

Meeting of Federal Open Market Committee

January 8-9, 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., starting on Tuesday, January 8, 1980, at 3:30 p.m. and continuing on Wednesday, January 9, 1980, at 9:15 a.m.

PRESENT: Mr. Volcker, Chairman  
Mr. Balles  
Mr. Black  
Mr. Coldwell  
Mr. Kimbrel  
Mr. Mayo  
Mr. Partee  
Mr. Rice  
Mr. Schultz  
Mrs. Teeters  
Mr. Wallich

Messrs. Guffey, Morris, Roos, Timlen, and Winn,  
Alternate Members of the Federal Open Market  
Committee

Messrs. Baughman, Eastburn, and Willes, Presidents  
of the Federal Reserve Banks of Dallas,  
Philadelphia, and Minneapolis, respectively

Mr. Altmann, Secretary  
Mr. Bernard, Assistant Secretary  
Mr. Petersen, 1/ General Counsel  
Mr. Oltman, Deputy General Counsel  
Mr. Mannion, Assistant General Counsel  
Mr. Axilrod, Economist  
Mr. Holmes, Adviser for Market Operations

Messrs. Brandt, Ettin, Henry, Keir, Keran,  
Kichline, Parthemos, Scheld, and Truman,  
Associate Economists

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

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1/ Entered the meeting prior to the action to adopt the domestic policy directive.

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

Mr. Coyne, Assistant to the Board of Governors  
Messrs. Kalchbrenner and Prell, Associate  
Directors, Division of Research and Statistics,  
Board of Governors

Mr. Siegman, Associate Director, Division of  
International Finance, Board of Governors  
Messrs. Beck and Simpson, 2/ Senior Economists,  
Banking Section, Division of Research and  
Statistics, Board of Governors

Ms. Farar, Economist, Open Market Secretariat,  
Board of Governors

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

Mr. McIntosh, First Vice President, Federal Reserve  
Bank of Boston

Messrs. Balbach, Burns, Corrigan, J. Davis, T. Davis,  
Eisenmenger, and Fousek, Senior Vice Presidents,  
Federal Reserve Banks of St. Louis, Dallas, New  
York, Cleveland, Kansas City, Boston, and New York,  
respectively

Messrs. Danforth and Mullineaux, Vice Presidents,  
Federal Reserve Banks of Minneapolis and  
Philadelphia, respectively

Mr. Meek, Monetary Adviser, Federal Reserve Bank of  
New York

Transcript of Federal Open Market Committee Meeting of  
January 8-9, 1980

January 8, 1980--Afternoon Session

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

CHAIRMAN VOLCKER. [That was the change in System holdings of securities] since when?

MR. STERNLIGHT. That was for all of '79.

CHAIRMAN VOLCKER. Steve, if you want to add something that bears upon the nature of the operations, this is probably as good a time as any to do it.

MR. AXILROD. Mr. Chairman, we have some tables we could pass out, which are somewhat similar to the ones that we made available to the Committee at the last meeting and which might be helpful in considering how and whether to proceed with these techniques. These tables are designed to elaborate the numbers that underlie Mr. Sternlight's operations. As you can see, they are divided into two columns. On the thought that the Committee wouldn't want to get too far off its path for any sustained period, we divided this period--the seven-week intermeeting period--into a four-week interval and a three-week interval. The three-week period ends tomorrow. The tables [exhibit] all the perils of lagged reserve accounting, which makes the relation between reserves and money in the short run not as close as one might hope. [Operations] were designed to attempt to attain a growth rate in M1 in the September-to-December period of a little over 4 percent and in the November-to-December period of something like 5 percent. In the event, as you saw in the Bluebook, we were a bit short on the growth rate in M1 and also in M2; but I think within any reasonable margin of error we were not really very far short.

If you focus on the last column, which [covers] the most recent three-week period, you can see that the monetary base turned out about \$379 million short of the original path we set. And you can see that total reserves turned out about \$218 million short of the adjusted path. As will be clear shortly, the adjustments were only \$4 million. So it really is about \$220 million short of the original path; there was a currency shortfall involved. With total reserves running short, the Manager added roughly \$150 million to the original nonborrowed path. That is shown in the third panel, where you see adjustments of \$146 million. That simply is the \$150 million added minus the \$4 million, which was a decline in the original total reserve path. So that is the added adjustment to nonborrowed reserves because total reserves were running short of what seemed consistent with this money stock figure, again recognizing the looseness in linkages because of lagged reserve accounting. Thus, to translate that into borrowings, you can see that the original path based on the Committee's decision in November, which was to assume borrowings at \$1.7 billion, would be subtracted from total reserves to give [the level of nonborrowed reserves] the Manager would aim for initially. After the \$150 million adjustment, that would get us down to \$1,550 million in borrowings; and given the weakness in total reserves demanded relative to what was projected as needed to get the [desired growth in the] aggregates, actual borrowings, of course, fell short

even of that. So the deviation of \$218 million from the [assumed level of] borrowing turned out to be exactly the same as the deviation from the adjusted total reserve path of \$218 million. That's just simply arithmetic.

The source of some of the problems we were having is shown on the next page; they are inherent in this kind of targeting procedure. Again, I'd say that thus far I think we've been fairly lucky in coming up with growth in money that was pretty consistent with what the Committee wanted. As you can see, on the original total reserve path we were off \$222 million from [the path] we first constructed. Adjustments came later. They really involved two components, and they went in opposite directions. One was excess reserves, which actually turned out to be \$166 million higher than we had built into the original path; that is line B in the last column. And in terms of the uses of total reserves, required reserves were running \$388 million weaker. So, simply taking total reserves as the sum of excess and required reserves, total reserves were running [below by] \$222 million. Thinking of it from the sources side, we just didn't supply that much reserves. With lagged reserve accounting, to do so we would have had to pile in a lot more excess reserves than even the banks were willing to hold. I don't know how much that would have amounted to because we would have had to run down borrowings to begin with.

Now, the bulk of the shortfall in required reserves was in the type of liabilities requiring reserves that didn't enter into either M1 or M2. As you can see, there were shortfalls relative to expectations of \$80 million in large CDs, \$90 million in U.S. government deposits, and \$167 million in the marginal reserves, which are connected with the shortfall in large CDs. That's essentially because bank credit ran a lot weaker than we expected and banks simply were not borrowing in the market in order to meet those credit demands. Thus, we adjusted the path, really, so that the Manager wouldn't supply those reserves. We hadn't made any adjustments to path since October 6th until this past three weeks. And we had such large consistent shortfalls in these items that it seemed that we would get too much money unless we adjusted the path, so the Manager in effect absorbed the reserves released by the decline in these deposits. Of course there was a shortfall in currency relative to expectations, as shown in the third line, line E. And in terms of reserve requirements, that meant we would have had to add \$30 million to total reserves to compensate for the shortfall in currency. However, that was more than made up, as you can see, by the sharp drop in required reserves behind large negotiable CDs, U.S. government deposits, and marginal reserves. Those minuses much more than compensated for the added reserves needed for the shortfall in currency. That is, simply put, the drop in negotiable CDs released reserves that could be used to expand the deposits needed to make up for the shortfall in currency. So, netting through all those things, we ended up reducing the total reserve path by \$175 million, as you can see in line F, to reflect changes in deposit mix and in currency flows. It's a rather rough net that won't add up exactly, but it goes in the direction that all items listed under D and E would suggest on [balance]. On the other hand, because excess reserves were running extremely [high], we felt we had to add reserves because banks' behavior with regard to excess reserves was totally different in terms of magnitude from what we had expected. So in the end, as Peter mentioned, because banks kept holding more excess reserves than we

were expecting every week, somewhat belatedly we added \$171 million. So, those adjustments net out to virtually nothing. If you took that minus \$4 million and related it to the \$222 million, you get this \$218 million, which is the deviation from the adjusted path. In general, this time it seemed very reasonable to make these adjustments to the path. In the previous periods we did not because we didn't see extremely large sustained movements; the movements we did see in the earlier periods were more toward rapid expansion in CDs and in bank credit, things that we assumed the Committee wanted to hold down. However, this time it was toward very weak bank credit; and we assumed that the Committee did not want that very weak bank credit to be reflected in excessive expansion in M1, so we made some offsetting adjustments. Of course, with lagged reserve accounting, the impacts on M1 are not related one-for-one to what we do this week. One has to wait for some time to come. But in any event, by the time all this was done, we still ended up with weak total reserves because we couldn't provide enough nonborrowed reserves to bring total reserves up to path within this three-week period.

CHAIRMAN VOLCKER. I'm sure that's crystal clear! So, I think it's time to raise questions--not just on the details of Peter's operations, but questions that bear upon the operating techniques generally. Governor Partee.

MR. PARTEE. Well, just a comment. I think I understood the direction of your adjustments, Steve, as you went through this. But I certainly don't understand it from this table on the second page. I can't make out the magnitude of the adjustments. The arithmetic just doesn't work very well, at least as I was trying to follow what you said, although I understand the direction of change. The other question I have is on the very last comment you made, which was that even after these adjustments you fell short of the desired adjusted reserve path because you just couldn't supply the nonborrowed reserves. Would you explain why it is that you couldn't get in the nonborrowed reserves?

CHAIRMAN VOLCKER. He couldn't get in the total reserves.

MR. AXILROD. We fell short on total reserves, not on the nonborrowed.

MR. PARTEE. Well, one of the things that is disturbing me-- about the whole period really but particularly the last month or so-- is that we don't seem to be getting any market impact. We have to have feed-through if this process is going to work. And yet, regardless of the shortfall in reserves and the shortfall in money and the fact that borrowings were coming down, we held the funds rate at about 14 percent all the way through. It looks as if somebody else is determining the funds rate. My question is: Under those circumstances, since we weren't anywhere close to the bottom level of the funds rate range that was specified, why didn't you put in more nonborrowed reserves in order to try to get this process of adjustment in the market going more strongly than it did?

MR. AXILROD. Well, Governor Partee, that's certainly a very fair question. It has always been an issue, so far as I understand the procedures. My understanding of the original Committee decision was that we would put more weight on nonborrowed reserves than on

total reserves, but still the Manager would have freedom when there was clear cause. The staff would have the freedom to adjust the total reserves but the Manager would have the freedom to adjust the nonborrowed reserves when there was clear cause for there being a shortfall. So, early in the three-week period, we did add \$150 million to nonborrowed when it appeared that the gap between the total reserves path and total reserves demanded was something on the order of \$450 million. And then in each successive week that gap of \$450 million kept getting narrower as required reserves began revising up from what we had [projected]. The money supply [growth] estimate for December when we made this adjustment was on the order of 3-1/2 percent or so, I think; it has now ended up at 5-1/2 percent. So as that gap narrowed, I think--Peter can speak for himself--we were a little reluctant to make any further adjustment because we were going in the right direction and we were on the nonborrowed path. Now, it did seem to us that the funds rate ought to drop as member bank borrowing dropped from \$1.7 billion to the \$1.2 to \$1.3 billion area. In the event, now that bank borrowings in the last past three days have been running \$600 or \$700 million and the funds rate still has not dropped, there seems to have been a change in the demand for borrowing function, so to speak. That is, member banks, who had been very willing borrowers in late October and over the course of November--they had high borrowing at a funds rate that's lower than it is now--have backed away from the window. It's quite possible that we have been late in catching up with that and that in some sense the nonborrowed path ought to have been set higher because of this change in member banks' borrowing patterns. And as Mr. Sternlight mentioned in his briefing, this week in effect he's adding more to the nonborrowed path than is indicated even in this table because borrowing is running so low. If that's the case, then the \$1.7 billion of borrowing that was set originally was way too high to achieve those particular targets, and the downward adjustments in them are coming, in a sense, with a lag.

MR. PARTEE. There may be a fair [amount of] instability in that demand. You may remember a month ago, or seven weeks ago or whenever [the meeting] was, we thought there had been an increase in the demand for borrowings compared with earlier in the experience when there wasn't.

CHAIRMAN VOLCKER. What plausible reason do you have for the funds rate staying as high as it has with borrowings as low as they are?

MR. AXILROD. I don't have any very good reason at \$600 or \$700 million, but at \$1.2 and \$1.3 billion I think that's returning more to the historical pattern. When we evaluate the spread of the funds rate over the discount rate, \$1.2 or \$1.3 billion of borrowing isn't unreasonable. What was out of the historical pattern was November and late October when we had much higher borrowing at a spread that was even less than we have now. That was what was [off] the historical pattern. What we had up until three days ago is closer to the historical pattern. Now we have much less borrowing than one would expect historically, and I would assume borrowing is going to jump back up.

MR. STERNLIGHT. If I can interject, these last few days seem difficult to explain; the rather low level of borrowing is just not

what one would associate with a funds rate of around 2 percent over the discount rate. And, as Steve mentioned, because of that we made an interim adjustment in what we were aiming for in nonborrowed reserves, feeling that to try to press nonborrowed reserves down to the path level in this current week would have meant going into the market and extracting reserves when the funds rate was around 13-3/4 or 14 percent. That obviously didn't make sense; and in effect we've been running this week with an assumption that an adjustment of about \$500 to \$600 million should be added to the nonborrowed or taken away from the [borrowed] reserves.

MR. PARTEE. I know it's awfully early, but what bothers me about this whole experiment so far, Paul, is that I don't get any sense of dynamics working. That is, we had a very nice outcome taking the quarter as a whole. I think everybody around the table would agree that the money number calmed down and the markets have been better and all that. But that all could have been an adjustment to the one-time change in conditions that occurred early in October, with much higher rates and the availability constraint and that kind of thing. Since then I haven't had much sense of dynamics in the process that would lead to, say, restoration of a higher growth rate in money if it were lower than what we wanted. And it has tended to be lower than we wanted. Perhaps it's just too early, but I don't see it. That's what bothers me.

CHAIRMAN VOLCKER. We would have seen what you are talking about if the funds rate had seemed to reflect this low level of borrowing.

MR. PARTEE. I think that's probably right.

CHAIRMAN VOLCKER. Governor Coldwell.

MR. COLDWELL. Steve, for my simple-minded, poor mathematical abilities, tell me if I can make this statement and say it's reasonably accurate: That the things that threw you off were the demand for excess reserves and the shortfall in borrowing. The latter was being made up by an enlarged nonborrowed path and the former--coupled with a currency shortfall, I guess--brought you to the shortfall in the total required reserves path. Is that reasonably close or not?

MR. AXILROD. [Yes], in looking at the uses of total reserves. But if you really make it tough for yourself and analyze this by looking at the sources of total reserves, as I think one should--if you think you're on a total reserve target, which the Committee has not clearly said it's on, having said it's much more on a nonborrowed target--you would say that we fell short on the total reserves in this three-week period simply because we didn't put in enough nonborrowed reserves to push up the total reserves to target. Of course, if we had put in nonborrowed reserves--given the required reserves, which aren't going to change that fast--borrowings would have dropped, one for one. Then eventually we would have had to add to the excess reserves, which were running [about] \$400 or \$500 million, and we would have ended up with \$700 million or so in excess reserves--that would have been the mechanism--and very close to zero borrowing to attain this. The funds rate very likely would have dropped well below the bottom of the range. I would say--and I don't

know if Mr. Sternlight would put it in the same way--that if you thought we were on a total reserve target, the reason we fell short was that we didn't push out the nonborrowed reserves aggressively enough and push up excess reserves--which is all we can push around with required reserves fixed--sufficiently to get the total reserves. And what would have stopped us would have been the bottom of the funds rate range. We'd clearly have gone below that.

What in practice stopped us, I think, was that the pattern we saw developing was not out of keeping with what in effect had been planned at the time of the Committee meeting and, judging from the Committee's discussion, what the Committee would have found acceptable. That is, at the time of the Committee meeting we had a November rate of growth in M1 of 1.9 percent, and for December--it was just after the meeting when we had the revisions--M1 growth of 7.9 percent. Midway through the period we were looking at growth in November of 1 percent and in December of 3.8 percent. That was around mid-December. Then [our estimates changed] as we got to the end of December, and now we are looking at [M1 growth in] November of 1 percent and in December of 5.7 percent. So it began to look to us that growth was moving up. That's what I was explaining to Governor Partee. Required reserves were coming up and as the period went on--in the last two or three weeks--our shortfall against total reserves was becoming less; it appeared that we were moving in the proper direction. And since we were right on the nonborrowed adjusted path, which was already \$150 million above what was originally set, it didn't seem reasonable in that context to take a more aggressive action to chase the total reserves in this very short period. I don't know whether I'm being extremely clear, but I think that's the true answer.

MR. WALLICH. We're back in 1937.

MR. PARTEE. Well, we still haven't found out whether there are any dynamics here that will work or not.

CHAIRMAN VOLCKER. I think that's true. But I also think we're giving this an unfair test in assuming that we can be within 1 percent of whatever the money supply [target] is.

MR. AXILROD. I was going to say, Mr. Chairman, if I may, that I don't know what the test of success is, but if the Committee was aiming at 4.2 percent in M1 and achieved 3 percent, by my measure that's success.

CHAIRMAN VOLCKER. By all past [measures]. Governor Wallich.

SPEAKER(?). If it wasn't a coincidence, it's wonderful.

[CHAIRMAN VOLCKER]. If it was far off, the staff would say it was a coincidence!

MR. SCHULTZ. The Chairman giveth and the Chairman taketh away!

MR. WALLICH. The mechanism described just now must have some similarity with what went on during the '30s when [the FOMC] found that it could not generate the money supply it wanted. Well, I don't



know what [the FOMC at the time] wanted, but at any rate most of the expansion they did engage in, mostly through gold purchases not security purchases, went into excess reserves. But this is a very faint effect here, which would not worry me a great deal. What does worry me is that I now encounter, not only here but abroad, a criticism of our procedures that in effect says we're back to the procedures of the 1920s when borrowing was regarded as contractionary; the more borrowed reserves you had, the more contractionary effect you were setting up. Banks were trying to get out of debt, so to push the banks into debt was the way to tighten credit; that is sometimes associated with Riefler's name. As I say, I have heard this comment that our procedures now are very similar to that. We push the banks into rediscount, by operating on nonborrowed reserves; the less nonborrowed reserves we supply, the more they have to borrow; and that, we say, lowers monetary expansion. It does so presumably by driving up the funds rate and driving up other rates, and that reduces the demand for money. Now, I wouldn't say that this is a bad mechanism. And I wouldn't say that borrowing is expansionary as some of our critics say in the sense that more reserves, of course, is more expansionary than less reserves. I would say that we aim at a given volume of reserves and that the composition of that volume of reserves makes a difference. If they're all nonborrowed, it's more expansionary than if a higher percentage of them is borrowed. That seems to me a reasonable approach.

In support of a rejection of this criticism I would argue that some of the things we experienced here all do point in somewhat the same direction. We got low borrowing at a given interest rate. That would suggest that there is greater reluctance to be in debt now than there was in the past and that there is a true reluctance to be in debt that causes banks to restrain their [credit] expansion. Second, we get high excess reserves. Well, that seems to be the same phenomenon of caution on the part of the banks. They don't want to get into debt; they'd rather have excess reserves. And, finally, the funds rate remains high and doesn't go down as one would expect. Well, again, they're bidding for funds in order to have liquidity, in order to be safe. I could visualize that this is simply happening because we're in a transition period and they are learning the ropes. And after a while the willingness [to hold] excess reserves will wear off and the reluctance to borrow may wear off. But for the time being, it seems to me that this criticism that I hear--and as I say I was surprised to hear it in Switzerland--is not justified. I'd like to hear what Peter and Steve have to say about this.

MR. STERNLIGHT. Well, I think you sorted out those points very well, Governor Wallich. Borrowing has always had this kind of dual role. It's a source of reserves, but it's a source of reserves with a string on it and is certainly less expansionary than if those reserves came from open market purchases or even from float or some other factor beyond our control. We've found ourselves having to make adjustments for the possible change in attitudes of banks toward the window. I alluded to one just now. We are not sure--and any conclusion drawn from the last few days would be very preliminary--but to the extent that there may be something to it, we have made an interim adjustment to allow for that greater reluctance to use the window these last few days and have been willing to provide more nonborrowed reserves accordingly.

MR. SCHULTZ. They differentiate that much between buying money and borrowing it?

MS. TEETERS. But why would they change in mid-course? You seemed to be right on track in the first four-week period and then something changed and they became more reluctant [to borrow] in the past three weeks.

MR. STERNLIGHT. Well, we're puzzled, particularly because during the first two weeks of this last [period], as Steve said, it looked as if banks might be getting back to a more normal relationship of borrowing and the discount rate. And this current week just seems to be a little world of its own; I think it is really too [early] to draw any conclusion from it.

MR. PARTEE. You didn't comment on the excess reserves, but I don't suppose that can go all that far.

MR. STERNLIGHT. I tend to associate that with the year-end pressures to a considerable extent, perhaps more than the new operating techniques because, after all, they didn't jump to hold high excess reserves right after October 6th.

MS. TEETERS. The funds rate was also volatile in the earlier period. It just seems to have been almost cemented in the last two or three weeks.

MR. STERNLIGHT. It has been surprisingly stable, yes.

MS. TEETERS. It seems to me that they would have been more cautious at first--in the post-October 6th period--than currently.

MR. AXILROD. Exactly. That's what's so puzzling, Governor Teeters. One would have expected a response of a bigger demand for reserves--that is, wanting less borrowing and more excess reserves--earlier and then getting used to it later. And what we're seeing now is an increased demand for free reserves in the last three or four weeks relative to what was the case earlier. In some sense for any given amount of nonborrowed that we provide, if there's a bigger demand for free reserves, we're going to get less expansion for them [as they] go into excess or into reduced borrowing.

MS. TEETERS. And much less volatility in the funds rate.

MR. AXILROD. Well, that may depend on certain other factors like the attitudes of people in the funds market and how [they react] to the volatility.

[CHAIRMAN VOLCKER. Mr. Willes.]

MR. WILLES. Thank you, Mr. Chairman. I'll just make two brief comments. I'll start out by saying that I don't pretend to understand the procedures, so my comments are probably way off the mark. But the discussion fascinates me. It strikes me very much like the discussion one reads in the paper each morning where people are explaining what happened in the stock market. They always have some specific reason for why the stock market did what it did. I don't think we really know how all these demand functions--for excess

reserves, borrowed reserves, nonborrowed reserves--are changing in the short run. I just don't think [we know] anything that can make us reach very comfortable judgments on why things are doing what they're doing. Going back to Henry's comments, at times borrowings are in some sense restrictive and at times they're not; it all depends. I think the banking system can have a net borrowed position for a long time and not feel constrained at all, depending on an array of various factors. So, I just feel very uncomfortable with the procedure that we seem to be getting into where we're modifying paths and making adjustments and so on because presumably we are able to identify shifts of a kind that I don't see how we can identify. Now, I don't know what the alternative to that is. But somehow it seems to me that we've got to work our way to a position where we figure out which of these things really matters most--nonborrowed reserves, total reserves, the base, or whatever it is--and set the dial on that and then just let it run for a while. And if we see the dynamics that we ought to see, that's fine; if we don't, then we have to go back and find something else. I feel very [un]comfortable with the situation where we think we can operate on a reserves basis the same way we were operating on a federal funds rate basis. I think the two are very different kinds of procedures; we can't move from a federal funds target to a reserves target and make all these very refined calculations and adjustments.

MR. AXILROD. If I may, Mr. Chairman, the staff feels the same reluctance you do about modifying any paths, President Willes. In this three-week period it was the first time we did it in any consistent way during the twelve weeks this experiment has been running. And it was only, of course, because it seemed that we had a very clear movement of factors. That's a partial answer to Governor Partee. We did [the adjustment of] \$175 million early in the period, and as these factors got bigger or smaller we didn't want to adjust for small changes because, after all, then we would end up chasing it --going up one week, down the next, and we wouldn't know. So we try to [adjust] as infrequently as possible just on the grounds that you mentioned, because things would tend to average out. However, when there was a very clear change, it began to look as if we had very little alternative. But it was only because of very, very clear changes, we thought.

MR. ROOS. I wonder if some of the lack of dynamism or some of the sluggishness in this whole process might not be a reflection of the fact that large segments of the markets aren't quite sure exactly what we're doing. That leads me to the question that I would direct to Steve or Peter: What would happen if we specifically and publicly described what our paths are--or at least some of our paths--so that the markets could adjust to what they know our game plan really is instead of feeling that there's some vague thing going on that they're not sure of. Their reluctance or lack of reaction may be due in part to the fact that people don't want to stick their necks out in the markets until they really know what our reserve path is or what our monetary base path is. What are the negatives to defining those things publicly?

MR. STERNLIGHT. I think there is some appeal to that, President Roos, except that in a period like this where we felt there was an overriding reason for making these adjustments in the path, I would wonder if in this whole dialogue to the public announcing a path

and then having to modify it could lead to considerably more uncertainty and confusion than if we could have some understanding that we have to exercise some flexibility as we apply this procedure.

MR. ROOS. As this process goes on, Peter, and as we become a little more comfortable and confident in the process, would you anticipate that we would describe more publicly and more specifically what we're doing? Obviously, if unforeseen circumstances cause us to change, we could certainly explain why we're changing.

MR. STERNLIGHT. Well, I would certainly hope that we can get to the point where we can explain more to the public about the general methodology and how we formulate these paths and carry them out. At what point we might want to or be able to post the path on the wall while we're going through a period, I don't know. I feel it's too early to reach a judgment on that.

