come out to the same thing. But to my way of thinking--again, this is a highly judgmental thing--[there is a difference]. Raising the range and accompanying that with some verbiage along the line that several people, including Mr. Stern, have suggested says: We don't know what has happened; we don't know if it's over; we still think over time this variable matters; and we still have a view over time as to what we would like to do, but we are not going to--particularly in these current circumstances--let that view get carved in stone. Now, rebasing seems to say something that in my judgment is a little different than that. The way that it is different is that to me it does not carry the same conviction in terms of what we are trying to do over time.

CHAIRMAN VOLCKER. You escape me. We raise the [M1 growth] rate for a year and that expresses a great conviction.

VICE CHAIRMAN CORRIGAN. It doesn't express great conviction. I just don't think we can go on in the situation that we have in terms of rebasing when we don't have a good explanation as to why we are rebasing.

CHAIRMAN VOLCKER. What's your good explanation as to why you are raising [M1 growth] rates?

VICE CHAIRMAN CORRIGAN. Because I don't know.

CHAIRMAN VOLCKER. You lose me.

MR. PARTEE. In one case you wipe the slate clean and in the other case you don't.

CHAIRMAN VOLCKER. You wipe the slate clean and end up with a lower number; you don't wipe the slate clean and end up with a higher number. I don't think it takes any genius to say that you are at the same place at the end of the year.

VICE CHAIRMAN CORRIGAN. I think you can count it either way. All I'm saying is that in my judgment it strikes me a little better, and that's all, to do it that way. But I could live with it the other way.

CHAIRMAN VOLCKER. It doesn't make any difference either way; you end up in the same place, except in the one case you are putting in higher numbers and in the other case you are not.

MS. HORN. Mr. Chairman, coming back to both the integrity point and to Bob's point about what it is that we want to do with M1: Although I have a technical preference that I have already expressed for not doing anything on the M1 target and declaring it a monitoring

range, it seems to me the real issue here is not so much technically what we do, but the words you use to surround it. The real issue is that you in fact very carefully describe to people what it is about M1 and the uncertainty, what the circumstances are that we find ourselves in, and what kinds of circumstances we might find ourselves in the future that might cause us to do this, that, or the other thing. Those words in the end will be what preserves our integrity, whatever technical mechanism we use at this point.

CHAIRMAN VOLCKER. I can agree with that.

MR. BLACK. I pretty well agree with you, Mr. Chairman, that there isn't a lot of difference, but one minor issue is: Which one would make it easier for us as we work over the long run to lower those ranges? That's why, frankly, I came out in favor of the 4 to 7 percent range, rebased. I think it would be easier to get it down, as I assume we are going to have to do over time, if we have a top of 7 percent rather than a top of 8 percent. But that is a very minor point, probably.

CHAIRMAN VOLCKER. Rebasing carries a little more implication that we think this is probably an exceptional circumstance. If you don't rebase, you are starting with a higher number, and it's harder to put it down lower the lower you get. That's what it amounts to.

MR. BLACK. That's my point, really.

MR. BOEHNE. How do you view this? You are the one who has to sell this and we are talking a lot about cosmetics here. Do you think there would be a big problem if we suspended the M1 range altogether versus trying to put something in there that we say we don't know very much about?

CHAIRMAN VOLCKER. Well, the trouble with that from my standpoint is that if we ever have to tighten, it's good to have that M1 number out there.

MR. BOEHNE. Yes.

CHAIRMAN VOLCKER. If we abandon it completely, we've lost a [unintelligible]. Suppose it runs [above] whatever we put down, whether we change it for the year or rebase. We could always say, if we have to, that we have persuasive enough evidence that says we're going to run above it. If we don't have it out there at all, and we don't want to run above it, that's a little hard to do.

MR. BOEHNE. Good argument.

MR. PARTEE. It could be very hard to put back in too.

CHAIRMAN VOLCKER. I guess what the cosmetic issue comes down to is whether we want to say primarily that we think this is an exceptional case or whether we want to build the kind of background for a permanent increase in the rate of increase in M1. It might be right, if in fact the trend velocity is changing. Maybe it is. I think probably it is. Maybe we don't want to move the money supply down to where we used to think that we wanted to move it, because with the changed structure, it's going to have to be higher relative to the

nominal GNP. If that's what you think, then change the range for the whole year and begin getting people used to higher M1 numbers. If the odds are this is once and for all, rebase it. Who knows?

MR. BALLES. Mr. Chairman, it seems to me that, contrary to some of the views that have been expressed here, there is no greater implication of being forced to hit a rebased target than if we didn't rebase. I don't know what experience or earlier precedent would correspond to that conclusion. Circumstances change and uncertainties develop that we don't anticipate; I don't think we are stuck with any rebased range any more than we are stuck with hitting today's range.

CHAIRMAN VOLCKER. Well, that's what I am saying. The differences are relatively minor, but I do think it depends upon whether you want to get people used to higher M1 figures as a kind of norm or not. I think we are getting used to higher M1 figures anyway, because that's probably the fact of the situation. So, it's a question of how fast you want to go in that direction. I think it's hard to go from 5 to 9 percent--or whatever we are talking about if we don't rebase--down to 4 to 7 percent if that's where you want to go next year. Or less. It's much easier to do that if you rebase and don't have to go down at all or go down a relatively minor amount.

MR. BALLES. That's the big argument in favor of rebasing, in my opinion.

MR. BLACK. Mine too.

CHAIRMAN VOLCKER. All I'm sure of is that we are going to decide one way or the other.

MR. GUFFEY. I would like to ask a question about your last statement that it is more difficult to go to 4 to 7 percent next year from the 5 to 9 percent. If we rebase or raise the range this year because of an aberrant behavior of M1 that we think is behind us, and we select the fourth-quarter average as the next year's starting point, I don't see that 4 to 7 percent is any more difficult in 1986 from either of those two starting points.

CHAIRMAN VOLCKER. That doesn't say that you cannot do it. I just say that, marginally, it takes a little more explanation.

MR. GUFFEY. And the explanation has to be that it was a one-time aberration that occurred in M1 in 1985.

CHAIRMAN VOLCKER. Right. Do you express a one-time aberration more clearly by rebasing or by raising the range for the whole year?

MR. GUFFEY. I guess I would suggest that we don't do either.

CHAIRMAN VOLCKER. Don't do either?

MR. GUFFEY. Don't do either.

CHAIRMAN VOLCKER. But what I find a little difficult to say is that we haven't changed our range but we expect to be above it.

MR. GUFFEY. We said at the beginning of the year that we set a range of 4 to 7 percent and that we expected to be at or near the top. And indeed, we are above the top because of unforeseen circumstances. I don't see any problem with admitting that and admitting that we don't know--

CHAIRMAN VOLCKER. We will admit that we are above the top. That's where we are.

MR. MARTIN. If we do neither, every Friday we are going to be confronted by The Wall Street Journal's bad diagrams showing us not just above the top of the cone but at an extreme distance above the top of the cone.

CHAIRMAN VOLCKER. Well, if we express it strongly enough, they might stop showing the chart. But I take it that that's not what you want to do. You want to retain some discipline.

MR. MARTIN. That diagram looks out of control.

MR. PARTEE. That's because it is out of control.

CHAIRMAN VOLCKER. I don't know quite what words we would use to say our range is 4 to 7 percent but it doesn't mean anything.

MR. GUFFEY. You simply would describe in your testimony that, because of the uncertainty, M1 is on a monitoring basis or however else we may describe it; that it has informational content so that we are going to retain it; and that we don't know what is going to happen over the remainder of the year but we are still dedicated to the proposition that we are going to move toward price stability in the period ahead. And we do that with the 1986 targets.

CHAIRMAN VOLCKER. I can explain abandoning M1; that's straightforward. But I don't know what the 4 to 7 percent means if we are not intending to--. There is no content.

MR. GUFFEY. I think that's correct. But I don't know that you can explain any better 4 to 7 percent rebased or raising the range to 5 to 9 percent.

CHAIRMAN VOLCKER. Well, I have to say I think we expect to be within the range. That's not a promise. We can violate it again, if that's the wisdom. But at least I can say we expect to be around the upper edges. We do think it's once and for all--well, not quite once and for all--a step function. I don't find that very difficult. To explain that we don't have an M1 range is simple enough too. What I find a little difficult to say is our range is 4 to 7 percent, but that doesn't mean anything.

