TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

September 16, 1980

Prefatory Note

This transcript has been produced from the original raw transcript in the FOMC Secretariat's files. The Secretariat has lightly edited the original to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcript was not fully edited for accuracy at the time it was produced because it was intended only as an aid to the Secretariat in preparing the record of the Committee's policy actions. The edited transcript has not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Staff Statements Appended to the Transcript

Mr. Pardee, Manager for Foreign Operations
Mr. Sternlight, Manager for Domestic Operations
Mr. Kichline, Associate Economist
Mr. Axilrod, Economist

Meeting of the Federal Open Market Committee

September 16, 1980

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, September 16, 1980, at 9:30 a.m.

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

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

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

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

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

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

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Prell, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Siegman, Associate Director, Division of International Finance, Board of Governors
Mr. Beck, Senior Economist, Banking Section, Division of Research and Statistics, Board of Governors
Mrs. Steele, Economist, Open Market Secretariat, Board of Governors

Messrs. Boehne, Brandt, Burns, Fousek, Keran, Parthemos, and Scheld, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Atlanta, Dallas, New York, San Francisco, Richmond, and Chicago, respectively

Ms. Nichols and Mr. Sandberg, Vice Presidents, Federal Reserve Banks of Chicago and New York, respectively

Mr. Miller, Assistant Vice President, Federal Reserve Bank of Minneapolis

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CHAIRMAN VOLCKER. We can come to order and approve the minutes if somebody will make a motion to approve. Without objection we will approve the minutes. Mr. Pardee.

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

CHAIRMAN VOLCKER. Any questions or discussion? We have to ratify the transactions.

MS. TEETERS. So moved.

MR. PARTEE. Seconded.

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

MR. PARDEE. Yes, in terms of first renewals on swap drawings, there are six drawings on the Bundesbank for a total of $301.2 million. And there are three drawings on the Bank of France for a total of $85 million, one of which is a second renewal for $24 million. The second renewal will require authorization by the Committee.

CHAIRMAN VOLCKER. I assume that if we have to renew these, we will do that without any objection. I don't think it takes any formal action. I might say that Mr. Pardee raised with me the question of whether we want to change the terms on the swap agreements. We can consider that perhaps next month; I'll talk to the Treasury first. The Committee discussed making the terms more symmetrical a year ago or two years ago--well, maybe both--

MR. PARDEE. Both; [the first discussion was] about two years ago.

CHAIRMAN VOLCKER. Most of the swap agreements now say that when we are in debt, we share the loss or share the gain with the other central bank; when they are in debt, they take all the risk. So it's an asymmetrical arrangement and the Germans have raised the issue in the past. They didn't raise it again this year, did they?

MR. PARDEE. They are prepared to at any moment.

CHAIRMAN VOLCKER. They probably will raise it again. They have raised it in the past and we have had some discussion of it. The arrangement looks peculiar the way it is [structured] now. Whether we gain or lose on the operation depends not only on the gain or loss but on the interest rate differential, because the other side of the bargain would be to shift to the foreign rate rather than [use] our rate on the interest rate dimension on the swap. We, this Committee, if I am accurate, arrived at a consensus either two years ago or one year ago or both that it would be a good idea to change this and [make it] more symmetrical. The Treasury agreed in principle but didn't want to raise the issue at that time for a variety of reasons. I forget just what the reasons were.

VICE CHAIRMAN SOLOMON. My reason was very simple. At that point Proxmire was opposed to intervention and so was Henry Reuss. And the Exchange Stabilization Fund of the Treasury, because of paying off the Roosa bond guarantees, was beginning to run in the red--

CHAIRMAN VOLCKER. To put it mildly.

VICE CHAIRMAN SOLOMON. It's finally back in the black because the IMF drawing added to the resources, and the extra interest has helped on that. But at that time we were in the red and we would have gotten a major reaction from the Congress plus a very high level of unhappiness being expressed by both Proxmire and Reuss on intervention as opposed to free floating. So I said the timing was bad even though I agreed in principle. I think the conditions have changed now. Proxmire and Reuss are much more reconciled to a managed float and are not that unhappy with it, and the Exchange Stabilization Fund balance sheet has moved back into the black. Under those circumstances, I assume the Treasury would not object.

CHAIRMAN VOLCKER. Well, I don't know that for a fact; I haven't talked with them. And I don't mean to debate the issue today. I just want to warn you that it will probably come up [at our meeting] next month and we will provide a little more explanation and have some materials for the Committee. A logical time to bring it up is probably next month as we get ready for the [annual] renewal [of the swap agreements] in December. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Questions or comments?

MR. ROOS. Yes sir. May I start, Mr. Chairman? Peter, we did an analysis of the direction of interest rates in the period from June 13 through September 5. That's about a three-month period. And it's rather amazing, as you pointed out, that most short-term rates were up [significantly]--90-day certificates were up 239 basis points, 4-month commercial paper was up 236 points, and 6-month bill rates were up even more than that--and yet the fed funds rate increased by only 79 basis points according to our computation. Why would there be that enormous disparity? Why would the fed funds rate have risen so much less than other short-term interest rates?

MR. STERNLIGHT. I'm not sure. It depends somewhat on the time period one takes. Mid-June was just about the low point in the market rates. The funds rate had come down in June, I believe, to the 9 percent area.

MR. ROOS. Doesn't the funds rate normally track these other rates?

MR. STERNLIGHT. Well, I'm not sure which follows which. Normally, some of these other rates tend to build on the funds rate or on dealer financing costs, [which] tend to track fairly close to the funds rate. As one goes out in the maturity spectrum, there is a descending degree of tracking to the dealer financing costs.

MR. ROOS. You mentioned in your report the sense of the telephone conference, which caused you to intervene in the fed funds market. Did you have a feeling from that call that you had some constraints on--

MR. STERNLIGHT. I don't think it was a serious inhibition. I would not say that it was something that caused us to intervene; I would say that it was something that modified in some modest degree the form of intervention. We had some reserves to drain to meet our paths. We undertook those draining operations rather gingerly; for a few days, we got some help from the Treasury by getting them to raise their balance so that reserves could be taken out without the Desk having to enter the market in an overt way and be seen taking reserves out aggressively.

MR. ROOS. But you don't feel that--

MR. STERNLIGHT. I don't think it stopped us at any point, really, from reaching our paths.

MR. ROOS. That wouldn't have been a major contributing factor to the fed funds rate moving up only 80 basis points, whereas everything else was going up 250 to 300 basis points? We weren't holding the funds rate down, were we?

MR. STERNLIGHT. We were not holding down the funds rate; we were seeking in late August to reach our reserve paths in a way that avoided putting aggressive new upward pressure on it. In any event, the funds rate at one point touched the lower bound of 8-1/2 percent in July, around mid-July, and was up to nearly 11 percent in August. So it may be to some extent just a choice of the time period in your comparison.