MR. AXILROD. [I'd make] two other points regarding [the issue] you raised, President Roos. I don't think publishing a reserve path will make the relationship between reserves and deposits any more predictable. I doubt that public relations [efforts] would work in the direction of making that relationship more predictable because I think that depends on other things. We may want to publish a long-run reserve path, but I think it would have to be for other reasons. Secondly, though, if we [publish] a short-run reserve path--say for three months--I think we're going to generate in the markets the same effect that is generated by the money supply publication. Every time we come out with our reserves number, which we publish once a week, markets are going to see [where it is] in relation to the path and then start arguing with themselves [about what] that means. They might say it means that we're going to lower reserves next week and that means the funds rate is going to go up next week, which may or may not be true because we may have a pattern in mind very different from theirs. And it might generate unnecessary movements in the market. While that's not fatal to anything, it's an unnecessary impediment to the smooth carrying out of operations. Those are the other two points I would add to what Mr. Sternlight said.

MR. TIMLEN. Mr. Chairman, I must say that as a former discount officer I find my views very sympathetic to those of Governor Wallich. I'm reminded of the fall of either 1966 or 1969, when there was a good deal of discussion as to why the funds rate was so low. In my mind the explanation that fall was that under some program of easy access to the discount window related to business loan restraint, was borrowing \$1 billion for about three or four straight weeks. And the funds rate slipped, much to the consternation of the people at the Desk. But [the reason] was rather simple: There was an additional supply there against a rather constant demand.

CHAIRMAN VOLCKER. You didn't talk to the people at the Desk, did you?

MR. TIMLEN. Yes, I did. Spence Marsh and I went through that; I think it was in 1966. Yes, we have had some problems.

MR. PARTEE. They got an extra billion dollars?

MR. TIMLEN. Yes, they did. I think Governor Mitchell had some kind of program involving access to the window if a bank promised to be a good fellow in terms of not being aggressive and making business loans. I think the rate may have stayed high this past week because banks for some reason or other--maybe the reason Henry cited--have not borrowed. So there was a supply/demand factor here; the supply of reserves in totality was less, so the demand in the funds market was proportionally great and the rate stayed where it was. It's a question of the chicken and the egg every once in a while. I'm not sure which is the chicken and which is the egg in this precise period of two or three weeks.

MR. BALLE. Mr. Chairman, going back to October 6th, I think you wisely recommended to us that we not put all our eggs in one basket in terms of operating on a reserves target but that we experiment for a while with multiple targets. Now we not only have multiple operating targets, we have multiple intermediate targets in the various Ms. I wonder after three months of experience how the staff feels--I guess I would like to ask both Steve and Peter--about whether it's now time to make some provisional judgments on whether this three-pronged set of reserves that you're tracking is proving to be useful or if you'd rather have one single target. Another part of the question, going back to your remarks on lagged reserve accounting, Steve, and how it is complicating--I guess that's the word for it--your job, is whether in your mind any case is shaping up for a move toward contemporaneous reserve accounting to make the monetary policy implementation more expeditious.

MR. AXILROD. Well, there may be some differences [of view] among the staff on the issues you raised, President Balles. I'll respond to two of your points. I have not thought for the ten to fifteen years I've thought about it that there was ever any use to lagged reserve accounting, and this experience of the past three months reinforces me in that judgment. However, I also have not thought that doing away with a two-week lag is miraculously going to make it easy to achieve the monetary aggregates targets. So, while I think lagged reserve accounting is not a plus in targeting monetary aggregates through reserves, doing away with it isn't going to mean that we're going to do better than hitting 3 percent when we're aiming at 4.2 percent. We could continue, in an unbiased way, sometimes hitting 5.4 percent when we're aiming at 4.2 percent--getting within plus or minus a percentage point [or so] over a three-month period. In my own mind, and maybe I'm wrong on it, I think that was a fairly good result from the Committee's point of view.

Secondly, I've become more convinced--this goes back for years because I remember I spent some [time] years [ago] trying to talk President Morris out of total reserves--that in practice total reserves is the more appropriate guide in the short run, namely because of this fatal flaw of trying to decide what is the proper level of borrowing. It's very hard to decide that. And, therefore, while I know we can't hit a total reserve [target] even without lagged reserve accounting in the short run--because the banks can repay borrowing faster or things like that--this experience indicates to me that it's a somewhat better guide. But using [total reserves] more as a guide automatically introduces even more interest rate volatility than putting emphasis on nonborrowed reserves. So there's something of a tradeoff. Those are the two things--

CHAIRMAN VOLCKER. How are you going to use total reserves as a guide without making some judgments about borrowing?

MR. AXILROD. Well, we're inevitably going to have to make the judgments one way or another. But, for example, if banks aren't borrowing and we're on a nonborrowed target, we're going to fall short on total. If we're on a total reserves target and they are not borrowing, we automatically sort of have to put in more nonborrowed reserves and we would come up to our total target.

CHAIRMAN VOLCKER. If they are not borrowing.

MR. AXILROD. If they are not borrowing. It's simply like that. We, of course, will always have these kinds of judgments to make.

MR. BALLE. Steve, do I assume your absence of any comments on the base to mean that you haven't really been paying all that much attention to it?

MR. AXILROD. To be perfectly frank, we've paid no attention to the base in the process but we've paid attention to currency. That's because if currency were falling short persistently as it did last time--if it fell short \$500 million, then that would mean to me not to put in \$500 million more of reserves because doing so would produce a multiple in deposits and way too much money. The way we would do it is that we'd say currency is falling short \$500 million, 16 percent is the marginal reserve requirement on demand deposits, and that means to make up for that we would have to put in \$80 million more total reserves. If that were happening persistently, we'd have to adjust our path for total reserves up by \$80 million to make up for it. So, while not really paying any attention to the base in an operating sense, we are trying to pay attention to currency as well as non-member deposits to see that our total reserve path is properly adjusted to come close to what the Committee wants for money growth.

MR. PARTEE. You'd want to substitute \$500 million in deposits for the \$500 million shortfall in currency.

MR. AXILROD. Right, so we'd use a fraction of the reserves.

MR. MORRIS. Well, I'd point out that our debate about total reserves dates back to 1969, which tells you how long we've been thrashing around this problem. But we shouldn't be too impatient with this. We have a lot to learn about how to run this system. I certainly don't feel the way Mark does that the adjustments to the nonborrowed path were wrong. I think it would have been wrong to have permitted an even greater deviation of total reserves from the path needed to produce [the desired growth in] the aggregates. And just as we are learning, the commercial banks are going through a learning phase now. I think that \$600 million of borrowing is an aberration, which we are not going to find in future periods once the money managers of the banks have adapted themselves to this new operating procedure. I met with a group of them a couple of weeks ago and I found them in a great state of confusion as to how they ought to manage their affairs in this new regime. So we're both in a learning phase; and I think we can get back to more predictable commercial bank

behavior once the money managers begin to learn how others behave in this new regime.

CHAIRMAN VOLCKER. Well, we have to make some decision and we might as well dispose of it now, if we can, as to how to proceed at least until the next meeting, but I would presume it is going to be for beyond the next meeting. We are clearly open to modifications of the precise technique. Unless we want to argue otherwise, I think implicitly we will proceed with something like the present technique until [we decide to] change, assuming the general technique has support. There are certainly aspects of it that have to be looked at. I think it's literally true that only in the last week or so can we really begin questioning why the market didn't respond in a way one might have expected. And that's much too short a period to have any very [strong] judgments. I also think there must be some element of coincidence in our coming as close as we came [to our money supply objectives] in the sense that even if these techniques are better than I think they are, I doubt that each quarter we're going to be within 1 percent or even, as with the December figure, off by not much more than 1 percent of what we finally--

MR. AXILROD. That's right. Well, maybe lagged reserve accounting isn't the impediment I think it is.

CHAIRMAN VOLCKER. If we hadn't had a nice little bulge in the money supply in the last published figure, December would have been a lot below [our objective], but I don't think it was entirely our good management that produced that bulge at that particular time.

MR. COLDWELL. Mr. Chairman, I don't have any problems with continuing on the procedure. I do think there's some question as to whether the Committee would wish to leave with the Manager and whoever else is guiding this the right to change the nonborrowed path by exceptionally large amounts. The amount it was changed this time doesn't bother me, but I can see a possibility where the shortfall might be a half billion to a billion dollars. It seems to me that should be the Committee's decision, not a Desk decision.

CHAIRMAN VOLCKER. Well, let me return to that. On the very general question, leaving aside modifications of the kind you're proposing, I just want to be explicit about whether we want to continue this general type of procedure. Obviously, we're on it and it has worked; on the surface, anyway, it has worked. The results are more or less in line with what was intended. And I think it continues to have some of the advantages that were foreseen originally. While we still worry about what the federal funds rate is doing when it doesn't go according to our preconception, we at least avoid making a concrete decision--

MR. PARTEE. We haven't [moved the funds rate], anyway.

CHAIRMAN VOLCKER. That's right. We haven't done it in any direct way. I'm not sure how many people are convinced they know just where the federal funds rate should be now. Anyway, we avoid that explicitly. On the other hand, I would remind you that nothing that has happened--or that I've observed recently--makes the money/GNP relationship any clearer or more stable than before. Having gone through all these redefinition problems, one recognizes how arbitrary

some of this is. It depends upon how you define [money]. And the technique does, I think, make it a little more difficult in some ways, to say the least, to reconcile some conflicting short-run objectives we have regarding the domestic or international [economy] or money supply against interest rates, or whatever. There may be a time when we really want to see interest rates lower or higher and they may not be behaving that way, and they may continue not to do so for weeks and weeks and months on end with this technique. So, there are arguments on both sides. I just want to see whether we have a consensus that we will continue on this until further notice anyway. We need to make that explicit judgment.

MR. MAYO. I don't see that we have any alternative. Nothing seems to have been suggested as a clear alternative to continuing this and monitoring it awfully closely.

CHAIRMAN VOLCKER. Well, at the extreme, obviously we can go right back to what we were doing before. But I think it's fair to say, and I don't want to push it that cleanly, that there's a compromise every place along the line--on where we set the interest rate limits, on where we're operating, and on how much exercise of judgment we put into this even in making the kinds of adjustments that were made in the most recent period, which obviously were influenced by the fact that the money supply and interest rates weren't going exactly the way we might have expected. So, there is not absolute purity on either side of this, and we can make various compromises. But as a broad thrust, I think the question is whether or not to continue basically what we've been doing.

MR. PARTEE. Shifting back from a very successful experiment certainly would be hard to explain.

CHAIRMAN VOLCKER. There's no question.

MR. MORRIS. The reaction would be devastating.

MR. PARTEE. It surely would.

MR. BALLEES. Unthinkable.

MR. WALLICH. Well, I'd like to make one general comment. The experiment in terms of results has worked very well. I have no quarrel with that, certainly. But I think it continues to lay us open to the risks of unexpected and unexplainable declines in interest rates that can give us great trouble internationally. Now, we can always say that that is appropriate--that we're going into a recession, inflation is coming down, and it is fully appropriate. Nevertheless, as the Chairman has pointed out--he gets this question again and again and we get the same thing in the press and in criticisms at home and abroad--that by sticking to a firm money growth path and therefore a firm reserve path we can get unpredictable interest rate results. In fact, they may even be predictable in the sense that rates become very low when the demand for money lets up. And we may or may not want that. So, I do think we need to build in something at the lower end.

MR. MORRIS. The alternative is that we go back to unpredictable changes in the money supply.



MR. WALLICH. Well, that bothers me less.

MR. MORRIS. I think one of the two has to be unpredictable.

MR. WALLICH. That is very true. But the greater danger is on the interest rate side.

CHAIRMAN VOLCKER. They both would be [unpredictable] in varying combinations.

MS. TEETERS. But, Henry, when we adopted this procedure we were all perfectly aware of the fact that interest rates could decline under it and that they would be determined by market factors. I think it's more a problem of your educating your foreign compatriots about the procedure.

MR. WALLICH. Well, we're working hard at that. Every speech contains the same things that I said just now. And sometimes I almost believe them! [Laughter]

CHAIRMAN VOLCKER. Well, I don't think this is absolutely black and white. For purposes of moving ahead at the moment, [let's assume we will do] something like what we've been doing and let's get to Phil's question and maybe some others. But in the broader sense, I take it there's a consensus at the moment.

SEVERAL. Right.

CHAIRMAN VOLCKER. Now, I don't know whether we want to deal with Phil's particular question. It's a matter of judgment as to whether or not a big enough adjustment is being made that it should be brought back to the Committee. I wouldn't anticipate adjustments as big as you're suggesting. If we're going to meet as frequently as we've been meeting, because the Committee is [conversant] with the precise techniques we've been using, we can express some judgment when we're meeting. I suppose it's theoretically possible--and I don't know whether you have any answer other than to leave it to my judgment essentially--to say that when the confusion gets great enough we would want a Committee meeting.

MR. PARTEE. Well, we could have limits similar to what we do on foreign currency [operations].

MR. COLDWELL. Similar to the international.

MR. PARTEE. The only trouble is that I don't have any sense at this point of what those limits ought to be; and I think it would take a staff paper to indicate what might be the tendencies.

CHAIRMAN VOLCKER. Well, we could be very arbitrary and say that in some basic sense we are interested in something like total reserves now but the operating [variable] tends to be nonborrowed reserves. We can make a path for nonborrowed reserves at the time of the Committee meeting and say we can't deviate from it by more than "x" without [further consultation]. I don't know whether you want to do that.

MR. PARTEE. What's a reasonable "x"?

MS. TEETERS. But with nonborrowed it's zero. The big deviation is in borrowing and--

MR. COLDWELL. No, nonborrowed is zero after they've made an adjustment.

MR. MORRIS. Mr. Chairman, I think the solution is that the Committee's directive should be on the basis of total reserves, and the Manager should be allowed to vary the nonborrowed objective in order to achieve the total reserves.

CHAIRMAN VOLCKER. That's basically the way I interpret it now. That is the presumption under which we're operating but, of course, the total reserves are not very controllable and the nonborrowed reserves are. The question is how much we should change the nonborrowed to try to produce the total, which is the basic variable that affects the money supply.

MR. COLDWELL. We could have a situation in which the borrowing reverses its present course and jumps up to \$1.8 billion. Then would you cut back on the net borrowed path by \$1 billion? I strongly doubt that the Committee would want to do that right away, but--

CHAIRMAN VOLCKER. Well, you're making an assumption that the borrowings go up, the reverse of the present [situation], and that they go up without interest rates increasing particularly in the process. Now they are going down without interest rates decreasing. If borrowings go way up without rates increasing, just reverse the staff's judgment: They presumably would be moving in the opposite direction if that literally happened. If we have a big expansion in borrowing, it would decrease pressure on the market; and if the money supply were running high, the Desk presumably would make the opposite adjustment.

MR. COLDWELL. I guess you're crossing the bridge that there is a good explanation as to why the borrowings dropped from \$1.7 billion down to \$800 million. That's a \$1 billion drop and I'm not at all sure that the--

CHAIRMAN VOLCKER. Well, it's not the drop in borrowings itself. The borrowings would come out where they estimated, assuming they have a correct estimate of total reserves with lagged reserve accounting; and [if] they got on the path of nonborrowed reserves, eventually the borrowings would be forced up. But the borrowings were running low with a high federal funds rate. That's the confusing--

MS. TEETERS. Mr. Chairman, we've gone three months and only had problems in the last month. Like Governor Partee, I have no idea what the limit should be. I suggest we go another month, to the next FOMC meeting, see what we encounter and get some idea of how much the variation is going to be.

SPEAKER(?). Yes, I'd do that too, but we still don't know what the limits are. I don't think we know the magnitude of the problems yet and at what point the problems become a policy decision rather than a technical adjustment.

CHAIRMAN VOLCKER. I agree with you. Well, is that a satisfactory way to proceed? I do think that we ought to put on the table, if not now--and this is under continuing review--any ideas about it. It's all within the present technique, but we might change the technique a bit. It's quite possible.

MR. AXILROD. I would point out, Mr. Chairman, that the element of luck and coincidence in here has a lot to do with lagged reserve accounting. I may be safeguarding the staff's view because what happens to deposits this week does not have an awful lot to do with what we do with reserves this week. It has something to do with interest rates this week, so there is that element of luck and coincidence. If we didn't have lagged reserve accounting, we'd have more real problems that might emerge.

CHAIRMAN VOLCKER. Presumably the staff, despite Mr. Axilrod's predilections, is busily working in a neutral and unbiased way to present us with some recommendations on lagged reserve accounting. That will be before the next meeting or about the time of the next meeting.

MR. AXILROD. [The issue] will be before the Board before this month is out.

MR. WILLES. I'd just like to indicate that I have a lot of sympathy for what Governor Coldwell was saying. I think we need to try to get a feel for what the limits are; and the only way to do that is somehow to decide which of the reserve targets is really relevant. If you think total reserves is the relevant reserve target, then the tolerance limit on that ought to be essentially zero and we can adjust the others however we want to in order to get--

CHAIRMAN VOLCKER. But it can't be. The dilemma is that the relevant target is total reserves but it's not operational.

MR. MORRIS. It is operational, but it's not--

CHAIRMAN VOLCKER. Not in the short run. It's operational in a larger sense, but we can't make that zero because we don't control it to zero.

MR. WILLES. Well, we don't control it because of the way things are apparently set up. We can change things and set it up so we can control it.

CHAIRMAN VOLCKER. We'd have to shut the discount window; then it's controllable.

MR. WILLES. Well, I don't think that's right at all. All I'm trying to say, though, is that there is no arithmetic exercise that one can go through to figure out these limits. One has to [understand] the dynamics of the system and what we really want to try to fix and what we're willing to adjust in order to keep the other things fixed. That's all I'm trying to say.

MR. WALLICH. Even if we did close the window, we still could be thrown off by currency or by float.

CHAIRMAN VOLCKER. Well, it's operational factors plus closing the window that make reserves--

MR. COLDWELL. Yes, but it makes a whole lot of difference in terms of where we come out, not just in the period between [meetings of] the Open Market Committee but beyond, how much nonborrowed is thrown into that package. And if the staff, or you, or whoever else is guiding this operation is throwing an extra billion dollars in the path, the Committee is faced with a fait accompli at the next meeting. That's all I'm saying. If the Committee wishes to concede that to you and the staff, it ought to do so; otherwise it's wide open.

MR. BAUGHMAN. Well, it simply implies, does it not, that total reserves is our overriding target? And if that's true, then it seems to me that it doesn't present any great problem to accept a response by the staff on nonborrowed for the purpose of trying to move toward what we want on total reserves.

MR. COLDWELL. But I'm saying that if [the staff is] going to enlarge the nonborrowed path because of a shortfall on the borrowing side, some money will have been put in that at the next Open Market Committee meeting we're not likely to get out.

MR. AXILROD. Governor Coldwell, the effective constraint on that--the way it's structured now--is the funds rate. That is, the funds rate constraint stops us. In my view Mr. Sternlight probably couldn't have raised the total reserves in this last [period beyond] that \$400 million [in] nonborrowed because he would have been stopped by the funds rate constraint. So the Committee--

MR. COLDWELL. In the sense of the bottom end of the constraint?

MR. AXILROD. Or the top, either way. You could interpret the present directive as the Committee's saying: "Here's where the constraint is; it's on the funds rate." Now, that might [not] be sufficient for you. But that is how it is at the moment.

MR. COLDWELL. I would doubt strongly that Peter couldn't have put in another \$400 million in this period if he had fed it in slowly.

MR. STERNLIGHT. Well, I don't know if you're speaking of the whole period or just this current week.

MR. COLDWELL. Yes, I'm talking about the whole period, an intermeeting period of a month.

CHAIRMAN VOLCKER. Well, we don't know because Steve is saying that if he had, slowly or fast, the funds rate would have been down at the lower limit.

MR. COLDWELL. I doubt that.

MR. AXILROD. Well, that may or may not [have happened] but that is the effective constraint that stops us at some point.

MR. COLDWELL. Well, it stops you at some point, but [where]?

MR. AXILROD. I assume that expresses the Committee's will. If the Committee wants to express itself in another way, that is of course its privilege. But at the moment that seems to me how the Committee expresses its will with regard to how much the Manager is free to do.

MR. PARTEE. I don't mean to disagree with you, Phil; I think it's something that has to be looked into. I would disagree with you, Ernie, in that I think we are concerned about nonborrowed as well as total because we have preconditions [bearing on how the operations affect] the circumstances for the next meeting. But that all has to be worked out.

MR. MAYO. Peter, would you have done anything differently if we had had a 10 to 17 percent funds rate range for this past week?

MR. STERNLIGHT. Not in this recent period.

MR. MAYO. I thought that would be your answer.

MR. AXILROD. I guess there are always divergent views among the staff; I would have given a somewhat different answer to be frank about it. We discuss these things all the time. And [my] answer would be that if the Committee were willing to see the funds rate drop as much as that, I would have been tempted to put in even more nonborrowed reserves. On the other hand, once I saw that the required reserves were rising against that, I don't think I would have made any further adjustments, because I realize the Committee wasn't intent on really forcing money out like mad to get a 3 percent growth rate. Chances are you might get more later. It's that kind of judgment.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, the physicists have always had a rather neat way of dealing with problems such as this by saying: Well, that's an engineering problem. In a sense, I think there's a good parallel here in that the Committee decides what rate of growth it wants in the aggregates--that's the problem for the physicists--and then it's an engineering problem to translate that into the volume of reserves. So, I would come out very close to where Frank Morris did on that in suggesting that the staff ought to allow for these things in absorbing the least reserves to make their best estimate of what volume we need out there to support the rates of growth in the aggregates that we have chosen.

CHAIRMAN VOLCKER. Well, we obviously will be returning to the engineering problems as well as those of the physicists from time to time. I think we have an understanding on how to proceed in the rest of the discussion.

MR. BLACK. Well, our engineers will be working on the problem continuously, and I didn't mean to suggest otherwise.

MR. SCHULTZ. I thought you were going to quote the Heisenberg [uncertainty] principle. That merely states that if you observe it, you automatically change it by the act of observation and, therefore, you can't possibly know what it actually is.

MR. BALLEES. Catch-22.

CHAIRMAN VOLCKER. [Let's turn] to the question of the new monetary aggregates, on which a memorandum has been distributed. Mr. Axilrod, I presume, is prepared to make a few summary remarks on the subject, including telling us why the different measures have more substantial deviations from each other in the past than in the projections for the future.

MR. AXILROD. Mr. Chairman, I might add that Mr. Simpson, who is well versed in these measures, is here and is--

CHAIRMAN VOLCKER. You probably were going to say this, but let me just make one introductory comment. We ended up with the M-1A and M-1B [measures] to allow for [negotiable order of withdrawal] NOW accounts and [automatic transfer services] ATS. As it turns out, in the current estimates there isn't very much difference. But we still anticipate that there will be substantially more difference if Congress goes ahead and straightforwardly authorizes NOW accounts. The theory here is that ATS, which has been legal for a year, has kind of run out of steam in terms of making any difference, but NOW accounts may well not have. So, whatever we decide upon for the long-range targets next month, we probably are going to have to go back and readjust if Congress does permit nationwide NOW accounts. We'll have to adjust both M-1A and M-1B, presumably in opposite directions. We can do that, I think, consistent with the substance of whatever we decide. By the time we announce them, Congress probably will have acted anyway.

MR. AXILROD. Mr. Chairman, I'm not sure that I have anything extremely helpful to add to this statistical material before the Committee. I was going to point out particularly tables 4 and 5 on pages 6 and 7 of the material that we sent out earlier. The remarkable thing to me was that the numbers for the new aggregates came out within reasonable ranges. That is, they are not numbers that are going to appear strange to the public; once the Committee begins targeting on the new definitions, the rates of growth that are going to have to be adopted will be reasonable relative to the current aggregates. For example, on page 4, looking over the recent 10-year period from 1970 to 1979, the rate of growth of the new M2 of 9.95, or almost 10 percent, is very close to the current M3 growth of 10.28 percent, which is its nearest counterpart. And the rate of growth in the new M3 of 11.08 percent is very close to the 10.64 percent rate of growth in M5, which is its nearest counterpart. Now, the new M3 is running faster than the current M3 because it has in it relative to the current M3 large negotiable CDs, money market funds, and RPs. But that higher rate of growth for a new concept is not so out of keeping with the rates of growth of the current M3 as to make for considerable confusion on the part of the public.

Similarly, on table 5 on velocity, you can see that the current and new measures are not behaving very strangely vis-a-vis each other. That is, if you look at the M1s, for the new M-1B, which is again a somewhat different concept than the current M1, the trend of velocity is the same. That is, there appears to be a consistent upward trend in velocity in the current M1; if you compare the peak-to-trough numbers in the middle panel for the current M1, they get larger in each one [unintelligible], so the trend is toward higher

rates of growth in velocity. We see a similar development in the new M-1B, even though savings accounts are in there. That may change a bit for the new M-1B if we get nationwide NOWs because we may get a lot of savings in there and that would involve a temporary drop in the velocity of that measure as we get a one-time transfer of savings as well as checking account funds into the NOW accounts. But, again, I don't think these numbers are strange relative to the old numbers. So, [I've come to the view] that the transition to the new numbers is not going to be as difficult a public [perception] problem as I originally thought it might be before I saw all these numbers laid out.