MR. GUFFEY. Well, I think we can find words to get over that hump, if that's the only hill we have to climb.

MR. PARTEE. Well, if you feel much more comfortable with rebasing, I'll accept it.

CHAIRMAN VOLCKER. Well, much more comfortable is an exaggeration. I don't feel very comfortable with no change at all.

Probably a better expression of where we want to be is to rebase--assuming that the arithmetic is all the same anyway [and] there is no argument on what it should be.

MR. MORRIS. My problem with setting new guidelines is that if we have every reason to believe that we are going to get still further lagged responses to declines in interest rates that have already taken place, that's a big uncertainty. It, therefore, makes more sense to me to set aside M1 as a target variable for this year and reconsider it again for next year.

CHAIRMAN VOLCKER. That's a perfectly coherent approach. Presentationally, it's easy. I don't see any objections to that side. That's a question of substance: whether we want to set aside M1 that far, which says we can't come back later in the year and say we think M1 is too high, in effect. It makes it more difficult. Do we want to throw out--throw out is a bit exaggerated--the possibility of saying that M1 is just too high and we want to tighten up?

MR. MORRIS. Well, if M1 is too high because the economy is stronger, the other measures are going to be too high as well. I don't see that retaining M1 is that critical.

VICE CHAIRMAN CORRIGAN. As a practical matter, I'm not sure how Peter and Steve would go about constructing a framework to operate in, literally, if we just throw it out.

MR. MORRIS. We did it in 1982.

VICE CHAIRMAN CORRIGAN. We didn't throw it out.

CHAIRMAN VOLCKER. In 1982, what did we do--rebase in the middle of the year?

MR. AXILROD. 1983.

CHAIRMAN VOLCKER. What did we do in 1982? We didn't do anything in 1982? We just ran above it.

MR. AXILROD. No, I don't think so.

MR. MARTIN. We ran at 8.8 percent against a top of 5-1/2 percent.

CHAIRMAN VOLCKER. We were within the range at the midyear meeting, I guess, in 1982 and we just let it run above [later].

MR. AXILROD. I think you made a statement in September or October of 1982 to indicate that that was happening.

CHAIRMAN VOLCKER. What we did was: We didn't change our range in mid-1982. We ran above it. We set a new monitoring range at the beginning of 1983, and then we rebased in the middle of 1983.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. And we said we were going to be more serious about it. That's the difference. In the middle of 1983 we

rebased and said we were going to get a bit more serious about it, I guess.

MR. PARTEE. This time we're going to rebase but we're not going to get more serious.

CHAIRMAN VOLCKER. This time we rebase and say but we're not going to get more serious. Well, we didn't say much more serious, as I remember. We still called it a monitoring range. Okay. I guess we didn't get a lot more serious about it in the middle of '83--only slightly more; we got more serious about it at the beginning of '84. Well, we'll go to something easy, like next year. Does anybody have strong feelings about next year?

MR. MORRIS. I just have one thing, Mr. Chairman. As I said, the evidence suggests to me that nobody knows whether it's a permanent change or not. But the fact is that it does seem now to take more money, more liquid assets, and more debt to generate a dollar of the GNP. Therefore, it seems to me that there is a strong case for maintaining the ranges and making no change for next year.

CHAIRMAN VOLCKER. For M1 for next year?

MR. MORRIS. I'm for [retaining them] where they are.

CHAIRMAN VOLCKER. You're for alternative I for next year.

MR. AXILROD. That retains the ranges for this year for M1 and M2 and reduces the range for M3.

CHAIRMAN VOLCKER. It just reduces the top end of the range for M3 by 1/2 percentage point; that's all it does.

MR. MORRIS. I don't--

MR. AXILROD. That's right. It reduces credit and I would think--

CHAIRMAN VOLCKER. It reduces the debt range.

MR. AXILROD. --you would reduce M1 if you move up the range or rebase.

CHAIRMAN VOLCKER. Yes, we're leaving M1 aside for the moment. The other three--

MR. MORRIS. I don't see any case for reducing the M3 and debt ranges. What rationale is there for that?

MR. AXILROD. Well, the main rationale is that this tracks the nominal GNP. The rationale is that there would be less debt expansion because the increase in spending is lower in '86 than in '85 because of the turn in the balance of payments. But that may or may not happen. And secondly, we expect that there will be less merger activity. That's the rationale.

MR. MORRIS. Yes, but I think there's going to be--

MR. AXILROD. Our point estimate for 1986 is 10.4 percent.

MR. MORRIS. 1986 will probably have a higher nominal GNP than 1985.

MR. AXILROD. Well, as I say, one of the questions raised is: Does the Committee like the GNP? If they don't like the GNP--

CHAIRMAN VOLCKER. I think that's correct. The GNP estimates [of Board members and Presidents]--well, there is a 5-1/2 percent on the low side and an 8-1/2 percent peak--are bunched in the 6-3/4 to 8 percent area, roughly. If you just took that and said there shouldn't be any velocity changes, you're more or less satisfied there. And for M2 and M3 and debt you could take alternative I or you could take alternative II too; there isn't much difference. Alternative III begins to look like a squeeze on our projections of nominal GNP.

MR. AXILROD. That was our idea, Mr. Chairman. Alternative II in some sense gives a little looser fit, which would provide some room if the Committee wanted to express a view of wanting more nominal GNP than is in the staff projection. Alternative III is tighter.

CHAIRMAN VOLCKER. There is so little difference between I and II that it's negligible, it seems to me. Alternative III does begin to be a pretty tight fit, given the nominal GNP figures that are projected. You can argue that they're too high, I suppose, if you want to tighten it. I think you have to begin arguing that, though.

MR. MARTIN. I think part of that argument, Mr. Chairman, turns on the expectation of what is the real growth trend line. Is it really 2 or 2-1/2 percent or is it 3 or 3-1/2 percent?

CHAIRMAN VOLCKER. Well, here I'm just talking about M2 and M3 and debt for which, presumably, in the long run there isn't any trend.

MR. BLACK. You meant real GNP didn't you?

MR. MARTIN. Yes, I'm talking about real GNP.

CHAIRMAN VOLCKER. Oh, I'm sorry.

MR. MARTIN. If 2 to 2-1/2 percent is the trend, then we could be comfortable with the staff structure rather than our own higher projections. But if that's incorrect and the longer-term growth line is around 3 or 3-1/2 percent, then the staff model will give us higher unemployment.

CHAIRMAN VOLCKER. I don't know where our real GNP average [projection] is. It looks like it ought to be over 3 percent. Well, I don't know; some are more pessimistic.

MR. MARTIN. Personally, I think it's closer to 3 or 3-1/2 percent and, therefore, we're flirting with higher unemployment at 2 to 2-1/2 percent real growth. Why should we take that risk?

CHAIRMAN VOLCKER. Well, I think it's fair to say by and large that the projections for next year cluster around a 3 percent

real growth. So, alternative I and alternative II would allow for that. You could argue that that's too low, but [unintelligible] probably higher price figures than are likely. Another fall of the dollar--. Well, I'm just looking at the easy aggregates now: M2, M3 and debt. Who's for alternative I? Who's for alternative II? Who's for alternative III? That knocks out alternative III. Not everybody raised his or her hand by a long shot. The difference between these is very small: it's 1/2 percentage point on the upper end of M2 and 1/2 percentage point on the upper and lower end in the debt range. M3 is the same [in both]. If I don't hear great howls, it seems to me those are nice round numbers; we don't get into halves.

MR. PARTEE. Yes, they are nice round numbers.

CHAIRMAN VOLCKER. Alternative I for M2, M3, and debt--that's all I'm talking about. Now, M1 is another story. That may affect what people want to do about this year.

MR. PARTEE. With monetary--

CHAIRMAN VOLCKER. The choices given range from 3-1/2 to 6-1/2 percent to 4 to 8 percent. Who has a strong feeling about that?

VICE CHAIRMAN CORRIGAN. I don't know how you can have a strong feeling about M1 at all right now. But, again, I would have a preference--not a strong feeling--for the specifications of alternative I. That's against the background of what I think is one of the stronger economic forecasts for next year. And I think there is a very plausible case developing that the velocity of M1 may be moving lower. Maybe in the current institutional, inflation, and interest rate environment the kind of trend or expected behavior of M1 velocity is more like 1 percent instead of 3 percent. That's what I [tend to factor] into my own thinking.