MR. MORRIS. Early in the period, Larry, the market was leading the funds rate in anticipation. And I think that's the base period pattern.

MR. AXILROD. Well, the dating might change your results. It is true that recently other short-term rates have risen more than the funds rate. But I don't think that is terribly unusual. After all, you are talking about 3- and 6-month rates as against a 1-day rate. There are times when people begin to expect a rise in rates, and the 3-month or the 6-month rate will move a little more than the funds rate under those conditions. In August we had a big resurgence in bank credit demand and large CD issues, which pulled up the CD rate in particular. I don't think that is extremely unusual, although those rates have moved up closer to the funds rate than had been the experience over the past two or three years.

MR. ROOS. Those figures in that period did seem to be [unintelligible].

MR. STERNLIGHT. Well, if you used something like the past 5-week interval, the funds rate would be up something like 1-3/4 percentage points--from around 9 to, say, 10-3/4 percent--which is roughly [comparable to the move on] other short-term rates.

MR. ROOS. Thanks, Peter.

MR. BLACK. If we hadn't overshot our targets, [the funds rate] would have been up more, too, more than likely. I wonder if that didn't contribute to some of the rise in the other rates.

MR. STERNLIGHT. Total reserves were [above the path]; we were about on target on the nonborrowed reserves. If the aggregates had not overshot the target, yes, that surely would have made--

CHAIRMAN VOLCKER. Peter, based upon nothing more than reading the newspaper, I have the sense that the market is a little less hypersensitive to our daily operations than they were two months ago. Is that true or not true?

MR. STERNLIGHT. Just in the last week or two, I would share that sense. There was one incident during the period, which I mentioned, when we did some RPs and the markets really took off; but they just may have been reacting because they had overdone their sell-off during August. I wouldn't want to bet a lot of money that they have really matured to the point where they will take our operations as fully in stride as we'd like from day to day.

VICE CHAIRMAN SOLOMON. Even though you're right that it hasn't been [the case] in the current [period], I still think there is a residue of misunderstanding about the Desk's operations. I hear that from all of my visitors--that the Fed is giving conflicting signals. They don't understand [our new procedures] completely no matter how much Paul has said on this. That's why we were thinking that a technical explanation by Peter and his people to the dealers, with the press listening in, might make a lot of sense. But it might be wise to wait on the timing of that until we sense that concern increasing again. At the moment things are quiescent.

CHAIRMAN VOLCKER. I think The New York Times has a different guy writing the articles now, don't they?

MR. STERNLIGHT. That's true, but--

CHAIRMAN VOLCKER. That fellow seems to have gone out of his way a couple of times to say that these operations are just to provide reserves or to withdraw reserves and they have no implication for interest rates.

VICE CHAIRMAN SOLOMON. But he's quoting dealers, too. And some of the dealers who were critical a couple years ago are more relaxed.

CHAIRMAN VOLCKER. It wasn't quite clear to me whom he was quoting. I thought maybe he was quoting Peter or you; I'm not saying that was so but I think--

VICE CHAIRMAN SOLOMON. [Unintelligible].

MR. STERNLIGHT. Well, with the Times change, there is a better man on the bond market. But this period of misunderstanding did not involve just that one paper or just the press, Mr. Chairman. I think it was people in the market, too.

MR. ROOS. The Wall Street Journal has changed its team. I noticed that Mr. Foldesse, or whatever his name is, who used to write --or used to misinterpret this--is no longer on that column in the Wall Street Journal. Is that his name?

MR. STERNLIGHT. It's Foldesse. He is writing it sometimes, I think.

MR. ROOS. Is he?

MR. STERNLIGHT. Maybe he's on vacation.

CHAIRMAN VOLCKER. Any other comments?

MR. EASTBURN. I have questions, Peter, about the discount rate. First, has the rate level been a problem for you in the seasonal targets and so on? Second, what is the market sentiment about the discount rate and the changes in it?

MR. STERNLIGHT. As to whether the rate level has been a problem, it has [made it] difficult in these last couple of weeks in terms of aiming for nonborrowed reserves in that we expected some greater borrowing. It has been hard to gauge just how much that borrowing would be. I think one of the factors was that the funds rate was 1/2 or 3/4 or sometimes even a point above the discount rate and there was an attraction to the discount window, which makes it harder to judge. I wouldn't say that it is a serious problem for us at this point nor do I get the sense that it has been that serious--some of you [from the Reserve Banks] probably know better--in the administration of the window. As to market expectations, there was some feeling around late August that there might be a move on the discount rate. That has died down some. Possibly it has begun to crop up again lately, but I have not heard too many comments on that.

MR. EASTBURN. Would a change be a substantial shock to the market?

MR. STERNLIGHT. I think at the moment it would be something of a surprise, yes.

MR. MAYO. Would it make your job easier if there were a change, or is that an unfair question?

MR. STERNLIGHT. I don't see it making the job easier.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Peter, when you made that adjustment of $150 million to the nonborrowed reserves target, what determined the decision to make it that amount and not $100 million or $200 million or some other number? This had to do with the overrun on the total reserves so, of course, by that decision you were determining the level of borrowing. The level of borrowing again determines the funds rate. So I'm trying to understand the structure of this reasoning.

MR. STERNLIGHT. I'm not sure we have a closely reasoned rationale for just how we arrive at those [adjustments]. This is done in consultation with Mr. Axilrod and his staff, but it was with Ed

Ettin at the time I believe. Were you there, Steve? We have close consultation with the Chairman as well. On this occasion and in other instances when that kind of adjustment was made, it was typically for some fraction--often roughly but not precisely half--of the overage or underage of total reserves from the path. I must say that on this particular occasion it was also because we had had a bulge in borrowing in the Labor Day week. And if no such adjustment had been made--if we had not reduced the nonborrowed path--it would have left us in a position of expecting almost no adjustment borrowing for the balance of the period. In a way one might say we backed into it by saying, in effect, that we probably wanted to keep adjustment borrowing in the $400 to $500 million area. And that contributed in a major way to that $150 million decision.

MR. WALLICH. Do you use a monthly model or do you use some relationship between the funds rate and the level of borrowing?

MR. STERNLIGHT. I don't think it's that--

CHAIRMAN VOLCKER. We don't have that pseudo-precision.

MR. ROOS. Well, if the level of borrowing comes in higher than we would anticipate, [can't] you reduce the level of the nonborrowed reserves path accordingly? Can't you adjust your open market operations for the unexpected bulge in borrowing or the unexpectedly low borrowing if you ignore the effect on the fed funds market? Can't you just supply or withdraw reserves to compensate for what has happened?

MR. STERNLIGHT. Yes, we could. There's always that question of how much we want to compensate for that high borrowing. We faced that kind of decision in [this statement] week.

CHAIRMAN VOLCKER. The Desk can't [adjust] in the short run. It's fixed. In a sense they could do it over time if people are borrowing more, as they may be now. They seem to be borrowing more than we would expect, given the differential from the discount rate. But in any particular week it is fixed.

