

Meeting of the Federal Open Market Committee

November 18, 1980

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, November 18, 1980, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman  
Mr. Solomon, Vice Chairman  
Mr. Gramley  
Mr. Guffey  
Mr. Morris  
Mr. Partee  
Mr. Rice  
Mr. Roos  
Mr. Schultz  
Mrs. Teeters  
Mr. Wallich  
Mr. Winn

Messrs. Balles, Baughman, and Eastburn, Alternate Members  
of the Federal Open Market Committee

Messrs. Black, Corrigan, and Ford, Presidents of the Federal  
Reserve Banks of Richmond, Minneapolis, and Atlanta,  
respectively

Mr. Altmann, Secretary  
Mr. Bernard, Assistant Secretary  
Mr. Petersen, General Counsel  
Mr. Oltman, Deputy General Counsel  
Mr. Mannion, Assistant General Counsel  
Mr. Axilrod, Economist  
Mr. Holmes, Adviser for Market Operations

Messrs. Balbach, J. Davis, T. Davis, Ettin, Henry,  
Kichline, Truman, and Zeisel, Associate Economists

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

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

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Mr. Coyne, Assistant to the Board of Governors  
Messrs. Prell and Siegman, Associate Directors, Divisions  
of Research and Statistics, and International Finance,  
respectively, Board of Governors

Mr. Beck, Senior Economist, Banking Section, Division of  
Research and Statistics, Board of Governors

Mrs. Steele, Economist, Open Market Secretariat, Board  
of Governors

Mrs. Deck, Staff Assistant, Open Market Secretariat,  
Board of Governors

Messrs. Boykin, Doyle, and McIntosh, First Vice Presidents,  
Federal Reserve Banks of Dallas, Chicago, and Boston,  
respectively

Messrs. Boehne, Brandt, Danforth, Keran, Parthemos, and  
Scheld, Senior Vice Presidents, Federal Reserve Banks  
of Philadelphia, Atlanta, Minneapolis, San Francisco,  
Richmond, and Chicago, respectively

Mr. Kubarych and Mrs. Nichols, Vice Presidents, Federal  
Reserve Banks of New York, and Chicago, respectively

Mr. Ozog, Manager, Securities Department, Federal Reserve  
Bank of New York

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CHAIRMAN VOLCKER. We need to act on the minutes.

MR. PARTEE. So moved.

MR. SCHULTZ. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Pardee.

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

CHAIRMAN VOLCKER. Should we ratify the transactions before I forget?

MR. SCHULTZ. So moved.

MS. TEETERS. Second.

CHAIRMAN VOLCKER. Without objection they are ratified. Is there any discussion?

MR. WALLICH. Scott, you made a number of very interesting observations. I just want to check on how to interpret them. One, you said we bought as many marks as we possibly could. Was there really in some sense a restraint on how much we could do? Why couldn't we have done more?

MR. PARDEE. It's an interesting exercise in how we achieve a certain objective. In order to maximize our purchase of marks, we have to have a rising dollar market. So each time the dollar would rise, we would be in the market either in New York or in Frankfurt through the Bundesbank. But we would do small amounts. And to the extent that we would be perceived as operating we would [then want to] be perceived as backing away. It's quite different from an operation in which we're trying to stop a movement in the rate. The idea was to allow the rate to continue to move and thereby we would continue to amass marks. Once the exchange market comes to a stable point, it's very difficult to dig many marks out of it.

MR. WALLICH. My second question: You said the dollar might have been driven to levels that would have been perceived as unsustainable without this intervention. Do you have any thoughts as to what these levels might have been?

MR. PARDEE. It's very possible that it could have gone over 2 marks to the dollar, but with a much more volatile market, much greater pressure on our foreign central bank counterparts to do something in response to the decline in their currencies, and much greater pressure on the EMS snake relationship.

MR. WALLICH. I also noted that you said we helped other countries hold their interest rates down. I believe that is right and I believe intervention can have that function. And it's an important effect. I just want to argue that one can't trade off intervention for interest rates very far, though there is some such effect.

MR. PARDEE. I tried to phase it artfully. I don't see that necessarily as an objective of policy. No one has told me that it's an objective of policy. I'd say it's more a result of the policy.

MR. WALLICH. And finally, were you satisfied with the amount of foreign support you got and their maintenance of orderly markets once the dollar dropped sharply and then recovered sharply?

MR. PARDEE. Well, the only instance of foreign support was from the Bundesbank on that Tuesday morning. Since we are operating through them to buy marks, there is the possibility that we would complete the circle and ask them also to sell marks for us. The risk is that once we start intervening through the Bundesbank really in support of the dollar, then we will take over all of the operations on both sides of the Atlantic, which could be very expensive. So on that morning, I talked to my friend from the Bundesbank who said he had no particular interest in buying dollars that morning, but he did notice some conditions that he considered to be disorderly--that is widespread, sharply moving rates--in the market. So he did step in and buy dollars even though as far as his broader interests were concerned there was no need to step in at that time. But we did have good cooperation. I hope our operations now are buying a good bit of cooperation for the next sequence of difficulties for the dollar.

MS. TEETERS. What do you mean by that? Do you think the dollar is going to drop?

MR. PARDEE. Exchange markets are very volatile. We have periods in which the dollar rises and we have periods in which it drops. And as I indicated, to the extent that interest rates level off or drop back, we may have a decline in the dollar. And to the extent that the markets tend to overreact then, I am sure we will be back in the market on the other side. This has been the way of life since 1973.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Scott, would you say that our trading partners are estimating our current account improvement at close to the same magnitude as the staff estimates?

MR. PARDEE. You might know more about that than I do, [Ted].

MR. TRUMAN. I am not sure about our trading partners per se. The market in general tends to have a somewhat smaller [estimate of our] current account surplus in 1981 than we do. The OECD has a forecast for our current account surplus for 1981 in the \$12 billion range as compared with the staff's \$18 billion. Now, I would consider those in the same ball park, but we tend to be a little higher than the consensus that I am aware of.

MR. BLACK. Thank you.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I guess I don't understand the operating rules that we use for intervention any more, Scott. I thought we intervened only in disorderly markets. We have had a market that has been moving

up; it was not particularly disorderly. You said we bought as many marks as we possibly could. I didn't understand that to be what people did when they intervened. And my impression is that we bought far more marks than the Germans did. That is, we are doing the supporting of the mark, not the Germans. And you gave as a reason for it that it helps hold down interest rates abroad, which I think is a very strange reason indeed because it seems to me that if we want to hold down interest rates, we ought to hold them down here not abroad. So I just don't understand what is happening. You also said that we were doing this to match the Treasury's [foreign currency] debt. But we have matched the Treasury's debt. We have gone \$100 million over the Treasury's debt and you were still buying like mad early this week. So I think it's time for a discussion of the terms on which we intervene and what our strategy is other than that we just buy as many marks as we can every time the dollar goes up.

CHAIRMAN VOLCKER. I don't know how prolonged a discussion we can have, but I would state it somewhat differently.

MR. PARDEE. I am open to discussion, but--

CHAIRMAN VOLCKER. I don't know about buying all that we can. That's a matter of interpretation.

MR. PARTEE. Well, we bought \$250 million [worth of marks] or something like that on Monday. How much did the Germans do?

MR. PARDEE. The Germans have had a

have taken up a great deal of their time. So what we've had in terms of economizing time, is that the Bundesbank officials--

MR. PARTEE. If we do the buying?

MR. PARDEE. They've been worrying about the mark/French franc relationship and we have been worrying the mark/dollar relationship. We have been providing them with orders, which would be roughly the type of operations they would have in line with our objectives and in line with the kinds of operations they have conducted in the past as well.

CHAIRMAN VOLCKER. I think the Germans have a mixed mind about this whole thing. They don't like the mark depreciating, but they at least have an argument as to whether intervention is effective as a means of preventing it from appreciating. There's one school of thought that says: Let it go up so it will go down further and the market will learn a lesson. And I think that school of thought has been prevalent. But we have been in a position of rather eagerly buying in large part because the Treasury was extremely anxious to cover its losses. They are also anxious--I think it's a reasonable point and this is a combined operation--to have some surplus over the coverage of their [foreign currency denominated] bonds in case the dollar goes in the other direction. They want a cushion so we will have some margin of protection without making them short. And I suppose from our standpoint, a cushion seems reasonable too.

MR. PARTEE. Well, I don't know why that is.

CHAIRMAN VOLCKER. Well, it's a small cushion now; we haven't debated precisely how big the cushion might be.

MS. TEETERS. But isn't that really the question? What are we going to do now? We've covered the Treasury's debt.

CHAIRMAN VOLCKER. That's only part of the story. The other part is that, with the dollar rising against the mark, a normal leaning against the wind does relieve pressures on both us and the Europeans to do something different in domestic policy than we really want to do. So the two things have to some degree coincided, to the extent the latter is important. I wouldn't put a lot of weight on that in terms of affecting interest rate policy. But to the extent it affects that, it goes in [the right] direction. So both of those reasons coincide in suggesting that when the mark is weakening appreciably some intervention seems desirable.

MR. PARTEE. As I look at the experience of other countries over the last couple of years, Paul, I observe that the countries with the smallest inflation rate have been the ones with a rising currency. There's some circularity in that, of course, but it is certainly true, other things equal, that a rising currency reduces the observed inflation rate for a country. We have as a major objective of policy reducing inflation. I should think, therefore, that we would like to have a rising currency.

CHAIRMAN VOLCKER. I don't mind having a rising currency to some extent, and it has been rising. I think it's clear from what Scott said that we have not been intervening in a way to prevent any rise in the dollar.

MR. PARDEE. In fact, to the extent that we backed away--

MR. PARTEE. When we buy \$250 million in a day, we certainly have prevented some rise in the dollar that day.

MR. PARDEE. To the extent that you back away, you leave an impression in the market that you're not holding the rate or, in fact, that your operations are not effective in holding the rate where it is. So you are helping the rate to move along that way.

MR. WALLICH. Well, with respect to the dollar, I think we have to aim at a happy mean. We want a strong dollar because it helps on inflation. We don't want it to get so strong that we're not competitive. We've had considerable appreciation in real terms. And as far as the accumulation of reserves is concerned, in the long run I think we have to become like other countries and rely on owned reserves, not on the swaps that others can deny us the use of. And we ought to be building up some reserves gradually.

VICE CHAIRMAN SOLOMON. I second that very strongly. Chuck, it's a different kind of world in the last few years and will be increasingly so. First of all, I would hope that we are not going to be living permanently in a world where our interest rates are so ridiculously high compared to those of other industrialized countries. I hope we will find ourselves in an improved domestic economic situation. Under those circumstances, once that artificial stimulus [in interest rate differentials] is removed--to have a spread of 9

percentage points between Eurodollar and Euro deutschmark rates is incredible--the dollar is going to go down very, very sharply.

MR. PARTEE. The dollar will go down because inflation subsides. Is that what you are saying? After all, inflation is the reason that interest rates are high.

VICE CHAIRMAN SOLOMON. Yes, but what I am assuming is that there will be some moderation, but only partial, of inflation. There will be a much larger drop in interest rates at periods of time because of the way we've seen history [work] on this.

MR. MORRIS. Perhaps in the next quarter.

VICE CHAIRMAN SOLOMON. Maybe next quarter. Nobody can be sure of these things, but I suspect we will see disproportionately large reverse movements in the dollar. I think we have to have a very substantial volume of our own foreign exchange resources to cope with such a situation. If we are always drawing on swap lines every time we have to move in, the other countries can call the tune on us much more easily. Having our own resources will make us a little more masters of our own policy. I am not sure I see why you are concerned about this. I would not place the emphasis on intervention being a good thing because of the interest rate policy moves one can therefore avoid to some degree. Your concern relates to intervention to accumulate foreign exchange resources more than--

CHAIRMAN VOLCKER. I am not sure what the facts are on this, Scott, but my impression is that at times in the past the U.S. government has had substantially more net foreign exchange resources when the dollar has been strong. I don't mean huge, but our net [holdings] are only at about \$200 million plus now, right?

MR. PARDEE. Yes.

CHAIRMAN VOLCKER. They have been substantially higher than that in the past at times of--

MR. PARDEE. Well, before the Carter notes on a couple of occasions we held \$300 or \$400 million worth of marks. It was in that range, but not substantially more.

SPEAKER(?). We hold quite a lot of yen.

MR. TRUMAN. We have yen and Swiss francs, too, at the moment.

MR. PARDEE. Yes.

MR. RICE. Mr. Chairman, may I raise a technical question?

CHAIRMAN VOLCKER. Yes.

MR. RICE. Do we have to sell securities in order to finance our purchases of foreign currencies?

CHAIRMAN VOLCKER. Sure, yes.

MR. RICE. Have we tied specific sales of securities to a specific volume of--

CHAIRMAN VOLCKER. In effect, it is washed out as another operating factor. You can't identify a sale of a security for a foreign--

MR. RICE. How do we know we need funds for financing our foreign exchange purchases?

MR. PARTEE. It is a factor affecting the reserves.

MR. RICE. Our foreign currency purchases?

CHAIRMAN VOLCKER. It just goes into all the other factors draining or providing reserves. So there is somewhat of a one-to-one relationship.

MR. RICE. So when we sell securities, we raise interest rates in the United States, do we not?

MR. PARTEE. Well, that was one comment that I was going to respond to. One thing I disagree with on our policy here is that we are not buying government securities. Instead, we are buying German marks, and that does have a market impact in the United States.

CHAIRMAN VOLCKER. Well,--

MR. PARTEE. Secondly, we are taking an exchange risk that I don't think is warranted for the central bank.

CHAIRMAN VOLCKER. Wait a minute. We are not buying Treasury securities; instead we buy marks in the very short run. But you have to ask what those people would do who want to get into dollars otherwise, and presumably those people are getting into dollars and buying some securities. They may not be Treasury securities, but in the larger scheme of things it is a wash in our domestic market. We are getting a capital inflow which we would not otherwise get.

MR. PARTEE. They are going to do that anyhow, aren't they though?

CHAIRMAN VOLCKER. No, because otherwise the exchange rate would go up and presumably we would get an equilibrium in the market and they would not buy the securities. Sure, the analysis is that in the immediate sense we are just selling Treasury securities; but somebody is on the other side of that [transaction], buying something coming into dollars.

MR. RICE. Are you saying that the net effect on interest rates in the United States is neutral?

CHAIRMAN VOLCKER. The net is probably zero in that sense, yes.

MR. PARTEE. But it is downward on the markets [unintelligible] interest rate. Wouldn't the same thing apply in the case of marks? [More holders will] be able to sell out of marks?



CHAIRMAN VOLCKER. I am discussing now a mechanical relationship. How it affects policy, whether the Bundesbank wants to raise their interest rates or lower their interest rates because of [movement] in the exchange rates is a different matter.

MR. TRUMAN. We wouldn't get the capital inflow without the intervention. I agree with your point, but the capital inflow is facilitated by--

CHAIRMAN VOLCKER. No, we wouldn't have the capital inflow.

MR. TRUMAN. That's because the official intervention is the outflow counterpart to the private inflow.