CHAIRMAN VOLCKER. Maybe it's even zero.

VICE CHAIRMAN CORRIGAN. No,--

MS. SEGER. Minus 2.

VICE CHAIRMAN CORRIGAN. I certainly don't have any illusions about that judgment, but I think the M1 specifications of alternative I are quite compatible with growth in the real economy of 4 percent next year, which is basically what is in my forecast anyway. So, that's where I come out.

CHAIRMAN VOLCKER. [Unintelligible] maybe you get 1 percent increase in velocity with that projection.

VICE CHAIRMAN CORRIGAN. Right.

CHAIRMAN VOLCKER. Even if you're in the top of it.

VICE CHAIRMAN CORRIGAN. Right.

MR. PARTEE. Well, I like 4 to 7 percent too, because this is supposed to be a tentative indication for next year. We know very little about what M1 is doing, as we are going to admit in one way or

another again. So I think tentatively what we should say is that we would hope to reestablish this range.

MR. BLACK. There is a cosmetic aspect in this. If we voted 4 to 8 percent this year, then 4 to 7 percent looks better to me for next year than if we vote 4 to 7 percent rebased and 4 to 7 percent for next year. I think we ought to appear to be working toward our long-run objectives; I'd like to see it a little lower than whatever we select.

MR. BOEHNE. Well, it gets back to the explanation that we give for why the ranges in M1 are no longer valid. If we think it's something more permanent, then it's going to be hard to argue to keep dropping the top of M1. If we argue that it's a one-shot deal in 1985, then one can make the argument. I find it hard to decide what to do in 1986 until I have some sense as to which argument you feel most comfortable giving for whatever we're going to do on M1 in 1985. I think there's a logical consistency here that one needs to pay a bit of attention to.

MR. BLACK. But if, by the time we get to 1986 we have that information on the velocity of M1, as I assume we will--and if it looks as if it has permanently declined--then I would be willing to go up at that point. I don't see that evidence now. When we had the last episode in '82-'83 we had a decided decline in inflationary expectations and there was reason to expect the trend rate to decline. We haven't had that this time, as I read it. So there is less reason to expect the trend to decline, although there certainly does appear to have been that one-time downward shift in velocity.

MS. SEGER. What if it isn't a one-time downward shift? What if it's going to happen again?

MR. BLACK. If it keeps happening, it's going to become more or less permanent and then I'd be willing to have higher ranges. That's what I'm saying. By that time I think we would have the evidence, and I would favor higher ranges if that is in fact true. I'm a real pragmatist, despite what you may think.

MS. SEGER. You're a purist.

MR. BLACK. I'm a pure pragmatist.

CHAIRMAN VOLCKER. I suppose there's something to be said for 4 to 8 percent simply on the basis that it's a wider range, given all the uncertainties we have talked about.

MR. MARTIN. And given that we will be overshooting--overshooting, changing, rebasing, and so forth for this year.

MR. WALLICH. I would find it hard to understand. It's true that there's greater uncertainty, but also the number is higher. The upper number is higher and it sounds as though we are yielding.

MR. MARTIN. It's not higher than what actually is going to occur in 1985. It's much lower; 8 is lower than 10, I believe.

MR. PARTEE. We don't know what's going to happen in '85.

MR. MARTIN. I wouldn't bet on 8 percent for '85.

MR. PARTEE. I wouldn't bet on 10 percent either.

MR. KEEHN. In that this is a preliminary look at next year, it seems to me that establishing a range of 4 to 7 percent now would be appropriate. If the circumstances are significantly changed at the end of the year and we want to have a higher range next year, we will be perfectly free to do that when we get into the February meeting.

MR. BALLES. I happen to agree with Si on that, but I think it's time for our semi-annual reminder from Steve. The July figure that we pick out, as I seem to recall, Mr. Chairman, more often than not--and probably very more often than not--is never changed by the time we get to January. For some reason this Committee has felt in January that we ought to stick with what we picked out in the beginning of July. Am I wrong on that, Steve?

MR. AXILROD. Well, let us get the figures; I just want to check my memory.

CHAIRMAN VOLCKER. Well, 4 to 7 percent looks like a perfectly reasonable figure on the kind of analysis we used to use. Whether that's still reasonable in terms of potential velocity under today's conditions is the question; it's an awfully tight fit. And it assumes an increase in velocity.

MR. STERN. I come out on the other side, given that this is a preliminary number. For that reason I'd start with something like 4 to 8 percent. If the economy is doing better as the year progresses--and when we get into 1986 if M1 is looking a little more reasonable--it seems to me that February would be the time to move to 4 to 7 percent. I suspect (a) that that's not a big change; and (b) that 4 to 7 percent would seem to be appropriate and easily justified under those circumstances at that time.

CHAIRMAN VOLCKER. Well, how many like 4 to 7 percent? How many like 4 to 8 percent? That encompasses the range, unless somebody else has some other feeling.

MR. BLACK. Not knowing what we're going to do this year, but assuming we might rebase with 4 to 7 percent, I like 3-1/2 to 6-1/2 percent [for 1986]. I think a lot of people are going to say when we rebase that in fact we have eased. And if we don't wave the flag and show some determination to deal with inflation down the road, then I think we've got a problem there. That's why I'd put it a little lower than whatever we select for [this] year. It might be merely a statement of pious intention, but I think it might be important.

MR. WALLICH. It would be a very [specious] thing, though, to say we don't know what M1 is doing and now we're going to change the range by 1/2 point. I would try to convey the sense that M1 is in suspense, and that is best done by an unchanged range for 1986.

MR. AXILROD. Mr. Chairman, in response to President Balles' question, we really do change the ranges at the February meetings from what was adopted tentatively. Only in one year, 1982, were all the

ranges tentatively adopted maintained. In four other years--this is going back to 1981--there were substantial changes.

MR. BALLES. Oh yes?

MR. AXILROD. Sometimes there were changes in M1. The most spectacular, of course, was in February 1983 when M1 was deemphasized to a monitoring range and that monitoring range was raised substantially from the one that had been adopted the previous July.

MR. BALLES. I take it all back!

CHAIRMAN VOLCKER. Well, I find it difficult to work up a great deal of emotion in assuming what the language is going to be; it's quite tentative anyway.

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. I think we probably ought to do the short run and come back to this.

MR. BLACK. This gets back to your point, Bob.

CHAIRMAN VOLCKER. The situation we have is that the economy looks pretty sluggish and there is not much sign of a breakout on the up side, apart from looking at the M1 figure. If you look at the M1 figure you might say that maybe we are going to have a great increase [in GNP]. I don't know where that's coming from. But as a practical matter, if you wanted to stimulate, where can you stimulate? You can stimulate housing, which is already high, and maybe consumption and you would get more distortions in the economy and more imports. It's hard for me to see, particularly in the midst of this, that we should tighten up, barring evidence that the economy is expanding [too fast] or further evidence on M1. So, I conclude that we [should] stay about where we are.

VICE CHAIRMAN CORRIGAN. No argument here.

MR. MARTIN. I have no argument with it.

CHAIRMAN VOLCKER. I suppose what that means, just in terms of setting forth specifications, is that we do something like alternative B, with a clear understanding that everybody would be delighted, I'm sure, if July and August suddenly had a jump downward in M1. We would not take that as a sign for great easing unless it were accompanied by very clear evidence that, say, the dollar was strong and the economy was weak. Conversely, I certainly would agree, if M1 continued high and there were pretty definite signs--or some signs anyway--that the economy was expanding more rapidly, we might have to react. Even then I'd be a little more tentative about that if the dollar turned out to be very strong. I don't think the dollar will turn out to be strong during this period. Hypothetically, I think we could get a combination of a declining dollar, a little more evidence of business firmness, and a high M1, and then we would tighten up. Except we don't make that decision today. We would make the decision to do that if those circumstances arose.