Another problem the Committee may want to consider, when the transition is made, is to what extent it wishes to operate on M-1A, M-1B, M2, and M3 on the new definitions. At least until there are nationwide NOW accounts, I would think you would want to keep operations most focused on the aggregate that is most controllable through the reserve technique, if the Committee's going to continue using the reserve technique. That seems to me to argue mostly for M-1A or M-1B. But when NOW accounts become very important, M-1B will be distorted as will M-1A. And in that case one might have to fall back to a degree more on M2 and possibly M3. But I would assume at least starting in February that M-1A and M-1B would tend to be an index, unless the Committee really wants to change how we've been doing it.

MR. COLDWELL. Will you weigh the two of them equally?

MR. AXILROD. Well, under the current system, I think M-1A would get the same weight that M1 now gets. That's how I would tend to interpret it.

CHAIRMAN VOLCKER. Every time we discuss this, I get very nervous about this great targeting. Is this all comprehensible? Do we have comments or [questions]?

MR. MORRIS. I have one question on M2. I presume, Steve, that in setting your compatible ranges for M2 for 1980, you're assuming that short-term rates will not get down low enough to produce any great reflow of funds into the thrifts?

MR. AXILROD. Exactly. That's right.

MR. MORRIS. If you look at 1975, say, which was a year of recession, a year comparable to 1980 [as projected], M2 went up by 12.3 percent even though I think our 1975 policy was not too expansionary.

MR. AXILROD. I think we still have short rates and even short coupons high relative to the fixed rate ceilings on deposits, so we'll still be getting the funds into these alternatives mainly in the fluctuating rate ceiling deposits. We're not assuming substantially different behavior for now--some increase, but it would be very modest.

MR. PARTEE. But of course in '75 [rates] fell below the fixed rate ceilings. So even the passbook rate was affected. That obviously is not in the projection; it couldn't be.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. I just wanted to say, Mr. Chairman, since I was one of those who was rather unhappy with the then-proposed M2 the last time we met and discussed this subject, that I think the newly adopted M2 is a great improvement. Certainly, the inclusion of small time deposits, which are now incorporated into the new M2, is going to have a great advantage, as I see it, of reducing the interest rate sensitivity [of M2] over the business cycle. That's largely because the money market certificates that are included have offset the reduction that otherwise has been occurring in small time deposits. And I feel pretty optimistic, as a matter of fact, because if we look down the road I think at some point we're going to get a further relaxation or abandonment--the sooner the better as far as I'm concerned--of the Regulation Q ceilings. That ought to make the redefined M2 even less interest sensitive than it is now. So, I for one am quite happy with the outcome and I thought I ought to make that clear, having raised objections to the earlier proposal.

MR. BLACK. For similar reasons you would object very strenuously to M3.

MR. BALLEES. That's right.

MR. MAYO. Well, Mr. Chairman, just to start this part of the discussion going, it seems to me--

CHAIRMAN VOLCKER. I thought it was just finishing!

MR. MAYO. --that we're better advised this time around with these new measures coming out to settle on, say, M-1B and adjust it if necessary later on rather than try to straddle an average of M-1B and M2 because we don't know about nationwide NOW accounts. I think it would be cleaner and easier to explain if we just settled on one [measure], even though we recognize that we might have to make some adjustments to it later on.

CHAIRMAN VOLCKER. I don't think that is the reason that we're straddling. We're not looking at an average. It's just that we presumed at the time that NOW accounts would be enacted and that that would produce a strikingly high M-1B figure as it's now defined, which would have been very difficult to explain. Indeed, from our own standpoint, we didn't know quite what its significance would be because a lot of [the NOW account funds] will come out of savings accounts. So it provides us with both an easier explanation publicly, although it looks more confusing, and lets us know a little more about what's going on ourselves.

MR. MAYO. Well, I think that's true. But I'm arguing a little different point: That if we get into placing a lot of reliance on M2, a considerable part of which we would have no control over, it will give the wrong public image, too.

MR. PARTEE. I think it's more M-1A and M-1B that we're comparing, Bob. The bigger the growth of NOW account-type deposits, some of which will be drained from M-1A and some from M2--maybe something like 50-50--the bigger the divergence between M-1A and M-1B, so we thought we needed both. The one, M-1A, will be running too low



to reflect reality; and the other, M-1B, will be running too high to reflect reality until this stock adjustment process is over.

MR. MAYO. That may be all right. Certainly no one in the preceding discussion has suggested that we average nonborrowed reserves with total reserves. I'm just arguing that we ought to get away from this averaging regardless of which--

MR. PARTEE. Old M1 with M2?

MR. MAYO. Or M-1A with M-1B. What does that mean?

MR. COLDWELL. Do we even have all the data now to [calculate] M-1B?

MR. AXILROD. I'd like Mr. Darwin Beck to answer that.

MR. BECK. M-1B? We have [some of the data] in process; they are not yet flowing in. We have the historical monthly data but we are in the process [of putting together] quarterly data and weekly data.

CHAIRMAN VOLCKER. We will have them at the end of the month, right?

MR. BECK. That is the schedule. As far as we know we will have them at the end of the month, yes.

MR. COLDWELL. Well, I was just pointing out that there is a problem knowing what M-1B is going to be. If we have a shortfall of data, we may be sitting here next month wondering what M-1B was.

MR. PARTEE. You won't have M-1B as quickly for Desk operations, will you, Darwin? M-1B will not become available as speedily as M-1A.

MR. BECK. There may be a somewhat greater delay, hopefully not too much greater.

CHAIRMAN VOLCKER. But when the stock adjustment falls out, presumably we will drop M-1A.

MR. PARTEE. Yes.

MR. AXILROD. When we start publishing this, which presumably will be shortly after the next meeting, we are planning to publish M-1A and M-1B weekly but not M2 and M3. They will be monthly [data].

CHAIRMAN VOLCKER. But M-1A and M-1B will be published on the same time schedule.

MR. ROOS. Are we planning to go public with the nomenclature M-1A and M-1B? Isn't that going to get us some laughs? In other words, I think either M-1A or M-1B would be a very acceptable aggregate, but can't we rename the baby M1 again and explain it? I think every columnist in the world is going to write that you economists are fuzzing this up again. Is that a problem or not?

CHAIRMAN VOLCKER. It probably is a problem, and our only defense is that reality is complicated.

MR. COLDWELL. If you had your druthers, Steve, M-1B is what you'd focus on now?

MR. AXILROD. It doesn't really much matter, Governor Coldwell, because NOW accounts are such a small proportion. But I have a feeling--don't make the obvious retort, please--that I know more about M-1A than I do about M-1B. And until M-1A declines into a much smaller proportion of the world than it now is, I would tend to prefer M-1A. All our models, such as they are, are built on M-1A and historical experience; I just know more about it and feel a little more comfortable with it myself. So, I really thought it was a good solution, which emerged out of the Board discussions, [to use both measures for a while].

CHAIRMAN VOLCKER. We'd get a very funny M-1B if we got a big nationwide movement to convert savings accounts into NOW accounts.

MR. COLDWELL. Yes, but that's down the road.

CHAIRMAN VOLCKER. Well, down the road 3 months from now.

MR. COLDWELL. It may not be very far, but we don't know--

CHAIRMAN VOLCKER. If they don't enact that [legislation], then there's no difference between them, basically.

MS. TEETERS. Don't you have a problem of not being able to seasonally adjust these measures because you don't have the data [on the components that account for] the difference between M-1A and M-1B?

MR. SIMPSON. That's right. Thus far we feel that we don't have enough historical experience to seasonally adjust the other transactions balances that go into M-1B.

MS. TEETERS. Basically, the quality of M-1B is going to be somewhat uncertain for a while until we have more experience with it.

MR. MORRIS. Well, we've had a number of years of NOW account experience in New England; I doubt that our seasonal is that much different from the rest of the country.

MR. PARTEE. It's much colder! [Laughter]

MR. BLACK. But lately they don't get as much snow.

MR. AXILROD. When there are nationwide NOW accounts, what we won't know about M-1B is the extent to which and how fast its velocity is going to revise downward, as people shift savings into NOWs rather than just demand deposits. We simply aren't going to know that. Similarly, we're not going to know very much about how much is going to go out of M-1A. But I feel more comfortable in the sense that--

CHAIRMAN VOLCKER. I think a proportion of savings deposits moved in the present M1--after M1 got squeezed so much.

MR. COLDWELL. Well, Mr. Chairman, it seems to argue for focusing on M-1A until we get a nationwide NOW account bill.

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. Oh, no. I think the way it's going to work out may be slightly different. If we don't have a nationwide NOW account bill, it's not going to make much difference. As the staff shows in its estimate here, [growth in M-1A and M-1B] are within 1/2 percentage point. If we get the nationwide NOW account bill, there may be a period of a year when M-1B is a little tough to interpret because we won't know how much is coming out of saving accounts.

MS. TEETERS. So will M-1A.

CHAIRMAN VOLCKER. So will M-1A, but I would guess to a lesser extent.

MR. BLACK. Until [the shifting] disappears.

MR. COLDWELL. But we can't seasonally adjust M-1B. How can we use that right now?

MR. AXILROD. I don't think the seasonal factor is that bad because NOW accounts are a fairly small proportion of the total. Now, if they were 1/2 or 1/3 of the total--

CHAIRMAN VOLCKER. The more we discuss this, the more I hate to say we have a target for either one of them. Maybe that is a note upon which to stop.

MR. GUFFEY. Maybe I shouldn't say anything, but would it be possible in this transition period to publish M-1A and to use M-1B as a memorandum item with a notation that, indeed, M-1A will be replaced by M-1B when the transition period is completed?

MR. AXILROD. Well, we were planning to publish M-1A and M-1B right next to each other. I really don't believe large problems will come from that. Then we'd show a couple of other items, the RPs and the money market funds and go on to M2, which will include the RPs and money market funds. The difference in level between M-1A and M-1B is not going to be vast until we get the nationwide NOWs. And I really wouldn't anticipate any--

CHAIRMAN VOLCKER. I don't anticipate that there will be too much trouble with that. But it is complex. I think the complexity of this is inherent in the facts and the circumstances.

MR. GUFFEY. But it's particularly important when the Committee expresses its view in the directive to the Desk as to whether or not equal weight is to be given or what we're focusing on. Thus, it would [reasonable] to put M-1B in the public domain but as a memorandum item, initially at least, so that the public and the markets can track it.

CHAIRMAN VOLCKER. I just don't know how worthwhile it is to try to guess whether it's better in a memorandum item or the table. We may have the problem that M-1A will look very low. And would we

want to keep publishing a figure that looks very low without having a figure along side it that looks relatively high? I don't know how we can outguess all this.

MR. PARTEE. Besides, Paul, it's additive. M-1A plus the components make M-1B, which then goes into M2. So it's logical just to extend it along the columns.

MR. WILLES. I'm fascinated by what Steve just said in terms of the table for publication. Can you go through that again?

MR. AXILROD. As I understand it, the first column would be M-1A, the second column M-1B, the third column overnight RPs and overnight Eurodollars, which would just be Cayman Islands Eurodollars, and the fourth column would be money market funds. The fifth column would be M2, which would include the first, third, and fourth columns as components.

MR. WILLES. So people could construct any M they want?

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. The other two are kind of memorandum items in a column because they have some characteristics of a payments--

MR. ROOS. But you're not going to publish the difference between M-1A and M-1B as such.

MR. AXILROD. But we'll have all the components. We'll have a separate table with all the components of all the aggregates as well. So, that will all be available.

MR. GUFFEY. This table that you just described will be published monthly and then there will be weekly publications of M-1A and M-1B?

MR. AXILROD. We'll be publishing that table weekly. There will be weekly estimates of M-1A and M-1B and of all the commercial bank components of all the Ms, including those in M2 and M3. M2 and M3 will only have monthly figures, but the table will be published weekly. M-1A and M-1B will have weekly figures, as will the commercial bank components [of the broader aggregates].

MR. KIMBREL. This may be just a preference, but what were the main reasons you were reluctant to include overnight RPs and Eurodollars in the M1 measure?

MR. AXILROD. There was considerable Board discussion on that; perhaps I should let the Chairman summarize it.

CHAIRMAN VOLCKER. I'd prefer that you do that! [Laughter] Mr. Axilrod is being modest because I remember he was vehemently on one side of the argument, the reasons for which escape me.

MR. AXILROD. Many members of the staff, including myself, felt that there was a large investment component to RPs. That is, we felt that money managers were not viewing RPs--to an extent of 100

percent or [even] 50 percent--as a substitute for demand deposits but were viewing them as an alternative to investing in 3-month bills or 3-month CDs, depending in part on their interest rate expectations. So, therefore, if RPs were somehow outlawed, we felt that only a small fraction of the money in RPs would be going to demand deposits and the rest would go into CDs or Treasury bills or commercial paper.

CHAIRMAN VOLCKER. Mr. Axilrod felt that way. Governor Rice, as I recall, felt the opposite. It's basically a question of whether they are actively or passively managed, I think.

MR. AXILROD. Our econometric evidence, I believe, is quite mixed. The staff is well divided on the subject. With the Board divided and the staff divided, the Board came up with a very judicious decision.

MR. ROOS. Mr. Chairman, does the Committee not feel that the marketing or explanatory aspect of this is important? I'm talking about the ability to relate to my friendly broker, who busted out of school his sophomore year! I'm being facetious, but isn't it important to make an effort to be as clear and as simple as possible in describing this?

CHAIRMAN VOLCKER. Well, I think it's an important problem, and one with which we anticipate some real difficulties. I take a literal exception only to your final point. The effort to be as simple as possible may be misleading. I come back [to my view that] the reality is complex. That is the difficulty we are dealing with during this transition period. But I think it is a major problem, and we plan to have press briefings and so forth beforehand so that we give as good an explanation as possible. Now, as you can see, providing there is no change in the law--if the staff is right and I don't know whether they are or not--there isn't much difference between the two measures, which makes this all look rather unnecessary. But if they are right and we have nationwide NOW accounts [authorized by] Congress beginning in March, there's going to be a significant difference between the two. Therein lies the problem. We're preparing the way. If the law were going to remain unchanged, I'd say dispense with M-1A or M-1B. We would go one way or the other and make it simple. But we do anticipate a significant difference if we have nationwide NOW accounts.

MR. ROOS. Would we drop the other if--

CHAIRMAN VOLCKER. Well, if they don't change the law, we probably can. I'm just talking offhand. If they don't change the law, I think that argues very strongly for dropping some of them.

MR. COLDWELL. If they change the law, we could drop M-1A.

MR. ROOS. Wouldn't you drop M-1A if they change the law?

MR. PARTEE. Yes, and we'd drop the M-1B components. But we're certainly going to get share [drafts], which are developing.

CHAIRMAN VOLCKER. Two years from now we'll probably drop it anyway, assuming they have a nice clean law and don't change it within a 2-year period.

MR. AXILROD. I'd just assume, Mr. Chairman, that it would be a useful explanatory device for the Committee, if there happens to be a surge in M-1B, to be able to point to a drop in M-1A so that no one reads too much [into the surge in M-1B].

CHAIRMAN VOLCKER. One can reverse all this and say that by exposing the problems that lie in these figures inherently, we're going to be better off in the end and people will understand it better. But there is a hump to get over yet. There's no question.

MR. COLDWELL. Wouldn't the real problem occur, Steve, if we got a surge in M-1B and [the funds] didn't come out of demand deposits? If we got a big jump in share drafts--

MR. AXILROD. If M-1B was surging and M-1A was strong, I assume things would be read into that.

MS. TEETERS. But we might have a drop in M2?

MR. COLDWELL. Yes. We could have a drop in M2.

CHAIRMAN VOLCKER. As I say, the more we discuss this, the more uneasy it makes me.

MR. COLDWELL. I know, but you didn't discuss the size of M2 here.

MR. BLACK. I think a few people will understand it much better and a lot will understand it much less.

CHAIRMAN VOLCKER. Well, maybe it's a net advantage if Larry Roos' third grader--his broker--doesn't understand it!

MR. MAYO. Did you do well in the market last year, Larry?

CHAIRMAN VOLCKER. Have we finished with this subject?

MR. BALLE. One more question or suggestion, Mr. Chairman, if I may. I think there's a big difference between what we publish and what we target. I certainly have no problems with what is proposed to be published here, for those both inside and outside the System who'd like to experiment with different versions or measures of money. I believe we ought to think pretty hard, though, about whether we want to continue to target four intermediate variables. In the past we've had four targets: M1, M2, M3, and bank credit pro forma. But in practice [our targets] have turned out to be M1 and M2. In practice we haven't really tried to control M3, and we have just observed what goes on in bank credit. The Bluebook again sets forth in the various alternatives four different intermediate targets. I have a strong feeling that that's about two too many. I wish somehow we could find a way of narrowing that down to about two that we really use in practice, no fooling, as far as decisions of this Committee are concerned. I'm not sure whether--

CHAIRMAN VOLCKER. You don't have L on here do you, Mr. Axilrod? Do you have another table where that appears?

MR. AXILROD. Well, I'm not sure we're going to be up-to-date on L by February.

CHAIRMAN VOLCKER. I guess we'll publish another [column] on that table, which is L.

MR. BALLEES. As an information variable, just like M3 is an information variable. I would hope we could have some discussion of this tomorrow before we make even provisional decisions on what the ranges should be or what magnitude we ought to be talking about.

CHAIRMAN VOLCKER. I was hoping to have a little discussion this afternoon on that subject--not necessarily on that aspect but--

MR. BALLEES. Well, if I had to do it right now, I'd pick M2 for one of those versions. I think having two variables as intermediate targets is really about all that is needed and all we can meaningfully handle.

MR. BLACK. Could somebody tell me exactly what the Humphrey-Hawkins Act says? I thought it indicated M1, M2, M3, and credit.

MR. AXILROD. It just says "monetary and credit aggregates."

CHAIRMAN VOLCKER. But in practice, as we go along week by week in the future we're going to be on M-1A and M-1B because we won't have the data for M2 and M3. That doesn't mean we will get an [overlap] at the end of the month. But when we're making some of these weekly decisions I suspect we're going to be biased, just by the availability of data, toward the M1s.

MR. WALLICH. Well, the purpose of these measures is not so much to hit them all at once, which is impossible, but to be warned if something is going off track. The purpose is to have a sense of the relativity of the things we're mainly aiming at.

CHAIRMAN VOLCKER. Well, that can come up in the later discussion. Let's turn to the long-range targets, again not with the intent of reaching any decisions but of having an informal exchange in a preliminary way of what seems to make sense here. The first point I had was that, in fact, there's going to be a lot of confusion with the new numbers. That point has already been made. At a fairly technical level, this alternative 1 in the Bluebook is based upon some broad concept that 4-1/2 to 7-1/2 percent is supposed to be the same as the current target, which is listed there as 3 to 6 percent. But that makes a 1-1/2 percentage point adjustment for ATS and NOW accounts and that would kind of reverse. In fact, these are not equivalent, if I think it through correctly, [because] for reasons I won't attempt to explain in too much detail the change is small.

I do want to raise the question of what we say--again we don't have to decide now--[for the period] beyond 1980. There are arguments on both sides of this. The extremes are quite clear: We could say nothing about beyond 1980 at one extreme or we could lay down a pattern beyond 1980 and say that cross our heart and hope to die we really intend to make it, just like we intend to make the 1980 one. There is a strongly held body of opinion--perhaps in both

[Congressional] committees but I know particularly strongly in the House Banking and Currency Committee--that we should not only say what the targets are beyond 1980 but that they should legislate them. So, I think it's an issue that will come up in testimony one way or another. And if we say something, we should have some guidance as to how much it's a hope or how much it's a real expectation or something in between. My own feeling is that we probably have to say something; but that leaves a lot of room between expressing it as a general hope or a solid expectation and intent. We don't have to give an official FOMC position, but it is an issue that we ought to discuss a bit.

Let me just mention a few considerations that occurred to me. Given the position that we're in, for a variety of reasons, I think it could be hard to come up with targets that are in fact or appear to be higher than those we had for this past year. I'm thinking not primarily of the fact that the staff, at least, is projecting a lower nominal GNP but that given the psychological and expectational state we are in, it would be a big decision to have a range of projections that in substance was higher than we have been operating with. Secondly, and I go back to the discussion about the targets we had just 3 minutes ago, there is among other factors the arbitrary nature of the targets. More importantly--well, it may not be more important but equally important--given the uncertainty that I at least perceive in the economic outlook for a variety of reasons, I think there is a question as to how wide a range we want. We have been operating with fairly wide ranges of 3 percent. We have to consider whether we want to narrow those ranges. There are pretty persuasive reasons, given the uncertainties regarding both the definitions and the outlook, why it's wise to have a significant range. As a part of that issue, there is a question of what we mean by the range: whether the middle of the range does reflect some central tendency of what we think is appropriate on the basis of what we know now. But there is a difference between attaching some very great significance to the middle of the range as opposed to saying that in the light of all the uncertainties we may well feel, as the year progresses, that it would be quite reasonable [for growth] to be toward the lower end of the range. That's a decision, obviously, that can be reviewed as we go along. But how we treat that is of some significance.

I did not intend to discuss the economic outlook extensively right now, although logically [the agenda] may be in the reverse order. That will be on the front of the agenda tomorrow when we actually have to make a decision about the short-run ranges. As you know, for what it's worth, the staff is projecting a 7 percent increase in nominal GNP [for the year], but [the increase] is rather small in the first quarter and then it rises progressively. That's not a pejorative comment. [Laughter] I indicated my personal view. There is a considerable amount of uncertainty about any economic forecast. But it's interesting that there is in a sense a lull in terms of nominal GNP. [GNP growth] is quite low in the first quarter; it's less than 5 percent. And then it's projected to be about--in fact precisely--double that for the fourth quarter; it goes from 4.7 to 9.4 percent. I'd just note that if we take that as an economic forecast and we attribute importance to historical relationships between velocity and interest rates and all the rest, if we have a steady growth in money demand the year, it implies a very different set of money market conditions early in the year as opposed to late in the year, assuming that those relationships hold true. And there is a



question as to how we want to play any particular target during the course of the year in the light of that or other possible patterns of economic activity.

In that connection, the Bluebook does suggest--and of course it bears very directly on the decision tomorrow about the short-run ranges--some alternatives [regarding] the question of strategy, which to some degree we do have to settle tomorrow, certainly for the next month. It can worded in various ways. [The issue is] whether we deliberately aim for a pattern of monetary growth [this] year that deviates on the average--whether we take our risks in various directions as the year proceeds--and how that meshes with anyone's view on the economic outlook, the interest rate outlook, the international side of the equation, and I think ultimately, too, fiscal policy considerations. In other words, do we just want to set a dial at one extreme and say aim at the average throughout the year and see what happens? Or do we consciously want to take some of these other things into consideration as we see them from month to month within the ranges specified for the year? In terms of the particular setting that we're dealing with now, to make just a few points, we have had more strength in economic activity than we anticipated throughout the second half of [last] year. Certainly it continued through the fourth quarter as a whole. I don't know what you think about this, Mr. Kichline, but I see that Ms. Courtney Slater, the Commerce Department's chief economist, while she expects a recession this year has now decided that GNP grew by 2 to 3 percent in the fourth quarter instead of 1-1/2 percent. I guess she's getting ready to publish a figure fairly soon and I don't know whether that's it.

MR. KICHLINE. She controls the staff that puts it together.

CHAIRMAN VOLCKER. When is that preliminary figure due--in a few days? Well, I guess it's due out in a week or more than a week.

MR. KICHLINE. Right.

CHAIRMAN VOLCKER. I don't know whether that [statement by Ms. Slater] reflects [the number they will publish] or not. They will get some more information before they publish that number, won't they? Do they get retail sales?

MR. KICHLINE. Yes. They will have information later this week on the employment situation, and they need inventory numbers. Inventory is important and data are due [to come out] on January 18.

CHAIRMAN VOLCKER. Well, I don't know what that reflects, but it's in the same direction we've been seeing of [the economy] having more strength than was anticipated. When one looks at the business picture one has to say, as reflected in the fact that the figures keep coming out better than the projections, that in a sense we're pretty clearly off econometric patterns and other patterns. That's particularly clear in the saving rate, which has gone below the bottom of anybody's ranges. And that's what makes things quite uncertain as we look ahead. It seems to me that there are a number of explanations of why we're off the pattern. It doesn't help much in projecting, but part of it must be a response to inflationary expectations. And we've surely had our share of international disturbances recently that affect inflation and affect the dollar and are visible in the gold

price, the silver price, and commodity prices. Obviously, that leads into the oil situation, which has a very direct and pronounced effect both on inflation and what we think about the business outlook. That situation has been highly unstable and I have the feeling myself that the next few months will give us--without overdramatizing it--a kind of important last chance to see whether we will get some balance in the oil market between consumption and production so that there isn't continuing upward pressures on prices that are going to carry us to some unknown level later this year. So long as the spot price remains above whatever the OPEC official decisions are, which are rather mixed in themselves, we will get a very unstable situation. And we don't know how far this upward momentum in oil price numbers can go.