MR. ROOS. Do we have to supply the reserves?

CHAIRMAN VOLCKER. We have to supply the reserves.

MR. ROOS. [Why] do we have to supply the reserves? If we did not supply those reserves, we'd force the commercial banks to borrow or to buy fed funds, which would move the fed funds rate up. What is lurking in the back of my mind is this: Are we, in effect, frustrating our ability to achieve what we want with the aggregates and with reserves because of possible concern about fluctuations in the fed funds market? In other words, do we accommodate that problem?

CHAIRMAN VOLCKER. We can force [the depository institutions] to borrow more in a given week, but we can't force the level of reserves lower.

MR. WALLICH. Yes, but by forcing them to borrow more, we are raising the funds rate. And the question here is: Are we in that more distant sense back on a funds rate target?

MR. ROOS. You said it, Henry!

MR. AXILROD. Governor Wallich, as you know, with lagged reserve accounting there is simply nothing we can do in the current week other than determine the level of free reserves in the banking system with open market operations, given required reserves. And to the degree that there is a relationship--and it's pretty loose these days--between free reserves and interest rates, we are in some sense in the short run determining the funds rate. But in the longer run, of course, it's the market movement in the money supply relative to our target that will determine the funds rate.

CHAIRMAN VOLCKER. All this affects the funds rate, but I don't think one can say that doing what we did, which was a compromise in that one week, was aimed to affect the funds rate. You could argue that if we were pulling back the nonborrowed reserves, that would [imply] a funds rate objective--that we were forcing a higher funds rate.

MR. AXILROD. I was trying to say that, inevitably, doing that in one week would have an effect on the funds rate relative to not doing it in that week because required reserves are fixed. But over the longer run--though I don't know what the funds rate would be because of the looseness in the relationship between free reserves and the funds rate--it does not. That little [effect] passes away.

MR. WALLICH. I'm not saying that this was not the best way of coping with it. But conceptually, for instance, one could say that for every dollar of overrun on total reserves we will reduce the nonborrowed not by $.50, not by $1.50, but by $10. Well, that would have produced massive borrowing and the funds rate would have shot up. Presumably that wouldn't have been a very good decision with the reason being that one shouldn't disturb the markets unnecessarily. It's a question of how much of a disturbance to markets one is willing to accept in order to get closer to the total reserves path.

MR. AXILROD. Well, as Peter mentioned, this was done in the fourth week of a 5-week period. So one could ask: Should it have been done in the third week or the second week? It was delayed until the fourth week because there was some hope that what was in train in the first and second weeks, in terms of tightening, would show some evidence of bringing down required reserves. Then, by the fourth week we were still running well above our total reserve path, so by that time it seemed only reasonable, in view of past experience and past operations with this technique, to make an adjustment of roughly half. As Peter mentioned, if that adjustment hadn't been made at that time--and I would say maybe we should have done it earlier--then we would have had a very sharp drop in borrowing and maybe some drop in the funds rate in the short run, but I'm not sure. We had a large bulge in borrowing earlier without a lot of rise in the funds rate.

CHAIRMAN VOLCKER. We have been in one of these periods, which seem to be recurrent or almost perpetual, [where the incoming data on the aggregates seem to move] in one direction or another. It's not always in the same direction. But all of the actual preliminary figures and the estimates keep showing lower money supply figures than eventually materializes. We have had runs either of this sort or precisely the reverse before. But it doesn't seem to be random. It does--

MR. PARTEE. It's a [long-running] characteristic. I've seen it--

MR. MORRIS. Well, I think it's because the economy is stronger than we are projecting, Paul.

CHAIRMAN VOLCKER. That may be, but I [don't] see why that would affect the actual estimates that are made. Why these preliminary numbers run low or high when they are supposed to be a kind of random sample is beyond me. But it seems to happen for weeks in a row.

MR. MORRIS. Nonetheless, I think the system is working, Henry, in the sense that the Desk has pushed the funds rate up 200 basis points, which I suspect is more than this Committee would have done if we had made an overt decision on it.

MR. WALLICH. That's for certain.

MR. ROOS. I hate to belabor this, but if we look at the quarterly average rates of money growth on page 7 [of the Bluebook], for example, we see that in the first quarter M-1B grew at 6 percent, in the second quarter it declined at minus 2-1/2 percent--[the number in the column labeled "Alt. B"] is a misprint, I think--and in the third quarter its growth has skyrocketed to 12-1/4 percent. One can't feel that our basic objective is being met with those violent fluctuations. And I don't think those rates of growth in any way reflect any action that this group agreed upon or any policy or directive that we gave. They're just all over the lot. And what worries me is--

CHAIRMAN VOLCKER. I don't understand those numbers, frankly. Just stop for a second. That second quarter has a misprint in it?

MR. ROOS. Yes, that's minus 2-1/2 percent, I think.

CHAIRMAN VOLCKER. It should be minus 2-1/2 percent in both of those columns.

MR. ROOS. But what worries me is that we will agree on something today for the next three months, or whatever period, and then we will hope like mad that somehow or other something out in the wild blue yonder will occur to enable us to meet that. I don't have the feeling that we really are causing the events to occur through our operations that we on the Committee have agreed upon from time to time.

CHAIRMAN VOLCKER. Well, I think that's quite true. But the question is whether we have control in the short run, and I'm afraid this recent pattern that you point to shows that we don't. Most of this increase in the third quarter came in one week!

MR. WALLICH. But we really do have to look at what Frank Morris pointed to, the behavior of interest rates. You don't like the behavior of aggregates. Interest rates have been the one thing that have been even more volatile. And I think that since the mechanism works through these interest rates, we really have had more leverage in what we have done.

CHAIRMAN VOLCKER. Well, we got criticized by the bankers when they were here the other day for having too much volatility in the money supply growth and too much volatility in interest rates. I told them they could criticize us for one or the other but not both at the same time.

MR. FORD. Did you offer them interest rate controls!

VICE CHAIRMAN SOLOMON. We have had volatility in both. Why can't they criticize us for both?

CHAIRMAN VOLCKER. I don't know what mechanism gets rid of the volatility in the one without increasing [the volatility in] the other.

MR. ROOS. Well, Paul, maybe we ought to do some work to try to see whether we're approaching this in the most effective manner in terms of accomplishing what we have all agreed we ought to accomplish and whether the mechanism [we're using] is really the best one or not.

CHAIRMAN VOLCKER. I think that's always a fair question.

MR. GRAMLEY. Mr. Chairman, if we do that, we ought to be sure we understand what our long-run objective is. As I view it, it is not to make the money supply grow by a steady amount quarter by quarter but to achieve a longer-run path of monetary and credit expansion that is conducive both to healthy economic growth and a reduction of inflation. I don't see the system as working out unfavorably just because the quarterly pattern is so erratic.