CHAIRMAN VOLCKER. That is precisely my point. You don't get the capital inflow without the intervention.

MR. ROOS. To further confuse the issue, look on page 10 of the Bluebook. I was always under the impression that strong interest rates domestically tend to attract foreign money into our economy and bolster the value of the dollar. But on the bottom of page 10 it says "Continued intervention by the United States to slow the appreciation of the foreign exchange value of the dollar could generate additional pressure in Treasury yields, as the Fed offers securities to the market to finance foreign currency purchases." It looks as though, if I understand this, we are totally chasing our tail because we are selling [Treasury securities] in order to seek [less] appreciation in the value of the dollar in foreign exchange markets, and in the process we are doing something that could generate additional downward pressure on Treasury yields. I thought that upward pressure on Treasury yields is what bolsters the value of the dollar. Or do I have it totally backwards?

MR. SCHULTZ. That is what it does; it pushes it up not down.

CHAIRMAN VOLCKER. This gets into rather--

MR. PARTEE. Except, Paul, they wouldn't have any--

MR. ROOS. Except for what? It certainly doesn't do--

CHAIRMAN VOLCKER. In the immediate sense, it requires more selling of Treasury securities. There is no question. That is because Treasury securities is all we operate in. The other side of the transaction is not identifiable and it may well not [involve] Treasury securities. Now, if that makes a difference to you, it can be of some significance. But in terms of the general supply and demand in the money market as a whole, it is probably a wash. But in a very direct sense we sell Treasury securities to the extent we buy marks.

MS. TEETERS. But isn't the real question before us: What are we going to do from here on out?

CHAIRMAN VOLCKER. I don't know if you want to have a prolonged discussion today; we can do it next time, if desirable. The general issue, as I understand it, is concern about how much [we should accumulate]. What should be the guidelines and all the rest

and what should be our net positive position in foreign currencies? There are really two questions. There is that question plus under what conditions does it make sense to intervene. Now, we have just been basically leaning against the wind for a variety of reasons that have been mentioned. We now have--looking at the government as a whole, and I think it is relevant in this particular case because the Treasury has been looking at our balances as a hedge against the Carter bonds at the moment--a \$200 million positive position. If there's real concern about that positive position and about that getting to the considerably bigger magnitudes that we are talking about and if interest rates stay high, then we have an immediate problem. I frankly do not feel that concern. I think it would be a reasonable precaution to hold amounts within the ranges we are now talking anyway--by which I mean in the hundreds of millions area. I have no real problem with that; I not only have no real problem, I think it is desirable for the reasons that have been suggested.

VICE CHAIRMAN SOLOMON. May I comment on Chuck's second point, the exchange risks? Of course, we have the same exchange risks when we borrow on the swap lines to support the dollar. I would argue, Chuck, based on my experiences at Treasury, that the exchange risk is much smaller if we have substantial resources of our own. We are almost sure to make money on our present operations. We are buying the mark at a time that it is weak.

MR. PARTEE. Well, you think it is weak.

VICE CHAIRMAN SOLOMON. I know it is weak.

MR. PARTEE. You cannot foresee the future, Tony.

VICE CHAIRMAN SOLOMON. Well, one can't see it completely. There could be a Middle Eastern war, which would upset the situation. But if--

MR. PARTEE. That is a very reasonable possibility, isn't it?

VICE CHAIRMAN SOLOMON. Okay. But if you extract from military [conflict and other] extreme assumptions, in economic terms with inflation in Germany now running 3-1/2 to 4 percent and with the miserable [inflation] record we have, when our interest rates come down--which they will to some degree though I am not saying they will come down a helluva lot--we are going to see some major reverse flows. I think you will find that we are in a better position to minimize our exchange risk and maximize our gains if we have a stock of resources than if we are forced to start borrowing. It's just a longer-run plan basically. And it is a more comfortable situation for the people who are actually managing this. There is no mathematical proof of this, but I feel that most people in the Treasury and in the foreign exchange area in New York would agree with me that this is the way to operate in practice. We have not done badly at all in the last few months on this whole question of exchange risks and profits and loss. And one can be a better manager when one has--

MR. PARTEE. Well, certainly, if one assumes that 180 is the right rate for the mark, we ought to buy all we can at more than 180 because when--

VICE CHAIRMAN SOLOMON. Well, I think 193 is not sustainable.

MR. PARTEE. I don't know.

MR. SCHULTZ. Mr. Chairman, could we get a staff analysis of our own reserves and those of other countries and some analysis of this particular question? Then maybe we could discuss it at the next meeting.

CHAIRMAN VOLCKER. Yes, that is probably what we ought to do. But I would point out, just in terms of this general problem, that we have an example currently of a country that is taking the extreme opposite view, which is the United Kingdom, and even they have accumulated some reserves. They have had a very high inflation rate, high interest rates, and a prolonged and very sizable appreciation of sterling. Whether that is good or bad is the question. But that is an example of a country that is taking a different view. They have not taken it so extremely that they haven't acquired any foreign currencies; they have. But they haven't acquired very many.

MR. WALLICH. That is for monetary policy reasons not because they made decisions about reserves. I think we ought to bear in mind first Tony's point that--

CHAIRMAN VOLCKER. I don't think it has anything to do with their fears about gains or losses on foreign exchange transactions. Whether it's for, as you say, monetary policy reasons or economic policy reasons, they are willing to take a strongly appreciated pound to put pressure on their inflation rate.

MR. WALLICH. I think gains and losses in the exchange market have to be evaluated including the interest that one earns. On one side if we have D-marks, as Tony says, the chances are that in the long run the D-mark will be stronger than the dollar, but we will have lower interest earnings on that. On the other hand, if we owe D-marks, having drawn on the swap, say, that is an adverse position because the D-mark may appreciate. If we pay interest in D-mark terms, we would be benefitting from that. So the interest to some extent counteracts the risk factor insofar as the risk factor is based on purchasing power parity considerations, which will not work out exactly in the long run. Also, I would like to remind you that other countries have enormous reserves. The Germans still have, I think, \$40 billion; they had \$50 billion plus. The Japanese have \$20 billion. They all take a great risk because these reserves are mostly in dollars, which from their perspective have depreciated, giving them losses. We have a very large gold stock. Every time the gold price moves, we are becoming richer or poorer. We [never] pay any attention to that, and rightly so. But let us not say that we are without exchange risks from the movement [in the value] of our financial assets.

MS. TEETERS. But I am afraid we are making policy by default. By not giving any guidance at this point, we are saying to the international Desk in New York to go ahead and do what it has done for the past month. That could lead us not to \$100 million but to another \$2 billion in marks. And that seems to me a rather major decision. Do we want the Desk as the mark rises to buy marks as

rapidly as they can and to accumulate a war chest? Is that what we are telling them to do?

CHAIRMAN VOLCKER. I think it is a bit of an exaggeration to say they bought as many as they could, but that is a market judgment.

MR. PARDEE. This is what I am telling the Treasury anyway.

CHAIRMAN VOLCKER. Institutionally we have to face the fact that the Treasury is extremely eager to acquire marks and build up a nest egg. They will build it up if we don't. It is very awkward for them to--

MS. TEETERS. They've done it.

VICE CHAIRMAN SOLOMON. Yes, but they're still short [of their objective] by about a billion dollars.

CHAIRMAN VOLCKER. It is in fact very awkward for them to hold [marks]. I don't have any disagreement with the Treasury policy.

MR. GRAMLEY. I think Governor Partee's and Governor Teeter's point is well taken. What Governor Partee is really asking is: What underlies our intervention policy? What are our objectives? Should we be using intervention policy to impede progress on the inflation front by [not] letting the dollar appreciate? What are we doing? So, I think some more analysis of the broader context would be helpful.

CHAIRMAN VOLCKER. I accept the notion that people think that is true. And I have no reluctance to do it. I do not myself feel the least bit confused about what we are doing, which apparently we have not articulated correctly. We are leaning somewhat against the appreciation of the mark and we are willing to accumulate some balances for all the precautionary reasons that have been suggested. That's apart from mostly in the past being in the position of just getting back into balance as the United States and that phase at the moment is over. It changed very rapidly a week ago when we suddenly got into a minus position after being in a positive position for a few days. But having reached that arithmetic point, I had presumed that we were willing to acquire some additional foreign currencies consistent with our general philosophy of being willing to lean against the wind, anyway. Now, if that is wrong, we ought to change it; but I don't think it is wrong.

MR. PARTEE. To avoid disorderly conditions?

CHAIRMAN VOLCKER. Well,--

MR. PARTEE. I believe those are the terms of the directive of the Committee.

MR. GUFFEY. The Committee does have rules with respect to what the Desk can hold.

CHAIRMAN VOLCKER. That is right. The [informal limit] now is \$1-1/2 billion. [Secretary's note: The \$1-1/2 billion informal limit is for all foreign currencies excluding yen. There is a separate limit of \$1 billion for holdings of yen.]

MS. TEETERS. And we can change it by notation vote between meetings.

MR. GUFFEY. Well, there is an intermeeting limit as well as a maximum we can hold in any one currency. Aren't we getting at or near that limit? If it is not changed--

MR. PARDEE. We might be. As I said, in marks we now have \$1.1 billion against [an informal limit of] \$1.5 billion. The maximum for the total open position was left at \$8 billion from an earlier siege; that we have not changed.

SPEAKER(?). In all currencies?

MR. PARDEE. Yes.

MR. GUFFEY. So in the period ahead, we are talking about accumulating a maximum of \$400 million in marks unless we have a notation vote to change the limit during the intermeeting interval.

CHAIRMAN VOLCKER. As things now stand, that is correct.

MR. GUFFEY. That seems reasonable.

CHAIRMAN VOLCKER. Well, we can schedule a longer discussion of this--

MR. PARDEE. Technically under the directive we have two reasons for intervening. One is to counter disorderly conditions. The other is to change balances in light of future needs. There is a very weak need [currently] for piling up lots of marks, but in light of future needs it's something we clearly have in mind. Also [the directive requires that] we have close and continuous consultation with the Treasury. And right now the Treasury is in a mood to have us buy as many marks as we can.

MR. PARTEE. Of course, this is run by a steering committee of the FOMC, [the Foreign Currency Subcommittee]. But that subcommittee has to observe the rules that the Committee has laid down. I just think the subcommittee ought to read those rules and decide whether it is authorizing transactions in keeping with them or not. And I would like to have a review of the subject.

CHAIRMAN VOLCKER. We can review the subject. We will review the subject.

MR. BALLEES. Mr. Chairman, I wonder if I could ask Scott a question. I would be interested, Scott, in your views on the divergent trend between the spot and the forward rates last month. The dollar rose by an average of 1.1 percent against six major countries on a trade-weighted basis. But the forward rate for one year went down by about .3 percent. And the longer-term forward rate went down about 1 percent. What do you make of that divergent trend?

MR. PARDEE. Well, we've had substantial movements in interest rates.

CHAIRMAN VOLCKER. Unless the market is in disequilibrium, it is an interest rate arbitrage.

MR. PARDEE. There are wider and wider differences between dollar rates and foreign rates.

CHAIRMAN VOLCKER. The market is in equilibrium isn't it? The forward differential changes every time interest rate differentials change.

MR. PARDEE. I don't know of anything other than [that].

MR. TRUMAN. If you believe--and some people do and some people don't--that the forward interest rate is the expected future spot rate and has something to do with purchasing power parity, as Governor Wallich mentioned, and things like the longer-term outlook for a country's current account and so forth, then the fact that the forward rate has moved over this period could be interpreted as suggesting that expectations of inflation in the United States [relative to abroad] have moved up over this period. That would be one story. I am not sure, personally, whether one would want to put a lot of weight on that particular story. But that is a possible and plausible interpretation of why there was an increase in the divergence between the spot and [forward rates].

MR. WALLICH. I would like to add to what Scott said about the purposes of intervention. There are those two reasons he mentioned. One is countering disorder, not maintaining order; we sometimes say it is countering disorder. Disorder this time seems to be mostly on the way up whereas in the past it usually was encountered on the way down. There is also accumulating for future needs. And I would say that forming a reserve is provided for in that. But the main qualification is that it has to conform with article IV, paragraph something, of the IMF articles of agreement. And that gives a fairly wide degree of latitude for intervention in conditions of floating [exchange rates]. It specifies mostly what one is not prepared to do, such as driving the exchange rate.

CHAIRMAN VOLCKER. It speaks of erratic--

MR. WALLICH. Erratic fluctuations, yes.

CHAIRMAN VOLCKER. Well, we will have a more orderly review of this at the next meeting. Do you have a recommendation with respect to operations?

MR. PARDEE. Yes, the swap lines are cleared. But between now and the end of the year all of our swap lines with 14 foreign central banks and the BIS come up for renewal for a further 12 months. As in the past, I am recommending that the Committee approve the renewals at this meeting, so there will be ample time for the formal exchange of cables with our partner central banks who must also go through their formal approval processes. This year the negotiations are somewhat more complicated in view of the Committee's decision to eliminate the risk-sharing provisions on our drawings and to switch to our paying of interest rates based on what one would pay on the currencies we borrow rather than on the U.S. Treasury bill rate. We have had no problem with substance with the other central banks which

are most affected by this decision. They agree that this is a logical approach. Indeed, I found out that the Bundesbank had been rather quiet about pushing the issue because they made some further calculations and found that it might be to their advantage to keep things the way they were, given the interest differentials. But they haven't complained that we are moving this way. For most we are waiting for each of the central banks to indicate which specific instrument in their market, a Treasury bill or whatever, corresponds most closely to our Treasury bill. In most cases there should be little difficulty. But in two important instances, with the Bundesbank and with the Bank of Japan, the corresponding instruments to our Treasury bill are not obvious. We must be careful not to link our swap drawings to a higher cost instrument than a Treasury bill might be. For swap arrangements on which we are not likely to draw, I see no need to negotiate a specific instrument on their side. Nevertheless, we could come down to the wire on some of these negotiations, so I would like to recommend that the Committee approve the renewal of swap arrangements now subject to a final review and determination by the FOMC subcommittee when these negotiations have been completed that the terms and conditions are acceptable. So it involves agreeing generally now that we can proceed with the negotiations and then a review by the subcommittee that the terms on the elimination of the sharing of risk and on the particular instruments that we will be using are acceptable to the Committee.

CHAIRMAN VOLCKER. My recollection is that the Committee hasn't formally approved these [agreements at this stage] but that you are authorized to proceed and undertake these negotiations. We will have to approve them formally at some stage. There has been some limited consultation with the Congress by the Treasury. So far as they are concerned, it is okay, but I am not absolutely clear in my mind that there will be no objections.

MR. TRUMAN. There hasn't been any objection on the House side to date. There was just one question.

CHAIRMAN VOLCKER. We had a consultation on the House side?

MR. TRUMAN. Yes. The Treasury staff talked to people on the House side and they have not stirred up any objection.

CHAIRMAN VOLCKER. It looks as if it's proceeding on course, subject to these technical [details].

MR. PARDEE. But they are important elements of the negotiation.

CHAIRMAN VOLCKER. I understand.

MR. PARDEE. We want to know what interest rate we are going to be paying on the marks we borrow.