So far as fiscal policy is concerned, all that I know indicates that the present Administration is going to hang tough, if that's the right phrase, in terms of any sign of a tax [reduction] program at the moment. On the expenditure side, I don't know anything more than has been leaked, which is that the total is up around the \$615 billion level. We have a higher level of real defense spending. We are projecting some real increase in federal government spending which, if anything, I guess is a little low relative to what the Administration may be projecting. It's either [about the same] or a bit on the low side. But there is no proposal that I'm aware of for any tax reduction. And I don't think there's all that much discussion of it, although that's a little more doubtful given the spate of reports that will come out on the federal budget and the Economic Report in a few weeks. I don't think that means that the Administration is not aware of the case for tax reduction or necessarily would absolutely rule it out; it depends upon the evolution of the business scene. But I think it does mean that they're not going to push it; they're going to resist it and resist discussion of it right now. While one has to make one's own judgments about how Congress will respond, that certainly makes [a tax cut] less likely at the very least in the short run than if the Administration were pushing it.

Looking at the period since October: On the one hand, while all the financial data are within our immediate objectives, I don't think we've made as much expectational progress, if I can put it that way, as conceivably might have been hoped. Indeed, in some sense we have not made as much progress on interest rates; one might have hoped that they would be coming down a little more clearly by this time. Looked at from an October point of view, we haven't seen those developments that might have been anticipated. It's fairly obvious why not, given the international turmoil and the lack of more visible progress on inflation. In that connection, I might say that if there's anything I would feel relatively certain about in the near-term economic and price outlook, it is that the price figures are going to look worse rather than better for some months, particularly in the consumer price index where we will get both the impact of oil and the impact of interest rates from the last three months. The mortgage rate has not been worked into that [set of rates] in anything like a full way. So, when we look at expectational factors and disturbances, whether here or abroad, psychological or real, I think we have a hump to get over for probably three months anyway of higher [rates of increase in the] consumer price index. And in one or two of those months I suspect the increases could be significantly higher than anything we have seen so far. That is the situation with which

we have to live whatever questions we have or whatever we think of the longer-term prospects for inflation and business [activity].

With those general points, let me open the discussion to what people think is relevant with respect to these longer-term targets both on the one-year target and at least a little feeling, although that's more of an open question, about what people think we should say in presumably more general terms about the period beyond 1980. Mr. Eastburn.

MR. EASTBURN. I'd like to respond in three points: One, we've been talking for three years or so now about our basic strategy being one of gradually reducing the [growth of the] aggregates. I think your points about the business situation and inflationary expectations and the image are exactly right. In view of that, it seems to me that our strategy should be one of gradually reducing the [growth of the] aggregates. Rather than alternative one or two, I like the formulation on page 11 of the Bluebook, which has the four strategies. And of those four, I like number four best because I think we probably are going to get a tax cut and should plan a gradual reduction [in the growth] of the aggregates in light of a likely tax cut.

CHAIRMAN VOLCKER. What is strategy four?

MR. EASTBURN. Strategy four is a progressive reduction in M1 growth from 6 percent to 5 percent to 4 percent in successive years, assuming a tax cut of \$30 billion.

CHAIRMAN VOLCKER. Let me just say a word here and I'll shut up about it. When I look at these different strategies, all of which come off the econometric equation from the base forecast, I must say that I have great doubts about these adjustments in the econometric equations. I guess you're driven to strategy four because it looks [good] on all the numbers.

MR. EASTBURN. I'm not arguing the numbers at all, Paul. I'm arguing the basic philosophy of proceeding [with] a gradual reduction. All right, that's the first point. The second point is that I feel strongly that we should not announce that strategy and specifically that we should not announce numbers. I think we have a credibility problem and I believe expectations hinge basically on policy performance and not what we say, because nobody will believe what we say until we perform. So, I think we should have this as our philosophy but should not announce any specific numbers. We can talk about this being our intent.

Third, we should reserve flexibility for change in case we want to change our strategy as circumstances develop. I was struck, for example, at the precision that's incorporated later in the Bluebook in the forecast of interest rates, assuming various alternatives and combinations and permutations. That may be an interesting exercise but I think its accuracy is greatly in question. What we should do is remain flexible enough so that we can change and depart from this strategy if and when circumstances require it. But that should be the basic idea unless we see reason to change.

CHAIRMAN VOLCKER. Well, you're now talking about 1980 and beyond. From your last comment do I infer--I don't want to put words in your mouth--that consistent with that you like the idea of not narrowing the range, anyway, in the short run? By the short run, I mean 1980.

MR. EASTBURN. Yes. I didn't address the question of the range, but I think that's right.

CHAIRMAN VOLCKER. Do you have any feeling about where the range should be in 1980 as a very tentative [view]?

MR. EASTBURN. Well, I think alternative 2 is too sharp a reduction from where we are. But around 5 percent is what we ought to have as a central tendency.

CHAIRMAN VOLCKER. I don't think anybody should feel at all wedded to what they tentatively say today. We have another whole month before we [need to decide]. Mrs. Teeters.

MS. TEETERS. I would support what Dave was saying. Announcing 3-year targets is an invitation to losing all our credibility. We have enough problems projecting out 1 year let alone 3 years. To box ourselves in by saying we're going to come down to certain levels by 1982 is an unnecessary restraint and an unnecessary danger. We may have that intention, but there's enough variability in this economy that we shouldn't go out on that limb; we should continue to do it by performance. I'm not sure I even want to talk too much about what we're going to do in the future--other than [to say we want] to continue to restrain [money growth]--so that we have the opportunity to change our mind as time goes on. I've probably done more 5-year projections than anybody else at this table and I speak from experience: They're all wrong. You don't come out where you say you're going to if you go down that line. I strongly oppose any publication or any commitment to a specific number for future years. I wouldn't narrow the ranges. We have a difficult year ahead of us and I think we will need all the space we can get. For the alternatives, a midpoint somewhere around 5 to 5-1/2 percent is probably the appropriate way to go.

I would like to bring up one thing that bothers me a little. A year ago we were in much the same position. We had the money supply down--in fact, going negative--and I'm not sure any of us really understands why the money supply did that between September and March.

CHAIRMAN VOLCKER. It was a demand shift! [Laughter]

MS. TEETERS. The econometric equations didn't fit. There's a strong possibility that something is going on that has nothing to do with our careful reserve management and all the rest. We just may be in the period of the 6 months when the money supply goes down. And [last year] we didn't really have a very good explanation as to why it took off after the end of March. So, before we pat ourselves too greatly on the back, let's remember that aspect of it and give ourselves enough leeway to accommodate sudden spurts on a monthly or weekly basis, if we do have them, and still not be outside our range.

MR. SCHULTZ. What would [your view be] if we say on the long-range issue that we are not going to publish any figures but merely say that we are on a long-range program to reduce inflation and we're just going to set money supply [targets] each year that are consistent with a continued reduction in inflation?

MS. TEETERS. Well, that would be fine, Fred, if we were the sole source of the inflation. But it's like playing poker with the other players always pulling all the wild cards. We're playing with OPEC, and we really have no control over oil prices. To say that we're consistently going to reduce inflation in a situation where we don't have control over inflation is, to me, going out on a limb. There may be a time, if this so-called recession turns very deep, when we might want to reverse our policies completely. And the risks on this recession, it seems to me, are basically on the down side. So, I just find it very difficult to commit myself to any sort of long-term position.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, it seems to me that we're not going to have the privilege of avoiding making some fairly definite commitment as to what our policy posture will be beyond 1980. There's also a possibility of getting some positive mileage from taking a fairly specific posture as to our plans regarding the orientation of monetary policy beyond 1980 because if we're going to be able to make progress on the inflation front, we've got to begin to have an effect on long-term contracts. Such contracts have become a fairly common part of the economic environment, particularly in the wages sector. So it seems to me that we should be serving up notice to those who engage in the making of long-term contracts that insofar as the monetary policy environment within which those contracts will be made or lived through is concerned, it will be a changing part of the [overall] environment. And it will be changing in the direction the Vice Chairman has suggested of trying to work toward lower numbers. And, as I believed you mentioned, if we don't say it, there's a fair probability that the Congress will say it in harder terms than we would be inclined to say it. So, I think the prospective benefits lie rather clearly on the side of saying something [about the period] beyond 1980. And what has to be said is that we will be moving gradually to smaller growth rate numbers both for money and bank credit, trying to make it sound as credible as possible.

CHAIRMAN VOLCKER. You're saying you wouldn't give numbers.

MR. BAUGHMAN. I would not give numbers unless in a final showdown we have to give numbers to avoid numbers being legislated. But I would go so far as to be rather unequivocal in terms of stating that we have every intention of having diminishing magnitudes of monetary growth rates and credit expansion in each of the succeeding 2 or 3 years. If it develops that it is simply not possible to live by those plans, I think we still might have purchased something beneficial rather than negative on balance. Furthermore, we have the opportunity to make adjustments midstream; if developments come along which are so persuasive that we need to make adjustments midstream, the provision is there for that. But I'd be inclined not to make adjustments midstream unless the case for doing so were very, very

persuasive--so persuasive that we would appear just not to be in touch with the real world unless we did make adjustments.

Now, on where we come out for 1980, I find your observation persuasive that we simply cannot appear to be giving higher targets than our experience in 1979. With respect to a specific target or a range, my own preference since we started setting targets has been to set a specific target, recognizing that we will never hit a specific target but nevertheless having something specific to shoot at. I would feel in view of the great uncertainties we're looking at that there may be some benefits to a range for 1980. But if we were to give a wider range than we used in 1979, we would lose credibility. I think it would be a mistake to widen the range of the target, whatever target we select for 1980, from what we had in 1979. That's about all I'll say right now.

CHAIRMAN VOLCKER. You don't want to say anything about the level of the target?

MR. BAUGHMAN. I had hoped we would take that up tomorrow.

CHAIRMAN VOLCKER. Not the annual.

MR. BAUGHMAN. Well, my inclination would be something on the order of our experience in '79 with a downward tilt. In other words, if we [adopt] a range, I'd put the midpoint of the range below the experience in '79. If we pick a specific target, I'd say the highest it should be is the absolute increase in '79.

CHAIRMAN VOLCKER. Governor Coldwell.

MR. COLDWELL. Mr. Chairman, I approach this from two interesting bases. Number one, membership of the FOMC will not be the same three to four years from now. In fact, if my count is correct, we're going to lose at least one-third of the members. I doubt very much if we're going to commit anybody out that long. I think it would be a mistake to commit because we'd lose credibility; in fact we may lose a bit this year in [adopting] a set of hard targets. There are enough uncertainties and instabilities in this economy right now that we'd better have about as much leeway as we can get. If we followed Ernie's path of selecting a particular point, then my aim for a point would be something like 4-1/2 to 4-3/4 percent; [if we set a range that would be my] midpoint with a 2 percent margin on either side. But that would obviously widen the range from the 3 percentage points that we've had in the past.

As I look at the picture of the alternatives in front of us, new definitions and current definitions, I'm not quite sure I understand all of them, except that the first two seem to be identical until you get to M2. It seems to me that we might fudge a bit here and maybe use 3-1/2 to 6-1/2 percent or 3 to 6 percent. We had a 5-1/2 percent growth rate for 1979. If we're trying to hold down inflation in 1980 and 1981, I don't see how we could aim for 5-1/2 percent; it seems to me that we have to aim for something lower. We've been hitting the tops of the ranges or have been outside them on some of these aggregates, so my preference would be to put the top of the range very close to what I really want to shoot at and then scale down from there and hope we are able to make some progress. And if

growth came out at the top of the range, we'd have an excuse of a worsening economy or something that would clearly demand more credit than we had planned. But I do think this economy is so unstable that it's difficult to know which way to plan. We've already talked about recession for months on end. It isn't here yet, except in the automobile and housing sectors, and maybe 6 months from now it still won't be here except for automobiles and housing. I don't know. It's hard to see how the consumer can continue to fight this. Maybe he is going into dissavings, but somehow or other he's keeping up his expenditures and may continue to do so for a while. My preference would be not to talk about 1981 because I think we're going to get into a box. I'd like a range of 4 percentage points, but if the Committee thinks 3 points is the most we can get away with, I'd take the 3-point range and I'd shade alternative 2.

CHAIRMAN VOLCKER. Down?

MR. COLDWELL. Down.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I start with the experience we've had of hitting our target on M1 and getting as a result a severe acceleration of inflation plus a much stronger economy. We've been waiting for this recession now for a year. It was predicted for the early part of '79. So, this leads me to think that there is something about our numbers that just does not reflect the true concept of money. [I don't know] whether we're going to capture that by our revisions. I think we'll make improvements but not really capture everything that is happening in the way of rising liquidity, and that makes me lean toward low numbers. I also see that there are very ominous changes going on in people's habits and expectations. In the last surge of inflation, 1974-75, there was a worldwide tendency for saving rates to increase. That was almost the same in all major countries. I haven't checked out what happened in this period, but we see now what happens to us. People have a different attitude. They are less afraid that they'll lose their jobs, but they're more convinced that inflation will go on. That is what the decline in the saving rate seems to me to say.

Now, as to action, I share the view that we shouldn't make a numerical commitment because the meaning of that commitment isn't clear enough, particularly if we had to start with a commitment that says 6 to 5 to 4 percent or 5 to 4 to 3 percent. I very much doubt that we'd hit that because circumstances could force us into a pro-cyclical pattern. We're not going to have the desire or ability to cut off a strong economic expansion, and we'll find ourselves being pro-cyclical. Therefore, I think we have to start with a low rate of money growth right away. I would say that 3 to 6 percent is a good starting point. If we went much higher than that, we'd be in immediate danger of getting into negative real interest rates with what they do to allocation of credit and inflation and the dollar. On the other aggregates, I'd like to see more clearly how they are likely to behave. But I think a fairly narrow [M1] range like 3 to 6 percent, aiming at the midpoint of 4.5 percent and expecting that that really is a symbol for much more liquidity than it seems to give us, is the way to start.

MR. AXILROD. Mr. Chairman, Governor Wallich's comment reminded me of a fact that was inadvertently left out of the Bluebook. We showed the actual growth rate of M1 for 1979 of 5.5 percent and I meant to show also in parentheses, and did not, the growth of M1 as if there had been no ATS accounts. One would have had to add 1.3 percentage points to that on our latest estimate. So, 6.8 percent would be the growth if there were no ATS accounts. That same 1.3 would be added to M-1A, and its growth would be 6.3 percent if there were no ATS accounts.

MR. WALLICH. Well, that explains a little more why we were able to finance such a tremendous inflation, but the increase in velocity still remains very large.

MR. AXILROD. Other demand shifts may also be occurring.

MR. MAYO. Do you consider the 6.3 percent consistent with the range of 3 to 6 percent, though?

MR. AXILROD. No. That would go with a range of 4-1/2 to 7-1/2 percent.

CHAIRMAN VOLCKER. I really don't want to prolong this, but you say 6.8 percent [without ATS] accounts. Is the implication that that's the part that came out of demand deposits?

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. But you have M-1B, which is the number with all of the ATS and NOW accounts, at 7.3 percent. Are you saying that most of the NOW accounts came out of demand deposits last year?

MR. AXILROD. No, I was referring to M-1A; that would add 1.3 to M-1A. I don't have at hand at the moment any additional M1 data.

CHAIRMAN VOLCKER. Well, we'll explore that another time. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. There are two or three points I would like to make. One, on the discussion of whether or not to retain ranges, I think there is comfort in ranges and that we must retain them for 1980. And I think a spread any narrower than the spread of 3 points that we have had in the past would be ill advised. Secondly, as to the projection of our intentions for 1981 and beyond, I would agree with the comments that it would be perhaps more destructive to credibility than helpful. If we project for 1981 and beyond, we would have to do it either [by giving] a set figure of where we project the money supply to be, which takes us out of the range concept, or by saying that we are going to reduce money growth 1 percent from the year before, whatever that may be. There is real danger in trying to project into 1981 and beyond. It seems to me quite appropriate, however, to express what probably would be a consensus of this Committee that our objective is to move the money growth to a lower level [within] those ranges, [namely around] 5.5 percent. That's still a very restrictive monetary policy for 1980 as opposed to 1979. That would be moving from growth of 7 percent in 1979 to 5.5 percent in 1980, which I consider to be a fairly restrictive policy. I would like to recommend that we look at a range



for 1980 for M1 or M-1A, and I think they are both the same, of 4 to 7 percent rather than either alternative 1 or alternative 2.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Well, I would take a somewhat different tack. You talked about the complexity of reality as we view the Ms and reserves. I think the complexity of the economy with respect to the outlook is even greater. Second, I think we are boxed in because of the law saying we have to do this and do that. If I were doing it, I would indicate very clearly what my economic scenario is and then what my recommendation is in [that context] rather than say that this is our target irrespective of what happens. I suspect that the economic outlook is going to be far more variable--and I'm not saying on which side--than any of the projections would indicate, and that makes our target setting even more important. And I would offer to go back to Congress at an appropriate time because of my lack of confidence in my long-range forecast on the economy. I would surely put my economic scenario out there if I put out any kind of targets.

CHAIRMAN VOLCKER. What I don't quite understand, Willis, is that you say you would put your scenario out first, but then you say you don't know what the scenario is.

MR. WINN. Well, that's correct. But [I'd say: Given] this hypothesis, this would be true. For example, Paul, go back to October and look at what you would have projected on the international front versus what you feel now. That can change far more dramatically in a very short period of time. Let's assume we go to a military draft or assume we get involved militarily; all of these [projections and targets] would be out the window. On the other hand, if we just take a look at our inflation rate and what that could do, [the recession] may be far deeper than any projection we have if things started to come unravelled on that score. Then we would have to adjust to the reality as best we see it at the time, rather get into this longer range kind of set up. You can take the President's economic outlook or any one you want, and say: If that's true, then this would be our goal. But because we are not certain about these things we are going to have to adjust as time goes by and we are willing to come back and report when we adjust. But to get caught in a longer-range [target], even a year's target at the moment, is really buying ourselves another trap. Or else we have to have a wide range because of our uncertainty about the reality.

CHAIRMAN VOLCKER. You dismiss entirely the argument that the more firmly we set a range the more we might be influencing the reality?

MR. WINN. At this time, yes.

MR. SCHULTZ. Do you think we have the luxury to do that, Willis? It seems to me that we are charged with deeper responsibility than that.

MR. PARTEE. Well, the Board has to [indicate] what projection is consistent with the numbers it chooses [for the aggregates]; and that is the scenario.

MR. WINN. That's right; that's what I mean.

MR. PARTEE. And that could be wrong.

MR. WINN. It could be very wrong. I think the reality is that we have a much greater [chance] of being wrong this time than has been true in a long time.

CHAIRMAN VOLCKER. Where would you stick the number today, subject to change tomorrow?

MR. WINN. Around 5 or 5-1/2 percent as a midpoint, Paul.

CHAIRMAN VOLCKER. Mr. Kimbrel.

MR. KIMBREL. Mr. Chairman, I guess for different reasons I would opt for not going to longer projections. Frankly, there are so many uncertainties that there are enough difficulties with 1980. And even there, I would hope that we could relate our longer-run look at 1980 to the actual targets that were in place for 1979 and not our results or our experience for 1979. I would not be too much for changing these during the year, even with the chances of recession or OPEC influences. I think [any] changes we are going to make [in the ranges] are going to have a rather minimum influence, and I'd be inclined to stick to our longer-run targets. In doing that I have a preference for looking at those associated with alternative 2. Contrary to what some of the others have suggested, I'd be inclined to narrow the target ranges, maybe still with 4-1/2 to 5 percent as the midpoint, but certainly not wider than 4 to 6 percent if M-1B is what we are going to be talking about.

CHAIRMAN VOLCKER. Mr. Timlen.

MR. TIMLEN. Mr. Chairman, I must say I am pleased that this is only a preliminary discussion of our long-range targets be they for 1980 or 1980 and 1981. I am not sure whether I am distracted or overwhelmed by major external political forces as well as external financial forces. I have no idea how or when they may be wound down; maybe we will have a better idea for the final discussion in February.

CHAIRMAN VOLCKER. [Unintelligible] proposing making it for the last quarter.

MR. TIMLEN. Why not? At any rate, I think these external developments all pose threats on the side of impeding our inflation fighting efforts, and they pose a risk to the strength of the dollar if there's a renewed reason for a flight from [other] currencies. Finally, I would agree with some of the people to my immediate right that a recession is upon us. I look at the auto situation and housing and the cost of energy as we go into the winter and the impact on consumers. For me inflation continues to be the overriding concern. Inflationary expectations are as rampant as ever. The dollar continues to be vulnerable in the foreign exchange markets to any appearance of an easing in our policy, and [market participants] do focus on interest rates. So my prescription as of this preliminary discussion is not to compose another dramatic package like October 6 or November 1, but to restate our resolve on inflation and commit the Federal Reserve to a reduced rate of growth in money and credit. I

would avoid any appearance of an easing when we go to the new definitions. And we should make such a commitment not only for 1980 but also for 1981. I'd say if we need any countercyclical policy we should look to the Treasury and the fiscal side. I haven't really studied the numbers much yet. I would be inclined to go for something very close to alternative 2 on page 8 of the Bluebook.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. First, I would use the 3-point ranges that we have had. As a matter of fact, if I could, I might choose a 4-point range as Phil [suggested]. [But] given the fact that we have had ranges of 3 points, I just don't see us broadening them out. I would remind you that we fully used the ranges this past year. In fact, we more than used it in the case of M1. Now, maybe our new procedures will make the variations a little less, but I would guess that we may use pretty much of the ranges this year. In addition, I think it would be desirable to borrow a little from tomorrow to have [money growth] on the low side in the first part of the year and on the high side in the second part; therefore, we might want [wider] ranges just for that purpose. So, I would have 3-point ranges.

Secondly, I would not make any 2- or 3-year statement regarding specific reductions in our monetary growth rates because it's unrealistic. For example, take this econometric projection. We would be saying that after unemployment got to 8.1 percent we would reduce the monetary growth rate again and then presumably after it got to 10.5 percent we would reduce it again. I just don't think that's [realistic]; we're not going to do that. Indeed, I don't think we are going to reduce the monetary growth rate a great deal until some of the things that are adding to inflation tend to fall off. For that reason, it's important that we be pretty conservative with 1980 because I doubt that we will be able to reduce the ranges much beyond the 1980 ranges that we set. In fact, I don't think 1980 will be much of a problem in terms of [growth] being within the ranges because there will be enough of a recession that we're probably just saying how low we want interest rates to go when we set the ranges for the year. So, I would say that we ought to center the range on 5 percent for M1, which would be an improvement over what we experienced [last] year, and that would mean about 3-1/2 to 6-1/2 percent, [with] a little more on M-1B and the other ranges in accordance with that. And then [we should] hold to it. I might remind you that not only do we face the possibility of recession, but we may be in a semi-war [status] and it will be important, I think, to have a range that is quite explicitly stated to which we can hold.

CHAIRMAN VOLCKER. But when you say "hold to it," you mean consistent with your first comments about using the range if necessary.

MR. PARTEE. Yes, that's right. And, as I said, I'd drift a little low in [the range] in the beginning with the view that growth will be rising within it later on.

CHAIRMAN VOLCKER. Mr. Black. I don't know whether we will get through with everybody today, consistent with getting out at a reasonable time. But if it's agreeable, let's go on a little longer.

MR. BLACK. Mr. Chairman, I come out very close to Ernie Baughman in feeling that we ought to stress our range in 1980 and not indicate specifically what the ranges will be for future years but indicate very clearly that we still hold our oft-stated intention to reduce these ranges gradually over time until we get them down to what we hope to be a noninflationary basis. So far as these new aggregates are concerned, M3 is probably the worst because it seems to be the most interest sensitive. I think M2 is going to be rather interest sensitive, too, because we have taken out of it all the nonnegotiable CDs at weekly reporting banks and all the large CDs--whether negotiable or nonnegotiable--at the other banks. I would think, John, that would probably more than offset the advantage from [including] the money market funds, but I'm not sure about that. I believe M-1A leaves out an increasingly important part of the transactions balances, so I would settle on M-1B as the best one of all. I would favor narrowing the width of the ranges. We have had 3 points suggested at times in the past; we have had 2 points. I would favor 1 point for the two M1 ranges and probably 2 points for M2 and M3, which I don't think we can control that precisely anyway. The main thing that I want to do is to set these targets below what we achieved in 1979. In terms of M-1B, which is what I build all this around, we had a 7.3 percent rate of growth in '79; I'd say 6 percent might be a reasonable rate in '80, so [a range of] 5-1/2 to 6-1/2 percent would look about right to me on that one. If we can explain satisfactorily that M-1A really was not 5 percent as the figure shows but 6.3 percent, then maybe 5 to 6 percent would be reasonable for that. For M2 I'd suggest 6 to 8 percent and for M3 6-1/2 to 8-1/2 percent.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, I find myself philosophically interested in the idea of reducing the ranges, but I don't think this is the time to do it. I think we need all of the flexibility we can have here. I find myself at least at the moment utterly opposed to going above 6 percent on the upper end of our range for whatever we call [narrow money]--M1, M-1A, M-1B--for psychological reasons. It would give a wrong impression abroad regardless of how much we tried to explain it, and to some extent that would be true at home as well. So I come back to the 3 to 6 percent range that we had, not just because we had it this [past] year but because I think we have established some modicum of credibility in keeping [actual growth] within the 3 to 6 percent. We're certainly very close to the upper edge, but we still have established a credibility which I have the impression at least was not achieved even by some of our more austere partners, Germany included. I feel that this a restrictive policy.