CHAIRMAN VOLCKER. These are all matters that we have to look at as time passes. I don't particularly like what has been happening in the sense that we have put all this money in the money supply and have had these quarterly fluctuations which don't seem to be particularly controllable. What is the significance of that? The most optimistic view is that these quarterly movements are not very significant. We had a decline in the second quarter and we have [now] made up for it. We will see what happens in the fourth quarter, but the jury is still out. We may have had a short-run bounceback here.

MR. WALLICH. But by having interest rates collapse as dramatically as they did, don't you think that we did a good deal to shorten the recession? Housing must have come back somewhat earlier and some other things may have come back earlier than they would have had we let interest rates go down gradually the way we otherwise normally would have done.

MR. PARTEE. And then as the economy [rebounded], the demand for money increased again and we found ourselves reacting against that. There is a demand side, Larry, and it has shown sharp shifts this year. We've worked against them and, of course, it's a question of judgment as to how strongly to work against the demand factors in the market. But by [historical] standards, we worked against them a good deal harder than we did in the past. We have had both a sharper decline in rates and a sharper, earlier recovery in rates than ever before in my recollection. And that is because of the change in policy announced last October.

MR. ROOS. Chuck, I think we've made great progress. All I'm asking is whether from time to time we shouldn't review what we are doing and try to make it even better.

MR. WALLICH. If we do something along those lines, I would urge that it include an effort to see if we can't systemize the periodic adjustments in the path and find some way to appraise what the likely effect will be of [making adjustments of] $100 million or $200 million or whatever.

MR. SCHULTZ. I would call to your attention that Mr. Axilrod and Mr. Lindsey recently wrote a paper for the American Economic Association which addressed some of these questions. You might find it interesting reading. I suspect that you will not agree with it very much, President Roos, because the indication is that we need to continue to exercise some judgment and that we need to continue to look at interest rates to some degree. I also felt that it argued very strongly for keeping fairly wide target ranges, which I think is consistent with that as well. But there has been some thinking and some writing on that subject, and you might find that article interesting.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Paul, I wonder if the October 6th anniversary date doesn't give us an opportunity to make some educational efforts that are unrelated to the current market scene to reaffirm some of these things.

CHAIRMAN VOLCKER. Well, we have been considering how best to do that. I have a public appearance tomorrow; I may or may not take the opportunity to do that. But it is a matter that continues to concern me and we will find an opportunity. Mr. Black.

MR. BLACK. Mr. Chairman, my point is related to the one that I believe Henry was making. It seems to me that we may have held off making the adjustments to the nonborrowed reserve target too long because we expected, on the basis of our projections of the demand for money, that we would get certain behavior. That's very hard to [predict], as all of us know. It's almost next to impossible to do, I think, so I would favor a little more prompt adjustments to the hard data we have in terms of setting our nonborrowed reserve targets.

VICE CHAIRMAN SOLOMON. Could I differ with that? I see problems with that. There are times when, given the unpredictability of the markets, if we are in there too quickly making adjustments, we could be whipsawing the markets. And we will get all kinds of complaints about the unpredictability of Fed policy. I don't think there's any across-the-board rule of thumb that we can adopt on the frequency of adjustments. I think we have to leave it to the judgment of the people who are [tracking] this on the Board staff and at the Desk, regarding the chances that a certain movement will get reversed and whether we should move [immediately] or wait a day. I just don't see any other way of playing this.

CHAIRMAN VOLCKER. Well, we probably ought to find some time to discuss this at greater length. But following up on Mr. Solomon's comment, there is a danger [in making adjustments too promptly]. Let's take March, when the aggregates were running a little high. We were pretty tough then, but suppose we had followed this procedure and had made even sharper adjustments to the aggregates when they were running high in March. What would have happened in April? We in fact had a 16 percent [rate of] decline; one just doesn't know looking ahead. The problem is that this process apparently runs, like everything else in economics, with some lagged effect. And it's those lags that give us 90 percent of the problem.

MR. BLACK. Mr. Chairman, could I just make a brief statement? I think Tony is right that we would get a lot of criticism from the market for more movement in interest rates, but I believe we would smooth out some of these abberations in the money supply.

CHAIRMAN VOLCKER. It's a question of what is important. Now, we can't answer these questions this morning, but I have begun to hear a lot of comments from people who say the volatility of interest rates in and of itself is a bad thing.

MR. BLACK. Most people believe that, I think.

CHAIRMAN VOLCKER. I'm not just talking about market people. I've had a complaint from automobile companies that their dealers will not hold inventory because, while they perhaps can afford present interest rates, they're not going to get stuck with a big inventory of cars [with] the risk that the interest rate will go up to 20 percent on them and they can't get rid of the inventory. It's that kind of problem, which I don't think is irrelevant. I hear the same thing from the homebuilding industry. I don't know how justified that [complaint] is, but--

MR. BAUGHMAN. It's not necessarily bad.

CHAIRMAN VOLCKER. I don't know.

MR. PARTEE. It depends on what your economic objective is.

CHAIRMAN VOLCKER. It's hard to say. The housing people, of course, argue the same thing: That they'd go ahead at current interest rates, but they are afraid of getting caught in an upswing [in rates] before the house gets completed. So, I don't know whether it's good or bad. But there are a lot of problems here that are--

MR. BAUGHMAN. Capital goods can be built to order.

MR. AXILROD. Mr. Chairman, if I may just take one minute of the Committee's time: It's a little difficult to think of what is going on with the money supply in a vacuum, independent of what is going on in the rest of the economy. In the spring we had rather strange events: We had the introduction of a credit control program, which was rather unique in our history; we had interest rates going to levels that were unique in our history; and we had responses in the rest of the economy that were rather unique. Among those responses were that people chose to get out of debt rapidly and to get along with less cash by a huge amount. And the mechanism that the Committee put in place, as I would see it, was flexible enough--it could be a lot more rigid with certain institutional changes--to be responsive to those changes. I believe it's wrong to think that in the short run the money supply will behave only in the way the Committee a priori wants it to behave, Rather, in the short run it will behave in response to what is going on in the economy, only toned up in certain ways by what the Committee wants. It's an awfully big thing the Committee is confronting and in the short run it's very hard to influence it.

CHAIRMAN VOLCKER. Well, there is a range of issues to which we will be returning continually and maybe in a more orderly fashion than this morning. Mr. Kichline.

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

CHAIRMAN VOLCKER. In view of the questions about the present economic situation and the discussion of a turning point and all the rest, let's just pause here for questions and comments on the business situation. And if anybody wants to volunteer attitudes toward tax reduction, I would be interested in hearing them. Mr. Black.

MR. BLACK. Mr. Chairman, I wonder if I might ask Jim: What was the selling rate for automobiles in the first ten days of September?

MR. KICHLINE. It was 7.3 million units using our seasonals, and in both July and August it was 6.4 million at an annual rate.

CHAIRMAN VOLCKER. When do the leading indicators come out?

MR. KICHLINE. I don't know.