CHAIRMAN VOLCKER. I understand. You don't need any specific action now today, do you?

MR. PARDEE. Well, approval of the renewal of the [swaps].

CHAIRMAN VOLCKER. Are they going to be done before the next meeting?

MR. PARDEE. Yes, December 4th is the first maturity for a number of them.

CHAIRMAN VOLCKER. All right. Do we have a motion on that?

MR. SCHULTZ. So moved.

MR. BLACK. Second.

CHAIRMAN VOLCKER. Any objections? That is approved. Now, there is this one question of the Swedish swap, I take it, as to how big that will be.

MR. PARDEE. Right. They haven't said anything, so we have let sleeping dogs lie. We have a sentence in the cable that will go out indicating that we are reconfirming the increase to \$500 million through May, which is the date set [for the expiration of the temporary increase]. We will make reference to the agreement of last May in this cable. They might come back to us.

CHAIRMAN VOLCKER. This is the case where we temporarily increased the line through next May, and you are suggesting that the renewal would be consistent with maintaining the increase but only until next May.

MR. PARDEE. Right. I assume that at some point they will come back to us and ask us to make the increase permanent. But since they haven't made it an issue, as I say, I have let sleeping dogs lie.

CHAIRMAN VOLCKER. So that doesn't require any action then.

MR. PARDEE. No separate action for today.

MS. TEETERS. Why did they want an increase in the swap?

CHAIRMAN VOLCKER. They were in trouble.

VICE CHAIRMAN SOLOMON. They wanted the increase because Governor [Wohlin] felt that they might have to draw on the swap line. The \$200 million line was extremely small, so we felt it would be a gesture of cooperation to increase it to \$500 million and it would give him a little more clout, so to speak, in talking with the Swedish government about what he felt were certain inflationary policies that were putting the Swedish currency under pressure. And this was a way of reinforcing his position. He felt that there might be a need for it. The last time I saw him at the BIS last week he

CHAIRMAN VOLCKER. This was arranged last April I believe.

VICE CHAIRMAN SOLOMON. Yes. It is not a burning issue, but it seemed like a useful gesture of cooperation at that time.



CHAIRMAN VOLCKER. It was discussed with the Committee, though.

VICE CHAIRMAN SOLOMON. Oh, yes. We approved it.

MR. PARDEE. I am sure it will come up again because they will probably ask for a continuation; but at the moment they haven't.

CHAIRMAN VOLCKER. So we are not doing anything on that. Our earlier decision stands. All right, Mr. Sternlight.

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

MS. TEETERS. Mr. Chairman, could we have the most recent money supply numbers?

CHAIRMAN VOLCKER. M-1B startled me. I don't know how there came to be such a difference between M-1A and M-1B, \$700 million for M-1A and \$1.4 billion for M-1B, as Peter said. I was just looking at these data and M-1B is only \$100 million higher than it was four weeks ago while M-1A is \$500 million lower than it was four weeks ago. Now, the figure four weeks ago had a little spike, but we haven't had a big increase since the [October meeting]. We have had two weeks of decline and then this week of increase which has about balanced off [the declines]. I might say on those money supply figures that they don't reflect complete reporting; they reflect reporting for all the member banks and the sample of nonmember banks that we used before. When we complete the tabulation of the nonmember banks that we have not been getting, there may be a need for a benchmark revision, which would be exactly analogous to the benchmark revisions we have been making every quarter anyway. We indicated in the announcement that that might become necessary. There is no reason to think that the benchmark revisions will be any bigger than those we have made in the past, but it is going to take several more weeks, I take it, to get the flow of data from the new reporters before we integrate it. We will do that all at one time and then if it comes out different from [the estimates based on] the sample, we will announce a benchmark revision.

MR. ROOS. Will we get back on the Friday cycle this week?

CHAIRMAN VOLCKER. I am not positive of that. Mr Axilrod is a little skeptical, I guess. We expect to do it on Monday if we don't do it on Friday. But we are not certain yet we can do it on Friday. I might say that as I understand it, the whole process went quite smoothly. People seemed to be reasonably satisfied with the data we have, though we don't have all the new reporters. Tell me, Mr. Beck, if I am not reflecting your views and other's views accurately. We do not yet have the data from the new reporters but the data from the old reporters seem to be in pretty good shape, and we got the numbers together with a relatively short lag. I think that's quite a tribute to the efforts throughout the System to get this done in an orderly way. And it does seem to have gone quite smoothly. I know it involved a lot of hard work around the System generally.

MR. BLACK. When we publish these figures, are we going to break down the reserve figures for the old members and then the new reporters separately?

CHAIRMAN VOLCKER. What we are going to do?

MR. AXILROD. If you are talking about publishing the reserve figures, I don't think so.

CHAIRMAN VOLCKER. No, there is a problem here which you may be referring to but I can't recite it all exactly. Steve, you can correct me, but I think the main problem we are running into is that we have a huge amount of excess reserves now with the new system.

MR. BLACK. That is what I was thinking about.

CHAIRMAN VOLCKER. It is all this vault cash. So, what we are going to do is to put an additional line on the statement that says "excess vault cash" or something like that. For analytical purposes people presumably will subtract out the vault cash that is just sitting there from the total of excess reserves to get an excess reserve figure that seems functionally [equivalent to] the old excess reserve figure.

MR. AXILROD. We are going to publish two forms of total reserves. One will be the total including all the vault cash of all nonmember institutions, which would imply very sizable so-called excess reserves. But then we are also going to publish a total reserve figure which will include the reserve [deposits] held at the Fed of all depository institutions, vault cash of those institutions that hold required reserves at the Fed, plus the vault cash for those who do not hold required reserves at the Fed up to [the amount] equal to their required reserves. The sum of those figures [less required reserves] would be excess reserve balances at the Fed, but not excess vault cash since we are not putting in the [surplus vault cash of] nonmember institutions. And that's the item we propose to run on; that will have in it an implicit excess reserve figure that is very little different from the excess reserves that we've had recently.

CHAIRMAN VOLCKER. In effect, it's excess reserves of bound banks, bound banks meaning those that have a reserve requirement higher than the vault cash they ordinarily hold.

MR. BLACK. I was just thinking about the problem of interpreting these for people on the outside.

CHAIRMAN VOLCKER. It's a real problem, but I--

MR. AXILROD. We will explain that.

CHAIRMAN VOLCKER. We think this should satisfy them, but it's a problem for us too.

MR. BALLE. Mr. Chairman, only half in jest, I would like to suggest that this would be a good excuse to stop publishing weekly figures at all and to publish them about once a month. I am more convinced that these weekly numbers create more mischief than they do good. Is that doable at all under the Freedom of Information Act?

CHAIRMAN VOLCKER. We've [looked at] that, I think.

VICE CHAIRMAN SOLOMON. It is doable in one way, because I have looked into it. If we publish the weekly seasonally unadjusted figures and only make our seasonal adjustment calculation once a month when we publish the seasonally adjusted figures for the month, then we are okay under the Freedom of Information Act. But if we don't publish the seasonal adjustment and still prepare it internally, then we could be subject, although with a time lag, to a Freedom of Information request.

MR. PARTEE. People in the market would do their own seasonals.

VICE CHAIRMAN SOLOMON. Yes, but there would be all different kinds of seasonals; [they would be] all over the lot.

MR. PARTEE. A Sindlinger seasonal and so forth.

CHAIRMAN VOLCKER. I don't know, but my own instinct is that we would not get by with that. I have had some casual conversations [about whether] we would be subject to Freedom of Information Act suits if we didn't straighten out these reserve figures somehow to show them on some basis that made sense and was comparable with the past figures, which is what we are trying to do by the way Steve described it. [I was told that] people were about to bring suits to demand that we make such calculations so that they're not fouled up. I cite that as the sensitivity in this business.

VICE CHAIRMAN SOLOMON. Well, one can make a persuasive argument that the weekly seasonal adjustment is so unreliable that it shouldn't even be prepared internally, and we could prepare it on a monthly basis [only]. Therefore, I don't see that anybody would have to face this issue. My lawyers tell me that--

MR. BALLE. That would appear to me to be a viable way out of this trap, Tony.

CHAIRMAN VOLCKER. It boggles my imagination to think that we would really operate for a whole month without attempting to seasonally adjust the figure.

MR. PARTEE. Well, we would have to get successive estimates of the month we are in based on weekly information, using the monthly seasonal adjustment factors. I think it could be done. But I don't think it would be constructive to have ten different seasonals of the weekly numbers floating out there in market; that in itself would be a source of great confusion.

MR. SCHULTZ. Legal questions aside, we are already getting enormous criticism that we are not doing a very good job of explaining what we are doing right now. And if we attempted to do that, I think we would get inundated with criticism. And I suspect certain members of the Congress would rise in wrath.

MR. WALLICH. I think the basic objection is that we would be throwing away information, even if it's not very good information. We can always filter that. There's a great deal of research on whether one should throw away information just because it's not very good. The answer is to filter it and give it little weight. We may be

giving too much weight to the weekly data, but to throw them away totally just reduces the accuracy of the steering mechanism.

CHAIRMAN VOLCKER. I may be too Polyannaish, but when I observed the market recently, I thought there was a change in that they have kept these weekly figures in some reasonable perspective. They haven't jumped all that much just on the basis of one week's data. Occasionally, we get a jump because they say, in effect: We were hoping it would come down and now we have lost hope. And that's pretty much the way that we have looked at it, too. If we have these targets, we really can't blame them for observing [the trend] over a period of time.

VICE CHAIRMAN SOLOMON. I think that's true, Paul. Peter Sternlight also feels that the market is reacting to the weekly numbers in a more moderate way. Even so, it is interesting that three more public-minded and important market participants in New York in telephone calls to me over the last couple of months basically made the same suggestion that John Balles has made. They believe that the weekly figures are inadvisable and are causing much more volatility in the market.

MR. BALLEES. That's what I am concerned about. Surely, there can't be anything that says we have to publish bad numbers. We have been faced with enormous changes, such as social security changes and government pay increases and so forth, that have created real suspicion about the meaning of the numbers we are churning out, despite the best job that the staff can do. I am sure that the staff is doing their best on these weekly seasonals, but they have to be the wildest, most unreliable things that we--

MR. GRAMLEY. But if we publish seasonally unadjusted numbers, they will be even more erratic. And it's true that there will be a lot of seasonal adjustment factors floating around the market. But the official numbers put out by the Fed will be even more erratic than what we put out now. It doesn't seem to me that we can ever correct the problem that is bothering the market except by not reacting to the weekly numbers the way we do. We are [now] causing a problem by reacting to them.

MR. BALLEES. It's the market that is reacting to them, though, not us.

MR. GRAMLEY. Those numbers were around there for a long, long time, John, before we got onto the policy that generated these erratic movements in interest rates. It is not the market's fault. It is our fault. If we want more stability in rates, we know how to get it.

CHAIRMAN VOLCKER. Look, I am willing to re-examine this issue. I don't know how to do it analytically. My own instinct, as expressed by Fred Schultz, is that even if 90 percent of the people in the market agreed with us, the other 10 percent are going to raise a ruckus and there's going to be a big brouhaha. We can look at the issues; I don't know how to look at them systematically, but we can try.

MR. AXILROD. Mr. Chairman, we have done various kinds of research, which we could make available to the Committee, to try to determine if the market has behaved "rationally" or not. My memory is that the results are that mainly they have behaved rationally. That is, they have moved when they view the change in the money supply as a good predictor of the change in the federal funds rate and have not moved otherwise for the most part. So from that point of view, there doesn't seem to have been all that much irrationality in market reactions. But we can update that research and present it.

CHAIRMAN VOLCKER. Look, we would lose something [by changing] this. On some occasions, obviously, it is extremely annoying to publish these weekly numbers which may be erratic. On other occasions, like today, when the market is thinking that the money supply is even stronger than it probably is, it is nice to get the numbers out and show them it is not quite as wild as they think it is.

MR. BLACK. Let's just publish them when they're good!

CHAIRMAN VOLCKER. If I could edit the figures--

MR. WALLICH. I can't see how one can believe in markets and then try to avoid supplying information, however [questionable it is].

CHAIRMAN VOLCKER. Well, why don't we have a little paper written on the pros and cons of this.

MR. FORD. Paul, if we do that, which I strongly [favor]--I support the notion that we should look at the pros and cons of all of the issues that have been raised--we ought to consider one other basic question, which we are assuming can't be raised. And that is just not generating the numbers so often. I heard you say that we couldn't operate for a month or even two weeks without going through this exercise. But [I wonder about that] when I look at the commitment of resources that we are making to this--the overtime, the blood, sweat, and tears of the staff. One can discount that very heavily in terms of a need for information. But there are other countries in the world, it seems to me, that operate their monetary policy without going through this tremendous expenditure of resources and all the problems of revising and re-revising and interpreting and re-interpreting the data.

CHAIRMAN VOLCKER. Of course, if you raise that question, you have to raise the question of how we keep reserve requirements, because basically these figures are generated in the first place so the banks know what their reserve requirement is. [Unintelligible] monthly reserve requirements.

MR. GRAMLEY. We could take the incoming deposit reports, which are on a micro basis, and calculate reserve requirements which are not based on the same concept of deposits that goes into the money supply. Then we could if we wished, as we used to do many years ago, just calculate the money supply on the last day of the month.

CHAIRMAN VOLCKER. We can theoretically; it is not going to save much work.

MR. PARTEE. The problem of [using just] that day is that it might be high and it might be low. Then it would be like--

CHAIRMAN VOLCKER. Why don't we do a paper raising all these issues.

MR. AXILROD. We wrote it 3 or 4 years ago.

MR. SCHULTZ. Well, I would hope that if you do a paper of that kind there would be an added dimension to it. And that is that given the environment we are living in today, communication has become an integral part of monetary policy to a degree that it never has been before. What people are thinking about in regard to what is going on and our credibility are of considerable importance to the policy itself. So I would say to you that there may be an added dimension in terms of communications that wasn't an issue 2 or 3 years ago, which should be addressed in such a paper.

CHAIRMAN VOLCKER. In this general connection, let me make a point about something I have looked at recently in preparing some testimony. I don't know if it will provide you with any reassurance or not, but if you think our M1 has been unstable, look at any foreign country's M1 figure. If you look at the data over a period of years, the standard deviation in the United States is about half of that in other countries on a monthly basis, as I recall the numbers. Even the annual numbers don't look any better; they look worse. Isn't the characteristic of all these series that M1 is much more unstable than M2 and M3?

MR. ROOS. In this connection, could someone just report briefly on the progress of Steve's effort to restudy how we are doing?

CHAIRMAN VOLCKER. Well, let's try to do it later. I don't know what it is myself. But let's get on with our work here.

MR. BALLE. One final point, if I may, Mr. Chairman. I have been impressed with the ingenuity of the Board's legal staff in finding ways around the date in the Monetary Control Act on which reserve requirements would have to be put into effect. I hope they will exercise that same ingenuity with respect to our purported responsibility under the Freedom of Information Act to put out weekly money supply figures. I hope that issue can be examined in depth.

CHAIRMAN VOLCKER. We will produce a memorandum. Did you have a comment that you wanted to make earlier, Bob?