Like Willis, I feel that the variability of the outlook is even greater now than it has been, certainly in my memory as a member of this Committee. That's one of the reasons I wouldn't narrow the range. I would also urge that we keep our powder dry until we see how things are moving along six months from now. As to whether we want to change that range, I certainly wouldn't make [our intent] public, and I certainly wouldn't stick to 3 to 6 percent through, shall we say, hell or high water. I feel very strongly that to use a [number] of any kind beyond 1980 is foolish. I feel, much as Ernie does, that if we state our intention in the present environment as defined by the President's messages and so forth and so on, our own analysis and related intention to reduce the expansion of money supply further as

long as the inflationary forces rage as strongly as they do is as far as we can go in talking about '81 and '82. I join Nancy [in her view about long-term projections]. I'm not going to question whether she's made even more 5-year projections than I have, but we made the first one on the budget in the 1971 Economic Report. It was a fine paper exercise, and the way to start is to start. But I would hate to go back and review that now, even with all the adjustments, and realize how shaky it was at the time.

CHAIRMAN VOLCKER. Mr. Willes.

MR. WILLES. My wife made me promise that I would be more agreeable in the new year, so I would like to say that I agree with everything that has been said. I'd like to say it, but the fact is that I don't agree. But since the hour is late I will be very brief in stating my disagreement. We all agree that the outlook is uncertain. Where we disagree is whether that makes any difference or not. If we really think that if we knew what the outlook was we could affect it in a systematic way, then we end in one side of the [corner]. But some of us have the view that even if we think we know what is going to happen, there is no systematic, predictable, effective way that we can have an impact on it. Because of that, one can end up with quite different policy implications. I feel perfectly comfortable in the abstract in saying that, yes, the outlook is uncertain but that policy ought not to be uncertain. Policy ought to be a given, and by making policy a given we can in fact reduce some of the uncertainty of the outlook. The implication of that is that we should not only decide but should specify in great detail what our targets are for the next five years. Unfortunately, we have one minor problem with that, which is that a change in technology is going on in the financial markets that makes all the numbers, if not irrelevant, at least highly uncertain. So, since you have given us an extra month, I would like to wait another month and then be able to come back and tell you what I think those numbers ought to be. It's clear that we can't in the current environment spell out any M for the next three years because the technology is bound to change in such a way that it would make any number we specify obsolete. It may be that we are going to have to move to some kind of reserve target and spell that out for three years. But whatever we do, we need to find a way to reduce the uncertainty of the outlook that is associated with policy. We can't reduce the other uncertainties, but we can reduce that uncertainty. I think that would be a substantial accomplishment indeed.

CHAIRMAN VOLCKER. You are not going to offer any numbers?

MR. PARTEE. Next month he will.

MR. WILLES. Next month.

CHAIRMAN VOLCKER. Well, we'll stay in suspense. Mr. Balles.

MR. BALLEES. Since the hour is late, Mr. Chairman, and since I don't really have any convictions but only tentative leanings at the moment, I'm not sure I will give a number either. But I would like to refresh recollections by going back five years when we didn't have to have publicly announced ranges. Subsequently, when we did announce them, we had a very unhappy result [after] proclaiming a long-run

strategy of gradual diminution in monetary growth. That was about four years ago. Psychologically, [targeting] gradual reductions in the ranges year by year was probably good; the actual outcome was just the reverse. Nearly every year the actual monetary growth kept accelerating. Whatever we do, we have to avoid that kind of outcome like poison, if we give any credibility to our actions of October 6. I think we need to stick to that long-run strategy and really make it work this time. We need to diminish gradually the rate of money growth, however defined, and it's going to be more difficult as we get into these new definitions.

So, with respect to the different alternatives that are outlined here, with the risk of making a pest of myself, I'm going to come back to the theme of whether we need all four [variables]. I think we are getting the cart before the horse in a way, by trying to set numbers for four [measures] when we haven't really decided whether we need or in fact can control all four. When I think of the new content of M2 and the huge amount of savings deposits at nonbank depository institutions--deposits that really aren't under our reserve influence--and when I think of the volume of money market mutual funds shares and so forth, like you, I begin to have some doubts about whether we really can control M2. It might be important information for us on which to base our other actions. But if I were forced to give a provisional number for M-1A or M-1B as of today, I would lean to a midpoint of about 1 percent. I'd like to reserve for a more definitive--

CHAIRMAN VOLCKER. A midpoint of 1 percent?

MR. BALLEES. I'm sorry. As you can see, I'm getting punchy; the hour is late. Please don't record that. I agree with your [suggestion of] a midpoint in the general area of 5 percent for either M-1A or M-1B. I think the important thing is to demonstrate within the context of how serious this recession may turn out to be that, while we may have to depart temporarily from the reduction mode during the depth of the recession, the minute we get beyond that it is our longer-run plan to continue this gradual diminution [in money growth] in view of the strength of inflationary pressures.

CHAIRMAN VOLCKER. Well, I'm torn here between the hour and having only three more names left. I'd rather like to get through the three names if we can do it with great dispatch. Mr. Rice.

MR. RICE. Well, Mr. Chairman, I don't see how we can look much beyond 1980. As a matter of fact, I would prefer not to look beyond the next 3 months.

CHAIRMAN VOLCKER. You'll have that opportunity tomorrow.

MR. RICE. But since we have to look at 1980, I would favor some moderate reduction in the rate of monetary growth for 1980. Since the M1 range we would be reducing from is 4-1/2 to 7-1/2 percent, [whose midpoint is] roughly equivalent to the rate of growth in the target for 1979, 3-1/2 to 6-1/2 percent would be an acceptable range to me. I think the range should be kept fairly narrow, at 3 points. So, 3-1/2 to 6-1/2 percent would be acceptable. I'd be prepared to see perhaps a slightly higher range up to 7 percent, say, 4 to 7 percent. But I could certainly live with 3-1/2 to 6-1/2

percent with a midpoint of 5 percent. I know we are supposed to discuss the 3-month target tomorrow, but what happens in the next 3 months is of great importance right now. And I think over the next 3 months is a good time to lean rather heavily on monetary growth as compared to over the year as a whole. It would have good credibility value and I think it can be done without much harm.

CHAIRMAN VOLCKER. By "leaning on it," you mean down?

MR. RICE. Down. I think it can be done without much harm. It will be a period when unemployment is still relatively low. So, I would argue for more restraint, or a rate of growth toward the lower end of the range over the next 3 months with the understanding as the year unfolds that higher rates of growth would be tolerable.

CHAIRMAN VOLCKER. Mr. Morris, are you feeling brief?

MR. MORRIS. Very brief, sir. I think we ought to be able to show a substantial reduction in our guidelines for [this] year, simply because it is [likely to be] a year of recession. It's a year when the demand for money is going to be down. And it's only in recession years, in my judgment, that we are going to be able to reduce the guidelines. I can't see us reducing them in '81 from the levels we set for [this] year if the economy is expanding. As a theoretical proposition I'd like to see [growth] go from 5 percent to 4 to 3 to 2; but it seems to me that if we don't cut the ranges back now for '80, we are not likely to cut them back for '81 or '82. Therefore, I would go for the 3 to 6 percent [M-1A] range and try to explain to the market that it is a reduction. I think we are going to have a hard time explaining that it is a substantial reduction because everybody is so confused about the ATS add on and take off and so on that they are not going to be as impressed with 3 to 6 percent as we are.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. First of all, if I may, let me commend the staff. I think the form of this Bluebook is the best I have ever seen. Maybe we will only keep it within our own family, but it enables us to make these decisions in the context of economic implications instead of just looking ahead for 2 or 3 weeks as we sometimes have in the past. I would very much recommend that we announce--or that at least you announce--as forcibly as possible our intention to lower our growth rates over a 3-year period. I think it's important to recognize that there is absolutely no way in the world other than by affecting expectations to anticipate a reduction in inflation during the calendar year 1980. The only possibility we have of accomplishing anything along these lines is to make our longer-term intentions sufficiently clear that anticipations and expectations would react favorably. It's vitally important in the world in which we live that our new--and I certainly feel proper--approach to monetary policymaking not be pre-judged with the expectation that we will get results in the year 1980. I think that would cause political pressures that would be disastrous. Specifically, I would recommend a 5 percent [growth] rate, as shown under the alternative 2 description on page 8, and strategy 3 on page 11 in terms of 1980, 1981, and 1982. Possibly, if it's unpalatable to think of actually putting out numerical [intentions] to the world--and I'd say in that regard that our primary responsibility is not to protect our own flank but to come

to grips with inflation and to accomplish these other [objectives]--at least our determination to reduce money growth over a 3-year period should be announced and announced clearly. That's the only way we are going to have any effect in anything like a short-term context. That's all I have.

CHAIRMAN VOLCKER. Mr. Schultz has promised me he can pronounce an interim benediction in 30 seconds.

MR. SCHULTZ. It's an uncertain world so we need all the flexibility we can get. We need at least a 3 percentage point range, with a midpoint of 4-1/2 to 5 percent, which would argue for alternative 2 or a half point higher. Longer range I agree that we'd be absolutely foolish to set specifics. I do think it's necessary that we say something that indicates some commitment or resolve of some kind. We're the only group that has any credibility to do so. I think that's absolutely essential for us if we are going to continue to attack the inflationary expectations problems.

CHAIRMAN VOLCKER. I very much appreciate your staying here until 6:30 p.m. I didn't give you much choice, I guess, but nobody vocally objected anyway. I think it was very useful to hear these preliminary expressions and to get this part of our agenda out of the way. We will proceed with Mr. Kichline's economic outlook when we all return tomorrow morning.

[Meeting recessed]



January 9, 1980--Morning Session

CHAIRMAN VOLCKER. I guess I, or we collectively, neglected to ratify the domestic operations. Is there a motion to ratify the domestic operations?

SEVERAL. So moved.

CHAIRMAN VOLCKER. Without objection they are ratified. While we're in the process of ratifying, why don't we hear about foreign currency operations.

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

CHAIRMAN VOLCKER. Questions? Comments?

MR. SCHULTZ. What in your opinion is likely to be the effect of the announcement this morning that OPEC is seriously going to pursue a basket of currencies?

MR. PARDEE. They've been discussing that off and on. Who announced it? If it was the Saudis and there's a general agreement, then it could lead to selling of dollars. But if it was the Kuwaitis or some research economist in one of these areas or newspapermen, it's unlikely to be [more than] a momentary blip in the market.

MR. TRUMAN. It was a story that came out yesterday afternoon, I think, when you were probably still on the plane, Scott. And the Desk reported at that time, although it was on the ticker in the morning yesterday, that there had been no effect on the market. The nature of the story, as I heard it, was that some Arabian official had said that eventually they probably would have to go to [a basket of currencies] or something along those lines, which would suggest a change in the Saudi's position on that particular issue. But it is probably fair to say that they have been talking about it for so long that it has been fairly well discounted. Even the psychological effect, in terms of diversification, may not have been a factor in the market yesterday, according to the Desk.

MR. ROOS. According to page 4 of The Wall Street Journal, it was a West German newspaper reporter quoting Saudi Arabia's oil minister as saying that the currency basket appeared inevitable.

MR. TRUMAN. That's the story we got yesterday. We've heard that before.

MR. COLDWELL. Scott, in your Desk operations and your wanderings abroad, what's your sense of the direction of currency management on the part of the multi-nationals? Are they making any significant shifts?

MR. PARDEE. No, in fact they have been rather out of the market. They were a major factor early in December as they transferred some of their profits and earnings home. During the late part of the month and early this month, in our conversations with them, they said they just don't know which way to go. They're very nervous [about the situation] politically as well as with respect to

other elements. But they haven't been moving funds very much. The real problem for us in the exchange market, as far as dollar sales, has come from the diversification by the Iranians and perhaps other central banks. On the other hand, the risk of talking to corporate treasurers is that they start warning us that if the dollar begins to decline, they will sell dollars; it's that sort of thing. We have not heard of major shifts by corporations. They're not very optimistic.

CHAIRMAN VOLCKER. Would you like to ratify the transactions?

MS. TEETERS. I move to ratify.

CHAIRMAN VOLCKER. Without objection they will be ratified. Do you have any recommendations, Mr. Pardee?

MR. PARDEE. Well, we are now getting into the phase of second renewals of swap drawings and I do need authorization. Some of the drawings relate to our operations last summer, in July. We have eight swap drawings in the amount of \$335 million that are up for second renewal between now and February 14. I would like to recommend that we roll them over once again, if we haven't had the chance to pay them off before then.

CHAIRMAN VOLCKER. Any discussion? Do we have a motion to that effect?

MR. MAYO. I'll move.

MR. RICE. Second.

CHAIRMAN VOLCKER. Without objection we will approve that proposal. We turn to Mr. Kichline who has the unenviable job amid all of this uncertainty of giving us a prudent, considered, forceful, accurate view of the economic outlook.

MR. BALLE. How about unambiguous? [Laughter]

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

CHAIRMAN VOLCKER. Did I understand you correctly that you're projecting domestic energy prices up 60 percent?

MR. KICHLINE. That's correct. That refers to crude oil prices--the wellhead prices--not the total energy component.

CHAIRMAN VOLCKER. What were they up in 1979?

MR. KICHLINE. Well, substantially less. I think for the year it was about 45 percent.

MR. MAYO. How much of your 8 percent [inflation forecast] would be energy-related then?

MR. KICHLINE. Well, it varies. In 1981 it's a little over a percentage point, about 1-1/2 percent, and in 1980 it's about 2 percentage points. Let me just say, as it turns out, that domestic wellhead prices in 1979 are estimated to have been up 55 percent. The price of domestic crude oil is estimated to have been at \$14-1/2 a

barrel in the fourth quarter of last year. Given the decontrol schedule and our OPEC price assumption, by the fourth quarter of 1980 the price of oil is expected to go to \$23-1/4.

CHAIRMAN VOLCKER. You're just talking about domestic crude oil prices?

MR. KICHLINE. Domestic wellhead prices for crude oil. But the current decontrol schedule, which is obviously subject to change-- the President does have that authority--would by October of 1981 place domestic crude oil prices at the world price level. So, we're going in two years from \$14-1/2 to \$33-1/2 on the price of half our oil supply.

MR. WALLICH. But this still would have very little impact on the price of gasoline, wouldn't it, barring an increase in taxes? What would be the price of gasoline, would you say, corresponding to a world level price for crude oil?

MR. KICHLINE. We've got all these numbers. Let me just say that lots of things intervene in getting to the retail price of gasoline including importantly margins, which we have assumed will shrink a bit. Gasoline prices are estimated to have increased 50 percent in 1979; [the estimate for] 1980 is 29 percent and for 1981, 15 percent. So the rate of increase is slowing.

MR. SCHULTZ. Jim, you have an inflation rate of about 15 percent this first quarter, don't you?

MR. KICHLINE. For the CPI.

MR. SCHULTZ. There was an announcement that the prices of homes declined some in November. We've been wrestling with this question of when we will start to see a leveling out of the housing component in the CPI. Are we getting any better feel as to when we will see some impact? Is it as early as March, or are we going to have to wait until later before we see any impact?

MR. KICHLINE. Well, as you know, there are two important influences on that housing component: One is the price and one is mortgage interest costs. Mortgage interest costs tend to lag commitment rates by about a quarter. So, what happened in the fourth quarter in mortgage rates would appear in the CPI measure this quarter. Given our expectations that mortgage rates have peaked and will be drifting down, we think that by this spring the mortgage interest component should not have an important influence in driving [the CPI] up. In fact, late in the spring, in June or so, it could begin to operate the other way. On house prices, some of the measures of house prices recently have declined. Unfortunately, that's not the information that is directly used in computing the CPI. Our best guess is that house prices in the CPI will be shown to be rising somewhat less rapidly through the next several months, but probably at a rate that's still near 10 percent. So, we don't expect measured inflation in the CPI due to the house price component to be a helpful factor in the short run.

MR. SCHULTZ. You did mean to say it was multiplicative, didn't you?

MR. KICHLINE. I get into so much trouble when I use that term that I decided to avoid it today.

CHAIRMAN VOLCKER. Why is that different index used?

MR. KICHLINE. Well, as I understand it, the index used to measure house prices is an FHA series. It's based in effect on FHA loans, which as you know are a small part of the market. It's designed to measure "a representative house." The series that come out monthly are Census series, which are based upon the turnover of new and existing homes. And in those I believe the average price of homes declined a little in November. The question is: Was that attributable to a change in the mix or in fact did "the representative house" decline in price? It is assumed at this juncture that people opted for lower priced homes and thus the turnover was concentrated in such homes rather than that house prices were declining.

MR. BALLEES. I was wondering whether the staff has had any chance to [develop] even a preliminary view on the likely impact on inflation rates of this morning's announcement of the upward adjustment on the wage/price guidelines.

MR. KICHLINE. Well, that was pretty much in line with our expectations. We have assumed in the forecast for some time now that the wage/price restraint program would reduce compensation by perhaps 1/4 percent or so, or a couple of tenths, but not a great deal. In effect, part of this is the notion of: Do you experience settlements that are well above your guideline or do you move the guideline so that few fall outside the program? And, that's a bit what is going on here. It is a flexible guideline, as I understand it, with a 2-point spread. We expect that the program in practice has been eased from the restraints of a year ago and that at best it will have a small damping influence, but not [much].

MR. PARTEE. Your projection of the average earnings increase is up into that guideline, isn't it?

MR. KICHLINE. Yes, we have compensation in total running in the 9-1/2 percent area, so it's at the top end of that program. I might also note, though, that this is a fairly heavy bargaining year. We face [labor negotiations by] the steel workers, communication workers, some longshoremen, and the aluminum can industry; so 1980 is not an easy year in terms of major collective bargaining settlements.

CHAIRMAN VOLCKER. Did I see someplace that nonunion wages are now rising faster than union wages?

MR. KICHLINE. I'm not aware of that.

CHAIRMAN VOLCKER. Maybe I just picked up the idea.

MR. COLDWELL. In effect, Jim, what you've done by the revisions this time is to push the recession into 1980; 1979 is no longer a recession year. What are the chances of [a recession] being deferred another six months?

MR. PARTEE. That's not his projection.

MR. KICHLINE. Well, as you know, [those chances] are clearly there. If you look back, we had assumed in the staff forecast that a recession or a downturn in economic activity would take place in the third quarter of 1979. We were a bit late in coming to the recession view and, as it turned out, obviously not late enough. It is possible that we will be surprised. The outlook hinges importantly on consumer behavior; that by no stretch of the imagination is the big surprise in the fourth quarter, if the numbers hold up. I do believe that the ability of consumers to rely on reducing their saving rate for a couple of quarters to below, let's say, the 3-1/2 percent level begins to be a possibility, but it's very unlikely. I also think that we have in place now a clear downturn in the housing sector and weakness in business fixed investment, and those factors will tend to drive up the unemployment rate and provide somewhat less income growth. So, I think the probability is now higher that economic activity is declining, but I would not rule out the possibility that we will be surprised.

MR. COLDWELL. Well, Table I-10 in Part I of the Greenbook seems to indicate that you're forecasting a six-quarter decline in personal consumption expenditures, heavily concentrated in the goods sector--in fact, all in the goods sector--with services continuing to rise on a real basis. You're forecasting very heavy declines [in total consumer spending] in the first three quarters, tapering off until you get a positive figure finally in the fourth quarter of 1981. What does history tell us about this kind of pattern? Is this consistent with, say, the 1974-75 pattern?

MR. KICHLINE. No. What we have had often in the past is a sharper slowdown, particularly in goods, but nothing that has stretched out for six quarters. What is unusual about this is not so much the size, but the duration--that is, six consecutive quarters of declining real personal consumption expenditures. I would associate a good deal of that with the fact that this expansion and projected recession have very different characteristics than past history. For the extended period ahead one of the key differences relates to policy assumptions, both monetary policy and, very importantly, fiscal policy. There are no discretionary fiscal actions in our forecast--in fact there are tax increases--during the downturn. So we would [attribute] a good deal of it to that.

CHAIRMAN VOLCKER. I was going to ask a question later but it's timely to ask [now]. You have a prolonged recession or sluggish period here and you have no fiscal action assumed. You make some assumptions about monetary policy. Would you like to comment about an appropriate policy mix over this period, looking six to eighteen months ahead?

MR. KICHLINE. Sure. In my own view, I think a posture of monetary restraint indexed by a rate of growth of the Ms that is no higher, and perhaps somewhat less, than we had in the last year would be appropriate. I also believe, however, that action should be taken on the fiscal side. [I'd note] two important aspects there. One would be to roll back the social security tax increases scheduled in 1981. It seems to me, in some way or other, that is not consistent with trying to gain control over inflation. However, something like \$18 billion in federal revenues are generated out of that, so that by itself would mean about an \$18 billion tax cut. I also think some tax

reduction that would affect the corporate sector by trying to provide business investment incentives would be appropriate. Realistically, it seems to me that such a package would be in the \$30 billion area. But when one thinks of having tax cuts in an election year period that do nothing for the consumer sector, that seems to me rather unlikely. So, probably when we are talking about a tax cut, we would be talking about a bigger number rather than a smaller one.

MS. TEETERS. What about the timing on that, Jim? Just rolling back the social security tax is no tax increase rather than an actual tax cut. Isn't there a possibility that a tax cut in the payroll tax, say in mid-1980, would be appropriate timing?

MR. KICHLINE. That's quite conceivable. That would mean we could avoid part of the increase that would be coming along this year because as of January 1 we did have about a \$4,000 increase in the social security tax base and effectively for consumers that will come into play largely in the second half of this year. So, that's right. If you are talking about this, you do not think in terms of doing something eighteen months ahead but rather around mid-1980. That is when one would want to have this [lower tax become] effective.

CHAIRMAN VOLCKER. You have given us a scenario here of an \$18 billion tax cut in social security taxes and something for business and you say, realistically, something for consumers, too. So I don't know how much above \$30 billion you are.

MR. KICHLINE. Well, I didn't recommend that. I said I think that's one of the facts of life. The number may go higher.

CHAIRMAN VOLCKER. It would bother you if it were higher, right?

MS. TEETERS. Don't forget the \$18 billion so-called tax cut is just not a tax increase. It's a funny tax cut.

MR. WALLICH. That should be offset or compensated for by a rise in the personal income tax, shouldn't it?

MS. TEETERS. Pardon?

MR. WALLICH. We're talking about a shift of the social security financing from the payroll tax to personal income tax. So we would have to anticipate the rise in the personal income tax as we cut back on the social security tax increase, if we didn't want to increase the deficit.

MS. TEETERS. Well, given the size of the full employment surplus as shown, it doesn't bother me at all to have an increase in the deficit. By the end of '80 it's shown as being 4 percent of GNP.

CHAIRMAN VOLCKER. Your budget deficit for 1981 is what?

MR. KICHLINE. \$30 billion. The Administration, we understand, is trying to hold the number in its budget message to around \$15 billion. But we have a different economic situation. I think that's right that [the deficit] is an upward constraint because

if we have a tax cut [this year], it seems to me that in fiscal year 1981 the deficit could easily be in the \$60 to \$70 billion range.

CHAIRMAN VOLCKER. What does the 50 cent gasoline tax do to the consumer presently?

MR. KICHLINE. It's about 2-1/2 percent under a direct measure.

MR. PARTEE. On the level of the index or--?

MR. KICHLINE. No, if inflation were rising at 10 percent before, it would rise at 12-1/2 percent for a year.

MR. PARTEE. For a year. So it raises the level of price increases by 2-1/2 percent?

MR. KICHLINE. Right. The percentage change goes up by 2-1/2 points.

MR. COLDWELL. Mr. Chairman, I would like to go back to this forecast of personal consumption expenditures because I think it's an important point. You have forecast an increase in unemployment of roughly 1/2 point per quarter in this period ahead, at least for 1980, and industrial production is only going down about 2.3 percent [in the first quarter] and 6 or 7 percent, roughly, for the full year. So, one wonders a little whether these are consistent with the decline you have forecast in personal consumption. If the goods part of this consumption is going down at more than 7 percent in the first two quarters and 6 percent in the third quarter, isn't that likely to have a greater impact on industrial production?

MR. KICHLINE. Well, one of the important points here is that industrial production is only a part of this; what has been driving the changes in industrial production recently has been autos. And we expect that to spread. When you talk about the unemployment rate and IP, you are talking about the bulk of employment outside the manufacturing sector. The strong growth recently has been in trade and services. We expect that employment in manufacturing will drop but we also are going to get much slower employment growth in the trade and services area. Combined, that is likely to drive up the unemployment rate relative to changes in industrial production. I don't think they're inconsistent. What we are talking about here is our view that we will have employment adjustments in the short run once businesses become convinced that their sales picture has changed. And labor markets today are still quite tight in many areas, particularly for skilled labor. Businesses are unwilling to give up skilled labor resources unless they are convinced that, in fact, the picture has changed for them.

MR. COLDWELL. Presumably they get convinced by the end of the second quarter with a two percent reduction in goods sales.

MR. KICHLINE. I think that would be convincing evidence, assuming that our forecast is right.