CHAIRMAN VOLCKER. Not very soon.

MR. MORRIS. It's usually at the end of the month.

VICE CHAIRMAN SOLOMON. Am I correct in associating the increase in employment with the reduced rate of decline in real output? I get an impression that probably no productivity gains are going on.

MR. KICHLINE. We have a significant decline in productivity in our forecast for the third quarter. The decline in the second quarter was revised since the last Committee meeting. The early numbers showed a decline of 4 percent; it's now roughly 3 percent and we have forecast a further decline. That is, the increase in output is not sufficient to offset the substantial change in hours worked, and our productivity number in the current quarter is down about another 2 percent at an annual rate. So the productivity performance that is associated with this forecast is a distinctly poor one.

VICE CHAIRMAN SOLOMON. When people talk about the underlying rate of inflation corresponding to the average hourly increase in labor costs in the industrial sector are they assuming flat productivity?

MR. KICHLINE. Well, people refer to different things. A standard approach is to use a cyclically adjusted productivity number, and those estimates range all over the lot. Our own is something like 3/4 of a percentage point. And it's assumed that businesses tend to respond to changes in productivity over a longer period of time and are not influenced by the quarterly changes. So, taking those kinds of productivity numbers on average, they would dispense with [the quarterly fluctuations] and say that the underlying trend is something like [a rise of] 1/2 to 1 percentage point. Using that kind of number gives us unit labor costs running about 9 percent. Compensation is 10 percent, and with 1 percent or so productivity you get unit labor costs of 9 percent.

CHAIRMAN VOLCKER. Aren't hours worked going to be down in this coming quarter?

MR. KICHLINE. Just a small amount--3 percent relative to [a decline of] 8-3/4 percent in the second quarter. So they are still down.

CHAIRMAN VOLCKER. Three percent down. But you have a GNP estimate down 3 percent, roughly. I just--

MR. KICHLINE. Well, I am referring to the nonfarm business sector. Nonfarm business sector output in this forecast is down 4.9 percent. Nonfarm productivity is down 1.9 percent and hours worked are down 3 percent.

MR. MORRIS. But you implied that if you had had the retail sales figure when you made the forecast that the forecast would show less weakness than was in the Greenbook.

MR. KICHLINE. Yes, we would take some of the gain in personal consumption expenditures out of inventory, so it wouldn't all show up. But I think we'd have at least a percentage point less decline; instead of a 3 percent decline in real GNP we would now have a decline of perhaps 2 percent or a shade under.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, I have a question, which I could have asked last time too but didn't, on the gross domestic business product fixed weight price index. That is the index the staff uses in its projection as the best index of inflation. [The projection has for] the first quarter of '81 of [an annual rate of] 10.3 percent, for the second quarter 9.5 percent, and for the third quarter 8.5 percent. I can't understand what causes that tremendous improvement in the inflationary outlook in those two quarters. Also, my second question is: Why do we use this rather than the GNP deflator, particularly since we usually respond in terms of the GNP deflator when Congress or others ask us for figures along this line?

MR. KICHLINE. With regard to the first question, the major change in this improved outlook is that we have assumed the increase in social security taxes in January. The employer portion will be cranked directly into unit labor costs obviously, and we assume that businesses will try to pass those increased costs through fairly quickly. So, the first half of the year is importantly influenced by the social security tax increases, and that effect tends to wear off. In addition, running with slack labor markets and unutilized capacity for an extended period of time we think will begin to make larger inroads on the level of inflation. But it's mainly social security affecting the first half and pretty much absent in the second half.

MR. MAYO. In the 1980 pattern, though, you have a higher rate of inflation in the fourth quarter. I assume that's the Civil Service [pay] increase and you don't have that for the next year.

CHAIRMAN VOLCKER. There's a Civil Service increase in here?

MR. MAYO. It's 9 percent.

MR. KICHLINE. The big factor is the rapid acceleration of food prices that we have projected. On the second question you asked, on why use this one, all of the price indexes now present a [distorted] picture and we are frustrated as to which one to choose. We obviously shifted away from the implicit deflator because of the shifting weights, which give a distorted picture at times. You are quite correct that the Congress and others often refer to the implicit deflator. My own preference, frankly, is for something like the PCE deflator. But in a world in which we have rapid increases in energy prices, both the implicit deflator and the business fixed product deflator tend to understate what is happening because of the subtraction that is cranked into these numbers. So, you can put your money down and take your choice. There are many indexes available.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Jim, I have noticed--and this may be grasping at straws--that the average hourly earnings series for the months of July and August shows a very marked deceleration to around 4-1/2 to 5 percent on top of almost 10 percent for each of the first two quarters. Is there anything to that or is that just a statistical aberration?

MR. KICHLINE. On average hourly earnings, I don't know of any quirky information in terms of the monthly numbers. We have assumed, in fact, on a quarterly average basis that the hourly earnings index will be running around 9 to 9-1/4 percent, down a little from the second quarter. These numbers are very volatile on a monthly basis but we have not altered our view that there is a developing trend that's very different from what we have seen in the first half of the year.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. The economy seems to be coming around much faster than expected. This could be for one of many reasons, which could be very hard to disentangle. I'd like to get your reaction. One would be that the automatic stabilizers are stronger than we think, that the budget goes into a bigger deficit faster, and other such events. Another might be that our interest rate policy has been particularly effective. A third might be that the economy is just so inflation jittery that after people catch their breath they rush out and try to beat the game again. But in any event, we do seem to have gained a responsiveness to upward factors and lost a responsiveness to downward factors. I'd like to get your thoughts on that.

Now, with respect to tax policy, I'd just say that if the economy is stronger than expected, interest rates presumably will be higher. Monetary policy in some sense would be tighter. A tax cut will make fiscal policy easier. So we would be moving exactly in the wrong direction on the fiscal/monetary policy mix--toward tighter monetary policy and an easier budget stance. That's just the opposite of what a growth-oriented economy should have.

MR. KICHLINE. With respect to your question, I would link the second and third quarters together. If you look back at the misses in terms of actual performance relative to expectations, the second quarter was a big miss not only to the staff here but I think as a general matter. It was much weaker than before. So, I would think that the rather extraordinary measures taken in late winter or early spring had a significant impact, and in retrospect a greater impact than we would have judged at the time. It would not seem unusual, therefore, to find some snapback in the third quarter in some of those sectors that were sharply depressed. Now, [I don't know] whether that has occurred because interest rates are lower, consumer attitudes are different, monetary policy is different, the automatic stabilizer response is working, or fiscal policy [is easier]. I think in general one can say that we got off track in the second quarter and it's not unusual to see some snap-back. The critical question is whether in fact this is the beginning of a sustained sizable expansion in real activity. And assuming the monetary policy that's in the forecast, which we perceive to be restraining--consistent with some further rise in interest rates--even with the tax cut we do not believe that we are on the verge of seeing sustained strong expansion. It's quite possible that we could have a couple of months of fairly strong business news followed by some weakness. But I don't see that. The key issue is whether we are set up for continued strong expansion. I don't see that as a likely outcome at the present time.