MR. BALLES. I would support alternative B, Mr. Chairman. I think that makes a lot of sense in view of all the uncertainties we're wrestling with here. I think the other alternatives would be putting up too big a bet. One of the things about alternative B that I like is that it's more or less an explicit admission--at least I interpret it that way--that we're prepared to go along with the overshoots in the first half of the year and we have no intention of trying to get M1 back within that original range. I think that would be a terrible mistake in view of all the uncertainties we've heard around this table the past two days. Therefore, I think alternative B would make a lot of sense.

CHAIRMAN VOLCKER. When you say alternative B, you are also encompassing something around the borrowing target that's in there?

MR. BALLES. Oh, yes.

SPEAKER(?). Which is what?

MR. MARTIN. $350 million.

MR. BALLES. Around $350 million.

MR. WALLICH. The principal argument in favor of "B," it seems to me, is that it is clearly and definitively inaction. Any action that is possible here is very small relative to the distortion in M1 that has taken place. So, one would seem to be making a half-hearted gesture trying to deal with M1. "B" seems to say we're not taking M1 seriously and we're suspending judgment.

CHAIRMAN VOLCKER. You're in favor of "B"?

MR. WALLICH. Yes.

VICE CHAIRMAN CORRIGAN. Me too.

CHAIRMAN VOLCKER. Corrigan is in favor of "B."

MR. FORRESTAL. Mr. Chairman, I would support alternative B also, for many of the reasons given. I think stimulation of any kind at this point, as you've indicated, would get us exactly where we don't want to be--stimulating the side of the economy that doesn't really need it and not doing much for the areas that are really, really distressed. I think it's too early to make a move one way or the other without further economic indicators. So, I would support alternative B with the borrowing at around $325 to $350 million.

CHAIRMAN VOLCKER. I myself, just in the area of fine tuning, would say $350 million played somewhat cautiously. In other words, it might be more likely to be higher rather than lower, depending upon how market conditions develop.

MR. GUFFEY. $350 to $400 million?

CHAIRMAN VOLCKER. Well, that's getting a little narrow, considering what we've gone through. Basically, I would aim at $350 million but not put funds in there if the market is very easy and--

SPEAKER(?). That's right.

MR. KEEHN. I would be in favor of that. I'd be a little clearer in my judgment if I knew what we were going to do with regard to the rebasing of ranges. But basically, I'd be in favor of "B."

CHAIRMAN VOLCKER. Well, let's make this all tentative until we come back and look at the package as a whole. And we have to consider the language too. But you're basically "B"?

MR. KEEHN. Right, with a trending up in the borrowing along the lines you described.

CHAIRMAN VOLCKER. I wouldn't say trending up. Trending up if the economy gets stronger.

MR. KEEHN. Tolerance of--

CHAIRMAN VOLCKER. Tolerance, okay.

MR. FORRESTAL. Then does that tolerance include a little on the down side if the economy turns out weaker?

CHAIRMAN VOLCKER. Well,--

MR. FORRESTAL. You know, there's not much difference between them.

CHAIRMAN VOLCKER. Well, if the economy turns out weaker, then we have different circumstances. Then, I presume we would write a directive that says if everything comes out weak we would ease and if everything turns out tight, we would tighten. But I'm talking about apart from that now; I think the word "tolerance" is for a little higher [borrowing] depending upon market circumstances. It's what we have been doing, basically.

MR. GUFFEY. I would support "B" with the caveat on the borrowing. It would appear, just looking back at the historical numbers, that the $350 million is pretty low. And we have had the federal funds rate dropping below the discount rate for some short period of time. Whatever the number is, I'd start at $350 million as kind of the base--

CHAIRMAN VOLCKER. Okay.

MR. GUFFEY. --and accept something a bit higher than that providing the funds rate is trading around the 7-3/4 percent level.

MR. BLACK. If we got 5-1/2 percent [M1 growth] from June to September, and then to December, that would mean for the year as a whole it would be something in excess of 9 percent. That seems a little too rich for me. I just don't think we need quite that much liquidity.

MR. PARTEE. The problem is that July is rather high and we can't affect July; it may be the wrong number but we are not going to affect it. And then it drifts right down; by September the point estimate is 4 percent or something, isn't it?

MR. AXILROD. Yes.

MR. PARTEE. I think that's about as sharp a dampening as one would want, Bob. And what we would then look forward to is a lower fourth quarter than the third quarter.

MR. BLACK. Well, on a quarterly basis, the second quarter to the fourth quarter would be 7.6 percent.

MR. PARTEE. That's continuing in the fourth quarter what the third quarter--?

MR. BLACK. Yes.

MR. PARTEE. I could accept that.

MR. RICE. I would like to see some gesture in the direction of less M1 growth, but I don't want to tighten up the interest rates.

MR. BLACK. I think that's where I am, Emmett.

MR. RICE. So, I could go for alternative B, keeping in mind that at the next meeting it might be necessary to do something to tighten.

CHAIRMAN VOLCKER. Well, under certain conditions, it may be necessary to do something before then. That would not be to get a lower M1, I guess, but in response to a still higher one. Who else?

MR. RICE. A minor gesture for public relations reasons might not hurt.

CHAIRMAN VOLCKER. You have different public relations in mind than I do, Emmett.

MR. MARTIN. I support alternative B with $350 million of borrowing for reasons already given.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I guess I'm more concerned about the health of the economy than most of my colleagues. The sluggishness in some areas is actually almost to be described as a recession, if you look at certain parts of the industrial sector. And Mr. Guffey's farm area I would almost call a depression. Looking at the strong dollar and the effect that it's having on the manufacturing sector, I would really like to push for something that is considered easing; if that's alternative A, then that's what I would vote for.

CHAIRMAN VOLCKER. That's alternative A by golly. Does anybody else have anything? Well, it looks like the center of gravity is at B. Is the coffee out there?

MR. BERNARD. Yes.

CHAIRMAN VOLCKER. Why don't we have our coffee? We'll come back and consider what the directive should say for the near term and consider the longer-run alternatives, working around alternative B.

[Coffee break]

CHAIRMAN VOLCKER. I think we might return to this issue of the targets for the year. If I am correct, I think the sentiment is to change the targets. Let me assume that for the moment, one way or another. If we change it to 5 to 9 percent for the year as a whole, that is roughly the same as rebasing it at 4 to 7 percent. Is that correct, Mr. Axilrod?

MR. AXILROD. Yes, that is right. The upper limits would be roughly--

CHAIRMAN VOLCKER. It's not quite the equivalent, I suppose. If we change it to 4 to 8 percent or 5 to 8 percent with rebasing, what's that equivalent to? That's equivalent to 5-1/2 to 9-1/2 percent?

MR. AXILROD. Well, 8 percent is roughly 9-1/2 percent and 5 percent is roughly 8 percent for the year.

CHAIRMAN VOLCKER. I assume we're going to do something in that area with some language fuzzing up M1 to some extent. Those are arithmetic equivalents, so I think it's purely a presentational difference. Let's talk about the substance for a moment, which I will say whichever way you [want me to] present it: Is it 5 to 9 or 5 to 9-1/2 percent, which are the equivalents of 4 to 7 and 4 to 8 percent, [respectively]. Is it the lower or the higher of those that we're talking about?

MR. MARTIN. It's the higher, to give ourselves operating room when the expectation, I think, on balance still is for a higher rather than a lower rate of growth in M1, even given the decisions made in the short run. I don't think we should set ranges that we feel have a higher probability that we can't obtain them.

VICE CHAIRMAN CORRIGAN. I'm confused.

CHAIRMAN VOLCKER. I'm not discussing whether we rebase or not.

VICE CHAIRMAN CORRIGAN. Oh, I know. I'm confused because you've lost me on the numbers.

CHAIRMAN VOLCKER. Looking at it in annual terms, the issue is whether we make the high number--which is the relevant one--9 or 9-1/2 percent; they are equivalent on rebasing to 7 or 8 percent.

MR. MARTIN. I'm arguing for 8 or 9-1/2, Mr. Chairman, depending on which way the Committee goes. It's operational; I'll join the pragmatists. We heard from a pragmatist.

MR. BLACK. Well, as another pragmatist, I'll take the other side on that because I think that that 9-1/2 percent, even with all these things going on, might be a little too much liquidity.

MR. PARTEE. It's the same amount.

MR. BLACK. No, you see--

MR. WALLICH. The symbolism is tremendous, it seems to me.