MR. BLACK. Mr. Chairman, we have gotten right far off [the topic]. My comment was related to a technique on monetary policy. I don't know whether you feel we have time for anything more on that or not. I can ask at a later time. It's an important point, but we have spent right much time, so I'll wait.

CHAIRMAN VOLCKER. Did we ratify your transactions, Mr. Sternlight?

MR. EASTBURN. Could I ask Peter a question? Peter, would you elaborate just a little on the techniques of the Desk in view of

the uncertainties in these numbers? Are you operating pretty much as before or what?

MR. STERNLIGHT. I was apprehensive a month ago about the kind of flow of information we might have as we came up to the November 13 date. I was gratified that we did not seem to be getting as much confusion and uncertainty [as I expected], at least, as that week began. Things seemed to be settling down in a reasonable pattern. Now, I have to allow that I was thrown off by the demands for reserves that we experienced yesterday. I just don't have an explanation of that. I am not sure whether it had more to do with the changes coming out of the Monetary Control Act or whether it was just some unsettlement in the immediate wake of the new discount rate and penalty rates. Until I can see more on the behavior in terms of desired holdings of excess reserves and so on, I just don't have a good answer. But at least up until now, we have not felt a need for a significant departure from what had been our mode of operation.

MR. CORRIGAN. May I ask just one quick question, Steve?

CHAIRMAN VOLCKER. It better be quick.

MR. CORRIGAN. In terms of what you mean to publish, I think you said that the reserve numbers will include the required reserves associated with the new reporters. The money supply numbers and total benchmark when done will not? Is that correct?

MR. AXILROD. That's right, but it will include the same sample.

MR. CORRIGAN. The sample of nonmember banks?

MR. AXILROD. That's right, but that might be for only a very few weeks.

MR. PARTEE. It's the sample that is used to estimate the universe, Jerry.

MR. CORRIGAN. I appreciate that. Do we now have a firm fix on how many nonmembers will actually have to post reserves and what the level of total reserves associated with the nonmembers is?

MR. AXILROD. No, not at this moment. We don't even have the total required reserves for members for this week as of this very moment. That may be part of the source of Mr. Sternlight's problem.

CHAIRMAN VOLCKER. Mr. Kichline.

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

MR. SCHULTZ. Jim, do you have the preliminary survey on building permits for last month?

MR. KICHLINE. We have it for the first half of the month, which was down 14 percent from the level in September.

CHAIRMAN VOLCKER. Why don't you go ahead, Steve, and then we'll have a general discussion.

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

CHAIRMAN VOLCKER. I think we now want general comments on the economic situation and strategy. Let me make only two preliminary points. First of all, the story isn't in yet but I will anticipate the story. I don't know what is going to happen to long-term rates. I take it they are higher now, or not much changed anyway, than before we changed the discount rate.

MR. STERNLIGHT. Not much changed but somewhat higher, yes.

CHAIRMAN VOLCKER. It appears that the discount rate change has had an impact on short-term rates. I'd just point out once again that thoughts that a discount rate change is a "freebie" in adjusting to the market are not warranted in the particular situation that we are now in, when banks are borrowing very heavily. The use of the surcharge is an attempt to moderate that reaction, but just how much it will moderate it or whether it will moderate it at all is not totally clear. That's the general point on the paths. Looking ahead, let me say that I would find too intense a discussion on precisely where the target is in the short run sterile--not only sterile, but possibly misleading--because it doesn't have much to do with where we set the path. As I indicated last month, we've had repeated indications in the past few months when the figures were coming in high that it made very little difference where the target was set. It made a lot of difference as to how we reacted to the deviation from the target, right or wrong. And that's precisely what the discussion ought to center on more profitably--whether one looks at it in terms of what the borrowing adjustments in particular should be or, as some people may, in terms of what kind of interest rate changes one is willing to tolerate or permit. Those are the variables. And they have very little to do with whether "A," "B," or "C" is chosen because the actual events are likely to [vary] over a much wider range, up or down, than is indicated [by those alternatives]. The results are unpredictable, and as Steve just said, probably not much affected by what we do between now and the end of the year because we simply don't have that much time to affect the aggregates. So we have to look at it with a view that what we are doing today may affect developments after the end of the year. I don't see how one can avoid it. So, with those preliminary comments--

MR. ROOS. Mr. Chairman, could I just repeat my question to Steve on the technical study of how we go about achieving our targets? Is that progressing well?

MR. AXILROD. Well, President Roos, we are going to have all-day staff meetings tomorrow and Thursday on the first drafts of the papers and I would be in a much better position to comment after that than before. But so far as I can tell, people are right on schedule in the production of the documentation and I expect to have a very fruitful meeting.

VICE CHAIRMAN SOLOMON. I'd like to ask a question also. Am I correct in assuming that when when you talked about being in the lower half [of the ranges] in the coming year that that would be based on the actual fourth quarter of 1980 and would not attempt to correct for any overshooting?



CHAIRMAN VOLCKER. That has been the practice and I would presume that that is what it will be, yes.

MR. PARTEE. I would think we'd adjust our targets in the light of it.

CHAIRMAN VOLCKER. Yes. Consistent with past practices, if we wanted to adjust, in effect, we would put the target lower and explain that as the reason why the target was lower. I don't know that that's written in concrete, but that is the implication of what we've done before anyway. It is what the Congress is used to and it's what we are used to. So in a sense we still have a sliding base on an annual basis. We no longer have it on a quarterly basis if we continue that procedure. We could debate that, but that has been the presumption, anyway.

MR. WALLICH. Well, that gives excessive weight to the achievement of the target for the rest of the year. I think it would be much better just to adjust the path for the next year rather than [to try] to reach a particularly low base in order to avoid base drift.

CHAIRMAN VOLCKER. Yes, I see no reason [why we couldn't] do it that way--to say we're still targeting with an older base--if the Committee wanted. We'd have some confusion, I think, in explaining ourselves. But if that's what we wanted to do in substance, it is conceivable.

MR. PARTEE. There are other questions involved, too. There always were [unintelligible] questions about justifying the floating quarterly base and they certainly would be stronger if we were targeting on a floating annual base.

VICE CHAIRMAN SOLOMON. I am not recommending that because it would seem to complicate things even more if we were to change the practice. How are we going to adjust for the NOW accounts [in the effort] to understand all these changes? But I was just wondering if you think we will be under political pressure or internal pressure to in some way absorb the overshoot.

CHAIRMAN VOLCKER. I don't know. I haven't thought about that question particularly. I certainly haven't thought about a change in procedures. [Unintelligible] there is something to say if it changed the procedure despite all the very valid objections you have. If it was thought terribly important to try to make up for an overshoot, instead of just having a target that sounded terribly low next year, we might get the same result but it would look a little different. I literally had not thought of doing it that way. I think there would be a horrendous problem in explaining precisely what we were doing, but it may have some merit.

MR. WALLICH. Different aggregates have overshoot or not overshoot in different degrees.

CHAIRMAN VOLCKER. We would have to change the relationship among them. I am sure of that. Well, I think we ought to begin a general discussion. Governor Wallich.

MR. WALLICH. It seems to me that the picture we are facing is one in which the economy has been a great deal stronger than we expected. But we also now face the prospect of a greater degree of weakness hereafter resulting from this strength. In other words, it puts somewhat of a ceiling on the development of the economy if it becomes really strong temporarily and that raises interest rates to levels that will push the economy down again. I would not try to counteract the prospective dip in the economy, if that is what might happen in the first quarter. I think we ought to look further ahead into the future, both with regard to the real sector and the monetary aggregates. Now, I think the chances of a repetition of the second quarter of 1980 are very slight, even if interest rates don't go down as sharply as they did then. I doubt that the economy will suffer anything like that. But the chances of a severe drop in interest rates are there again. And if we [allow] that a second time--if interest rates go up and then go down again in a yo-yo fashion--we will be accused, reasonably, of destabilizing interest rates beyond what is necessary. Our new techniques do imply that interest rates will be more volatile, and that's the way the economy is kept on track under these conditions. But we shouldn't yield to that tendency of the system very much.

So far as the aggregates are concerned, my inclination would be to try to get back on track in the first quarter of 1981 but not in the present quarter, even if that were possible by a drastic wrench. But at the same time, I'd try to limit the interest rate implications of that. The interest rate implications of just saying we are going to get back on track in early 1981 might be to allow interest rates to drop quite far if the economy is weak. I would say we should aim at a relatively reasonable growth path from here on out; something between "A" and "B" might do it if we want to be back on track with M-1B in the first quarter, but not with the interest rates specifications of "A" or "B." The interest rate specifications of "C" give us a chance, if interest rates tend to go down sharply, at least to review the situation and not to accept the slide willy-nilly as we did in the second quarter.

CHAIRMAN VOLCKER. Just in the interest of clarification, Governor, I understand why you like the lower limit of alternative C from what you've said. But I might have thought, knowing you, that you might not like the upper [limit] implication because of the swing in interest rates and the emphasis you put on--

MR. WALLICH. I don't feel very strongly about the 19 percent [upper limit for the funds range]. It just seems to me that we should not make the range too narrow.

CHAIRMAN VOLCKER. You're mainly concerned about the lower limit.

MR. WALLICH. I have a concern about the lower limit. And 18 percent [for the upper limit] would be just as well.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. To step back a little on the economic picture, Paul, I am concerned about two things. One is the energy situation. While at the moment we are faced with a glut of storage space for oil

in this country and temporarily have a big supply hanging over the market, trying to get a fix on what is happening in the Middle East is extremely difficult. I came back from there with reports of from 3 to 10 years to put things back together. In this country we are talking about 3 to 10 months. I don't know what the truth of the matter is, but I think we are more heavily exposed to energy problems than we have been in the past. If [those problems materialize], the price implications are very scary for agriculture and [many other sectors] because of the energy situation. Things are happening, and we have had an interruption of supply. And not to try to get a better fix on that is a serious mistake.

CHAIRMAN VOLCKER. Well, I don't know that we can get a better fix on it. I strongly underscore what you have to say: That this is a major uncertainty. It is very much analogous to the situation at the end of last year when we were humming along in some sense and thought we might make a little progress on inflationary sentiment and other things, and along comes a 50 percent increase in the oil price. That has a certain implication for psychology, behavior, money pressures, and everything else. The way that situation is developing, we surely can't exclude another shock of that kind in the relatively near future.

MR. WINN. They are talking about big increases in prices this time, and that really scares me. My second observation--and this is perhaps a sample of one--is that I can't help but be impressed by the amount of military supplies that are being moved to the Middle East. And that makes me think that defense expenditures in real terms are going to be much larger than anything we see in the budget figures today. I realize that the expenditures have gone up but it seems to me that the assumption built into the models needs to be questioned seriously. And this could alter the budget figures, resulting either in offsetting [cuts] in other areas or again an uncertainty in the picture that hasn't been completely built into the forecast for next year.

CHAIRMAN VOLCKER. After citing all these uncertainties, do you care to express a judgment as to what you think is going to happen or the nature of the problems we face?

MR. WINN. I am afraid we are going to get both [higher] energy costs and a big increase in defense expenditures.

CHAIRMAN VOLCKER. Does that make you want to be tighter or easier in terms of the money supply?

MR. WINN. Tighter, sir.

MR. PARTEE. Tighter in terms of the money supply?

MR. WINN. Yes, I came back very much depressed about the inflation picture over there and the complacency with which they face it--the efforts to index it and then to juggle the index, the whole problem of what it is doing to the economy, the brain drain that has set in and the implications of that. I think it's a complacency that we just can't buy in this country.

CHAIRMAN VOLCKER. What country are you talking about?

MR. WINN. Israel and Egypt.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I think we have all been surprised by the resiliency of the economy since July and we are concerned about the dip that the staff is projecting in the first quarter. We'd all like to be able to produce a smooth 2 percent real growth rate for the next couple of years but I don't think that's compatible with our attempts to decelerate the rate of monetary growth gradually. It seems to me that the rather small undulations in economic activity that are probably ahead of us, as much as we may dislike them, can't be avoided. We have probably produced a great deal by our actions in the past months that is not yet reflected in the economic statistics or in the monetary growth rates. Nonetheless, I like the alternative B growth rates for the aggregates simply because I don't think we can continue to raise our objectives for the quarter month after month in response to unexpectedly high increases in the aggregates. We did it last month. But I don't think we can maintain our credibility if we respond to bulges in the aggregates by raising their targets. So I would stay with the growth path for the aggregates that the Committee voted for last month. I would set a 13 to 17 percent funds rate range because I have a feeling that we can accomplish our objective within that. If we find that we can't, then we can reassess it later.

CHAIRMAN VOLCKER. Well, you may have answered my question in your last comment, but I say this for everyone's benefit: The whole question, whichever one of these targets we pick numerically, is going to be how hard we work to get to those targets and at what expense in terms of borrowings or interest rates. And I think you have expressed the dimension of your interest rate feeling anyway.

MR. MORRIS. Well, I think we have to give the Manager up to 17 percent on the funds rate, which is roughly 2 percentage points above what we have already done. But I don't see the necessity of pushing the top of the range to 18 percent.

CHAIRMAN VOLCKER. Well, I don't want to do it prematurely, but I'd like to get to some [views on the] borrowing assumption before we finish. Mr. Gramley.

MR. GRAMLEY. Mr. Chairman, I find myself in the unusual position of being sympathetic with some, though not all, of the remarks of Governor Wallich. I haven't been with him since last spring, so--

MR. SCHULTZ. I was with him right up to the very last.

MR. GRAMLEY. I was, too. I don't think we ought to try to prevent a decline in economic activity in the first quarter. It's too late for that. I think the staff is right that it is in the cards. But I believe the staff may be underestimating the severity of the decline that could occur early next year for two reasons. One is that when the staff put its forecast together last week, it was able to write: "Our forecast assumes a further rise in interest rates." That no longer is true. The rise in interest rates which the staff assumed is already here; it has happened. So interest rates are going to have

to decline somewhat from present levels if the staff's forecast is going to hold. The second reason is that the staff has built into its forecast for next year, and has continuously done so since early 1980, an assumption that the money demand function is going to shift down. That assumed shift, when they first put it in, was a year away. But now it is right ahead; it is six weeks ahead. If that shift doesn't happen, then interest rates not only are not going to stay at current levels or go down a bit, but as the staff indicates, they will have to go up 3-1/2 percentage points further in the first quarter. If we get bill rates in the 16 to 17 percent range and the prime rate in the range of 19 to 20 percent for the quarter as a whole, then peak rates will probably exceed their levels of last spring. And then I am not at all sure that we would not be in for a decline in economic activity every bit as severe as the one we had in the second quarter of 1980.