MR. WALLICH. This few months of weakness that you set out as a possibility: Could you visualize that going to the extent of GNP growth turning negative again?

MR. KICHLINE. Oh, I think so. That's the double dip or the W or the extended L or any of the other exotic terms in fashion. I think that's quite possible. In the staff forecast, for example, we are talking about a small negative, and it doesn't take a great deal at an annual rate to find something that would flip that to positive or [more] negative.

VICE CHAIRMAN SOLOMON. In our financial report for the Redbook, we included the views of some key financial experts in New York. And Henry Kaufman in those remarks is predicting a double-dip recession.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Are there any estimates yet as to the amount and the timing of capital expenditures associated with the energy programs that are now apparently getting shaped up and into form for financing either directly by the government or by government guarantees of the interest rates?

MR. KICHLINE. We do not have anything in house and I am not aware that anything is available within the government. Our own assumption is that the program is being funded essentially with windfall profits and [will involve] synthetic fuel and that sort of thing. We have much longer lead times. It would not have an appreciable impact within the year 1981 but would be building over time. The energy sector itself in our forecast is fairly strong. We implicitly are using the energy sector as one that is holding up business fixed investment. That is, we'd have a sharper decline if it weren't for substantial energy sector investments. I can't answer your question directly, but I'm not aware of any such numbers around.

MR. BAUGHMAN. Would you anticipate, assuming the program evolved, that we would be speaking about magnitudes of capital expenditures that would become a significant element in the trend of the economy?

MR. KICHLINE. Yes, over the long run. But I really do think we are talking about a medium-term horizon, in the mid-1980s or so, given that these programs have long lead times. So, later on in this decade, if the programs continue, the dollars expended [will be significant]. In current dollar terms, expenditures of $200 billion plus over a period of time are being talked about. That, in fact, will be a principal feature of the business investment sector later in the decade.

MR. BAUGHMAN. As to your question on the turning point, Mr. Chairman, I think the staff projection is about as good as can be done. I see no reason why it doesn't have as high a probability of materializing as any that might be made. And I certainly share the view that we don't seem to have the stage set for a sustained recovery. I would visualize the next year or so as an ongoing battle between monetary restraint and the deeply imbedded and still spreading inflationary thrust, with the result that improvements in employment and production may well be a casualty of the struggle between continued [monetary restraint] and the surging inflation thrust.

CHAIRMAN VOLCKER. I don't know whether I should regionally adjust that comment; I interpret it as quite bearish.

SPEAKER(?). Yes.

MR. PARTEE. That was a national comment; it wasn't a Texas comment.

MR. BAUGHMAN. Now that you've provided an opening, there is a continuation of what strikes me as a rather unbelievable volume of new office building construction in all centers of significant population size through the Southwest. It does not seem to be slowing down. That is, new projects are being planned, funded, announced, and started. And the financing for them, particularly the equity money, almost without exception seems to come from foreign sources. I'm told that if you can't figure a project so that it looks as if it will be profitable and viable with some debt in it, that presents no particular problem. The suppliers of the equity simply supply more equity and are willing to take a fairly low computed return on the equity they put in. It just goes on seemingly without--

CHAIRMAN VOLCKER. There must be some correlation between our ability to sustain office building and not do much factory building and the productivity figures.

MR. BAUGHMAN. That could well be.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. You asked about where we stand on tax policy, and that's one of the things my staff has been looking at. We're very concerned about the explosive growth on the spending side that we've seen in the last year or so. It now appears that on a year-over-year basis federal spending both for defense and nondefense purposes is well up into the double digit range, well beyond earlier forecasts. I'm curious to know, Jim: In your projection and in your model of the federal deficit on an NIA basis, I take it that $67 to $68 billion shown is without the tax cut.

MR. KICHLINE. No, we have a $28 billion tax cut in our forecast; [that is an assumption] we adopted two months ago or so. We have not changed it; we haven't matched it up with the Administration's proposal. So we do have roughly a $28 billion tax cut.

CHAIRMAN VOLCKER. Effective January 1st?

MR. KICHLINE. That's right. Well, retroactive to January 1.

MR. FORD. You're saying that without the tax cut there would be a $40 billion deficit next year?

MR. KICHLINE. Well, roughly. We'd have a somewhat weaker economy, we would assume, so receipts would be lower. So it wouldn't all be taken out. The Administration has a $36 billion deficit in fiscal '81 with their tax proposal, which is assumed to come along late in the fiscal year and that affects receipts principally in the following fiscal year.

MR. FORD. Well, I remember the President saying just a few weeks ago that there was going to be a zero deficit next year. So I [proceed] based on the trend in their forecast rather than the absolute level. Looking at off-budget spending trends that are coming on stream and adding them on to a realistic estimate of the deficit, I would come to the conclusion that we definitely have to resist a countercyclical tax cut at this time. It would lay the groundwork, as a couple of the previous commentators have noted, for a very tough situation for us early next year in that we would be looking at a lot of pressure in the financial markets with a possible crowding out scenario. We'll be caught in the trap of either having to create and be given [the blame] for a credit crunch or for letting the aggregates get away from us in the first, second, and third quarters of next year. And when we have already committed ourselves in public to reducing the rate of growth of the money supply I don't see how we can hope to do that if we have to do it in the context of a huge deficit developing early next year. So, I think we have to fight this countercyclical tax cut. But if we wanted to add something to what we say, I'd say it should be directed toward the need for a longer-term change in the tax structure that would emphasize taxing consumption more and investment and saving less, together with some indexed reduction over a longer period of time of the inflation premium in the tax structure on incomes of all kinds. I'd be inclined to continue to fight the tax cut as a countercyclical [measure] and start to fight for tax reform as a longer-term measure.

CHAIRMAN VOLCKER. Mr. Gramley.

MR. GRAMLEY. Mr. Chairman, I'm basically in agreement with the staff's view on where the economy is going. In the near term I might be even a bit more optimistic than the staff. I've felt for some time that the recession is likely to be short and I think when we look back a couple of months from now we may find that July was the trough of the recession and we were starting to come out of it in August. But the long-run growth prospects that the staff sees are not good. And certainly the growth of 2 percent is far, far below what we have typically seen for the first four quarters of a recovery. I believe we need slow growth, and I'd be happy with 2 percent real growth. I do think Ernie is right that we're going to be struggling over the next year. I think we will struggle not just over the next year but over the next 5 to 10 years with the question of how we trade off real growth against fighting inflation. We're going to have to try to find a policy that will let us stick with the long-run battle against inflation and not try to get it done right away.