MR. BLACK. Yes, but it's not--

CHAIRMAN VOLCKER. Do you want to talk in terms of the rebased numbers so we don't have to keep talking in terms of both, without in any way prejudging that decision? Let's just refer to the rebased number or the other number.

MR. MARTIN. Yes.

VICE CHAIRMAN CORRIGAN. Let's do that. Rebased.

CHAIRMAN VOLCKER. Let's use the rebased number, which gives us two round numbers. We're talking about 7 percent or 8 percent.

MR. MARTIN. 8 percent.

SPEAKER(?) 7 percent.

MR. BLACK. 7 percent.

MR. BOEHNE(?). 7 percent.

CHAIRMAN VOLCKER. How many do we have? One 8 percent--

MR. WALLICH. 7 percent.

CHAIRMAN VOLCKER. 7 percent.

MR. KEEHN. 7 percent.

MR. FORRESTAL. 7 percent.

CHAIRMAN VOLCKER. Who am I hearing 7 percent from?

MR. PARTEE. The problem is that 7 percent is very tight.

MR. MARTIN. Very, very tight.

MR. PARTEE. That's the trouble with rebasing.

MR. MARTIN. Not with 8 percent.

CHAIRMAN VOLCKER. Well, it's the same--

MR. BLACK. That's no tighter than 9 percent if we don't rebase. It's the same; well, it's 1/10th of 1 percent different, if I read it right.

MR. PARTEE. I think if we're going to rebase that we ought to have a figure that we can have some reasonable presumption of hitting, so I'm for 8 percent.

MS. SEGER. I'm for 8 percent also.

MR. RICE. If we rebase, we may as well make it 8 percent.

CHAIRMAN VOLCKER. I'm assuming people want to be consistent arithmetically whether or not we rebase. So, I'm automatically assuming anybody that says 8 percent is for 9-1/2 percent on M1 if we change [the range] for the year.

MR. RICE. Right.

MR. PARTEE. Well, I would take 9 percent. I'd skip the 1/2 point.

MR. RICE. No, no.

MR. BLACK. Well, that puts you back down to 7 percent then, Chuck, I think.

MR. PARTEE. The 1/2 point does?

MR. BLACK. Yes, it does.

CHAIRMAN VOLCKER. To repeat: The arithmetic equivalents, I think, are 9-1/2 and 8 percent and 9 and 7 percent.

VICE CHAIRMAN CORRIGAN. I can live with 8 percent.

CHAIRMAN VOLCKER. Now, cosmetically, people may think it's different. They may be happy to do 4 to 8 percent but not 5-1/2 to 9-1/2 percent, even though they're the same thing.

MR. MARTIN. The media will talk about the top of the range; the media will talk about 8 percent. They've done it again and again. I think, cosmetically, we will have them talking about rebasing for one day and it will be forgotten.

CHAIRMAN VOLCKER. I'm not sure I've heard from everybody here. Mr. Balles.

MR. BALLES. Oh, I guess to give us a little room I'd go for 8 percent.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. 7 percent for me, Mr. Chairman.

CHAIRMAN VOLCKER. Well I've heard from all the Committee members. Do I want to hear from anybody else?

VICE CHAIRMAN CORRIGAN. It depends on what they want to say!

MR. BLACK. The Committee members didn't do a particularly good job; maybe you ought to listen to them.

CHAIRMAN VOLCKER. Any non-Committee members have a strong feeling that they want to affect this narrow balance here?

MR. MORRIS. They both seem unrealistic to me, Mr. Chairman. One is growth of 1/2 to 1 percent June to December and the other is 2.8 percent; and both of those seem improbable. No, that's not right.

MR. PARTEE. 5 percent.

MR. BLACK. It's 5 percent.

MR. MORRIS. I thought you were talking about 7 or 8?

MR. PARTEE. This is quarter 4. We're talking about rebasing.

CHAIRMAN VOLCKER. This is if we rebase, which is the equivalent of 9 or 9-1/2 percent if we do the full year.

MR. PARTEE. That's a little more than 5 percent.

MR. MORRIS. I could take it; I was looking at the wrong numbers.

MR. BOEHNE. If we're going to take the heat of rebasing or upping the range, it seems to me we ought to go far enough to give us some breathing room. I wouldn't want to go six months and every week get hit on the head because we have gone over target.

MR. PARTEE. Rebase again!

CHAIRMAN VOLCKER. Well, I'll just add that we're going to start off high and we're just stuck here. Unless we rebase on the first week in July, we're going to start out above. I don't know that we start out above the parallel lines, but the parallel lines close up pretty fast; we've only got six months. But we're going to start off well above the cone simply because the trajectory was so sharp in June. It's not going to look appreciably different whether we pick 7 or 8 percent because it doesn't make any difference when we're that close to the origin.

MR. PARTEE. What about 3 to 8 percent, Paul?

MR. BLACK. That's a little sneaky.

MR. WALLICH. At least that says that--

MR. PARTEE. If it comes back down, why, we'll accept it.

MR. WALLICH. Yes, that they're not taken to be quite so weighty.

CHAIRMAN VOLCKER. There are so many permutations and combinations. What we have is a slight majority for 8 percent at the moment. Now, let's see whether this has affected where you are on rebasing or not. Let me just ask the Committee members; we'll probably be 50/50. Now, all of this is going to have some kind of language that depresses the importance of M1, probably somewhat short of calling it a monitoring range, if I understand this [discussion] correctly. It won't be demoted all the way to a monitoring range but it will be deemphasized a bit.

MR. PARTEE. With a certain amount of diffidence.

CHAIRMAN VOLCKER. That's right. Who wants to rebase? One, two, three, four, five, six. [Secretary's note: Messrs. Balles, Black, Forrestal, Keehn, Martin, and Ms. Seger.] Did I count that right? Yes, just what I figured.

MR. BLACK. Well, you could break the tie, Mr. Chairman.

VICE CHAIRMAN CORRIGAN. We don't have a tie.

MR. MORRIS. Now ask about the other one.

MR. PARTEE. Ask about the other one.

CHAIRMAN VOLCKER. Do you mean: Who doesn't want to rebase?

MS. HORN. If you want [to be] certain.

MR. PARTEE. You definitely want to rebase?

CHAIRMAN VOLCKER. You think that some are indifferent.

MR. RICE. Probably.

MR. BLACK. There are 6, and if the Chairman is going with it, there would be 7.

CHAIRMAN VOLCKER. Who doesn't want to rebase?

MR. WALLICH. Well, I'd go with rebasing provided we stay with the 4 to 7 percent.

MR. PARTEE. The reason I asked is that I'm going to vote with you. I would prefer not rebasing; but if you want to rebase, I'll rebase.

CHAIRMAN VOLCKER. I don't think this is the most crucial issue in the world. Let me ask the question somewhat differently. Who feels strongly that we should not rebase?

MR. GUFFEY. I'm not a voting member, but I would prefer not to.

MR. PARTEE. You could hardly be strong about this.

CHAIRMAN VOLCKER. Who feels strongly that we should rebase? That was 3 or 4 members. We have more qualitative strength of feeling on that side. Now, we'll lose them all when we put the numbers on. The majority was for 4 to 8 percent if we rebased. Or we could make it 3 to 8 percent. Does that help? Would people like to make it 3 to 8 percent?

MR. MELZER. That might give a little more room to tolerate much slower growth toward the end of the year.

CHAIRMAN VOLCKER. Does anybody object to saying 3 to 8 percent?

MR. PARTEE. It gives you a little better average too.

MR. BLACK. I don't object to the 3 percent; I object to the 8 percent.

CHAIRMAN VOLCKER. Who's in favor of 3 to 8 percent, rebased?

VICE CHAIRMAN CORRIGAN. That's a landslide!

CHAIRMAN VOLCKER. Yes. Well, I don't think we're going to get any combination that's better than that, but the floor is open for anybody who wants to try another number.

MR. FORRESTAL. I said 4 to 7 percent originally, but I don't feel strongly enough about 3 percent on the down side; it seems to me to be fairly unimportant given the state of M1 at the moment.

CHAIRMAN VOLCKER. Well, a way we could face that, I suppose, is if the dollar were weak, quite weak, and we felt it necessary to respond to it. If we began getting low money supply numbers, we might want to say that's fine--with that big increase we had in the first half of the year and the dollar weak, the economy is going to get better. That's the kind of conditions. It may be a very outside [chance], but I don't think it's absolutely impossible.