Now, we are facing a very difficult long-run inflation problem. I don't see any reason for thinking that any improvement has occurred at all yet. But it would be extremely counterproductive to follow a course of policy which pushed the economy over the cliff once more. I think interest rates are high enough now. I don't want to see them decline much; on that I agree with Governor Wallich entirely. I think they should stay about where they are but not come down much from here. We have recently seen performance in the money measures along the lines that we wanted. We're starting to see the slowdown we have been trying to get. In the past four weeks, as you indicated, the M1 numbers show rough stability if we balance off M-1A and M-1B. I could go with either of Steve's suggestions: Either narrowing the federal funds range or setting some upper limit to the growth rate of the monetary aggregates and accepting a shortfall, provided the numbers come out right. If I were going to select the federal funds range that suited my predilections, it would be something like 12 to 15 percent. Or if I wanted to go in the other direction, I would take the specs of "A" and accept any shortfall in money growth from that.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, as far as the economy is concerned, I think the staff projections and estimates are as good as they can be. I agree entirely with Mr. Winn's comments about the uncertainties associated with oil and I agree that the whole fiscal economic policy area is one where what does or does not come out of the hopper could have an enormous impact on expectations if nothing else.

In looking at policy, I am driven by two conflicting thoughts. One is the desire to come as close to the 1980 targets as we can, or at least in line with Mr. Morris's comments not to adjust the targets for the current quarter upward at this point. But at the same time I'd like to enter 1981 on a growth trajectory that is roughly compatible with what our targets for 1981 might be. There is a bit of a paradox in that I think the first criteria would bring one squarely to "B" and the second in some sense might bring one to "A" in terms of the growth rates for the aggregates. I would reconcile that paradox by accepting aggregate growth numbers somewhere around "B" or maybe a bit higher. But in line with one of Steve's suggestions, I'd treat those numbers as maximums, with the explicit understanding that if we were hitting or exceeding those maximums we would adjust the nonborrowed growth targets to offset any growth over the maximum. I

recognize that that in itself would probably mean that we'd end up above the maximum for the period anyway because of the time it takes to know we are above them and then to respond. But I, too, am a bit encouraged by these more recent money supply numbers. And if there were some maximum, I think it is possible that such a maximum could be compatible with a funds rate band of maybe 13 to 16 or 13 to 17 percent. On borrowing, I'm just having a heck of a time figuring out what might be [appropriate], given all of these number problems.

CHAIRMAN VOLCKER. Before we are too encouraged by the aggregates in the past four weeks--and I'd love to be encouraged, too--I remind you that these things have come in lumps and if we go back one more week, we had a \$5 billion increase.

MR. CORRIGAN. That's why I like the idea of trying to use a maximum as more of a guide than perhaps we have in the past.

MR. SCHULTZ. Furthermore, the very preliminary figures would indicate another increase for next week, so--

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With regard to the economy, the staff's projection seems reasonable. I would just note that they consistently have underestimated the strength of the economy. And if that continues through the remainder of this quarter, we could have some of the additional pressures that Steve spoke of on interest rates. On the other hand, if I understand the Bluebook correctly, for the first time in several months the staff has not built into any of the alternatives any further downward shift in demand for money over this remaining two-month period. So it would give me some comfort that we may come closer to hitting those numbers between now and the end of the year than we have in the last couple of months when we experienced overshoots from the staff's projections at the time of the Committee meeting. Coming down to policy considerations, it seems to me there are a couple of things. The Federal Reserve has a credibility problem. It has been talked about around this table. Last month we chose to adopt ranges for the aggregates for the quarter that insured that we would be outside the [annual] range for at least two of the three targets--M-1B and M2.

CHAIRMAN VOLCKER. If I may just interrupt. I don't think our adoption of those targets insured a darn thing. We didn't know what the money supply was going to be.

MR. GUFFEY. No, but we understood that if we hit those targets it would take M-1B outside for the year.

CHAIRMAN VOLCKER. If we hit those targets. But there is nothing in our experience that says we are going to hit the targets over that kind of a time period.

MR. GUFFEY. I would agree with that. And unfortunately, the misses have always been on the high side.

CHAIRMAN VOLCKER. That is certainly correct recently.

MR. GUFFEY. And that brings in the credibility question, which I'd like to address.

CHAIRMAN VOLCKER. That's the issue; the actuals have been going higher.

MR. GUFFEY. And the revisions have all gone one way, unfortunately.

CHAIRMAN VOLCKER. That is correct.

MR. GUFFEY. As to the credibility problem, of course, we will be in a new era after the change of Administration and the change of Congress. And the Federal Reserve is going to be looked at in terms of how we plan to perform. It seems important to me that we not adopt aggregate targets at this meeting that would suggest we are taking another step, as Frank Morris pointed out, toward insuring that we will miss the aggregate target for 1980 to an even greater extent. It seems to me that "B" is consistent with what we set last month; thus I would opt for the B alternative with a funds rate range of 13 to 17 percent, having in mind that if we have underestimated the strength of the economy for the remainder of this year, we may be using that 17 percent. I am really suggesting that a cap of 17 percent might be appropriate.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Well, some of what I say will be a repetition of what Roger said. If one goes back to the fundamentals of what we are trying to do, I don't think there's any question that if anything emerged from the November 4 experience, it was a recognition that the people of this country--and we are serving them--are primarily and indelibly concerned with something being done about inflation. I think the second fundamental that we have to address is the eroding credibility of our ability to perform effectively in what we've announced we're trying to do. If we continue to operate as we have all year--I'm talking about our operating procedures--I would agree with the Chairman that the choice we make today in terms of the alternatives will probably have very little effect on anything because [the results for the year] probably won't be a reflection of the choice we make. However, if the Bluebook is correct, it's too late really to accomplish our annual objective in terms of the targets for the aggregates. But whatever action we take today will have a very real effect on our credibility. Recognizing that the world knows that we're above the upper limit of our M-1B target, for example, if we don't choose an alternative that at least appears to attempt to correct for that overshoot, I think we will see a further erosion of our credibility.

Secondly, another factor that is currently affecting our credibility is the increasing suspicions on the part of the public that we are indeed moving back toward what I at least consider to be a failed policy of attempting to stabilize interest rates. Therefore, our fed funds range should not be narrower than the width we've adhered to most of this year. I would opt for alternative C. Under any circumstances, the danger that I would perceive in the future would be permitting interest rates to drop significantly. And I would

not like to see us set a lower limit of the funds range at less than 14 percent.

Finally, I would hope desperately that by February, when we go into [our deliberations for our targets] next year, Steve's study will have been conducted and will be taken seriously. And I hope it will be conducted, as I know it will be, with an open mind to see whether we can't come up with a better operating procedure that would reduce the potential margin of error between the actions we take at these meetings or the alternatives we choose and how the aggregates actually [turn out].

CHAIRMAN VOLCKER. I just want to make your comments a little more operational, Mr. Roos. In choosing "C" are you saying that we should immediately decrease the nonborrowed reserve target substantially and therefore increase the level of borrowing?

MR. ROOS. No, sir. First of all, I feel that the technique of operating with the nonborrowed and borrowed reserve paths is not working. I can't answer your question because we place more emphasis on total reserves in our view than on borrowed and nonborrowed reserves.

CHAIRMAN VOLCKER. Well, let me just interpret that. I can understand that, but the only way we can affect the total is by affecting nonborrowed.

MR. ROOS. Well, I think we could control the total, couldn't we? Again, that's what Steve's people are studying and I hope they'll get data on that. But I can't translate "C" specifically to nonborrowed and borrowed reserve paths because I haven't asked our people to develop that. I am not prepared to respond to that.

CHAIRMAN VOLCKER. Mr. Rice.

MR. RICE. Mr. Chairman, I know we often say that we're facing a period of unusual uncertainty. But this time I really mean it. We obviously face uncertainty in the fiscal outlook resulting from recent political developments. Also, as you and Mr. Winn mentioned, there is uncertainty in the energy price picture. Also, with possible changes in the discount rate and the surcharge, we don't know what bank attitudes will be toward borrowing. So the picture is very cloudy. Despite that, there seems to be an unusual amount of agreement as to the direction in which we should move. I would say that in light of all these uncertainties, the staff forecast is about as reasonable as one could expect, and I see no reason to disagree with that forecast. I feel that if we were to take any action that would result in a significant raising of the targets, that would certainly be open to an erroneous interpretation, or perhaps even the right interpretation but certainly one that we would not like to see. And it would definitely run the risk of adding to inflationary expectations. So, I would not opt for alternative A. On the other hand, it seems to me that any further move toward restrictiveness would have the very undesirable effect of making the projected decline in economic activity in the early part of the year sharper than we would like to see or sharper than might prove to be the case if we followed a more moderate course. Therefore, I would support alternative B. And I agree with Governor Gramley that interest rates



are now about as high as they need to be. So I would combine my support of alternative B with a federal funds range of 12 to 16 percent. Now, the growth that we get, of course, may be inconsistent with this federal funds rate range. If it is, I would be prepared to see the funds rate somewhat higher--maybe one percentage point higher. But I would not like to see that occur without the advantage of additional information.

CHAIRMAN VOLCKER. Mrs. Teeters.

MS. TEETERS. I think the talk about the targets for 1980 is irrelevant. We're done. At most we have four weeks in which to operate and the reserves will be set with lagged reserve requirements. So it seems to me what we're really talking about is how high we're going to let interest rate go between now and the end of the year, and that's it. I am also strongly of the opinion that rates are already too high. We have already killed the housing market. We are depressing the automobile market. We have continued pressure on business fixed investment, and it's to a point where I think it will stall out. I would like to point out to you that the last time we had a federal funds range approximately like this was in February of last year and we had a 9-1/2 percent drop in real GNP in the second quarter. I think the changes in interest rates have influenced a great deal the pattern [of GNP growth] we got this year. And I don't think the staff has done a bad job. I went back and looked at their fourth quarter-over-fourth quarter projection of February of last year and they had a decline for the year of about 2 percent. And if they have the fourth quarter right now, it's going to be a decline of about 1-1/2 percent this year. The pattern was different; the pattern of interest rates was not the one anticipated. I think these rising interest rates have an extraordinarily damping effect on the economy and if we let them go any higher, we're inviting disaster again. In addition, we'd be [inviting] a rerun of the great interest rate cycle of 1980 on an economy that is not where it was last February. Last February we were at 85 percent capacity utilization and at 6 percent unemployment. A lot of things were different than they are now. We have a relatively severely depressed economy that would be put through the wringer again and I think that would be a mistake.

Some of you say you're going to take "B" because it's no different from what we did last time. There's a 4 percentage point increase in the federal funds rate range associated with "B." It was 9 to 15 percent [last month] and the staff is saying "B" is [now] compatible with 13 to 18 percent. I think 18 percent is outrageously high. On account of the growth in the money supply, we immediately run everything up to the top of the range, usually within a week after the Open Market Committee meeting. Consequently, I don't care what you do with the money supply. I do care what you do with the interest rate range. I would put the maximum at 15 percent with maybe a bottom of 11 percent. The borrowing assumption is funny because we determine the borrowing from the nonborrowed reserve path. By doing a nonborrowed reserve path, at least for the next two weeks, we determine what the borrowings are going to be. There's a Catch-22 game going on here.

MR. WALLICH. We determine the funds rate; that determines the borrowing, and that determines the nonborrowed, I think.

MS. TEETERS. You have worked it backwards, I think, Henry.

MR. WALLICH. That's the unspoken sequence.

VICE CHAIRMAN SOLOMON. If we have a wide funds rate range, then it's the borrowing assumption that determines the nonborrowed reserve path, not the reverse.

MR. PARTEE and MS. TEETERS. That's right.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. We seem to be all over the lot today. I don't think it's so much that the situation is uncertain, Emmett. In my view, it has been uncertain for some time. Now I find it threatening. That's the tone; my feelings echo Willis Winn's, only I haven't been to the Middle East. It seems to me that the odds are now getting to be rather high that there's going to be an oil price increase of size. I don't know that it will be 50 percent, but I wouldn't be surprised at a \$10 a barrel increase. And that's going to have a considerable impact on inflation. I must say my view has always been that when an external event like this occurs it's not the right response to cut money growth targets because no other price is going to give. If we cut money growth targets, all it does is compound the effect of the oil price rise on real activity by forcing it lower than it otherwise would be. And activity would already tend to go lower because of the oil price rise. Nevertheless, it will be adding to the inflation numbers and so will food prices. Thus, it occurs to me that what we might get is considerable strength in the demand for money associated with a nominal GNP that holds up [but incorporates] a decline in real activity and an acceleration in inflation, which could keep a lot of pressure on the money numbers. In that kind of environment, I think interest rates could go to 25 percent. And that's something that we have to be thinking about--what it means for the economy to have rates above 20 percent--because that may occur.

The second thing that troubles me is that we will be having fiscal restraint in the immediate future; that is, there's a tax increase in six weeks. On the other hand, the new Administration promises tax reductions, a series of them, which would certainly add to pressures in markets over that period of time as the government deficit is increased. I also agree that defense spending is going up and is going to go up sharply. The new orders figures already show it. The whole thrust of current thinking is that we will have to have a larger defense establishment--and I would almost say "much larger" defense establishment the way the talk is going. So without a war, which is possible, we have all these things working against the [successful] execution of policy.

I am very nervous about limiting the [governing factor]--that is, the perceived rate of growth that will be appropriate in monetary aggregates--by interest rate constraints because if we do that, we may lose sight of what is really happening. But I guess I am prepared to limit the governing factor of monetary expansion because of these uncertainties. I rather agree that with prospects for increases in defense, taxes, and oil prices we don't want rates to go down significantly because we're going to have an almost semi-war economy in the period to come. I also think interest rates are getting pretty

high. We are shutting off the building industry. We have the thrifts back into a lot of trouble. That 6-month bill rate means that they'll be paying over 14 percent for money this week, and they can't afford over 14 percent. Neither can a lot of small banks. So we're beginning to threaten the institutional structures of the economy again, as we did early this year.

So I feel that we ought to constrain interest rate movements, at least for a time, Paul. I have a fairly wide view of that, though. My funds rate range would be 13 to 17 percent, centered on 15 percent which is where we are now. I know it's nice to say that we have a posture that we don't want monetary growth to go up and, therefore, regardless of what is happening, we're going to hold the target right where it was. But it's very unrealistic to do that. If we take alternative B--assuming these November numbers are still more or less holding, though I don't know what that \$700 million increase means for the projected number for November--it means that to hit our target, we have to have a 5-1/2 percent rate of decline in the money supply in December. A 5-1/2 percent drop is a rapid rate of decline in the money supply. If we want to go to alternative C the way Larry does, and [the projection for] November is right, we have to have a 9 percent rate of decrease. That would be the second largest rate of decrease we've ever seen in the money supply in the month of December. And I just don't think it's responsible to have a target that seems to want such declines to occur. They might occur, but to want them to occur seems to me inappropriate.

Therefore, I think we are forced to alternative A as the target for the 2-month pattern, which is an M-1A of 2 percent, an M-1B of 4-1/2 percent and an M2 of 7-3/4 percent. Well, the latter could be 7-1/2 percent; we wouldn't have to have the quarter. So that's what I would recommend. Alternatively, we can even specify it in terms of the quarterly growth rates, which I believe the draft directive suggests. Those are not high numbers: 4-1/2, 6-1/4, and 8-1/4 percent. I'd specify it in those terms and take a 13 to 17 percent funds rate range and be prepared to see those aggregates come in markedly lower than the target if indeed that is what develops. But I am beginning to doubt that that will develop in the period immediately to come. On borrowings, I don't know. It's a funny thing and I hate to mess with it. I think we ought to have them right about where they are because it's awfully hard to assess what our [rate increases] last Friday will do to tensions in that borrowing market, with the 2 point surcharge. So I would take a neutral stance and begin where we are on borrowing and see how things develop as the period goes on.