MR. PARTEE. Well, I think the emphasis on the consumer is certainly appropriate here. I would point out, Phil, that in nominal

terms goods expenditures rise every quarter, which I think makes the point that consumers are being pressed not only by taxes but also by inflation, particularly the inflation in oil prices which doesn't really have a personal income counterpart in it. The saving rate behavior is extraordinarily interesting. I calculate that in '78 and the first half of '79 the personal saving rate averaged a bit above 5 percent, fluctuating up and down but never getting much below 5 percent and being above it in some quarters. That was a period of rapid increases in installment debt, which reduces the saving rate of course from what it would otherwise be since it's a reduction from gross savings. Then in the third quarter of '79 it dropped to 4.3 percent with a lesser rise in installment debt; and in the fourth quarter it apparently dropped below 4 percent to maybe 3-1/2 percent or something like that with a still further decline in the rise in installment debt. So the question is: In terms of components, what is moving that saving rate so strongly downward? I suppose one could argue that if people are moving from cash to goods, the financial saving is falling off. That would be one indicator. If, on the other hand, there is a generalized sort of squeeze so that people don't have enough income to cover [their expenditures] and there's an attrition in saving that results, that's a different kind of story. If it's the first case, we could have a continued high level of consumption. But that doesn't seem to me consistent with the reduction in installment credit. If it's the second case, we would have a very substantial decline in real consumption. You probably don't have much information on the components of the saving change, but do you have a view on what is happening there?

MR. KICHLINE. Well, I have a view that in fact the economy has not been generating much real disposable personal income. [Its growth] peaked out in December of 1978. In terms of the monthly figures, it bounced around but in the second half of last year, for example, real disposable personal income is estimated to have gone up less than 1/2 of one percent. And yet we are getting expenditures, which we estimate, for example, in the final quarter of the year to have been at 3 percent. Clearly, in our view, it's a strong attempt by consumers to maintain their spending patterns despite adverse factors in growth of real disposable personal income. So, it is that sort of issue. It's true that the issue is wrapped up with whether or not we are getting durable goods purchases [from] savings, and that would tend to drive the [saving] rate down in a given quarter.

MR. PARTEE. There couldn't have been much of an increase in car sales in that period; they probably declined. Were other durables strong?

MR. KICHLINE. Well, some appliance sales had been strong, but consumers were generating installment debt increases of around 10 percent.

MR. WALLICH. This change in consumer behavior, as I said yesterday, strikes me as very significant. If, now, in a period of accelerating inflation people don't save more but save less, there must have been some change in their evaluation of the situation. The most plausible guess, it seems to me, is that in '74 people were genuinely scared. They didn't know where the economy was going and whether they were going to have a job, so they cut back on average. Now with a more moderate recession predicted, there seems to be less



of that fear. On the other hand, there's a more rational attitude that if they buy now they save 13 percent. They are buying; they did buy cars, which was perhaps the first wave of that. Now they are buying something else. You are quite right that [consumer spending] seems to go from one thing to another. But I would argue also in looking at consumer debt, which has risen relative to income, that the consumer probably looks at it in relation to future income. So, with future nominal income rising, the debt ratio to him appears less than it is.

My main comment is on the nature of our staff's forecast. It is in a sense a formal exercise because you don't give weight to the political probability of a tax cut. So this [forecast] is what would happen if the things that are already planned and decided were to happen. The Board staff's forecast is under those of forecasters who are not bound by that constraint; I think those forecasters generally accept and expect a substantial tax cut sometime this year. Therefore, the shape of their recession is different. Their recession is shorter than ours and its end is different; instead of saucerizing out very flat, it comes up more V-shaped. And their inflation expectations--although I don't know this for a fact, but it seems logical from these differences in their view of the income pattern--should be higher than ours. Can you say anything about outside forecasts and the like?

MR. KICHLINE. I think your description of those forecasts is quite correct; most major models do have a somewhat deeper or perhaps the same decline, though shorter in duration, and a much stronger recovery. DRI is one example and that's clearly their forecast. On the inflation side, curiously enough, the Board staff's forecast would be in the upper range of inflation rates of outside forecasts that I've seen for 1981. In part that's attributable to the fact that many of the outside forecasts with a stronger recovery generate more productivity and they've incorporated a tax cut that removes the social security [tax] aspects. But I think the conditional assumptions here are very different from those being used by most outside forecasters.

CHAIRMAN VOLCKER. Your assumption of the impact of that social security tax increase on prices was what in 1981?

MR. KICHLINE. Well, we think it will be close to 1 percent without a constraint on the time horizon. We think it's probably closer to 2/3 of a percentage point or something like that in 1981. Compensation goes up by 3/4 of a percent because of that effect and we assume it will be fairly quickly passed through in the form of higher prices.

MS. TEETERS. What sort of a monetary interest rate projection do you have underlying this forecast, Jim?

MR. KICHLINE. We have a moderate decline in rates beginning in the spring and going on; the 3-month Treasury bill rate we assume will [drop to] around 10 percent in the spring [and will drop a bit more through] the third quarter and rise slightly thereafter to 11 percent in the second half of 1981.

MS. TEETERS. So it's basically a very restrictive monetary and fiscal policy.

MR. KICHLINE. Oh, yes.

MR. PARTEE. That's based on what--6 percent M1 growth?

MR. KICHLINE. Right.

MR. PARTEE. Is that M-1A or M-1B?

MR. KICHLINE. It's M-1A, but I'm not sure we would want to forecast a great deal of difference in interest rates on the basis of M-1A and M-1B.

MR. BLACK. Jim, I was a little surprised about the magnitude of the announced increase in real GNP for the fourth quarter. Where would you guess that will end up after the final revisions are in?

MR. KICHLINE. We don't have any additional information; in fact, I'm not sure that the Commerce Department has anything in the way of hard evidence right now. All of the data for December are essentially missing, including retail sales. The obvious assumption would have to be that consumer expenditures are even stronger than we have now in our forecast. [We have] a bit higher federal expenditures than Commerce had, a little higher exports, and our inventories were a little higher, I believe. So the major source of the difference is consumer spending. Our information, for what it's worth, would suggest to us that real consumer purchases in December were not that strong. We had built into our forecast an increase of about one percent in nominal retail sales increases in December, excluding autos, so it's virtually no increase. And if [Christmas] turned out to be a strong season, that 2 or 2-1/2 percent kind of number could well come out. I would be very surprised if it were 3 percent or higher. But a 2 percent number seems to me to be perfectly plausible at this point.

MR. PARTEE. 2 percent for what?

MR. KICHLINE. Real GNP in the fourth quarter.

MR. PARTEE. Okay.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Jim, first a question: I assume that these projections were glued together before the President's grain embargo statement was issued and therefore do not reflect either the suspension of additional exports to Russia nor the promise by the government for grain storage, whatever that may mean. Have you had a chance to evaluate what adjustment there might be to your forecast because of these twin factors?

MR. KICHLINE. Yes, we've looked at that. There are a number of uncertainties at this point. We don't think it will have much of an impact on real GNP. It will change the internal mechanics of accounting for it, namely about \$2-1/2 billion less in agricultural exports. And that would show up in farm inventories or government

purchases. But, in fact, for real GNP we don't think it will have much of an effect. The issue really is what price effect it might have and whether over the longer run that does change domestic and foreign exports as well as domestic production. And that's unclear. It had seemed to us that it might well in the short run lead to higher prices; but I notice prices seem to be falling, so we had that one wrong. It seems to us that the price effect is more important and we don't have a good fix on that right now.

MR. MAYO. Of course, there's also the question of what happens to the grain. It can't be stored indefinitely.

MR. KICHLINE. That's right.

MR. MAYO. My other point is an observation. It seems to me that one of the factors making consumers spend much more is that, for better or for worse, they have had such an increase in the equity in their homes that they consider that their kitty. That could be very dangerous if there is a prolonged slowing in [housing prices]. But I know of instances involving personal friends who feel much more prosperous and are willing to spend more of their disposable income just because they have a house that they think has gone up in value by 50 percent in the last couple of years.

MR. PARTEE. Although there was a decline in the saving rate in the second half of the year, do you mean they suddenly recognized their wealth?

MR. MAYO. Yes. Well, don't try to get me to predict the timing of some of these things; it just comes in waves. As we said, the product--whether they're buying automobiles or refrigerators or whatever the composition is--is elusive here. But [the rise in home prices] seems to me to be an important factor.

CHAIRMAN VOLCKER. Mr. Willes.

MR. WILLES. Following along your question and Governor Wallich's comments, I'd like to ask Jim a question and then reserve the right to comment on what I think his answer will be. The Chairman forced you into a policy recommendation on fiscal policy. Would you indicate--you've got to have some idea in mind since you gave that statement--what that would do to your own forecast? Would you be willing to spell that out?

MR. KICHLINE. Well, in terms of price behavior, we have performed some exercises with our quarterly econometric model to get some notion of the impact of something like a mid-1980 tax cut in a range of about \$30 to \$35 billion. We think that by 1981 that probably would result in a reduction in the rate of increase in the deflator by about 3/4 of a percentage point from what it otherwise would have been, and [a larger decline] over a longer time horizon. At the same time, it would have small impacts on real GNP; we think real GNP might be up by 1/2 percentage point or so.

MR. WILLES. The tax cut would lead to a reduction in the deflator?

MR. KICHLINE. That's because it's oriented toward social security and business fixed investment and not toward generating additional direct consumer expenditures. So, I gave you an answer that was different than you thought.

MR. WILLES. But in a way even better.

MR. AXILROD. President Willes, that tax package is essentially the difference between Strategy 3 and Strategy 4 on page 11 [of the Bluebook].

MR. WILLES. That's what I thought. Well, we've been having a lot of discussion about tax cuts and responding to recession and so on, which is a conversation that is similar to those we've been having for the last 10 years. And the only comment I would make is that we do that based on models that have proved to be off track almost every year for the last 10 years. That suggests to me that we have something misspecified. Of course, some of us think we know what that is. And I just think now is a time when we're going to have to be very cautious about what we think we really can do to try to have an impact in a systematic way on real variables. I think we all agree that we can have an impact on inflation; but it's not at all clear, based on the Fed's model--or any other model--that we have had to revise virtually every year because it went off track, [that we can have an impact on real variables]. Our view is that the model has gone off track because it's misspecified; and it's misspecified in such a way that it does not make it a reliable tool to use to do these kinds of exercises. I think we play a very dangerous game if we think we can say with very much precision that we're going to have an impact on these real variables by cutting taxes \$30 billion or \$50 billion or whatever it is when the best guess at the moment, as far as I can tell, is that all it will do is have an impact on inflation and have practically no impact on unemployment or real GNP or any of these other things that we really would like to get a handle on.

CHAIRMAN VOLCKER. Let me just see if I understand what you're saying. You're saying that a tax reduction of any sort will have an adverse impact on inflation and not too much impact on the real economy, you suspect.

MR. WILLES. I think at the moment that's the best guess.

MR. PARTEE. There's no impact on real activity through government policy?

MR. WILLES. No, I didn't say that. Clearly tax policy, monetary policy, and lots of things can have an impact on real economic activity. But as far as we know it can't have a predictable impact. We're going to change lots of things. Any time tax policy changes it's going to change things. It changes incentives, it changes functions, and so on. The question is: Can we predict in a fairly reliable way what that impact will be? And I don't see anything that suggests that we can because all the models that we have used to try to make those predictions have proved to be misspecified. And there's no reason to suppose that they are any better specified now than they were ten years ago.

MR. WALLICH. Are you simply saying that the variance around the forecast is wider? Or are you saying that the forecast is--?

MR. WILLES. It's not a question of variance. It's the fact that the parameters are unstable and will respond, in our view of course, to expectations. Therefore, by failing to factor expectations in, we've completely misspecified the shape of the economy. Ten years ago that would have sounded like an absolutely absurd assumption. I think now the evidence is rather considerably on that side. I just want to point out one thing. I think people as they've heard me talk about it have said: Well, he was a monetarist and this is just one mode of monetarism. The theories that we're talking about were primarily developed by Keynesians. In fact, the people around our place who have done the most work on it originally came to us to work on optimal control theory and used a model like the Fed model to develop optimal control techniques. So, it's not as if it's just the monetarists who think they've found a new tool to play with. I think it's a very serious challenge to the bases we've been looking for in terms of making the kinds of decisions--

MR. SCHULTZ. But don't you think, even though one could view this as very imprecise in terms of the numbers we come out with, that we can predict the direction? Isn't that really the more crucial question?

MR. WILLES. Well, the best guess that we can make, if we try to make adjustments--and one can't do this in a very precise way, of course, except in a very simple model--is that, yes, we can predict the direction fairly precisely. But the extent we can predict what would happen to real output is essentially zero.

MR. PARTEE. Then you are saying that we can't affect aggregate activity through government policies.

MR. WILLES. Yes, on average.

MR. PARTEE. This is very, very [specific].

MR. WILLES. Yes, it is. There's no question about it. But the evidence--I'm not sure I'm happy to say it but I will--is increasingly consistent with that view.

MR. COLDWELL. Jim, in your forecast you said you used 6 percent monetary growth as a base. Did you play around with this to take into account some alternatives to the Bluebook with the idea of maybe 3 percent for the first half and 6 or 8 percent in the second half?

MR. KICHLINE. No, we did not. The exercises that we did, using the model, are presented in broad form in the Bluebook. We did not for this meeting go into any other alternatives, of which there are an infinite number of possibilities.

MR. COLDWELL. Could you say what, let us say, 4 percent across the board would be?

MR. KICHLINE. Well, we took 4-1/2 percent and 7-1/2 percent. And the results for the year are shown in the Bluebook. We did not

use alternative paths that would have something like slow money growth and then fast money growth within the years.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. I get lost in the fiscal forest. For a number of years we had budget results in which expenditures fell below appropriations. To what extent is this going to be reversed? Plus the fact is that there is no reason why one can't anticipate next year's appropriations; orders [and] expenditures come later. And I don't quite know what you assume on those off-balance sheet activities such as Chrysler and other things. To what extent might we get a real surprise on the expenditure side or the orders side, as contrasted with this?

CHAIRMAN VOLCKER. Let me just add to Willis' question. What are you assuming about special government measures or Home Loan Bank measures or whatever?

MR. KICHLINE. We have built into the forecast government subsidized [housing] units of 300,000, which is pretty much in line with what the Administration talked about. That's 50,000 more than in the last fiscal year.

CHAIRMAN VOLCKER. It doesn't mean, then, that they are cranking up the tandem plan?

MR. KICHLINE(?). Well, that's part of it, but it's not a major cranking up of the tandem plan. As you know, the budgetary impact there is quite variable; it depends on when the government sells those mortgages. It's an interest [subsidy] that ultimately shows up in the federal expenditures. On the authorizations, that's a difficult question because we have built in a significant increase in defense expenditures along the lines of the Administration's proposals. That could well go higher. A good deal of what the Administration is proposing we have assumed will result in authorizations, but not expenditures, particularly not in the short run. To the extent that the defense sector is geared up more rapidly, there is a bigger increase in actual federal outlays. I think that's conceivable, and it would obviously feed into the real side forecast, particularly in 1981. So, we've assumed a good deal of lag between authorizations and expenditures. I might note that defense ordering has in fact picked up a good deal. And in the fourth quarter, one of the factors--not the main one--leading to a significant increase in federal outlays was a pickup in real defense expenditures.

MR. WINN. I'm somewhat amazed at the amount of money that's suddenly showing up in Cleveland. I don't know if that's the subject of charity coming home or what but the money seems to be coming out of the woodwork for that sort of thing. I'm gathering that this is really going to mean that this year we're not going to have any appropriations that weren't spent.

SPEAKER(?). That could [mean] a very big difference in the federal spending.

MR. MAYO. One of the aspects of this that is important, too, is the extent to which there is excess capacity in the defense

industry that could take up a significant increase in defense spending. We learned again in the Vietnam conflict that we couldn't spend as fast as was budgeted because the factory wasn't there; they had to tool up and so forth. It takes a much longer time to acquire a sophisticated product. But that is one of the considerations that perhaps--

MR. WINN. Related to that is the fact that inventories are rather tight and [are being carefully] watched in most of these special sectors. If we get any change in that area, we're going to see explosive prices and people scrambling for the short supply.

My final comment is that I'm struck by the number of people who tell me they're now pricing for inflation. They tell me they tried a price increase in midyear but it didn't go because their competitors didn't meet it. They tried a price increase in December and not only did their competitors meet it within 48 hours but they [moved] ahead of them in terms of the prices themselves. There seems to be an explosive development related to the inventory shortage in this area.

MR. KICHLINE. I'd like to correct the response I gave Governor Coldwell. We did not assume a flat 6 percent quarterly money path. It's 6 percent QIV 1979 to QIV 1980; but in fact we have built into our current forecast about 5-1/4 to 5-1/2 percent growth in M1 in the first half of '80 and about 6-1/2 percent or so in the second half.

MR. COLDWELL. But you didn't do any alternative scenarios?

MR. KICHLINE. No.

CHAIRMAN VOLCKER. Are there any further comments on the business situation? If not, we'll turn to the decision we have to make. Just by way of background, and summarizing yesterday's discussion, I thought there was a good deal of skepticism expressed around the table about the idea of seeming too precise much beyond 1980. I do have some concern myself about the point Mr. Baughman made that it may be a little hard to escape when [we are pressed for] some notion of what we're going to do after 1980. But the advice in sum seemed to me to be cautious on that side. There seems to be a pretty strong consensus that a range of a few percentage points [for the growth of the aggregates] is about right. As to possibilities within that kind of range, I don't want to prejudge where people are coming out on annual policy itself. There was a fair amount of [sentiment] for [growth] between 4-1/2 and 5 percent; there were some for a little above 5 up to 5-1/2 percent. I think virtually everybody was saying growth probably ought to be lower than what it was last year by some definition of what it was last year. So I think we are in that general area; it does affect what we do in the short range to some extent. It may be graduated in our individual minds anyway. It should be. That kind of background is useful to our short-run discussion. Why don't you introduce that subject, Mr. Axilrod.

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

CHAIRMAN VOLCKER. In turning to this matter, let me just mention a couple of things. As Mr. Roos said yesterday, given the new

technique we are using and all the complications of an annual and a short-term horizon, the Bluebook was put together admirably in my view. It does take a quarter's time horizon for this particular decision. That's arbitrary, and we debated as to what the right time perspective was. If anybody has any comment on that, they could offer it.

MR. PARTEE. The Committee on the Directive tried valiantly to get that put in a year ago without success. So we're happy.

CHAIRMAN VOLCKER. Well, it could be longer or it could be shorter, but it seems to be a tentative compromise anyway.

MS. TEETERS. Is it going to roll forward?

CHAIRMAN VOLCKER. Yes, presumably. I don't know whether we thought this all through, but I guess the presumption would be that in February we will have the next three months, if we continue in this framework. Now, that's--

MR. AXILROD. But it would be related to the path. You wouldn't lose sight of the longer-run path.

CHAIRMAN VOLCKER. It will always be related against the--

MR. AXILROD. We would continue to present the growth rates for the whole year as we go on.

CHAIRMAN VOLCKER. We thought of doing it for six months, but it's an arbitrary decision.

MR. COLDWELL. The three months is starting January 1st through March 31st?

MR. PARTEE. December.

CHAIRMAN VOLCKER. December to March is the way you calculate it.

MR. AXILROD. I presented December to March, and we have in the text the quarterly average growth rates that are roughly consistent with it.

MR. COLDWELL. Does it include December or does it not?

MR. AXILROD. December is the base. It's essentially the growth rates in January and February and March averaged.

CHAIRMAN VOLCKER. What is the difference? I didn't pick up on that. All these numbers you were giving here are the December-to-March figures. If you have 5 percent growth December to March, what does that make the quarterly average?

MR. AXILROD. The quarterly average is 4-1/2 percent. They're running about--

CHAIRMAN VOLCKER. Just a little lower.



MR. AXILROD. Just a little lower this time.

CHAIRMAN VOLCKER. In Steve's comments he raised the question repeatedly about whether the Committee, in effect, has any preference as to how interest rates evolve during this period. You can have different points of view on that: That you don't care or that it's a very important question. I would think comments on that point are relevant, if you think they're relevant. The only other point--I put these points down here earlier--is that I think the most certain thing about the economic forecast is that during this particular 3-month period we are very likely to have a higher consumer price index, for all that means in terms of expectations and problems of various sorts. So with that, we'll proceed. Mr. Roos.

MR. ROOS. Mr. Chairman, I am concerned about what you alluded to as a thread that ran throughout Steve's comments indicating a continued concern about interest rates because interest rate movements would affect output one way or another. It seems to me--and I don't say this critically in your direction, Steve--that we did adopt and publicly announce a new program whereby, within broad limits, we were going to permit interest rates to fluctuate freely in order to concentrate on the control and gradual reduction of money growth. I think we will frustrate our whole purpose and the possibility of succeeding in this new approach if we have tucked behind in our minds all the time the view that a primary, or at least very important, aspect of what we're doing is somehow continuing along the path that we were on of trying to control interest rates and hope that in this process we can achieve some [reduction of] money growth. I don't think we can have it both ways. I would ask Steve: Is the staff still imbued with a real concern about interest rates?

MR. AXILROD. The staff believes, I think--and I can't talk for everyone--that decisionmaking in the economy is affected by the level of interest rates and credit availability. On the other hand, the staff believes, or at least I do, that it's difficult for the Committee to make a priori decisions about the proper level of interest rates. That's why a money supply target is important because then those decisions come out of the market to a great extent. However, because we believe that decisionmaking by businessmen takes into account credit costs and availability, it seems important to try to suggest what the pattern of interest rates might be in the course of the year, and that's what I was trying to say. If the Committee adopted a pattern of money growth in the course of the year because it was chasing a long-run target and got way ahead of it early in the year and then wanted to catch up for credibility reasons late in the year, that might imply a very high interest rate. You may not want that, so you may want to give up on your long-run target, which could be one credibility problem. If we have very high interest rates, I believe it would have effects on economic activity in 1981. If we entered the year with 15 percent, I think economic activity in 1981 would be slower than we've been projecting. I've asked Mr. Kichline for verification of that.

MR. ROOS. Let me just ask this. There has been reference made to the possibility that interest rates would drop. I noted with interest and with admiration the fact that the Chairman in a recent speech said publicly to the world: Don't be concerned if interest rates drop because under our new practices interest rates could

conceivably drop and not signal any easing of policy. Now, isn't it possible, through the utterances of the Chairman and others, to say that we have somewhat of a new ball game? We're doing this differently and people should stop thinking along the lines they have been accustomed to thinking over the last 10 years because the last 10 years certainly didn't bring the desired results. I'm fearful that we're just letting ourselves be a little bit pregnant and running all over the lot.

MR. AXILROD. But, President Roos, to be very brief, I was simply addressing myself to the question--raising it for the Committee --of whether you want low growth of M1 in the first half and high growth in the second half or [vice versa] because the Committee has to make that decision, and there are certain implications. That's what I was trying to get to.

CHAIRMAN VOLCKER. If I may say in this connection, Mr. Roos, I think we've got a spectrum over which we can operate. We used to operate with very tiny changes in federal funds rates from time to time, or between meetings certainly, and not very large ones even at a meeting. There is no doubt that we have changed; in my opinion, the emphasis is quite different now. But in some people's minds it may be different than in other people's minds. That does not exclude necessarily some predilection about which way to bias this in the short run. People may have some druthers one way or another without at all implying that we're controlling the federal funds rate the way we did before. But one might want to lean in one direction or another. Maybe other people wouldn't want to lean in one direction or another. But we don't have to make it a choice between dismissing from the minds of everybody around this table any concern about interest rates and going back to what we were doing before, which was a very close focus on the federal funds rate within a quarter percentage point. It's just that we've got to make some decision. The decision is made in terms of the money supply, but that decision at any particular meeting may be biased in some people's minds by some guess, anyway, as to where they would prefer the interest rate music to accompany it--the treble to accompany the base or whatever that [expression] is.

MR. PARTEE. You don't have to recant in the presence of--

MR. WALLICH. If I may follow up on this. The purpose of a money supply target presumably is to force wider swings in interest rates. If we stick to the same rate of money growth through expansion and recession, we'll get very wide swings of rates, wider than we've been willing to impose by acting a priori, as Steve said, on the interest rate. But to me that doesn't mean that it is logical to move to severely negative real interest rates because we have a recession. There are considerations of having a positive or a negative real interest rate, and to my view the ability to swing widely toward a low interest rate is limited by that. It should not become severely negative.

CHAIRMAN VOLCKER. Perhaps we could combine comments on this conceptual and theoretical point with practical comments on where we should put the money supply target in the next month. Mr. Eastburn.

MR. EASTBURN. Well, I would like to respond to Steve's comments about the path of money growth. I think where we go on this depends on how smart we are.

CHAIRMAN VOLCKER. You're not assuming too much on that?

MR. EASTBURN. My conclusion from listening to the discussion before is that we're really not all that smart as to be able to do that. And that forces me into the position that if we have as a long-range strategy a gradual reduction of money growth, we ought to figure out where we want to start and pretty well stick to that. That puts me, since I came out yesterday at about 5 percent for 1980, with alternative B. I don't mean hold to that inflexibly if unexpected things develop, but I just don't think we're able to do the kind of fine-tuning that is suggested by the Bluebook in terms of front loading or rear end loading or whatever. I'd just put down 5 percent and stick to it until we decide we have to make some kind of a change.

CHAIRMAN VOLCKER. Mr. Coldwell.