MR. FORRESTAL. [Unintelligible] on the high side.

MR. PARTEE. If this May-June increase is reversible, we could get--

CHAIRMAN VOLCKER. Yes, just as a kind of natural reflux plus something else. As soon as we want to be pretty restrictive we might run into a low number.

MR. KEEHN. What's the message that moving the band from 3 points to 5 points conveys to the markets?

MR. PARTEE. Some uncertainty.

CHAIRMAN VOLCKER. I think that probably is fair enough, isn't it, given all the uncertainty we've expressed? That seems to be consistent.

MR. KEEHN. It's a fairly heavy change.

MR. AXILROD. That gives you approximately 7 percent for the year.

CHAIRMAN VOLCKER. For what?

MR. AXILROD. It makes it approximately 7 percent, 6.8 percent, for the year.

CHAIRMAN VOLCKER. What does?

MR. AXILROD. The 3 percent lower limit.

MR. PARTEE. If we happen to get 3 percent.

MR. AXILROD. Yes. Therefore, this involves no change--

MR. PARTEE. I could buy the top with a 3 percent [lower limit].

MR. BOEHNE. Well, there have been an awful lot of double-digit months followed by zero months.

CHAIRMAN VOLCKER. I think it's very unlikely we would get 3 percent, but I don't--

MR. PARTEE. I do too.

CHAIRMAN VOLCKER. If we had a combination of a desire to tighten some plus a kind of natural reflux, I don't think it's absolutely impossible. I don't think it would be very hard from a June base, but it's awfully hard from a second-quarter base, given how high we start out.

MR. GUFFEY. But with only a 6-month horizon we ought to have a wider band. A 3 to 8 percent range would be a--

CHAIRMAN VOLCKER. I agree with that. I don't know what the arithmetic is, but to get 3 percent for the year we'd have no growth from now on, I guess.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. That's pretty low.

MR. AXILROD. It means after July it would be negative.

MR. KEEHN. Then what do we do about the range for next year if we have 3 to 8 percent for the rest of this year?

MR. PARTEE. 3 to 7 percent.

CHAIRMAN VOLCKER. It was 4 to 7 percent that we were talking about, wasn't it? Well, is there a preference for 3 to 8 percent as opposed to 4 to 8 percent?

VICE CHAIRMAN CORRIGAN. Yes, I have a preference.

SPEAKER(?) Yes.

CHAIRMAN VOLCKER. Well, I've found a fair amount of support for 3 to 8 percent, all things considered. Does anybody have a proposal that they think will attract more support? We were going to keep the other aggregates unchanged, right? Well, let's try some language. Let me suggest something like this--and this is surely not written in concrete--looking at the language on page 20 [of the Bluebook]: "In furtherance of these objectives, the Committee at this meeting reaffirmed ranges for the year of"--whatever they are for M2 and M3. What is it, 6 to 9 percent--?

MR. BERNARD. 6 to 9 percent for M2 and 6 to 9-1/2 percent for M3.

CHAIRMAN VOLCKER. --"and 6 to 9-1/2 for M3. The associated range for total domestic nonfinancial debt was reaffirmed at"--

MR. BERNARD. 9 to 12 percent.

CHAIRMAN VOLCKER. --"9 to 12 percent." Now, if we change the base we would say: "The base for the M1 range was moved forward to the second quarter of 1985."

MR. PARTEE. And the range.

CHAIRMAN VOLCKER. "--was moved forward to the second quarter of 1985 and established at 3 to 8 percent, tentatively, in the expectation of a return of velocity growth toward more usual patterns, following a sharp decline of velocity during the first half of the year." I would insert something like "the appropriateness of the new range will continue to be reexamined in the light of evidence with respect to economic and financial developments, including foreign exchange markets." That is an attempt to say that we'll look at this with some flexibility but not use the term "monitoring range." And then I would leave that last sentence, I think: "The Committee agreed that growth in the aggregates generally may be in the upper parts of their ranges, depending on continuing developments with respect to velocity and provided inflationary pressures remain subdued." How does that package--

MR. RICE. Would you read that last part about--

CHAIRMAN VOLCKER. Well, let me read the whole thing again. This has some preliminary boilerplate sentences, if you go back to get the whole thing, to the effect that the Federal Open Market Committee wishes to do wonderful things. "In furtherance of these objectives the Committee at this meeting reaffirmed ranges for the year of 6 to 9 percent for M2 and 6 to 9-1/2 percent for M3. The associated range for total domestic nonfinancial debt was reaffirmed at 9 to 12 percent. With respect to M1, the base was moved forward to the second quarter of 1985 and a range was established at 3 to 8 percent in the expectation of a return of velocity growth toward more usual patterns, following a sharp decline in velocity during the first half of the year. The appropriateness of the new range will continue to be reexamined in the light of evidence with respect to economic and financial developments, including foreign exchange markets. More generally, the Committee agreed that growth in the aggregates may be in the upper parts of their ranges, depending on continuing developments with respect to velocity and provided that inflationary pressures remain subdued."

MR. AXILROD. "At an annual rate" [should be added] after the 3 to 8 percent.

CHAIRMAN VOLCKER. "Established at an annual rate of 3 to 8 percent"? It sounds awkward. That's the way to make it sound lower: "established at 1-1/2 to 4 percent"! I guess we say "at an annual rate."

MR. BLACK. I guess so.

MR. PARTEE. It might take some a while to pick that up.

CHAIRMAN VOLCKER. Obviously, if we change the range for the year we have to have a somewhat different sentence here, taken off from the other sentences in the directive. But how does that sound?

MR. AXILROD. That would be followed I assume, Mr. Chairman, by that paragraph that we didn't repeat on the top of page 20? "The Committee understood that policy implementation would require..." and all that.

CHAIRMAN VOLCKER. Where is that?

MR. AXILROD. It's on the top of page 20. That's the next paragraph in the structure of the directive.

CHAIRMAN VOLCKER. Why do we need that?

MR. PARTEE. We had that, didn't we?

CHAIRMAN VOLCKER. We already have it.

MR. AXILROD. You can take it out with the new wording.

MR. PARTEE. Yes, I should think that--

CHAIRMAN VOLCKER. It's in the short-term part. Why can't we just take that out?

MR. AXILROD. I think the way this is reworded, you certainly can.

CHAIRMAN VOLCKER. Well, the way I've just written this sentence, what I inserted has some of that sense. The appropriateness of the new range just applies to M1. If that general language seems all right, this of course assumes that we rebase. It also contains some numbers. I don't think there's any dispute with the numbers for M2, M3, and debt. I don't know that anybody has any better number to put in for M1. Does anybody have anything further to say about whether we rebase or not? If not, maybe we better vote on this.

MR. BERNARD. This is for the 1985 ranges:

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
President Balles	Yes
President Black	No
President Forrestal	Yes
President Keehn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. Let us go on to the 1986 ranges; I'm not sure I remember what we decided on before.

VICE CHAIRMAN CORRIGAN. Could be good reason for that!

CHAIRMAN VOLCKER. I think there was agreement on M2, M3, and debt. It would be: "The Committee agreed on tentative ranges of monetary growth measured from the fourth quarter of 1985 to the fourth quarter of 1986--". Well, the first question that arises is whether we want to leave M1 in that same sentence or deal with it separately. The numbers anyway are: 6 to 9 percent for M2; 6 to 9 percent for M3; and the associated range for debt was 8 to 11 percent. I think we pretty much agreed on that part. Now, whether we leave M1 in this sentence or not, I think we probably would want to say something separately about M1. Wasn't that the sense of where we were? Or we can just leave it. I don't know. What do you think? There was some disagreement about whether it should be 4 to 8 percent or 4 to 7 percent, with a majority at 4 to 7 percent.

MR. PARTEE. Well, all of these are tentative. Is there some word like "tentative" in there?

CHAIRMAN VOLCKER. It starts out by saying "tentative ranges." I think that's the question: whether we somehow want to try to indicate that M1 is even more tentative than usual.

MR. PARTEE. Especially tentative.