VICE CHAIRMAN SOLOMON. Where we are is \$2 billion.

MR. PARTEE. Well, I know. But we had--

MR. AXILROD. The implication of what we were targeting on was that \$1.6 billion in borrowing would emerge out of the week.

MR. PARTEE. That's what I mean. It came in high for the week, but we thought we were on a target of \$1.6 billion, and that's where I would [start] it. If the aggregates are strong, it will go up from there. If they are weak, it will stay about there. That's what I would do--not have an even-handed monetary target, but aim to hit

those numbers that I mentioned and if growth of the aggregates falls short, let the shortfall occur.

CHAIRMAN VOLCKER. We're running awfully late. I don't know whether people want to go out and drink some coffee before we finish this. Let's do that. Then we'll come back and complete this discussion.

[Coffee break]

[Secretary's note: When the meeting resumed after the coffee break, a few comments were missed.]

MR. BLACK. It seems that way. The first question is: How much confidence can we have in the relationship between the rates of growth in the aggregates and the federal funds range as specified by the alternatives? Everybody realizes that [estimating this relationship] is a very risky business at best and that we probably ask the staff to accomplish the impossible there. The second question is: What are the risks involved if we miss the paths specified in the alternative we choose, whatever that happens to be? I would consider a further miss on the up side to be pretty significant--much more so, of course, if we go with "A," less so if we go with "B," and maybe not so significant if we go with "C." But perhaps the most important issue of all is the likely effects on inflationary expectations of whatever policy option we select. They would be clearly worse under "A." That would involve raising the path for M-1A for the fourth straight month in the face of overshoots. I looked back and found that we had raised the December target figure for M-1A by a total of \$5.7 billion over the last three meetings. If we do more of that, it certainly would not augur well for inflationary psychology. Alternative B would involve not adjusting the target in the face of some overshoots and would, of course, be less detrimental to inflationary psychology. I think "C" would work positively [in that regard], and although I don't think there is any earthly way we could hit the target as specified by the end of the year, we could conceivably be within the range for M-1B.

In any event, I think it would be better if we were perceived as working toward a range even if we miss it, as I suspect we necessarily will. Finally, there is the question of what this implies for the 1981 targeting problems, which we've talked about. All of these options are going to involve some upward base drift, a problem with which we have contended for many years. Presumably "C" would involve less upward drift, although I doubt there is going to be a great deal of difference. So, I would come out for "C." I wouldn't object to widening the federal funds range; I have never objected to that. I don't like a range anyway, so to cover both "B" and "C" 13 to 19 percent would seem good to me. So far as the borrowing figure is concerned, I would start off where we are now on borrowing. But then if borrowing deviates from the figure we select initially, I think we ought to adjust the nonborrowed reserve target in the opposite direction by that full amount. In looking at the reasons for misses in the past, I think part of the blame lies with the Committee in not having selected the proper range, but in retrospect I believe we have not been sufficiently active in adjusting our nonborrowed reserves target to compensate for misses in the borrowing figure.

CHAIRMAN VOLCKER. Mr. Schultz.

MR. SCHULTZ. I can be very brief because I agree with Governor Wallich's and Governor Gramley's arguments and I come out pretty much where Governor Partee is. I think the economy is going to ease off considerably; I think inflation is extremely intractable; and I think volatility in interest rates is going to give us a real problem, so I would not like to see rates go up very much because I don't want to see them come down very much in the first quarter. We are going to have a great deal of trouble with this yo-yo effect. I like the technique we are using because it has a tendency to get interest rates to go more rapidly where they appear to need to go in an inflationary environment. But we must use judgment rather than adhere slavishly to some of these targets or we are going to get ourselves in deep trouble. I think we ought to look at the aggregates the way Governor Wallich has [suggested] we look at them--through the first quarter. So to me something between "A" and "B" makes sense for aggregates targets, but that's not the crucial question; at this point borrowings and the funds rate are. I would put borrowings at about \$1.6 billion and the fed funds range at 13 to 17 percent.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. Mr. Chairman, after listening to this dialogue, I wish we had the option of saying none of the above relative to "A," "B," and "C," because there doesn't seem to be a good answer. Broadly speaking, the dilemma that we've been faced with for some months has gotten worse. In a sense, we are still the only game in town in terms of an anti-inflation policy. Despite the election, if one looks at bond yields, inflation expectations haven't gone down. The fact that the forward rate on the dollar has actually gone down may indicate that inflation expectations in the view of foreigners have gotten worse. And while I continue to hope month by month, as does Steve, that these higher interest rates will result in some downward shift in the demand for money, I see a contrary trend going on. I think we are going to experience more of it because the cost of long-term money is so darn high that there is immense incentive on the part of businesses to borrow short--that is, in the commercial paper market or through banks--and that drives deposits up. So I expect this recent surge in business loans to continue.

As I see it, the really damaging thing to the economy is the height of long-term interest rates, and I don't see how we are going to get them down until inflation expectations come down and until the budget of the new Administration gets sorted out, which is going to be a source of uncertainty. Meanwhile, we have to worry about whether our monetary growth rates themselves are becoming a source of inflation expectations, as some of my directors and a good many of the professors at our recent academic conference think is the case. In view of all of this, I think it is too late in the year to aim for "C," which is a meat ax tactic; so the next less damaging [posture] would be to stay pretty much with "B" as Messrs. Morris, Guffey, and some others have said. I wouldn't want to increase further the ranges that we are shooting for. Furthermore, I would not be inclined to narrow the federal funds range, as some people have [suggested]. I think 13 to 18 percent is a viable range to stay with, given all the uncertainties that we face.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. The only comment I would like to make about the economy is that I think the Board staff's forecast is inevitably wrong in projecting a flat line beyond the first quarter, but we all realize that that reflects the uncertainty that we face beyond that. The first-quarter projection may be right, although I must say I am impressed by how strong the economy has consistently been and how wrong we have consistently been about that strength. What that does to me is to tend to shorten my sights and make me less concerned about what may be happening in 1981 and more concerned about looking to the short term. And even though we can no longer achieve our targets for the year, I think we ought to stick pretty much with what we had. So that brings me to "B." I would not narrow the funds range. We have been criticized and will be criticized for erratic interest rates but we are equally criticized for erratic money growth. And I think the limitations on the funds rate have had some effect in permitting money growth to exceed our targets. So I would stick with the range that we already have, do what we can to get within the limits of the targets for this year, and start off as low as possible for 1981. I don't know what the borrowing figure ought to be. I have written down a range of something like \$1 to \$1-1/2 billion; I think somewhere in that area is probably [appropriate].

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, I am a rather pessimistic guy these days and I couldn't get cheered up any with the discussion here this morning. I think there is much to what Mr. Partee has said about prices and wages, even given fairly strong monetary and fiscal pressures and whatever pressures [come from] substantial unused resources in the economy. And that means to me that about all monetary policy can do is to avoid fueling additional inflation. Even though we have had what we thought was a fairly tight policy for the last couple of years it has nevertheless accommodated additional inflation, so we must be pretty careful to try to avoid that situation continuing in 1981. I am not impressed with the idea that we can slowly and gradually wring inflation out of the economy using monetary and fiscal policy. I see inflation strengthening and I see more and more people apparently making a very good living out of marketing inflation protection gadgetry and developing what seems to me to be very high risk loans or uses of credit for that purpose. I read that as indicating that inflation momentum or expectations are still strengthening rather than weakening.

On monetary policy, I would think that the surcharge will pretty effectively discourage borrowing by the large banks, so I would not expect high levels of borrowing in the weeks immediately ahead. With respect to the monetary targets and the federal funds rate, alternative B seems to me about as good as one can do in the current circumstances. I believe it would be appropriate to hitch on to the "B" aggregate figures the suggestion that they serve as ceilings rather than midpoints. And I am sorry to share the view that we do have a fairly near-term end to this recovery that has gotten started, given what needs to be done in terms of monetary and fiscal [policy].

CHAIRMAN VOLCKER. Mr. Doyle, we're glad to have you with us today.

MR. DOYLE. Thank you, Mr. Chairman. There have been two prominent themes in the discussion so far, and I certainly would emphasize that there is some inherent conflict between what to do about the uncertainties on the one hand and what to do about the credibility issue on the other. The uncertainties question, as Governor Partee and others have already pointed out, may be changing from that status to something closer to [a real threat] in terms of the energy situation. I believe the reaction to movement in either direction on that is difficult to determine. That is, if a change does occur or is suggested in either direction, it's hard to say just how the market or anybody else would react in terms of dealing with these uncertainties that I don't believe are perceived by the markets generally at the present time. On the credibility side, I might suggest that the issue may not be that we have a credibility problem but that we don't have one. In fact, I think the public and market perception of the Federal Reserve, as someone else has just suggested, is that we are the only game in town and that we are doing the job right. Therefore, I would not like to see any further slippage from the targets that were [adopted] last month. I believe it would have a severe credibility [impact] and would produce some negative reactions. Therefore, I would support alternative B with some slight narrowing of the funds range, perhaps to 13 to 17 percent.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. I'm disheartened, as everyone is, about the alternatives in front of us. On the inflation front, Paul, everything we have discussed and everything we see is disheartening except the possible outside chance of house prices weakening due to a disaster in the housing market. That's clearly shaping up in front of us. I feel strongly that it's too late to try to salvage the year-to-year growth rates in the monetary aggregates because it would require a very sharp adjustment that would be extremely difficult to achieve. So I would come out, for essentially the same reasons Mr. Balles mentioned, in favor of alternative B with the proviso that the aggregate growth targets be viewed as a maximum. I would not be inclined to narrow the range on the fed funds rate. With regard to what Governor Partee said--he threw in something about how we communicate this to the other regulators--I do think we are headed into a period of very difficult times for the thrift institutions. In talking to Jerry Corrigan and other people in different parts of the country, we are now starting to see some really sharp deterioration in the balance sheets of thrifts all around the country. I am afraid that in the next few months we are going to see [the need for] some fast mergers in that area that are going to be rather difficult, and I don't know what this Committee can do about that. That's just another inevitable side effect of this period we are entering. Should we get a crisis in the Middle East, based on the OPEC meetings and consultations around this time, I think we would have to consider reconvening this Committee to restudy our entire program in light of the experience back in '74 when we went through [an oil crisis] the last time. Overall I come out in favor of "B" as it stands.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I would prefer a \$1.6 billion borrowing assumption and the specifications of "A." My first instinct would be a fed funds range of only 13 to 17 percent, but I am worried

that if things don't go as expected, we might find that the 17 percent upper limit would force the supplying of very large amounts of reserves, more than the Committee would want. So my instinct would be not to lock ourselves into the 17 percent but make it 13 to 18 percent with some flexibility in judgment regarding that 17 to 18 percent area. It seems to me that we ought to try to stay within the 17 percent, but if in consultation with the Manager it looks to you as though that will require supplying more reserves than is advisable, there ought to be sufficient flexibility in the directive for you to make the judgment to go up to 18 percent.

MR. PARTEE. That's consistent, though, with having 13 to 17 percent and then providing, as we've done previously, for consultation of the Committee if the 17 percent proves not to be reasonable.

VICE CHAIRMAN SOLOMON. You mean by telephone?

MR. PARTEE. Yes. The directive has that structure. I wasn't criticizing [your suggestion]; I was just making a point that what you said is consistent with choosing 13 to 17 percent and emphasizing the possible need for consultation, which also goes with what Bill said, I think.

VICE CHAIRMAN SOLOMON. There is also some advantage, Chuck, to leaving it at 13 to 18 percent with the Chairman understanding that the Committee hoped it would not go beyond 17 percent, simply because when the directive is published the market may overinterpret in a negative way the fact that we narrowed the range. So, strictly for the directive, I still would favor 13 to 18 percent but with an understanding that, if possible, not to go beyond 17 percent.

CHAIRMAN VOLCKER. Well, let's see whether we can reach a decision. There is a fair amount of difference of views on some of the specifics but some recognition on practically everybody's part of some common concerns, too. On approaches, I would just make two general points. I think what we are seeing now in general terms is the famous collision between the recovery and monetary targets that are in some sense too restrictive to permit recovery unless the momentum of inflation declines. I didn't expect to reach [this stage] this early, but here it is. A number of people have commented that these targets, just to put it very quickly, lower the limit on the ability of the economy to expand. They are going to continue to do that, I suspect, given all the uncertainties, with targets of the type that we have until inflation declines. And that's a very unsatisfactory picture from any perspective, other than sole-minded concern about hitting the targets. That's where we are and that's where we may be.

Somewhat related to that, which has already been mentioned, is that we still have some concern as to how much fluctuation we are generating in the money supply figures and interest rates by not recognizing some natural instability in these data. It's purely a matter of judgment and it's totally unsatisfactory in terms of reaching specific decisions because, to exaggerate a bit, we are guessing. Let me simply put it that if we bend over backwards to hit a target in the short run and find ourselves not making it, we end up with exactly the opposite problem in a very limited period of time in terms of the targets and with some real effects on the economy as time



passes. And we have unnecessary fluctuations; we may be stuck with them to a degree but they are not a happy circumstance in which to operate. But that doesn't give us precise guidance on how to balance those considerations.

As for hitting the growth targets or not hitting the growth targets--and I can only give you a personal view--I am not as concerned about that as some people are because I don't think, as I've said before, that these targets are written in heaven. There is a lot of uncertainty in these relationships. I do think we have to demonstrate, and I am satisfied that we have, that we take them seriously. That is important. Whether being precisely in the ranges or slightly outside of them is terribly significant to credibility or not I think depends in part upon our own attitudes, how we portray it, and how we describe the problems. [To the extent that] there is a recognition of the very real problems that we have, that credibility problem is diminished. If we attach what I personally think is undue importance to absolute precision, obviously the public is also going to attach more importance to absolute precision than they otherwise would. In that connection, I would only remind you that most foreign countries use a range. I believe they all do now. Is there one that doesn't, Mr. Truman? I don't know. There used to be.

MR. TRUMAN. The Swiss don't have a range and the French don't have a range.

CHAIRMAN VOLCKER. The French have been pretty good on their targets. The Swiss have varied between growth in M1 of 23 percent one year to minus 3 percent the next year to plus 4 percent the following year, I think.

MR. TRUMAN. There was a year in between when they didn't try at all.

CHAIRMAN VOLCKER. But they have not lost their reputation for prudence and concern in the process.

MR. PARTEE. They couldn't have a range--

MR. WALLICH. It's a small open economy.

CHAIRMAN VOLCKER. Sure, and that's part of the reason. All I am saying is that in part the public's attitude toward these things depends upon our general behavior, not the precise arithmetic precision with which we reach the range. Well, that's a philosophical comment. We have to reach a decision here.