Now, I want to call attention to the fact that I can agree with the staff's forecast for next year only if the kind of policy assumptions that underlie it [are realized]. They include a substantial tax cut at the first of the year and a monetary policy that I don't think is properly characterized as simply saying that M1 grows at the midpoint of the range we've been setting. [The reason is that] the staff's forecast hypothesizes a substantial reduction in demand for money. I'd like to have Jim expound just a little on his best judgment as to what the outlook for next year would be if in fact that drop in the demand function for money doesn't occur.

MR. KICHLINE. I think I've heard this question somewhere before! As you know, we have assumed a further downward drift in the money demand function. For 1980, from the fourth quarter of '79 to the fourth quarter of '80, given what has happened and assuming no further downward drift, the drop amounts to about 3-1/2 percent. For 1981 our forecast assumes [a drop of] about 4 percent. That is the difference between the assumed actual money growth and that which would be predicted by the econometric model, which was estimated through mid-1974. It implies that there are financial innovations or other changes. We have assumed 4 percent [based on] what has occurred in several years in the past. But it's really a matter of faith, one might say, at this juncture. There is some basis for assuming it.

MR. PARTEE. Is that for M-1A, Jim?

MR. KICHLINE. That's M-1A, right. Now if you take that away--

CHAIRMAN VOLCKER. It's M-1A unadjusted? You just take M-1A at its raw value?

MR. PARTEE. We've got NOW accounts--

MR. KICHLINE. No, we don't. It's M-1A adjusted for ATS accounts. It gets very messy and complicated and is best left untouched here. But in any event if we take that away, we have in effect a tighter monetary policy than is assumed in our forecast. We did a model run which essentially limited measured money growth to 4-1/4 percent and had no drift [in money demand], and we get no recovery in economic activity at all. It's flat throughout 1981 and the deflator is .3 to .4 lower. So we're talking about nominal GNP down 2 to 2-1/2 percent from what we have in the forecast now, but we don't get a recovery in economic activity. And the model says that we get astronomical interest rates that are hard to believe--a bill rate of 18 percent or something like that.

MR. GRAMLEY. Why are they hard to believe?

MR. AXILROD. It's hard to believe they'd be sustained, I think.

MR. KICHLINE. Yes, if we extend this to the second quarter of 1982, we can see the collapse. Bill rates are, say, 18 percent and the deflator is 8 percent. It's hard to believe that that would persist for any extended period of time.

MR. GRAMLEY. But it persists unless the economy has an even worse performance than that or unless the political pressures on us to give up are so substantial that we cannot persist.

MR. KICHLINE. Right. I have no problem with that. I'm just saying it's not a sustainable pattern. At some point you have to get back into balance, which can occur from any of a number of sides.

MS. TEETERS. What is the historical record on this drift in money demand?

MR. KICHLINE. Let me just read [the numbers]: 5-1/2 percent in 1975; 4 percent in 1976; 1-1/4 percent in 1977; 1/2 percent 1978 and 1979, and we're estimating 3-1/2 percent in 1980.

MS. TEETERS. It's not a steady series. It fluctuates rather--

MR. KICHLINE. Oh, it's by no means steady.

MR. WALLICH. It fluctuates cyclically, doesn't it? That is to say, at the beginning of a recovery velocity increases more.

MR. GRAMLEY. This is not a velocity increase; it's a downward shift in the money demand function. This takes into account the cyclical movement in velocity that accompanies rising interest rates. This series is one that says: What would the demand for money be, given both nominal income and interest rates?

MR. WALLICH. I was thinking without rising interest rates. At constant interest rates, velocity tends to increase more at the beginning of a recovery. The explanation would be that people have accumulated some liquidity and some idle funds.

MR. AXILROD. I think what Governor Gramley is saying, Governor Wallich, is that in '75 and '76 we might have been making an analysis that we were at the beginning of a recovery and velocity would be increasing. That's true. But if we only said that much, we would have been underestimating how stimulative monetary policy really was in 1976 because in addition we had this downward shift in money demand. People didn't want to hold money, so velocity was going up in part also because of that. That's what this demand shift is; it already takes into account the impact of interest rates. And with that impact, people want to hold even less money, so we have an even bigger velocity. In effect, the measured growth of money in '75 and '76 of 4 or 5 percent or whatever it was in an economic sense was really more like 10 percent.

MR. MORRIS. Yes, but what you're talking about is an unexplained residual that we can't forecast. Isn't that really--

MR. KICHLINE. That's the problem with this. This is an error in an equation in which [unintelligible].

CHAIRMAN VOLCKER. You know the great faith I have in these equations in general, Mr. Kichline. But given that great faith, the naive question that [occurs] to me is: Why do we keep talking about this equation that had [an end point] of '74? Why don't we refit it through '79 or something?

MR. KICHLINE. The period [since 1974] is one in which we have had lots of financial innovation going on; it [leads to] very unstable [relationships]. You can fit anything you want. We have an almost unlimited capacity to supply new equations or numbers. But you are quite correct in suggesting that one ought to be cautious in using this. Nevertheless, I think it is instructive in the sense that it's a money demand function that makes some economic sense.

CHAIRMAN VOLCKER. But when you read off those numbers it sounded as if this demand shift that Governor Gramley talks about would basically disappear if you had used the last five years in fitting the equation. It would be in the equation.

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

MR. GRAMLEY. It would be hard to fit that for the whole period and get [meaningful equations] because the co-efficients would be moving. You would be averaging through them and you'd get a result that would be neither fish nor fowl. It wouldn't pertain to the pre-1974 period or the post-1974 period.

CHAIRMAN VOLCKER. I was thinking about just fitting it for the post-1974 period. The average shift was what, 3 percent or something, in those numbers you read?

MR. AXILROD. If we throw out '75 and '76, it probably would still fit [the rest of the period]. It depends on what one thinks really went on in that period.

MR. KICHLINE. Well, [if you throw out] '75, '76, and '80, you're right on track, but--