CHAIRMAN VOLCKER. "Agreed on tentative ranges for M2 and M3 and an even more tentative range--"

MR. WALLICH. I think there's something to be said for staying with 3 to 8 percent and carrying that forward. But if we don't, then at least the midpoint should be preserved so that 4 to 7 percent is the logical thing.

CHAIRMAN VOLCKER. Well, 3 to 8 percent was not in the ballpark when we discussed it earlier. I'm not saying we can't do it now. I just have the feeling, in light of the earlier discussion, that if they're all left in the first sentence that way, which may be all right, we should put in a sentence saying that the Committee recognized that the behavior of M1 velocity was subject to particular uncertainties that would require reexamination at the beginning of the year or something. Does that thought make sense?

MR. MARTIN. Yes, that makes sense; and then preserve the 3 to 8 percent.

VICE CHAIRMAN CORRIGAN. It cuts the other way.

MR. RICE. Or we can say 4 to 7 percent.

MR. MARTIN. But I want to go from 3 to 8 percent to 4 to 7 percent, you see, eventually. And I want to start at 3 to 8 percent.

MR. KEEHN. Again, this is preliminary. What if we did go to 3 to 8 percent now and 4 to 7 percent but use some caveats that if the normal relationships didn't reemerge, we might consider a wider band?

MR. MARTIN. But they haven't reemerged. Why start backwards?

MR. KEEHN. Well, they might.

MR. MARTIN. They might, and then we can narrow the range. That's when you narrow the range--when you know something.

MR. KEEHN. But in the interim, don't you think it would be useful to have a message out there that we intend to continue moving toward price stability? This is a way we can accomplish that.

MR. PARTEE. Well, if we use 3 to 8 percent, it seems to me that it ought to be picked out of the first sentence and put in the second sentence.

CHAIRMAN VOLCKER. I agree.

MR. MARTIN. Yes, I agree.

MR. PARTEE. I must say that I think there's some merit to that argument that we need a little more certainty before we collapse the range.

VICE CHAIRMAN CORRIGAN. Yes, but we're not really collapsing it. The backdrop of even a tentative range for 1986 is going to be very, very rapid growth in 1985. I do think that in a context in which we emphasize uncertainty, the direction of the M1 range and the time to [unintelligible] should be set a notch lower.

MR. PARTEE. The fact of the matter is that if we need the 8 percent in M1 to keep the economy going, we're going to have 8 percent in M1 as a practical matter.

VICE CHAIRMAN CORRIGAN. I agree.

MR. PARTEE. But we [unintelligible] going to read the papers with interest.

CHAIRMAN VOLCKER. Well, I just wrote a sentence here. We could leave M1 in the same sentence at the beginning but then say: "With respect to M1 particularly, the Committee recognized that uncertainties surrounding the recent behavior of velocity would require careful reappraisal of the target range at the beginning of 1986."

MR. MARTIN. Good.

CHAIRMAN VOLCKER. Whatever number we put in there--. If we put in 3 to 8 percent, we can just say: "With respect to M1, the breadth of the target range reflected the uncertainties surrounding velocity, which would require--

MR. MORRIS. We could preface it, Mr. Chairman, by saying in the light of the fact that in 3 out of the past 4 years we have set aside or rebased the M1 target.

MR. PARTEE. I don't think we want to say that.

CHAIRMAN VOLCKER. That's right: '82 and '83.

MR. MORRIS. '84 is the only one--

MR. BALLES. Unless there's been a [unintelligible], that doesn't help.

MR. AXILROD. In '81, we sort of ignored it.

CHAIRMAN VOLCKER. Well, what number do you want to put in for M1?

VICE CHAIRMAN CORRIGAN. 3 to 7 percent.

MR. MARTIN. 3 to 8.

MR. KEEHN. 3 to 7.

MR. FORRESTAL. 3 to 7.

MR. PARTEE. 3 to 8.

MR. WALLICH. 3 to 7.

MR. BLACK. 3 to 7.

CHAIRMAN VOLCKER. 3 to 7 percent, let me note, is [unintelligible] low.

VICE CHAIRMAN CORRIGAN. 4 to 7 percent, then.

MR. BLACK. 4 to 7.

MS. SEGER. 3 to 8.

MR. RICE. 4 to 7.

CHAIRMAN VOLCKER. I think the choice is between 4 to 7 percent and 3 to 8 percent. Who's for 3 to 8 percent? One, two, three, four. [Secretary's note: Messrs. Martin, Partee, and Wallich, and Ms. Seger.] Who's for 4 to 7 percent? And we'll see how many are indifferent here between them. One, two, three, four, five, six. [Secretary's note: Messrs. Balles, Black, Corrigan, Forrestal, Keehn, and Rice.] I guess that says we make it 4 to 7 percent. Do we leave it in the same first sentence?

MR. PARTEE. Particularly if it's 4 to 7 percent.

MR. RICE. Yes.

MR. MARTIN. I'd rather see it treated special.

CHAIRMAN VOLCKER. It's partly special now because we put in a special sentence. It's a great subtlety as to whether it's doubly special or half the same and half special. I don't detect any ground swell to take it out of the first sentence. So it would read: "For 1986 the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 4 to 7 percent for M1, 6 to 9 for M2, and 6 to 9 for M3. The associated range for growth in total domestic nonfinancial debt was provisionally set at 8 to 11 percent for 1986. With respect to M1 particularly, the Committee recognized that uncertainties surrounding

recent behavior of velocity would require careful reappraisal of the target range at the beginning of 1986." We better change that last sentence. "Moreover, in establishing ranges for next year, the Committee also recognized that account would need to be taken of experience with institutional and depositor behavior in response to the completion of deposit rate deregulation early in the year." Does anybody want to suggest any modification of that language? Well, I'll get the question: Does that mean it's a monitoring range?

MR. PARTEE. I should say the whole thing's up for grabs given the two sentences. They both suggest to me that it's possible that [unintelligible] things could be done for--

MR. BALLES. I thought we were going to stop short of a monitoring range.

VICE CHAIRMAN CORRIGAN. One way is to say that it could become one but it is not.

MR. MARTIN. I don't think you need it. I don't think you need the word "monitoring."

MR. PARTEE. I don't either. No.

CHAIRMAN VOLCKER. Oh, you don't need it here, but I will be asked. That's pretty fuzzy, so I will be asked: What do you mean?

MR. PARTEE. It's pretty muddy. It might be one of those options.

MR. KEEHN. It's too early to form a judgment.

CHAIRMAN VOLCKER. If nobody has any improved language to propose here, I think we have 4 to 7 percent, 6 to 9 percent, and 6 to 9 percent.

MR. BERNARD. And 8 to 11 percent.

CHAIRMAN VOLCKER. 8 to 11 percent [on debt].

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
President Balles	Yes
President Black	Yes
President Forrestal	Yes
President Keehn	Yes
Governor Martin	No
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	No
Governor Wallich	Yes

CHAIRMAN VOLCKER. All right. Now we get to the operational part. Forgetting about the language for the moment, what we were saying I think fits this definition of "maintaining the existing degree of pressure," to be interpreted arithmetically, I suppose, as $350 million plus. We have a week this week that started out with a

high level of borrowings and we're saying we won't drive the average level of borrowings down to $350 million and push a very easy money market simply to meet that target. We make allowances on the up side more than on the down side, depending upon market developments. That's what we're doing initially. Heaven knows what happens from now on. If the money supply continues to rise fast, that certainly is a factor pushing us toward a tighter direction. That's easy to say, but suppose that is combined with a tone of worse business news; we'd be pretty cautious about it, I suppose. What we may have is a decided weakening of the dollar here. We may have broken through this three mark level of the dollar and we may see a continuing decline, which sooner or later probably has to come. But if it begins getting momentum, I think that's a factor on the tightening side. It's easy to say any one of these things singly. When they go in opposite directions at the same time--

MR. MARTIN. Which they will.

CHAIRMAN VOLCKER. They probably will. I don't think we can say much except that if this gets extreme enough, we will have a consultation. We get a nice clear picture if the dollar is weak, the economy is strengthening and M1 is high; we clearly would be leaning on the tightening side. But if things don't all go in that direction, we have a bigger mess. I don't know what more we can say about it, really.

MR. GUFFEY. That kind of description precludes easing, except when everything runs in the opposite direction that you just described.