So far as the money supply targets are concerned, I sense that we are dealing with two somewhat conflicting concerns. One, which I certainly recognize, is that we are in the middle of the quarter. If we were on the schedule that we talked about before, this would be the middle-of-the-quarter meeting. We would already have set a quarterly growth target and the inclination would be not to change that unless there was something very persuasive going on. But we would consider whether to change it and how to alter our operations. Certainly we have been forced to raise that target repeatedly in recent months, and one can argue that for purely presentational purposes it would be nice to avoid a further change in the target. I

think there is a lot to be said for that view. The consideration on the other side was described by Governor Partee: Is that being realistic? Is anybody here really proposing the strength of action and the kind of interest rates that might be necessary in our best judgment to reach alternative C--certainly "C" but even "B"--which implies from now on [unintelligible]. Is it realistic to think [we could achieve the target]? I don't doubt that it could happen, but given all the uncertainty about the normal relationships that the staff gives us, which in fact are very erratic but are all we have to go on--

MR. MORRIS. But given the run-up in interest rates we have already had in the last few months, it seems to me entirely possible.

CHAIRMAN VOLCKER. Well, it may be. You can reconcile yourself to that view and that's all right. I don't think the staff would say that that would be their best judgment.

MR. MORRIS. I think it's possible.

CHAIRMAN VOLCKER. Yes, I know. Anything is possible here! I agree it is possible.

MR. ROOS. I think some of us looked at it as a very short-range [step] that would avoid our having to jam on the brakes next year.

CHAIRMAN VOLCKER. Well, you could argue that. All I am saying is that if we took the staff's median judgment and reflected the distillation of assembled wisdom, recognizing that there is a huge range of uncertainty around it, I think one would have to say [it means]: Let's really bang it now. One could argue that that's a good idea because it's going to save us a lot of problems in the future. On the other hand, a lot of concern was expressed that really banging it now is just going to complicate our problem in the very short run. I think that kind of consideration would lead one in substance toward alternative A. If I take seriously what I think I am hearing in comments we have had about the interest rate range and the borrowing assumptions and all the rest--that people don't want to go out there and really bang it--that leaves me in something of a dilemma because I think the Committee is insomewhat of a dilemma. It doesn't exclude the possibility that we could hit the targets because we just don't know these relationships well enough. And there is the argument that it's better not to change things and mislead anybody as to our real intentions. I am not sure, but I believe the Committee members are mostly between "A" and "B." I haven't counted and I am not sure they all said precisely [what their preference was]. But that pretty well describes the considerations. We are somewhat artificially constrained because we are talking about a period that only has six weeks more to run. If we were not right at the end of the year--if we had looked at it from the perspective of the next four months instead of the next six weeks--and were somewhat worried about how this looks in terms of the targets for the year, I don't know whether people would say something like "A" is reasonable.

MR. WINN. But don't we have to consider the trajectory effect on 1981? To take the end of the year as the horizon with regard to where we want to be I think is the wrong [approach].

CHAIRMAN VOLCKER. Well, that's what I am suggesting in part. I would guess that people might say "A" would be all right if we were looking through the whole first quarter of next year. I don't know whether that's true or not, but I--

MR. PARTEE. Abstracting from that.

CHAIRMAN VOLCKER. I don't know what you mean by your comment. I think what a lot of people are worried about, Willis, is that by banging it really hard now, we're going to look foolishly low instead of foolishly high in the beginning of the first quarter or even in December. Now, one may think the economy is very strong--and I think it may have a little [more] momentum right at the moment than the staff implies, but I don't doubt that all the risks are for a decline in the time perspective of now through the end of the first quarter. But we may find the fourth quarter numbers are a little higher than the staff is suggesting, which further complicates this dilemma. We'll see just where you want to go, but I also detected some concern about the interest rate level expressed by a good many people. Consistent with what we're doing, I wouldn't like to get deliberately in an area where we have to work against an interest rate constraint because that changes the tone of our actions, but the borrowings have implications for that. A \$1.6 billion level of borrowings or thereabouts has been mentioned by a few people. That's lower than it has been, inadvertently or not, most recently. That seems not inappropriate to me, if we don't want to put a lot of additional pressure on the market because we just had a discount rate change. And in a sense, by moving the initial borrowing assumption down slightly, it probably will not have much of an easing effect on the market. But it prevents the discount rate move from being amplified and reverberating through the market excessively.

MR. AXILROD. Mr. Chairman, I mentioned that number because that was implied in the week's figure. But we tried to be clear to the Committee that in thinking this through we had assumed in the Bluebook, for whatever constellation of pressures you are considering on bank reserves, that with this discount rate move you'd have to lower borrowing relative to what it had been. So in some sense that \$1.6 billion was before the discount rate action; a level of borrowing consistent with that \$1.6 billion after the discount rate action would be somewhat lower. We'd put in a notional \$1.5 billion.

CHAIRMAN VOLCKER. To be consistent with "A," in effect.

MR. AXILROD. That's right. But even you just said you wanted to start at the recent level of borrowing. If you factored in the discount rate action, that would have to be a bit lower. That's just a technical [comment].

CHAIRMAN VOLCKER. If your conceptual level of borrowing before the discount rate action was \$1.6 billion, it should be lower now.

MR. AXILROD. That's right.

MR. GRAMLEY. How much lower?

MR. GUFFEY. The fact of the matter is that borrowing has been higher than \$1.6 billion. Over the 4-week period it has been about \$1-3/4 billion; it has only been \$1.6 billion for the week that we're in now. So what we're really looking at in terms of the recent borrowing level is somewhat higher than that \$1.6 billion.

CHAIRMAN VOLCKER. Well, it has been running somewhat higher than \$1.6 billion. What has the market done after your operations this morning, Peter? Where is the federal funds rate?

MR. STERNLIGHT. It pretty well held those opening gains after the money supply numbers.

CHAIRMAN VOLCKER. What did the federal funds rate do?

MR. STERNLIGHT. Funds trading opened at about 17 percent and went up to 17-1/2 percent--this was shortly after 11 a.m.--and we went in and have offered some overnight repurchase agreements.

CHAIRMAN VOLCKER. But you don't know what has happened since then?

MR. STERNLIGHT. I know that after we went in to do the RPs, the market strengthened very slightly further, but not enough to be noticeable.

CHAIRMAN VOLCKER. I don't know whether you're suggesting, Steve, that consistent with what I and other people were trying to say in concept--I lighted on \$1.6 billion as a few people did--we should really be saying \$1.5 billion.

MR. AXILROD. Well, we had suggested \$1.5 billion for "A" and \$1-3/4 billion for "B."

MR. PARTEE. Well, \$1.6 billion is right in between.

CHAIRMAN VOLCKER. In a sense, what a lot of people seem to be talking about is that they want to keep "B" for the reason suggested--that they don't want to show a further change in what we're aiming at. But we were talking more about the specifications of "A" with a higher federal funds rate on the low side of its range anyway. Let me just get reactions to this proposal: The "B" specifications and, taking account of Steve's comment, \$1.5 billion or thereabouts on borrowing, and 13 to 17 percent for the funds rate, which a number of people mentioned for that, and a hope that they are consistent despite an analysis that they might not be.

Steve has also suggested the idea--it sounds awfully complicated but it just is complicated at this stage of the game--of writing something into the directive that we are looking toward the first quarter, in effect. We could certainly write it into the policy record, anyway. We're thinking of "B" here on how we set the reserve path and would repeat the targets that we had last time, which are those in "B." And we'd put in some phrase that we recognize that there isn't much time between now and the end of the year to get on a specific path. But we would in a way reverse what we've said [in the past] if we adopted "A;" we'd say the Committee thought that a small overshoot would be tolerable, provided that growth in the aggregates

was at a pace consistent with more moderate growth next year. I don't know whether that language--

MR. PARTEE. We could say "in the early months of next year," or something like that.

CHAIRMAN VOLCKER. The early months of next year, yes. Now, what that leaves out is that some overshoot from the specifications of "B" or any of these alternatives, if it developed, would be tolerable in the short run without our aggressively moving against it. I don't know how much you would work that language in, Steve.

MR. ROOS. Didn't several proponents of "B," Mr. Chairman, also suggest that the aggregate figures in "B" be viewed as the top limits and that we should not tolerate an overshoot?

CHAIRMAN VOLCKER. Well, we have a conceptual difficulty there. I am sure that you are right, but sometimes those same people said we should not set out now to bang up the borrowing level and bang up interest rates. That's the inconsistency with which we are dealing. Verbally they may have said "Don't tolerate an overshoot," but they didn't seem to be supporting the strength of action that would be needed to insure against an overshoot.

MR. ROOS. In considering these figures, which are for the next six weeks--and I recognize that short-term fluctuations in money probably don't have a very real effect on output and the economy--are we overlooking the fact that the first six weeks of this quarter came in quite high? You speak of jamming the brakes on too hard with "C;" wouldn't that really be counterbalancing an almost run-away situation over the first six weeks?

CHAIRMAN VOLCKER. There is no question, growth in the aggregates was very high in the first six weeks; so are interest rates.

MR. GRAMLEY. Mr. Chairman, what would happen under these specifications if, in fact, we came out from now to the end of the year with what I would consider to be a very fine performance of the monetary aggregates, i.e., no change in M-1A. If M-1A were completely flat and let us suppose that in fact \$1.5 billion in borrowing were consistent with the specs of "B," then what we would end up doing I think--if I'm wrong, maybe Steve or Peter could enlighten me--would be taking actions deliberately to push interest rates up further. And instead of a federal funds rate of 15 percent we would end up with 17 percent.

CHAIRMAN VOLCKER. Steve can correct me, but my sense of it is that if we started out at the borrowing level that we're talking about and there were no change in the money supply from now on, week by week, we would come out very close to "B," wouldn't we, Steve?

MR. AXILROD. Actually M-1A would come out at "A." That is, the average for the week of the 5th and what we expect for the 12th comes out to a level for M-1A of \$387.9 billion, and that's the December level that's built into "A." To achieve the specs of "B" would require a drop in M-1A from here on in.

CHAIRMAN VOLCKER. You only get a \$.3 billion drop in December with no increase in the weekly figures from here on out? Aren't you assuming some increase [in those weekly figures] in that "A" [alternative]?

MR. AXILROD. I was giving you the December average level for M-1A; it would be \$387.9 billion. That's virtually no change from the November average level, and the first two weeks of [December] are roughly at the November average level. So there would be no change, in effect.

MR. ROOS. Does anyone view M-1A as a serious aggregate?

MR. PARTEE. I do. I still think it's the most important.

MR. ROOS. Even though the change has occurred toward a broadening--

MR. PARTEE. Sure, because I can't read M-1B with all those NOW accounts being created.

CHAIRMAN VOLCKER. The trouble is, Larry, that they're both wrong. You should average the two. It gives you a rougher "right answer," as a matter of fact.

MR. CORRIGAN. Mr. Chairman, on this matter of whether or not to have some maximum: If we took something like "B" or a little higher or something between "B" and "A" for the aggregates paths and treated them as a max--if for no other reason than having that be our consultation point rather than perhaps the federal funds rate--I don't think those things have to be incompatible. It comes down to a judgment as to how much of an impact the things we already have done will have. I think it might be possible to structure something like that, which would just put somewhat greater weight [on the aggregates], even if merely for consultation purposes.

CHAIRMAN VOLCKER. We're having a consultation right now. Our best estimate is that we are above "B." If you want to choose "B," we are consulting.

MR. CORRIGAN. I'm saying in terms of this maximum, [use] "B" or something a little higher than "B."

MR. PARTEE. We could say "A" is what we project and "A" would be what we plot. It means essentially zero for the rest of the year. And we'd accept any shortfall; but if it rose up above that, we would react strongly against it.

MR. CORRIGAN. In a sense I think that's the key because if it turns out that we get a couple more strong weeks, then all of a sudden we're in a position that we're not even realistically looking at [an outcome close to] "A" and then we're really in the soup.

MR. PARTEE. That's right. And that's a real possibility.

CHAIRMAN VOLCKER. We are realistically looking at "A" now. That is the projection. Now, it's an extremely uncertain projection, and I don't attach a lot of weight to it, but the experts say that's

where we are. The range of uncertainty around it is very wide. The sense of what I have proposed, just distilling some of your comments, is that for visual reasons, which are not unimportant, we will stick with "B" [for the ranges] and hope growth comes out at "B," but act somewhat like "A" at the moment. That leaves us with the question of how strongly we react if "A" gets confirmed or, worse yet, if growth goes higher than the specifications of "A." That's the sense of it if we adopt these specifications; and it's reflected in part in the federal funds range. Obviously, we have to consult if we hit [the limit on] that.

MR. WALLICH. You said earlier that we ought to think more about the deviations from the targets and the response to that than about the absolute targets, and I thought that very persuasive. So an important ingredient of this decision seems to be where do we go with the funds rate if [monetary growth] falls below or goes above. Now, one way of not capping but flooring the rate on the down side would be to set a rather high [level for the lower] limit, and I suggested 14 percent. Another might be to say accept a shortfall in the aggregates. I am not quite sure what that implies in terms of the funds rate, really.

CHAIRMAN VOLCKER. I am not sure what it implies in terms of [that rate but] there is a relationship. What it implies is that we're pretty slow about changing the nonborrowed path to make up for any decline in borrowing. That's what it specifically implies, which in turn slows down any decline in the funds rate.

MR. PARTEE. It might bring down the funds rate a little.

CHAIRMAN VOLCKER. It would come down some if we had a really big shortfall, but--

MS. TEETERS. I strongly object to pegging that rate at 14 percent. We have let it run up way above what we expected a month ago; and if you're going to play that game, Henry, you have to be able to play it on the down side, too. A rate of 14 percent is just ridiculous in this economy.

MR. WALLICH. After taxes fourteen is negative in real terms for those people who pay taxes. I am being told that there are many people who don't pay taxes and take the standard deduction or have no profits, so one has to take both things into account. I think the rates are almost there but not quite.

MS. TEETERS. Oh, baloney. Why shouldn't the security holders have a decline in real income, too? Everybody else has.

MR. PARTEE. We've had this discussion.

CHAIRMAN VOLCKER. I think it's clear that people in general terms are willing to [tolerate] some shortfall from whatever target we adopt, without moving very aggressively [on the funds rate]. I don't want to pin that rate at 14 percent at this point, but I would be slow to react on that side under our normal operating procedures. If the market really thought the money supply was coming in low, we would get a big psychological effect in the market that would move interest rates. But we would drag in changing our paths. I think what is at

issue is how much we drag on the up side. If we set these kinds of specifications, I would sense--without counting the people who did not talk too specifically, and many people did not--that there is no eagerness to whack it too hard if growth comes in above the ranges. We're going to get some reaction.

MR. MORRIS. Would you define "whack it too hard"?

CHAIRMAN VOLCKER. That's a technical term! Let me say, just in round numbers, that we start at \$1.5 billion [in borrowings]. You know, precisely what has happened after we argued interminably in the last two meetings about whether the target should be one percentage point more or less, is that within a week, or literally a few days, the next money supply figure that came in was over anything we were talking about. So we moderately whacked it, I would say. We raised the net borrowed reserves, we lowered the reserve path by \$100 million or so, which was enough, and we probably overshot the reduction a little. It was enough to have a very noticeable effect on the market. Growth in the next week came in pretty high, I think perhaps by coincidence. If it came in high [in the week ahead], let's say, but more moderately high than those numbers, maybe we wouldn't do anything for a week to see whether it was confirmed the next week. If it came in very high, we'd probably react but more mildly than we did the previous two times.