MR. COLDWELL. Well, Mr. Chairman, it seems to me that the direction we're working on here is to lower the [growth in the] monetary aggregates. I would accept alternative C, for which you have growth of 4 percent. I'd be willing to accept a range around that, although I'm not sure how this is all working out with single points versus ranges in the short run. But I'd be perfectly willing to accept, say, 3-1/2 to 5-1/2 percent or something like that. My present predilection would be to accept a lower level in the first half and see what the second half brings. Because my primary objective is to try to get some impact on the price level, I'm not sure that I totally agree--in fact, I'm fairly sure I don't agree--with what the staff is saying, which is that we can't have some impact on prices here. I doubt very much if this long-range low growth saucer forecast is really a reasonable one over a long period of time; things will change. A recession is likely in the next year; it's timing is uncertain. And I'm reasonably sure that something will come up and destroy that lovely little package over the next 8 quarters. The complex of political as well as economic and foreign factors is such that I would opt for a lower level in the range, particularly since we got something in the 3-1/2 to 4 percent area in the fourth quarter, as I recall, Steve, rather than the 4-1/2 percent we were [expecting].

MR. AXILROD. We got 3 percent from September to December and 4.9 percent, I think, for the quarterly average.

MR. COLDWELL. Yes.

CHAIRMAN VOLCKER. Just for purposes of clarification, Governor Coldwell, when you began talking about a range, is that merely a reflection of our frailties in achieving the number or do you have something in your mind about interest rates, let's say?

MR. COLDWELL. Well, I was coming to that, Mr. Chairman. The range I put down was partly because of our frailties in achieving a number, and I'd give the Desk a little guidance rather than just leave it to the Manager to make some ad hoc decisions on it. But it also reflects some interest in the interest rate package. Contrary to Mr.

Roos, I think interest rates are an important element of the impact both on expectations and on consumer and capital expenditures. So, I'm unwilling just to wash my hands of interest rates and say "Go where you want to go." I don't think it's likely [to have no impact] internally, and I think it's even less likely to have no impact externally in our relationships with other countries.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. As I indicated yesterday, Mr. Chairman, my preference on the long-run targets would be to go mainly with M-1B. It increased at a 7.3 percent rate last year and I think 6 percent is a reasonable rate for [this year]. If the relationships set forth over the next year between the old M1 and M-1B hold in the future, this would suggest that the appropriate long-run range for M1 would be about 5-1/2 percent. Against this background, I think we ought to be working down our target growth rates and I would favor alternative B. Now, that does specify rates that are below what I've indicated I thought was probable for M1 and M-1B, but I would be prepared to support that for three reasons. One is that I think we still have a very serious credibility gap. I find few people in the financial markets who really believe that we're going to stick with the policy we announced October 6th. So, I think we need some low growth rates very quickly in order to better establish our credibility. The second reason why I would favor being somewhat lower in the beginning is the point that Frank Morris made yesterday: This seems to be about the only time we can get the growth rates down. That may be in part because the market used to determine to a greater degree how much money it got than it presumably will under this new system, but there's still an element of that in there. And then, third, past experience has shown that we usually get bursts in the aggregates in the second and third quarters. While that may have stemmed from bad seasonal adjustments or the old methodology, I'm still suspicious that it might happen [again]; so I would like to get some pretty low figures under our belt before it does happen, if in fact it does. So far as the range for federal funds is concerned, philosophically I'd like very wide ranges and would be tempted on purely philosophical grounds to widen that range, particularly at the low end. But this is not a time to stand on pure philosophical preferences because it's undoubtedly true that foreigners and people in this market, too, are paying a great deal of attention to what interest rates are doing. So, I think it's important that we not let the rate go below 11-1/2 percent, and I would put that as a floor until such time as we have better credibility than I think we now have.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I'm pretty sympathetic with Dave Eastburn's comments. I think fine-tuning is difficult in practice, and I would point out that the main misses that we've had have been large misses. That is, it really isn't that we expect 5 percent and get 4 percent. We expect 5 percent in a month and get zero or a minus; or we expect 5 percent and get 10. That has been the nature of the chunkiness of that demand function for money, and I think that demand function is there just as it always was. The question now is: What kind of response will a sudden change in the growth rate of money bring in terms of policy? I guess I would say that under our new procedures it would bring a very abrupt and considerable change in interest rates,

either up or down. So, without fine-tuning I rather like the 5 percent on the old definition. I guess we're talking about current definitions, aren't we?

CHAIRMAN VOLCKER. Yes.

MR. PARTEE. We would specify it in current terms. I like the 5 percent of alternative B, partly because that would give us 4-1/2 percent for the quarter which, if we get it, will be on the moderate side from the standpoint of the ranges that we choose for the year. I would be willing to tolerate a little shortfall from that 5 percent, say, to 4 percent. But if it comes in significantly weaker than that, I think we would want to be supplying the reserves and we would want to be seeing interest rates move. There is something to what Larry says, although he perhaps overstated it a little, that we have to be prepared to see interest rates move in response to a need. I would like to see us take the alternative A specifications of 7-1/2 and 8 percent for M2 and M3 rather than those in alternative B. We don't really know what success that new [floating rate] certificate is going to have. It's being advertised very strongly by the thrift institutions and I wouldn't want to see us tighten up because it happened that the thrift institutions had a good inflow from the promotion of the 2-1/2 year certificate. [On the funds rate,] I think we're a long way from either 11-1/2 or 15-1/2 percent and I don't see how we could get to 11-1/2 percent without taking action on the discount rate. So I would leave that range right where it is at 11-1/2 to 15-1/2 percent.

CHAIRMAN VOLCKER. Mr. Kimbrel.

MR. KIMBREL. Mr. Chairman, I continue to be concerned about the expectations and realities of our price level and about the possibility of the influence we can have on our exchange rate frailties at the moment. I'd be very anxious to reaffirm our posture, a posture that would indicate a continuing steady move to a general reduction of the growth rate [of money]. I recognize that this might very well contribute to interest rate changes, but [with] some more flexibility. But in the real world we simply have to be a little attentive to the level of [unintelligible]. I think we cannot move quite that abruptly. All of that leads me to feel that I'd be rather comfortable with the numbers associated with alternative C.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, I want to make a couple of points. First of all, I want to agree with Dave Eastburn's philosophy of not monkeying around with fine-tuning among the quarters. This makes us think we are smarter than we are, among other things, to use his language. The purpose here is to set a long-term range and, unless we see some rather dramatic reason for changing it, to make our quarterly [objectives] basically consistent with that, subject to some small variations--and I mean small--that Steve may feel he has to introduce into the staff projection. I feel also, although we have made a giant step forward in moving [from 2-month horizons] to September-to-December and now December-to-March [time periods], that we need to make one more refinement of that in the interest of not being too overwhelmed by monthly changes [in the growth of money]. It would be much better if for the current quarter, or the decision which is being

made today, on January 9, to use the month of January as our center month and in effect take the fourth quarter of 1979 and go to the quarter centered on the current date. That means comparing the average for the fourth quarter with the average for December, January, February. Next month we would do January, February, March; in other words, it would be literally fourth quarter-to-first quarter. I think that makes a lot more sense and gets us over part of our hangup where we spend, it seems on occasion, an interminable amount of time trying to explore the seasonal adjustment deficiencies of a given month. Granted that going to three months is in the right direction, I would urge strongly that the Committee consider going from quarter to quarter. It may look awkward because in the first instance in effect we have to have December at both ends of our equation. But as we move on out, of course, that overlap would not occur. It's just a neater proposition and would help in the smoothing of this. Again, the point is--and I think Dave made it effectively--that we can do a better job that way.

I would add that I prefer alternative B partly because I like the 3 to 6 percent long range and the 3 to 6 percent short range, which yields a midpoint--whether by coincidence or not--of 4-1/2 percent for the quarter-to-quarter change. I guess that is for the fourth quarter to the first quarter literally, Steve. I don't know what it would be for December, January, February; maybe it doesn't make much difference. I feel very strongly that the answer to the question of "Do we pay attention to interest rates?" is that, of course, we pay attention to interest rates. We pay attention to interest rates just like we pay attention to real GNP, unemployment, and an awful lot of factors. In my mind we shifted in the October 6th package from a primary public emphasis on interest rates to a primary public emphasis on the aggregates, with the targets going through reserves. We have not abandoned all of our secondary emphases. We emphasize plenty of things, one of which has to be interest rates because we live in the real world and the execution of monetary policy must be through a market that pays attention to interest rates. There's no substitute for that; at least I've never heard of one in our type of society.

One other point: I think the Federal Reserve System would be making a serious mistake to publish M-1A and M-1B and M2 and M3 and L and say to the world, in effect: We don't know which of these is right; take your choice. Now, I'm perhaps overstating. I would pick M-1B myself and call it M1, drop the B. And if we have to qualify the description of it because of NOW accounts or other changes, we should qualify it. But we are being almost too research oriented, too much students of this rather than decisive leaders. If we can't determine which one we think is better, with some qualifications and so forth, nobody can. And I think our leadership role depends in large part on our ability to go through this whole redefinition of the aggregates and to avoid coming out with a definition that looks like the mouse has really squeaked by coming up with M-1A. I would recommend strongly that we publicize M-1B as M1. We can handle the consequences. End of speech.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, it seems to me that the targets set out in alternative C have a good probability of coming pretty

close to serving the needs of the environment as they unfold in the next couple of months or so. I've been rather impressed with the observation through time and in conversations here that we can't have much influence on how the expansion in money and credit is allocated between production and prices. The indication is that the structure of the economy and expectations are tending to allocate it more and more to prices and less and less to production, which leaves us in an awkward situation of simply embracing or accepting it or seeking greater slack in the economy--and probably for a fairly long period of time--in order to make some increased impact on the inflation problem. But it seems to me that the inflation problem must be given priority in part because the darn thing just keeps getting worse and worse. I'd be prepared to accept pretty much whatever interest rate pattern evolved during the appropriate time period as a result of pursuing these quantitative targets.

CHAIRMAN VOLCKER. Mrs. Teeters.

MS. TEETERS. Well, I want to ask a question first. Your economic forecast is based on a 6 percent rate of [money] growth. If you take the rate of growth of money down another full percentage point, what does that do to real growth and to the unemployment rate?

CHAIRMAN VOLCKER. You did assume that the rate of growth in money would be slower in the first half of the year?

MR. KICHLINE. Yes. The staff forecast is based upon the money path of alternative 1 on page 15 in the Bluebook, which is 6 percent for the year. It's slower in the first half--I think it's around 5-1/2 percent and then 6-1/2 percent in the second half--but the short-run path consistent with that is alternative B.

MS. TEETERS. What happens if you reduce that path by a full percentage point?

MR. KICHLINE. Do you mean for the long-run target or the short-run target? In the short run, if you stuck to the 6 percent target mentioned and simply altered the money path for one quarter and then picked it up the next quarter, it really wouldn't have a significant impact on inflation or real GNP.

MR. AXILROD. Governor Teeters, there's a degree of fine-tuning in the numbers here that has to be taken with a grain of salt. But on page 25 in appendix C, if you reduce that 5 percent to 4 percent and still aim at something like 6 percent M1 growth, which is what Jim's assumption is--that's the third column under alternative C--you'd end up in the fourth quarter with a somewhat lower funds rate than under his basic assumption to make up for the greater restraint now. That's in essence what that would tend to lead to. Similarly, if you had a 5-1/2 percent long-run growth, which we have not shown here, the funds rate in the fourth quarter would probably be somewhat lower under a short-run alternative C path than under short-run alternative B path.

MS. TEETERS. I'm not sure I got a [complete] answer. My inclination is that if we cut [money growth] below the 6 percent that's in the forecast for the year, we'll have a more severe recession on our hands as we keep the interest rates up. I have a

great deal of sympathy with Dave Eastburn's point of view that we should stick to a number and let the interest rates fluctuate. Where I come out is that I'd like to see a 5-1/2 percent growth rate for the year as a whole and I'd set a target of approximately 5 percent for the quarter to give us a little range to meet the needs at the end of the year. I don't think, frankly, that we can undertake a policy for 3 years of consistently reducing the rate of growth of money supply. I just don't think that's in the cards for us in terms of what's going to happen in the economy. We've brought the rate of growth down consistently now for 3 years, but there's a certain minimum to which we can get and I don't think it's 3 or 4 percent. We are going to get ourselves into a position of setting a target which is so much too low that it's either going to have severe impacts on the real growth of the economy or we're not going to meet our targets. Realistically, we're going to [have to] come down to a plateau for growth of the money supply and try to hold it there rather than reduce it a percentage point year after year; and a rate of growth in the money supply of about 5-1/2 percent strikes me as about where that minimum is, given the other things that are going on in the economy. So, I can buy alternative B for the quarter, but I do have a higher target for the year as a whole.

CHAIRMAN VOLCKER. Mr. Timlen.

MR. TIMLEN. My preference, Mr. Chairman, is for alternative C. I think it's consistent with efforts to reduce the growth in the aggregates over the year 1980 and also consistent with the [view] that the basic economy may be slowing in the first quarter. I think it would have an important impact on inflationary expectations and help our credibility. It will also [add] strongly to the message conveyed in terms of the relevant interest rates in the foreign exchange markets, where I must say the emphasis is on interest rate levels as opposed to the movements against reserve targets. I don't have a strong feeling on what the federal funds range should be, whether it should be 11-1/2 to 16 percent or 11-1/2 to 15-1/2 percent. I'd just as soon stay with the existing range of 11-1/2 to 15-1/2.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I continue to think that the economy moves on interest rates. If I rely on the money supply, it's because in [a period of] inflation I think that's a better way to get the right interest rates than to try to do it outright. But I don't regard the money supply as a black box where I have to accept everything that comes out. So if an unreasonable interest rate comes out, I reserve the [option] to evaluate that on its own terms. As Nancy said, we have reduced the growth of the money supply for 3 years running and have brought inflation from about 7 percent to 13 percent in doing so.

MR. PARTEE. With able help.

MR. WALLICH. With able help from various--

MS. TEETERS. We really brought the real rate of inflation from about 7 percent to 10 or 11 percent, Henry.



MR. WALLICH. Well, we can argue about the numbers, but [inflation] has gone up while the growth of the money supply as we define it has gone down. So I lean toward the tighter side for the long term, alternative II. And within that framework I lean toward alternative C in terms of the old definitions of money. I don't care whether we use the old or the new definitions, just so we don't misunderstand. I would go with the numbers that are in the Bluebook under alternative C: 4 percent for M1; 6.5 percent for M2; and 7 percent for M3. I would raise the lower end of the funds rate from 11-1/2 to 12 percent and make the top 16 percent. I agree with Chuck that before the rate got to 11-1/2 percent we would probably find ourselves making a decision about the discount rate anyway.

MR. BLACK. Henry, did you say you would change the top of the funds range to 16 percent?

MR. WALLICH. To 16, yes. And the bottom to 12.

CHAIRMAN VOLCKER. Mr. Willes.

MR. WILLES. Thank you, Mr. Chairman. It's amazing to me how I can have such a fundamentally different view about how the world works than Chuck Partee and yet find that he stated my policy position much more eloquently than I could ever state it. Whatever you wrote down for Dave Eastburn and Chuck Partee, write down for me and that would be great. I would just say that on Bob Mayo's point, it's not clear to me that a bad decision is better than no decision at all; I think we ought to publish all the numbers and let people help us find out--

MR. MAYO. I'm not arguing against that, but I think we should indicate a dominant preference.

MR. WILLES. I don't think we have enough information.

MR. PARTEE. We will [indicate our preference] in the Policy Record, certainly.

MR. MAYO. We are forced to do it. Let's be proud and carry the flag and not say we don't know but maybe this is the better of the two. I see us being too academically sound, if I can put it that way, rather than carrying leadership for a figure. And if we can't carry that leadership, nobody can.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I think alternative B looks good, even though I came out yesterday for a 4-1/2 percent midpoint. I feel that if we are going to bias the flow during the year, it ought to be the opposite of what most people have been saying. I think the rate of growth in the early part of the year ought to be greater and the rate of growth in the latter part of the year less because I think we will be better off with a saucer-shaped recession than a V-shaped one. So, to the extent that we can obtain these [rates of growth], it's such a weak economy that it should help to cushion the extent of the decline and hopefully produce a more saucer-shaped than V-shaped recession.

CHAIRMAN VOLCKER. You hope to produce a more saucer-shaped than V-shaped one [and would] increase the money supply more rapidly in the first part of the year and less rapidly in the second part.

MR. MORRIS. Right. Traditionally, following our earlier policies, we have supplied very little monetary growth in the early part of a recession. We have encouraged a sharper decline in the economy thereby. We lagged in reducing interest rates and then when the unemployment rate got really high, we turned around and produced very rapid rates of growth in the money supply. That led to very big swings in the economy, which I think are counterproductive in the long run to controlling inflation.

MR. RICE. May I interrupt, sir? Don't you think the shape or the depth of the recession is already determined now?

MR. MORRIS. It probably is, largely. I'm not suggesting that we can--

MR. RICE. So what we do now--

MR. MORRIS. It's just that to the extent we have to make a decision, it ought to be biased in this direction. But I'm not under any illusions that we can fine-tune this thing.

MR. RICE. I don't believe that anything we do today is going to make the recession more saucer-shaped or more V-shaped.

MR. PARTEE. Well, the second part of it could affect the character of the recovery.

MR. COLDWELL. It might prolong it.

CHAIRMAN VOLCKER. You're on, Mr. Rice. It's just that you have to expand on your comment because you are next on the list.

MR. RICE. Mr. Chairman, given the forecast for nominal GNP for this quarter which I believe is 5 percent and is, of course, very weak, and given the forecast for the inflation rate which I understand is 15 percent for this quarter, I would--

CHAIRMAN VOLCKER. The consumer price index.

MR. RICE. The consumer price index, yes. I think this is a good quarter to try to keep the rate of growth in money at the low end of the 1980 range. That would give us leeway to allow it to expand at a faster rate later on in the year if that appears desirable, and I think it will appear desirable. So for this quarter I would favor alternative C; I would be comfortable with a 4 percent rate of growth for the next 3 months. Also, I think this is not the time to accept a sharp reduction in interest rates, and alternative C will assure that interest rates will not fall significantly. So my preference at this time would be for alternative C.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. Mr. Chairman, as a number of people around the table have already noted, 1979 was a nonrecession year. It's a bit of

a humbling experience in terms of our ability not only to fine-tune but to forecast. As I recall your statements on the subject, I think it's to your credit that you spoke out and said that you weren't sure we were in a recession despite announcements coming from other high places that the recession began a couple of months ago and was already half over. That's an interesting commentary on the state of the art of forecasting. In any event, given that uncertainty about our ability not only to fine-tune but to forecast, it seems to me that inflation does remain the key threat to the longer-term health of the economy--to economic growth, employment growth, a sound dollar, and so on. For all those reasons and without going into any more detail, I, too, would come out at this time in favor of alternative C.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I, too, would opt for alternative C, taking advantage of what would appear to be fairly slow growth in money that we are focusing on in the first quarter. I would note that historically--in recent history at least--we haven't had very much growth in money in the first quarter and, quite likely, that history will be duplicated this year. To get somewhat of a head start on our longer-run targets it seems to me that we ought to accept that slow growth in the first quarter; and as a result alternative C would be attractive. I would also note that if you focus on M1, its growth even under alternative C is greater in the first quarter than we had in the fourth quarter, which turned out to be a fairly strong quarter. I don't know what that implies except that it just reinforces my thought that we quite likely will get very slow growth in the first quarter and ought to tolerate it whether it is below 4 percent or not. The interest rates are an important factor both domestically and internationally and we shouldn't lose sight of that.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I would like to be listed under the alternative B team. I think there is a possibility that "C" would represent too drastic a reduction from a higher level of money growth to a lower level of money growth, and that could have recessionary implications. So, I would opt for "B."

CHAIRMAN VOLCKER. Mr. Winn, would you like to say something?

MR. WINN. I guess I was shaken by last year's experience with money growth, so I am suspicious of almost any number we put on these things, frankly. I remind you that any number we pick is fine-tuning of a degree, and I'm not sure the numbers differ that much in terms of the fine-tuning aspect. I suppose because of last year's experience and the concern as to what will happen in the money demand area, I would probably stay with "C."

CHAIRMAN VOLCKER. Mr. Schultz, you're left; you are not volunteering.

MR. SCHULTZ. I'm just very uncertain about where this economy is going to go, particularly in this quarter. I can foresee a situation in which growth of 6 percent could be very restrictive and growth of 3 percent could be very loose, depending upon what happens. So I come out between "B" and "C" and I would hope that there's some

real flexibility for us to react as we see what actually is going to occur this quarter. I do have some concern about interest rates. I'd like to see them slowly come down as we go through the year. It would worry me if we had a sharp drop in interest rates in this quarter when we show very high inflation rates. That could be disastrous in the foreign exchange markets and I don't think it would give a very good impression to the country as a whole. I come out somewhere between the B and C alternatives.

CHAIRMAN VOLCKER. Well, we seem to have some differences of opinion, but they are not enormous. So let's ruminare a few minutes and drink some coffee and see whether we can bring this to a conclusion.

[Coffee break]

CHAIRMAN VOLCKER. Gentlemen, ladies. After great Solomonic perusal of the preferences expressed by the members of the Committee and others, and evaluation of those qualitative comments that were made--the acute ones and I discarded the others--let me make a general comment. I think, as a number of people have mentioned, that we have an image problem or an opportunity--I don't know which to call it--that is perhaps as important as the numerology at the moment. I have sympathy for the comments that said we have to appear to be quite cautious during this period, particularly until the market gets a little more settled down in terms of interpreting our actions. Substantively, I personally would not mind seeing some decline in interest rates; in fact, I think it would be desirable on the domestic side if we can get by with it on the international side. It may be a little inconsistent with the energy problem, and this is where the compromise has to be struck. Everybody was between "B" and "C" in one way or the other basically. There are probably a few more on the Committee for "C", but [the margin] is very narrow, and for the non-voting members it is a bit the other way.

Nobody talked much about the interest rate range. I would say, consistent with the desire not to have a misinterpretation of our actions, since there is not very strong reason to change the interest rate parameters anyway, let's just leave the range the same. In that respect we can say when this [directive] is published that there can be no misunderstanding about whether any change was made with regard to the interest rate parameters. I'm not sure that the bottom or top of any of the [proposed] ranges is going to be relevant during this period, as a number of people have indicated, so I don't think there is a strong reason to change the range. I would propose leaving it as is. It was also implicit in the comments that primary, but not exclusive, emphasis is to be placed on M1. That is the measure basically used to construct the paths; we don't ignore [M2], but it's not exactly a 50-50 weighting proposition. I'm not going to suggest what weight it has in any numerical terms. I think the primary emphasis will tend to be on M1, but we will keep a weather eye cocked on the M2 figure.

In terms of the range [for M1], as I said, everybody was [for growth] between 4 and 5 percent, and I would propose that we just state it in the directive as "between 4 and 5 percent," which I think is consistent with the atmospherics of the [situation]. That is open to an interpretation that I personally would not resist, but we would

draw a path on the basis of 4-1/2 percent consistent with that opening stance. But let me say that we would be more concerned about a situation where [growth] was tending toward the lower side, 4 percent or below--we can't control these things that closely--and interest rates were rising; we would tend to get aggressive more quickly, providing more reserves. And if it went in the other direction where it was drifting high, if interest rates were falling out of bed and giving us trouble on the international side we would be prompter about getting it back in the range, in terms of attitudes and judgments about the kind of path shifts that we have to make in the reserve numbers in the period. But we would start out with 4-1/2 percent.

MR. COLDWELL. I'm not quite sure you said what you wanted to say.

CHAIRMAN VOLCKER. Well, I may have said it wrong, but I think you--

MR. COLDWELL. You mean we should react more rapidly if M1 growth goes up with the interest rates falling than if M1 growth went down and interest rates were rising.

CHAIRMAN VOLCKER. No, either way. In other words, if M1 [growth] were low and interest rates were also low, we would be slow about changing. But if it were low and interest rates were high, we would change more quickly. It's how quickly we move to make the judgment, which might have to be made. It's just this judgmental issue, which we went through at least once, of changing the path in the view of what is happening.

Well, Mr. Altmann just wrote [suggested wording for] the directive which says "between 4 and 5 percent for M1 and on the order of 7 percent for M2." The latter happens to be the alternative B number. It's another way of saying something around 7 percent. So that's what I would propose for your consideration. Operationally, the question arises as to what that means in technically constructing a path. I suggest that it means 4-1/2 percent for the arithmetic of it, but we have to make this borrowing assumption in constructing the path. That seemed to be an easier decision before last week than after this week. This week has been somewhat of an aberration, where we had a high funds rate consistent with an exceptionally low--inexplicably low--borrowing level. All I can say--and I think we have to be prepared to look at it again after another week or two of evidence to see if this aberration seems to be continuing or if it seems to be reverting to the earlier pattern--is that I have a nice round number to suggest to you; that it is a round number may be its only virtue. But it falls between the earlier experience and the present experience, and the number is \$1 billion of borrowing. Now, that is lower than anything we have been dealing with up until this past week. The latest information on the money supply, as nearly as I can gather--I hate even to put this in your mind in a way, but having opened the issue I will put it in your mind--is that the tea leaves we have on the number for next week's publication would show fairly significant growth. It's not inconsistent with this 4 to 5 percent range but, if anything, it is a bit toward the upper side of that range for January.

MR. AXILROD. A stronger number, Mr. Chairman, is for [the week] we are not [yet] going to publish.

CHAIRMAN VOLCKER. It's not the number we are going to publish this week but the number we would publish next week. It's a very unreliable indication, but for what it's worth, it is not inconsistent with this kind of range. But it doesn't suggest that there is great danger of [M1] falling way down in the range in January. That's if that number means anything.