CHAIRMAN VOLCKER. Well, it's a matter of degree. If the economy looks soft, the other aggregates are behaving, and M1 is within the general range here, we might ease, particularly if the dollar were strong. Apart from that, we don't have a lot of room for easing anyway, on reserve pressures. [The Board] can easily make a change in the discount rate, but we can't get borrowings a heck of a lot lower.

MR. MARTIN. We can reduce the discount rate.

MR. BLACK. Does this mean you would say somewhat lesser reserve restraint "might" be acceptable rather than "would," Mr. Chairman?

MR. PARTEE. In the end of the second part of the sentence I'd be tempted to say "would" instead of "might."

MR. BLACK. Yes. I usually like "would" on both of them, but this time I--

CHAIRMAN VOLCKER. Do you want to say "might" and "would"?

MR. BLACK. That's what I would prefer.

CHAIRMAN VOLCKER. [Unintelligible] change the order. "In the implementation of policy for the immediate future the Committee seeks to maintain the existing degree of pressure on reserve

conditions. This action is expected to be consistent with growth in M2 and M3 at annual rates of"--what is that?

MR. BLACK. 7-1/2 percent and 7-1/4 percent, I think.

CHAIRMAN VOLCKER. Yes, but we don't want 7-1/4 percent in there.

MR. PARTEE. Yes, make it 7-1/2 percent.

CHAIRMAN VOLCKER. Continuing: "of around 7-1/2 percent during the period from June to September and with a substantial slowing of M1 to a rate of 5 to 6 percent." We could put that first, if you wanted to.

MR. PARTEE. Consistent with what we've been saying, put it second.

CHAIRMAN VOLCKER. All right. Well, I just changed something. Instead of just putting that number in parallel [with the others], I said "with a substantial slowing of M1 to a rate of 5 to 6 percent." And then the rest of it would be "might" and "would." There's nothing else there that needs to be changed particularly, is there?

MR. PARTEE. Would you like to change that funds rate range to 9 percent at the top?

CHAIRMAN VOLCKER. We could. But where are we now? We're not quite at the midpoint of a 6 to 9 percent range; well, we're pretty close to the midpoint. We could if you wanted to. I don't--

MR. PARTEE. Certainly people would be getting excited if it ran over 9 percent, wouldn't they?

CHAIRMAN VOLCKER. Yes, they surely would. I might even get a little excited if it went to 6 percent, too.

MR. PARTEE. Well, it seems to me some evenness--. I dislike [unintelligible] of the extreme numbers.

CHAIRMAN VOLCKER. I think the only argument against that--and I don't even know that it's against it--is that a month from now when this is published the press will play that as an easing, despite what we said earlier. I don't know if that's a big deal.

VICE CHAIRMAN CORRIGAN. Better leave well enough alone.

MR. MELZER. It was okay last month; it ought to be okay now.

CHAIRMAN VOLCKER. 6 to 10 percent.

MR. PARTEE. We will have a telephone call if it gets to 10 percent?

CHAIRMAN VOLCKER. I think I would have one somewhat before that.

VICE CHAIRMAN CORRIGAN. If it gets to 10 percent, Chuck, you won't need the telephone!

MR. BLACK. Some other people might be calling!

CHAIRMAN VOLCKER. If it gets to 10 percent, I may not be here to make the telephone call! If nobody has any further comments to make, we will vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
President Balles	No
President Black	No
President Forrestal	Yes
President Keehn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	No
Governor Wallich	Yes

CHAIRMAN VOLCKER. Well, we seem to have worked our way through this. Maybe you ought to get some clean typed copies of this [directive], Mr. Secretary, and we'll leave the record open for any editorial changes.

MR. PARTEE. Would you like us to reconsider our projections?

CHAIRMAN VOLCKER. Just in the normal course of events, you ought to reconsider the projections at this point. I would remind you that these are explicitly projections of members of the Committee and are presented on that understanding to the Congress. These projections are closer than they usually are, I think. There is usually an array of different numbers. Under the assumptions made, some of these inflation numbers look high to me. I think we have a substantial risk of inflation and worse when and if the dollar goes down, but that's not the assumption of these projections. And we will have a real mess on our hands if the dollar goes down sharply. We will have a real mess on our hands if it doesn't, which is unpleasant, and which is the measure of our difficulty. But I don't know how we turn around this trade balance without overtaxing at this point the industrial side of the economy, apart from the direct effects of the lower exchange rate on higher prices. We haven't got 10 percent of spare capacity and that's what it takes--probably more than 10 percent --to produce a trade balance in the course of three or four years.

MR. TRUMAN. 2 percent of GNP.

CHAIRMAN VOLCKER. 2 percent of GNP. And manufacturing is 20 percent of the GNP; it's more than that value added.

MR. TRUMAN. We're presuming we'll get some of this out of agriculture as well.

CHAIRMAN VOLCKER. 3 percent of GNP.

SPEAKER(?). That's right.

CHAIRMAN VOLCKER. Three, or more than three. We face the prospect of some indefinite number of years ahead of having lower domestic consumption than GNP, lower domestic demand than GNP. I don't know how you manage that except by budgetary policy and even then it's not very happy. Barring an equally violent shift in fiscal policy from what we've had, I literally don't know how it gets managed. If you try to do it by monetary policy, you tighten money and you hit the investment side of the economy--which is precisely the side that has to expand to meet the foreign demand. The tax reform bill hits the investment side of the economy and not the consumption side of the economy. And you say some of it is in agriculture; I think part of the problem is agriculture. The major part of the problem is that people aren't eating enough or the crops are too good in the rest of the world, depending upon which way you want to put it. In a residual supply you have a little difficulty in selling to a surplus market.

MR. TRUMAN. Not necessarily on quantity, but you might get something on price. That will help you too.

VICE CHAIRMAN CORRIGAN. That's a ways off too.

VICE CHAIRMAN CORRIGAN. Mr. Kichline, have you heard anything about these normal GNP revisions--the historical revisions that come up later in the year--pointing in the direction of a substantial downward revision in the deflator over the past several years?

MR. KICHLINE. Well, the whole national income accounts structure will be revised in a major way in December. The last major one of this significance was in 1975.

VICE CHAIRMAN CORRIGAN. Right.

MR. KICHLINE. And they will be rebasing the deflators to 1982 instead of 1972 dollars. That will make major changes. One area where they are struggling, of course, is in the computer area where for the last decade they held the price at $100 and the assumption is that the right price is something like one-fifth of that. But when they rebase, a lot of these things will disappear. There is a hint that they'll probably find more output along the way. There have been some upward revisions to income. The IRS has had a program trying to track down income growth and it appears that the numbers that IRS has come up with are much higher than incorporated in the national income accounts. So it appears at the moment that there will be some upward revisions to income in this set of revisions coming out. But it's going to be so major, any of the numbers you now remember will disappear as a result of the base changes and other things.

CHAIRMAN VOLCKER. When does the next GNP, or whatever they call it, number come out?

MR. KICHLINE. The first preliminary? It comes out July 18th, a week from tomorrow.

CHAIRMAN VOLCKER. The day before I testify, so I'll know what that is.

MR. BOEHNE. What date do you testify?

CHAIRMAN VOLCKER. July 19th.

MR. BOEHNE. The 19th?

MR. BLACK. I thought it was the 17th.

CHAIRMAN VOLCKER. The 17th. Oh, it's the day after I testify! I'll get asked what that figure is and I'll have to take a stab. Who does that now? Who's the head of that?

MR. PRELL. At BEA Allen Young is Acting Director.

MR. KICHLINE. Allen Young.

CHAIRMAN VOLCKER. That's a terrible day. I'll say I think it's really going to be low and then they'll raise it. They'll testify the next day with it.

MR. BOEHNE. Is it the House side first or the Senate side?

CHAIRMAN VOLCKER. House side first. I don't know whether the sandwiches are out there. Will somebody investigate?

SPEAKER(?). They are out there.

CHAIRMAN VOLCKER. Well, I guess the Open Market Committee meeting is over. I declare it over.

MR. KICHLINE. Mr. Chairman, the Board is scheduled to review drafts of this Humphrey-Hawkins report on Friday morning, so if there are revisions to projections we really would need them by tomorrow evening.

SPEAKER(?). Here's one.

MR. KICHLINE. Thank you.

END OF MEETING