MR. PARTEE. That is, we would end up not adjusting the nonborrowed reserve path.

CHAIRMAN VOLCKER. If it came in only slightly or moderately above the path.

MR. PARTEE. Yes, we might begin to get some tightening in the market.

MR. ROOS. Are you saying that we bias it to tolerate an overshoot more than an undershoot?

CHAIRMAN VOLCKER. No, I think we're saying the opposite of that. We're very tolerant of an undershoot. What I am trying to pin down is how tolerant we are of an overshoot. I think the general sentiment is that we're going to be less tolerant of an overshoot than we are of undershoots. But should we be tolerant at all of an overshoot is the question or do we react very quickly? My dilemma is that if we're really not tolerant at all of an overshoot, we ought to be whacking it right now, which is not what people said. So on how tolerant we are of an overshoot, I suppose what we're saying is that we'd be fairly tolerant right at the moment [up to the specifications of] alternative A. If it got above alternative A, we'd be progressively less tolerant.

MR. SCHULTZ. I'd rather consult if the funds rate got over 17 percent.

CHAIRMAN VOLCKER. Whether the funds rate gets over 17 percent or not depends upon how tolerant we are.

MS. TEETERS. It's already at 17 percent.



CHAIRMAN VOLCKER. That's right.

SPEAKER(?). Well, that's the point I was trying to express.

CHAIRMAN VOLCKER. I'm not sure we can escape this problem by saying we're going to consult next week. I'm trying to consult right now.

MR. FORD. Tony Solomon addressed that. What's wrong with Solomon's approach?

CHAIRMAN VOLCKER. Solomon's approach is fine, let's take it. Let us proceed. The funds rate is already in his area for consulting. I am consulting.

MR. PARTEE. Well, what do you want to do?

CHAIRMAN VOLCKER. What do you want to do? That's precisely the--

MR. SCHULTZ. That's the problem.

CHAIRMAN VOLCKER. Let's not put it off until next week. Here we are.

MR. SCHULTZ. I don't know. Chuck, what do you want to do?

MR. WALLICH. I think we ought to go slowly. I differentiate between 14 and 17 percent, and I would hesitate to go above that. Let's look toward next quarter and try to get on a [path] that will get us back on track. Then we will [unintelligible].

CHAIRMAN VOLCKER. Let me repeat: We put forward the "B" specifications; we put down a funds range of 13 to 17 percent; we put down a borrowing number of \$1.5 billion at the moment; we don't do anything except just what we're saying here at the moment.

VICE CHAIRMAN SOLOMON. Then we'll miss "B."

CHAIRMAN VOLCKER. I don't know whether we'll miss "B" or not. There is a lot of uncertainty. The staff tells us we're likely to miss "B." We understand that.

VICE CHAIRMAN SOLOMON. That's what I mean. Taking the staff's view, we'll miss "B."

CHAIRMAN VOLCKER. We understand that. We're misspecified in that sense. We're hoping that if the money supply comes in high against their current projections in the next week or two, we're going to increase that borrowing level. I can't be perfectly specific about how much we're going to increase it; we haven't got a formula for relating the borrowing level precisely to a new estimate of the money supply. I am saying that if it comes in significantly higher than that, we'd probably move it by \$100 million, but we wouldn't move it by more than that unless [the money supply] was enormously higher.

MR. AXILROD. Borrowing would rise in any event.

CHAIRMAN VOLCKER. That's right, borrowing would rise in any event. We're talking about whether we reduce the nonborrowed reserves.

MR. ROOS. What is the objective of that nuance? I'm a little lost. I'm not asking that in a critical way. Why are we not taking straight "B"?

CHAIRMAN VOLCKER. I want to get a sense from the Committee. I'm not talking in numbers that will turn out to be somewhat meaningless if we get new figures. I want to know how hard the Committee is willing to [resist an overshoot]. We're talking about a 20 percent federal funds rate if these numbers really come in high. I take it you're not--

VICE CHAIRMAN SOLOMON. Yes, but that's not your proposal. This is for 20 percent; yours is for 17 percent.

CHAIRMAN VOLCKER. Now. And 17 percent is barely marginal now. The presumption is that if we have a \$1.5 billion borrowing level immediately, it will come down from 17 percent. But almost any overshoot from what we now expect is going to force the consultation you're all talking about a couple of weeks down the road.

MR. CORRIGAN. If we had a \$2 billion increase in the money supply next week, all of these numbers presumably would be out the window.

MR. FORD. Yes, but if we put a 17 percent cap on the fed funds rate, that almost guarantees--I mean it could be happening before we get out of this room.

CHAIRMAN VOLCKER. I am assuming that the present situation is tolerable. We'll wait a week or so to see whether it comes down. If it doesn't, we will have to consult again in a week or two.

MR. ROOS. That means that for a week we'll supply money too quickly.

CHAIRMAN VOLCKER. I don't know whether it's too quickly or not. All I'm saying is that we only know that ex post, Larry. We'll know whether it was too quickly or too little along about next March.

MR. ROOS. I was all set in the spirit of Thanksgiving and generosity to move from "C" to "B," but this whacky proposal bothers me.

MR. FORD. It's not whacky; it's semi-whacky.

CHAIRMAN VOLCKER. That's right.

MR. PARTEE. Well, I couldn't vote for "B" as it stands. I would vote for "B" as you suggested it--that is, if we don't really mean the specs of "B."

MR. GRAMLEY. Should we instruct the staff to calculate the nonborrowed reserve path accordingly?

CHAIRMAN VOLCKER. [From what] I observed, a good many people came right to that conclusion. But there is enough difference so that I'm not sure I can see a majority anyplace.

MR. WALLICH. I'd be willing to go to 17 percent [for the upper limit of the funds rate range] provided the 13 goes to 14. My concern is more with the lower limit than the upper limit.

MR. GRAMLEY. Well, it isn't going to happen. You have no worries, Henry, between now and the middle of December on how low interest rates are going to go. The worry is in the first or second quarter of next year. And I think the higher we put interest rates now, the greater the danger is that by the second quarter economic activity is going to be in a nice steep decline and interest rates are going to be falling like a stone. We're going to be chasing the money supply. The way to keep out of this is, as the Chairman says, to not whack it too much now, to let things settle down. We've gone a long way. And we have gone a long, long way just since October. We've increased short-term interest rates by something like 2-1/2 to 3 percentage points in a month. In a month! We've increased long-term interest rates by a percentage point or so, a bit less for mortgage rates. Those are enormous increases by historical standards. We are really resisting money growth. I think the Chairman is quite right in that. We're showing our determination. And we have let interest rates move through swings since the summer, since recovery began, that are just totally unprecedented. Let's wait and see what happens.

MR. ROOS. Lyle, have we resisted money growth, though, to an extent that would have a beneficial effect on reducing inflation?

MR. GRAMLEY. [Unintelligible.]

MR. SCHULTZ. Over the long run it will. That's a long time, Mr. Roos.

CHAIRMAN VOLCKER. Let me see if people think we can reach some kind of consensus around stating "B" and in some sense adopting the specifications of "A" because of a feeling that they may prove consistent over time and that we shouldn't anticipate their inconsistency. I suppose that is the analysis that--

MR. MORRIS. But the reserve path is going to be drawn on "B." Is that what you're saying?

MR. SCHULTZ. Well, the reserve path is drawn on borrowing--

CHAIRMAN VOLCKER. The path is in a sense drawn on "B" but with a starting point on borrowing which the staff tells us in their best judgment is more consistent with "A." But we're overriding [the staff's judgment on] that in a sense. The changes from then on would be consistent with "B." Let me just finish this. Again, let me try to get some degree of consensus for 13 to 17 percent. I think Lyle is probably right that we're not going to hit the 13 in the next month. I recognize that we're at the 17 right now. Implicitly by citing that kind of target, we are accepting the current level of market rates. We'd accept it fluctuating even slightly higher for a few days in the thought that the specification for the borrowing will probably bring it at least slightly lower. If it doesn't, we will have to consult

because [our specifications] will be inconsistent. But we'll let that go for a week or so. We will react quite sluggishly to shortfalls. We will react less sluggishly to overruns, but without enormous aggressiveness. We don't have a formula for--

MR. BLACK. That's whacking it lightly.

MR. MORRIS. I don't think 17 percent is whacking it lightly, though.

CHAIRMAN VOLCKER. We're right there now.

MR. MORRIS. Yes, but we've only been there for a couple of days.

CHAIRMAN VOLCKER. That's right.

MR. STERNLIGHT. What I might say about the 17 or 17-1/2 percent that we are getting today is that I don't see our approach as accepting it. We are putting in reserves. I regard that very high rate of yesterday and today as something of an aberration. I would think, given what we're aiming for, that it ought to be getting down more than--

CHAIRMAN VOLCKER. Well, that's what we're assuming now. But you're basically operating on the reserve path, as I understand it.

MR. STERNLIGHT. Yes, but there are enough uncertainties in that reserve path that we feel this is one of those occasions that we just have to use a little discretion around that.

MR. WINN. What do you consider to be the normal rate at this time?

MR. STERNLIGHT. I would expect it to be more like 15 percent, given the borrowing level of \$1.6 billion that we've been aiming at this week.

CHAIRMAN VOLCKER. We could talk about mild [adjustments in] quantifications or whatever. Does that general pattern represent a legitimate consensus? Can I have a show of hands on that?

MR. PARTEE. How many would accept it?

CHAIRMAN VOLCKER. Yes. I'm asking whether it's essentially [acceptable], without getting into every last refinement: Is this acceptable, with the explanation.

MR. ALTMANN. Seven.

MR. SCHULTZ. That's better than you usually get on the first try. [Now] it's eight or nine.

MR. ALTMANN. Eight.

MR. ROOS. Instead of starving us into submission, you've whacked us into submission!

CHAIRMAN VOLCKER. It appears that I am as reasonably close as I can get to a consensus. I don't know if there is any refinement that will conceivably increase this number. Henry is worried about 14 percent on the lower end. I am not sure whether that's operationally significant or not.

MR. SCHULTZ. I think you did very well. You lost Henry and Nancy. And that's about as good as you can--

MR. WALLICH. Why not do it my way?

CHAIRMAN VOLCKER. Well, I'll tell you. Part of the reason, Henry, to put it baldly, is that it upsets a lot of people's doctrinal views to have [the range] that narrow.

MR. SCHULTZ. You better vote before you lose somebody.

CHAIRMAN VOLCKER. Let's vote.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Guffey	Yes
President Morris	Yes
Governor Partee	Yes
Governor Rice	Yes
President Roos	Yes
Governor Schultz	Yes
Governor Teeters	No
Governor Wallich	Yes
President Winn	No

It's 10 for--

CHAIRMAN VOLCKER. Well, "10-4" means the meeting is over! Let me say for all its difficulty, I think we were concentrating more on the right variables today. And it was helpful to me. We have some underlying problems that aren't going to go away. A number of people made comments, which I think are understandable, about whether the whole process of gradualism makes sense. I just don't think that's an issue that we can decide at this meeting. Nor, indeed, is it an issue that is up to the Federal Reserve itself because we're not going to deviate successfully from what has been termed gradualism without an effort by the government right across the board, of which we would have to be part.

When I speak of collisions next year, I think you ought to be aware, and I'm sure you are, of the potential for the Federal Reserve to be left out there hanging alone in extremely unsatisfactory economic circumstances with expectations, deliberately [encouraged] or not, of what we can do about inflation through monetary policy alone much overdrawn. And when policies are not a success, there will be an inclination for people to say that somehow inflation would have disappeared if we'd been 1/2 percentage point within the target instead of 1/2 percentage point outside the target or if we hadn't had a big fluctuation downward in the first quarter and upward in the second quarter or whatever. That is a conclusion that I don't think

bears much relationship to reality. Nonetheless, we're going to be extremely vulnerable, particularly if we feed that impression ourselves that somehow we're going to do it all alone.

MR. BAUGHMAN. I would think, Mr. Chairman--and I presume this is going on or will go on--that it would be desirable to get the new President to commit his credibility as early as possible to attacking inflation for the purpose of trying to erode somewhat the possibility that we will be standing out there alone.

CHAIRMAN VOLCKER. The danger that I see, and I put it very crudely, is that everybody will be committed to an attack on inflation but it's entirely up to the Federal Reserve to perform.

MR. PARTEE. That won't hurt. We've already been there.

MR. BALLE. I have a hunch that our Horatio at the bridge act isn't really going to change unless or until the size of that budget deficit comes down, however it may be done. Until then, we're under awful pressure.

CHAIRMAN VOLCKER. That is one major element. There are a lot of other elements in the inflationary picture. Don't forget, there are people out there who are approaching this from one point of view, which at the extreme--Mr. Corrigan ran into this the other day--is that the budgetary deficit doesn't make the least bit of difference. And other policies don't make the least bit of difference. Inflation is purely a monetary phenomenon. And if the Federal Reserve would only get its act straightened out, it would pretty much disappear in 12 months.

MR. BAUGHMAN. But I think that's a pretty small group.

VICE CHAIRMAN SOLOMON. They're very vocal, Ernie.

MR. BAUGHMAN. I know it's a very vocal group but I think it's pretty small.

CHAIRMAN VOLCKER. Well, in one sense, it's a small group. I'm not sure it's an uninfluential group. And when things don't go well, there is a certain irresistible political temptation to say that that small group was right.

VICE CHAIRMAN SOLOMON. Yes.

MR. CORRIGAN. But another thing, too, is that the Federal Reserve in its own way has done a marvelously effective job of convincing people that the growth of money matters, to the point where even for nonmembers of that small group it is very easy to latch onto [monetary policy] as the scapegoat. Even the nondoctrinaire people who don't even understand it--

MR. BAUGHMAN. I assume we're not prepared to disavow that.

MR. ROOS. Is that small group currently being subjected to a chastising?

MR. BALLE. You're getting whacked, Mr. Roos!

MR. SCHULTZ. What is even more disturbing is that I'm convinced that the vast majority of people in this country think control of the money supply has no connection to interest rates. That is really disturbing. They say: You know, interest rates wouldn't be so high if you people would just control the money supply. That puts us politically in a very difficult position.

MR. BAUGHMAN. Very often [the interpretation is] even narrower. It's if you wouldn't print so much money.

MR. SCHULTZ. That's right. That's what they're talking about.

CHAIRMAN VOLCKER. I bring to your attention that the next meeting is a bit off schedule to get us in line with our new schedule. So it's on a Friday because that's the time when we could fit it in. It would not be surprising if we have to have some consultation before that time. I hope some food is out there.

MR. ALTMANN. I am told that it is.

MR. PARTEE. It's only four weeks away.

MR. BALLE. Paul, are we meeting here for the planning session?

CHAIRMAN VOLCKER. Yes we are.

END OF MEETING