MR. AXILROD. We would be projecting a 5 percent rate of growth in January instead of 3-1/2 percent, if that number held up.

CHAIRMAN VOLCKER. So the proposal is for: 11-1/2 to 15-1/2 percent, or unchanged on interest rates; between 4 and 5 percent on M1 with the understanding that I suggested about 7 percent in M2; and starting out--but looking at that very hard in a week or two in the light of this recent aberration--with something like \$1 billion of borrowing.

MR. PARTEE. One cosmetic thing. Would it be better to say "about" 4 to 5 instead of "between" 4 and 5? It sounds very specific, as if we expect it to come between the numbers. I realize that's what we mean, but we won't accomplish it. So maybe if we said "about" 4 to 5 percent--.

CHAIRMAN VOLCKER. [The sentence] says "seeks". I don't know how--

MR. PARTEE. And "on the order of" is what you have for the second part.

CHAIRMAN VOLCKER. "On the order of" is what I have for the second part. I have the slight feeling that maybe "between" is a little better cosmetically, but it's no big deal. Henry.

MR. WALLICH. Well, I have a couple of points of uneasiness. One, it seems to me that we may be biasing this in the direction of lower interest rates by the low borrowing assumption. What happens if borrowing is higher? Then, presumably, until the nonborrowed reserve path is adjusted, total reserves would be higher than we thought. So the low borrowing assumption does have some implication for the total reserves we anticipate and for interest rates.

CHAIRMAN VOLCKER. I'm not quite sure that's right, Henry. We are getting into this darn lagged reserve accounting again. But in the immediate future, which is going to be relevant for judging this, we will know what the level of reserves is. We are just judging the nonborrowed reserve path, saying we are putting the nonborrowed reserve path at \$1 billion below what we know reserves will be next week. That's for the first week anyway. Now, it depends--and this is the uncertainty--but that would be tighter than last week in terms of borrowing when we had the market quite tight with a lower level of borrowing. We just don't know the significance to attach to that. You might be right, but it's not in accordance with the most recent experience.

MR. WALLICH. Not the very recent experience.

CHAIRMAN VOLCKER. That's right. Basically the \$1 billion was arrived at--other than that it's a round number--by being halfway between the experience of the last week and the previous week.

MR. MORRIS. It would seem to me a lot more sensible if the Committee instructed the Manager to seek a total reserve path that would be compatible with these [M1 and M2 growth rates] rather than have the FOMC try to estimate what the [appropriate] level of borrowing is. I think we could eliminate that from our agenda without any loss, and probably some gain, before--

CHAIRMAN VOLCKER. Well, you are going to have an argument, I suspect, with Governor Coldwell. Let me repeat. I think what we are doing is that we are aiming at a total reserve path and it's 4-1/2 percent [M1 growth] under this version. The instrument that we affect is nonborrowed reserves. What we don't quite know how to do is [how to determine] what level of borrowed reserves is consistent with the total reserves path that is really the objective. That's engineering in Mr. Roos' terms, I guess. But I'm telling you what I propose for that element of engineering.

MR. ROOS. If we worked with a monetary base--and I know that is a dirty word--we'd obviate all these problems, I think.

MR. WALLICH. It does make a difference what the source of reserves is, and we should not ignore that. It may be a refinement, but borrowed reserves are not quite the same thing as owned or nonborrowed reserves.

CHAIRMAN VOLCKER. From my standpoint, I suppose I'd be perfectly happy with what you suggested, Frank--just leaving it to the engineers, as Larry said--but I'm not sure the Committee as a whole is willing to leave it entirely to the engineers.

MR. AXILROD. President Morris, if you did that, some of the staff could sit around and make a decision and say: Well, we think borrowing ought to be zero. And the funds rate would be dropping very sharply immediately. We wouldn't make such a callous arbitrary decision, but you would be leaving that possibility open.

MR. MORRIS. I don't really understand that.

MR. AXILROD. Well, it's because we know required reserves for next week, and the Desk has to make the choice of whether those required reserves will be met by borrowing at the discount window or through the Desk's provision of nonborrowed reserves. If those required reserves happen to equal the total reserves that seem proper, the Manager still has to make that decision.

MR. WILLES. But you can't [play] that game for a quarter. You can do it--

CHAIRMAN VOLCKER. No, but that is always the position we are in for any particular week. Even looking beyond the week for which we know the reserve number, we know what level of total reserves we want to aim for to [support] 4-1/2 percent or whatever the number is. What we really don't know in a sense is how to get there, because we don't control one element in the reserve base.

MR. MORRIS. And, therefore, I don't think it makes any sense for the Committee to tell the Manager to follow a nonborrowed target unless we also tell him not to pay attention to total reserves. Now, in the last month he had to change the nonborrowed target. I think that was the correct thing to do.

CHAIRMAN VOLCKER. Well, if I understand the comment made yesterday and this is combined with your comment, we have to get some kind of compromise. We are interested in total reserves. Our success or lack of success in reaching that target will depend upon, over a period of time, how much banks borrow and how much we put in as nonborrowed reserves. Taken together it will depend on both of those things. It is not an indifferent decision in looking at the outlook whether they borrow or whether we put in the reserves. Frankly, I think we have to leave some room to the staff--or Mr. Sternlight, Mr. Axilrod and myself--in making those judgments as time passes. Governor Coldwell yesterday raised the question as to whether, if we make a big change in assumption, the Committee [wants] to look a bit at the engineering, in Mr. Roos' term. Now, I don't know at what point you want to do that, if at all. All I'm suggesting by throwing out this figure is that this is at least a chance to look at the initial [borrowing] assumption that goes in--we meet again only 4 weeks from now or whatever--and maybe that's enough. But there was a question about that yesterday. You don't even have to look at the initial assumption if you want to leave it to us. But it's a matter--

MR. MORRIS. I really think it's meaningless. But if people get some solace from it, maybe it's all right.

MR. COLDWELL. If you are willing to convert everything from borrowing to nonborrowed reserves, sure, you can call it meaningless. I don't believe it is meaningless. I think it's quite meaningful if we shift from \$1.5 billion of borrowing to zero borrowing.

CHAIRMAN VOLCKER. The staff presumably would only reach that judgment in the light of their own assessment as to whether it's consistent with the total reserve path. They have that constraint. And if they keep being off the total reserve path, presumably we will get a new staff or something because they are making the wrong judgments. But that is an inevitable matter of judgment inherent in the discount window that somebody has to make. It's a question of procedure as to how much the Committee wants to get into that judgment. I tend to agree with you, Frank, that the answer is "not too much." But at least initially, when we're meeting anyway, it's a question of how much we want to--

MR. BLACK. Mr. Chairman, I come out right where Frank did. It's not only the matter of borrowing, it's a matter of what liabilities the banks use up or [whether they] release reserves that are not part of the money supply. All those things have to be estimated and there are a lot of them. To me borrowing involves the same sort of problem. I see it just the way Frank does.

CHAIRMAN VOLCKER. Well, if you want to proceed this way, I will tell you instead of asking you in a sense--and permit you to object--that the staff is planning to seek borrowing of \$1 billion initially and they will use their best judgment as time passes. If you want to object to that, object, but it doesn't have to be part of



the decision in any formal sense. I don't think we need to prolong this unless somebody really wants to object to that Solomonic compromise between the experience of last week and the earlier experience.

MR. AXILROD. You mentioned the staff and the departure of the staff if we are off the total reserve path. In that regard the Committee should remember that with lagged reserve accounting, if deposits turn out to be strong, borrowing will rise and there is no way in the world to get back on a total reserve path in as short a period as 4 weeks; we are going to have to wait longer for the--

MR. MORRIS. But it will dictate because we have a 3-month--

CHAIRMAN VOLCKER. No. Whatever we start with, if nothing else goes wrong and we are moving above path, the immediate manifestation of that is a rise in borrowing; if we are moving below path, the immediate manifestation is a decline in borrowing. That's what happens.

MR. EASTBURN. I don't want to prolong this either, but I have some confusion on a related point and that is the role of the discount rate. I had been under the impression that the philosophy [at the Board] was that, given lagged reserve accounting, the differential between market and discount rates was not an effective factor in encouraging or reducing borrowing. However, in the Bluebook there is a comment in paragraph 18 on page 17 about what will happen if the discount rate isn't changed under certain circumstances and the influence of that on borrowing. Has there been further thought [at the Board] about that?

CHAIRMAN VOLCKER. Let me say that the question of lagged reserve requirements, which keeps coming up here, and the discount window posture, which bears upon this question, are under review. Within the next month or so I think we have to put both of these matters, certainly the reserve requirement issue, on the agenda. Are we going to be ready in time for the next meeting?

MR. AXILROD. That lagged reserve requirement [study] will be ready within a couple of weeks.

CHAIRMAN VOLCKER. What about the discount window?

MR. AXILROD. That will not be ready in that time frame.

CHAIRMAN VOLCKER. Not before the next meeting?

MR. AXILROD. I doubt it. It could be accelerated, but I don't think--

CHAIRMAN VOLCKER. The point I am making is mainly that any comment at the moment is tentative depending upon where we go on that. But given the way we are now operating--the way I look at it anyway--the amount of borrowing presumably will affect the level of market rates relative to the discount rate. A couple of comments were made this morning. Let's suppose borrowings [have to go] way down to achieve this path. For a while at least the discount rate is going to constrain how far [the funds rate] can go down, so long as the banks

are borrowing. Now, once they stop borrowing, it can go below the discount rate; but so long as they are borrowing significantly, presumably market rates will not go appreciably below the discount rate. If it went the other way and borrowings tended to increase, one would expect interest rates to go up given this level of the discount rate. In theory, I suppose, we could reduce the discount rate in those circumstances and at the same level of borrowing we might get lower market rates in the short run anyway than we otherwise would have. So the discount rate fairly directly affects the market rate, all other things being equal.

MR. EASTBURN. The practical aspect, as far as those of us at the Reserve Banks are concerned, is that we do have our Board meetings once every 14 days and they make recommendations on the [discount] rate. With a fairly restrictive directive so far as the aggregates are concerned, there might be some question one way or the other as to what happens to this--

CHAIRMAN VOLCKER. That judgment--I think I made this point before--seems to me to be more important than it used to be. That's because if you propose either an increase or a decrease in the discount rate, we can basically say that the message, if we're all interpreting it the same way, is that we want market rates higher or lower. We're not really saying we want borrowing to be greater or less, although that may be the ultimate implication over a period of time. But the immediate effect would be to change market rates rather than borrowing. Ultimately, [a new discount rate] obviously may affect borrowing because it has affected the climate in financial markets. But the short view, as I look at it anyway, is that if you're sending the Board a message about the discount rate, you're sending us a message on where you think market rates should be, all other things equal. Of course, this is why we didn't act in October and November when market rates were up wherever they were--14 or 15 percent on the federal funds rate--and a lot of people said we should raise the discount rate to close the gap. It was our judgment that, at least in the short run, it wasn't going to close the gap but was just going to put the market rates up further. So it was a question of whether or not we wanted market rates to go up further. I think all that changes if we open up the discount window. If we didn't have a natural restraint on borrowing, which we have had ever since the beginning of the Federal Reserve System, but if we operated [with an attitude of] borrow all you want if you find the rate attractive to you, then we'd have to manage the discount rate in a different way.

MR. PARTEE. I do think that the level of borrowings is somewhat of an index of possible need. That is, if we got a high and rising level of borrowings, that would mean we're exceeding the monetary targets and there would be more indication for a rise in rates than if we got a low and declining level of borrowing; in the latter case [reserves] probably would be falling below target and that would be consistent with the reduction so--

CHAIRMAN VOLCKER. In general.

MR. PARTEE. Yes, I don't think it really will seem all that inconsistent over time.

MR. WILLES. Mr. Chairman, could you explain how the discount rate influences--

CHAIRMAN VOLCKER. The market rate?

MR. WILLES. That's a little different than I thought.

CHAIRMAN VOLCKER. Well, Mr. Axilrod has a nice econometric function which hasn't worked so well recently, but nonetheless reflects the theory. Banks are reluctant to borrow. Their willingness to overcome their natural reluctance to borrow depends upon how cheap the discount window is relative to market rates. With a given reluctance to borrow, they will borrow more if the margin is 4 percentage points than if it's 1 percentage point. So, if you put up the discount rate and change the existing situation in the margins but you don't change anything else including the amount of borrowing, market rates will go up. And they are going to be forced to borrow \$1 billion in the current example. In the existing situation that's what we say. We can control that in the short run. We know they are going to borrow \$1 billion. We know, if this equation is right, that they will only borrow \$1 billion when the federal funds rate is 1 percentage point above the discount rate. So we now raise the discount rate from 12 to 13 percent; they won't borrow that \$1 billion that we are going to force them to borrow until the federal funds rate is 14 percent.

MR. WILLES. Well, that's a very interesting view of the world.

MR. AXILROD. It will hold, President Willes, for 2 weeks; that's certain under lagged reserve requirements.

CHAIRMAN VOLCKER. Now, the higher interest rates are then going to affect everything else, so we begin getting a different answer. But in the short run I think that's what happens.

MR. BLACK. That's implicitly assuming no change in excess reserves, Mr. Chairman. I don't think that's right.

MR. WALLICH. Well, the changes that can occur, such as changes in excess reserves and changes in total deposits that banks can bring about, would have to be enormous in order to offset any significant shortfall of reserves because the multipliers are so high for M1. That multiplier is on the order of 10 and for M2 it's on the order of 20, so banks would have to bring enormous pressure on their borrowers and the holders of securities in order to make up a given shortfall in reserves by changing their reservable liabilities.

CHAIRMAN VOLCKER. If they change their liabilities, it will ultimately affect reserves, and that's what would occur from the higher level of interest rates. It's not going to affect reserves for 2 weeks.

MR. WALLICH. I'm trying to say what the difference is between lagged and nonlagged reserves. It is a small one, as far as the [reserve] adjustments go.

MR. PARTEE. Because even with nonlagged you still have this tremendous multiplier. Yes, I agree.

MR. WALLICH. That's right.

MR. WILLES. Well, I don't want to prolong the discussion, but it makes me very nervous that we would take what in effect is a deterministic, very short-run model and decide the time path for changes in the discount rate, then market rates. I think that's a very questionable thing to do.

CHAIRMAN VOLCKER. I don't understand quite what you are saying. It doesn't mean that we can't change the discount rate. It just tells us to recognize that if we change the discount rate, the short-run impact is going to be to put market rates up, which may be what you want.

MR. WILLES. Well, what's the short run? Is it 2 weeks or 4 weeks or 6 weeks? We could get exactly the opposite results if you change the time horizon by a relatively small amount.

CHAIRMAN VOLCKER. I don't know about the small amount. But there's no question that if you put up interest rates, the ultimate result might be to reduce the money supply, which might have all sorts of impacts and produce lower rates over a period of time.

MR. WILLES. Fairly quickly.

CHAIRMAN VOLCKER. I'm talking about the immediate impact.

MR. PARTEE. Reduce the money supply and get lower interest rates!

CHAIRMAN VOLCKER. Well, we don't have to wait--

MR. COLDWELL. Do you want comments on this compromise or what are you going to do? Mr. Chairman, I'd rather have [a range] centered on 4 percent than the 4-1/2 percent you've chosen. The [risks] of 5 percent are too high to me. I think we ought to be aiming for something less than that in this coming quarter to make sure we do not overstimulate at this particular moment, and I'd much rather we have a 4 percent rate. The range could be 3-1/2 to 4-1/2 percent if we want a center point; or for a single point 4 percent would be my strong preference. With the \$1 billion in borrowing I have no problem.

CHAIRMAN VOLCKER. Any other comment?

MR. WALLICH. I feel somewhat the same way. Evidently these [choices] do not matter a great deal [individually], but the combination of what seems to me historically low borrowing, an unchanged lower end of the funds rate, and a somewhat higher rate of M1 [growth] all cumulates a little in my view.

MR. PARTEE. Well, I am on the opposite side. Somebody needs to speak. It looks as if the chances are that we will have something like 5 percent [M1] growth. I don't think we ought to be deliberately following a mechanism that pushes rates up in this quarter, which is

probably a declining quarter in the economy. I'm prepared to have 4 to 5 percent to accommodate other members, but I certainly wouldn't want to center [the range] on 4 percent, which I think does bias it in favor of a rise in interest rates.

MS. TEETERS. I also think it's the wrong time to have interest rates going up. If the economy slides off, for once we should be going with it rather than lagging behind it.

MR. COLDWELL. Steve, I thought you said alternative C was consistent [with the current] rate, not an upward [move in the] rate.

MR. AXILROD. Alternative C in the first quarter we assume would be [consistent with] something like the present interest rate level; it might go down a bit, but more likely--

MR. COLDWELL. [Down] a bit, but not upward.

MR. AXILROD. Not in the first quarter.

MS. TEETERS. But it seems to me we want to have some flexibility here. If the economy does slide off, I think we'd want to see interest rates slide off. If we go to a very stringent monetary policy of 4 percent [M1 growth], we are sort of gluing the [funds] rate at 14 percent with a possibility of it going higher. As I say, it would be nice for once to have Fed policy moving in sync with the economy. And if the economy doesn't slide off, the interest rate is not going to come down.

MR. SCHULTZ. As I see it, Steve said the best estimate the staff can make at this time is that January [M1 growth] looks like 5 percent. That would mean that if we center it on 4 percent, we're going to have to have some additional restraint at this point in time, and I'm not sure that that's that we want.

CHAIRMAN VOLCKER. Any other comments?

MR. BLACK. For once, Mr. Chairman, though Governor Rice and I voted at [opposite] ends of this spectrum, we have agreed that either of us could accept the other's position.

CHAIRMAN VOLCKER. Well, it's a pretty fine judgment when you get down to 1/2 percentage point differences. But I would suggest to both sides that under my interpretation of this the degree of resistance to either end of the range is somewhat affected by what does happen to interest rates, which I don't think we know. That is where the concern is on either side, and the concern is a reasonable one. But I get a little leeway in there. Now, one can argue that M1 can be put a little higher or a little lower but if there aren't any other comments, I guess we can vote. Is this package understandable?

MR. ALTMANN.	
Chairman Volcker	Yes
President Balles	Yes
President Black	Yes
Governor Coldwell	Yes
President Kimbrel	Yes
President Mayo	Yes

Governor Partee	Yes
Governor Rice	Yes
Governor Schultz	Yes
Governor Teeters	Yes
First Vice President Timlen	Yes
Governor Wallich	Yes

Unanimous, Mr. Chairman.

CHAIRMAN VOLCKER. There were a couple of other things I wanted to mention, which I'm not sure I remember now.

MR. MAYO. Don't mess it up!

CHAIRMAN VOLCKER. No, not on [the policy decision]. I just want to remind you again that both the discount window procedures and lagged reserve accounting are relevant to what we are doing, and if we are really going to stay on this technique, they urgently need examination. We are not talking about any easy change in either of those, if we want to change. While the surface logic seems to say to change from lagged reserve accounting, I suspect it would not be easy to do that mechanically in the banking system, particularly before membership gets resolved. I'm just not sure how easy it is to do. If we are really talking about changing the discount window mechanism to something that seems to me logically more consistent with this operating technique, again on first blush, I suspect we are talking about overthrowing 60 years of Federal Reserve history, which is not an easy thing to do either. So they are not going to be very simple questions to deal with, but they are inherent in this operating technique.

We had an agenda item on release of the FOMC Memoranda of Discussion for 1974. I take it this has been read by the staff and--

MR. ALTMANN. They have been read and reviewed by the staff and the international parts have been reviewed also by staff at the New York Bank. The Treasury has been consulted on it as well, all in accordance with past procedures.

CHAIRMAN VOLCKER. Do we need a vote on this?

MR. ALTMANN. Yes.

MR. WALLICH. I would like to say that it has been checked out very carefully. My own feeling, if I were one of the foreign central banks, is that I'd rather not have that much reported about what my representative said at particular meetings. But it has all been correctly checked out, as in the past, and there seems to be no uneasiness.

MR. PARTEE. The one thing proposed for deletion is the Bank of England's attitude toward support for the institutions operating in London. I would have assumed that would be public knowledge by now.

MR. WALLICH. You would rather have even more--?

MR. PARTEE. I'm really asking another question, Henry. There is something in a memo of yours, apparently, that is going to be deleted.

CHAIRMAN VOLCKER. As a matter of procedure, these are checked with the foreign central banks, aren't they?

MR. WALLICH. Yes.

CHAIRMAN VOLCKER. And they requested that this be deleted?

MR. TRUMAN. We volunteered to delete it in this case.

CHAIRMAN VOLCKER. And they are happier.

MR. TRUMAN. To answer Chuck's question: When this lender of last resort issue was being discussed 5 years ago there were some items, especially with regard to consortia banks, that were left fuzzy. Governor Wallich's notes are more explicit on the fuzzy part but because of the fuzziness there may be some disagreement. [It conveys more] than the public knows; they sense it but they don't know it. That and the fact that views are directly attributed in those notes is the reason we felt it was wise and consistent with previous procedures to delete it.

MR. PARTEE. My only question, Ted, was that I thought it was

He happened to be representing the Bank. But if it is more explicit than even current public understandings, then there is a basis for excluding it, yes.

CHAIRMAN VOLCKER. We need a motion on this.

MR. COLDWELL. So move it.

SPEAKER(?). Seconded.

CHAIRMAN VOLCKER. Without objection, that shall be released. The next meeting is February 5. I would assume that the discussion on the long-range targets, having had [this preliminary] discussion today, can go reasonably expeditiously. And on that basis I assume we can do it all in the morning. We do have the lagged reserve accounting question. We probably will not have a discount window question [to consider] by that point. I would hope to get something on the lagged reserve accounting out to all the members of the Committee before the meeting and that discussion. The meeting time doesn't necessarily have to be extended at this point. We probably aren't at a point to make a decision right now.

MR. AXILROD. Mr. Chairman, in view of yesterday afternoon's discussion, the basic GNP forecast would probably assume an M-1A growth rate of something under 6 percent. The staff in its wisdom will have to decide on somewhere around 5 to 5-1/2 percent to be consistent with that discussion. In any event, we would have some alternatives to interpolate.

CHAIRMAN VOLCKER. We have a problem. You remind me. I don't know whether it's particularly useful right now, but a precedent was created. Perhaps it's a precedent; we could make it a precedent anyway. The last time--was it earlier in the year or at the midyear meeting--?

MS. TEETERS. Mid-July.

CHAIRMAN VOLCKER. At the July 1979 meeting a forecast was given by the Board of Governors in the testimony. It was the Board of Governors [forecast] of GNP for 1979 and 1980, too.

MR. PARTEE. Well, if you read the Humphrey-Hawkins Act, that's what it seems to require.

CHAIRMAN VOLCKER. I don't think it technically requires that.

MR. PARTEE. It says the Board's view of the relationship to or the consistency of the Open Market's Committee decision with the outlook for the economy.

MR. COLDWELL. Consistency with the outlook of the Administration? Is that it?

CHAIRMAN VOLCKER. Yes.

MR. PARTEE. I know it's going to be hard to back up on it because it was very well received by the Committees. Very little attention was paid to it, though.

CHAIRMAN VOLCKER. It raises a bit of a question in my mind on whether it is worthwhile polling the Committee on what their economic outlook is. We went through that exercise once or twice with Mr. Miller. Do people want to be polled on what their economic look is? Is it a useful exercise?

MS. TEETERS. The law requires that the Board--

CHAIRMAN VOLCKER. I know. That particular [requirement] is for the Board, but I have no strong feeling one way or another on that.

MR. PARTEE. We'll be working off the staff projection at that time and I think an indication of agreement or disagreement or points of agreement or disagreement might be helpful.

CHAIRMAN VOLCKER. Well, I might ask you for that next time, but I don't know.

MR. ROOS. Mr. Chairman, did I understand that if we have staff papers on one or more of these studies that you anticipate those being discussed in the morning meeting rather than at an afternoon meeting?

CHAIRMAN VOLCKER. Well, we also have a request from a member of the Committee. Willis Winn sent me a letter raising all sorts of interesting questions on the international scene--I don't know whether



that letter was distributed other than to the Board members--and suggested that it might be a good idea to have a general discussion of the international scene. Some of the questions are quite profound. That raises the question in my mind whether [to allocate more time for discussion]. While I think we can pretty clearly do the work we have to do in February in the morning, would there be any desire in view of that and perhaps a discussion of lagged reserve accounting and inter-related matters to begin the discussion the afternoon before? I'm not sure it would have to be a meeting; it could be a discussion the afternoon before. How do people feel about that?

MR. MORRIS. I think it would be a good idea.

CHAIRMAN VOLCKER. There's no great resistance to coming in the day before, if I read you right.

MS. TEETERS. Could we start earlier in the day--everybody was here [yesterday] by noon--and end earlier?

CHAIRMAN VOLCKER. Well, I'm not sure that we will do it, but let me keep that option open if we have some of these other [issues] to discuss. I don't think it would have to be a meeting, for what difference that makes, but it might be worthwhile having an early afternoon discussion session. So, let me review that.

MR. ROOS. In spite of remaining flexible, the earlier we can get notification the more helpful it would be. Getting travel reservations is a real problem.

CHAIRMAN VOLCKER. Okay, thank you. I think we are finished.

END OF MEETING