MR. GRAMLEY. The point that I want to make is that since we're uncertain about this shift--and I agree with you, Mr. Chairman, that we just don't know enough to put a lot of faith in these equations--what we're looking at is a policy course that we really ought to be assessing in terms of a potential for real growth at something between 0 and 2 percent. We really don't know where [potential] falls in that interval. It may fall toward the lower end or it may fall toward the upper end. So we're looking at a forecast for economic activity which will produce an unemployment rate that may hold steady or may rise very substantially next year. And that is the way we need to assess what we're doing, I think.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Jim's answer to your question, Mr. Chairman, reminds me about a forecaster friend of mine who was quoted in the paper recently on the outlook as saying that he had a whole pile of numbers in front of him and they were all useless. It is frustrating when one hears all the scenarios that could develop--the double-dip, the L, and so forth. But cutting through all that, if one looks back three or four months ago and considers the divergence of opinion then, there may be a little more unanimity on what is really going on or likely to go on than there was earlier, for whatever that may be worth. What seems to be showing through, particularly in comparison with the expectations of last spring, is that almost everybody would agree that the recession is going to be shorter than expected--that's the good news--and that inflation is going to be worse than expected, which is the bad news. And I know a few that I would consider to be reputable forecasters who are forecasting a boom in 1981. And therein lies our real dilemma. As I look at the Board staff's forecast on real GNP and the implicit price deflator and the unemployment rate--and our staff forecast is not significantly different on any one of those--the inflation picture is certainly discouraging, particularly in terms of past cyclical experience. You will recall that in the last recession the GNP deflator stood at 10.6 percent at the trough, the first quarter of '75. But a year later it was about half that amount. We really made progress in the four quarters after the trough of the recession. If one tracks [the progress] in previous recessions, [the pattern] is essentially the same. The real dilemma for us on the policy side is posed by the inflation numbers we are looking at in this forecast, where one year after the presumed trough of the recession, which is the fourth quarter of this year, we still have an implicit deflator of 8.8 percent, an unemployment rate of 8.3 percent and a real growth rate of somewhere around 2 percent. The question it poses is: How much, in fact, can demand management do to change this? I'm not happy about what I consider a reversed mix of monetary and fiscal policy that seems to be shaping up; I would share Governor Wallich's feeling on that. But as long as we have this kind of inflation outlook, which is certainly too high to be socially or economically acceptable--and ditto on the unemployment rate--it would be hard for me to favor a tax cut for the reasons that have already been set forth. I cannot support a tax cut in view of the outlook for persistently high inflation unless or until the federal budget gets changed in a way I don't think it is going to get changed. I think we are stuck being the only game in town in terms of gradually bringing some pressure to bear on the inflation problem. And as much as I would like to see tax reform, tax reduction net, I share your view that it's something we shouldn't encourage in the near future.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. We're estimating in New York that the fiscal year 1981 deficit, brought up to date with all the recent adjustments, is around $61 billion. Most of the people in Wall Street are also estimating a deficit in the $60 billion area.

MS. TEETERS. Does that have a tax cut in it?

VICE CHAIRMAN SOLOMON. That has in it a tax cut which represents basically the consensus [unintelligible]. Remember, we have the Reagan tax cut, the Carter Administration's, and the Senate Finance Committee's. [Our forecast] is based more on the Administration's [proposed] tax cut. It also includes the cancellation of the import levy tax and the withholding tax on interest and dividends, which revises the estimates. And there is a revision involving improved revenue because of the earlier bottoming out of the recession. I understand that the Administration has updated its estimate only to $41 billion so far. What they did was simply to take the mid-session figure of $29.8 billion and add the adjustment for the economic renewal package and the failure of the bill on withholding tax on interest and dividends. Having said all that, I don't see how we could oppose for substantive reasons, aside from the momentum, a moderate tax cut. I think a moderate tax cut makes sense. I agree with what I believe is the general feeling in the country that it ought to be focused in a more structural sense to promote investment and hopefully, although I'm not very sanguine about it, some improved productivity. The impression in the press, Paul, was that you took the line in your first appearance on tax matters that a tax cut probably would be advisable this year but was premature to consider at the time [of your Congressional testimony] and ought to be studied carefully. I had the impression, maybe an erroneous one, from the press that in your more recent appearance you seemed to be opposing any tax cut. There was an implication of that more than the emphasis on timing and composition in your earlier appearance. Is that an accurate press [account]?

CHAIRMAN VOLCKER. I don't know that I meant there to be any difference, really. Both times I conceded that they could go ahead now if they wanted, if they didn't put the expenditures up any higher than they are now projecting on the investment side. I don't think that's possible or practical. I don't think they're going to go along with just the investment side alone, but there's room [for that]. I am not ready to say that there's room for anything beyond that unless the expenditure trend looks better than I so elegantly expressed it in my last appearance. And I don't know what that [will be]. The Administration's pro forma projection for '82--with pro forma meaning just where current services will carry it--is for roughly an 11-1/2 percent increase in budget expenditures in fiscal '82, which is when their tax proposal would have its full effect. That might leave us with a balanced budget if the expenditures were no higher than that trend, if I recall these numbers correctly, at around the 6 percent unemployment rate. The full employment budget would still be in surplus, but the full employment budget assumes a lower unemployment rate than that by a substantial margin. Now, is that adequate? I don't know. I think it's borderline. That is where I come out.

MR. WALLICH. Well, we're not looking at the substantial additional deficits from the off-budget agencies, which are now moving toward $20 billion. Then there's the borrowing by the sponsored agencies, which also is on the order of $20 billion. I don't know if it's fair to throw that one in, but surely one has to add the off-budget agencies to the $61 or $62 billion.

VICE CHAIRMAN SOLOMON. Right. But at the same time, given the increase in the tax burden and given the psychological attitudes in the country--and I'm not talking about politics in the narrow sense of the term--there will be an enormous loss of confidence in this country's future and in the vigor of the growth of this economy if people feel that they simply have to accept this increasing tax burden with no relief in sight. As I said earlier, I strongly support not giving any relief in across-the-board personal income tax cuts, even though those [taxes] are terribly onerous. But I think we have to do something to show that we're working toward a tax policy oriented toward structural improvement in the economy. I suppose it is analogous to my feelings on productivity. It's not a question only of tangibles, things one can quantify. It gets get into social, cultural, psychological, and work ethic attitudes around the country. In an intangible way the people's perception of the tax burden and what government is doing about it is a very important substantive factor in the economy. And I don't think we can just look at the numbers and say: Well, it's $60 billion and, therefore, because we know it's going to make monetary policy tougher we oppose it. Obviously, if we can bring down the expenditures side, that would be great. But I don't believe it's going to happen because of the defense component, no matter who gets [elected]. We have a choice among various unpalatable alternatives. If we can do something to get the spending side down, fine; everybody agrees on that. But the issue still is: Where do you stand on the tax cut?

CHAIRMAN VOLCKER. We are going to have a little difficulty with time here, if we don't move along. We have talk of a double-dip recession and we have a double-dip request to talk from Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I can't disagree with the staff projection, although I put myself in the camp that thinks the potential for a W shape [outcome] is very real. But we are also in another period where I think there may an inordinate focus on what the next quarter is going to be, whether it's going to be a little plus or a little minus. In a sense that question is academic because when we look beyond those numbers and underneath the numbers what we really have to come face to face with is a rather dismal picture. We are almost a year after October 6, 1979; and the year was by any standard a very wrenching one. Certainly, I think one can conclude that if it were not for the role the Federal Reserve played, it would have been a heck of a lot worse. But the fact of the matter is, looking now a year later at the price numbers, for example, one can throw a very, very small net around the annual inflation numbers for 1979, 1980, and

1981. And certainly the prospects for the real economy are at best mixed. When I think about the whys of that, I am even more persuaded now than I was that the volatility and the uncertainty that we see still reflect a fundamental fear and expectation that somehow or other inflation is going to get worse. There is a recognition, I think often subliminal, that if inflation does get worse, the result will be even more instability.

When I put that all together in the context of public policy, bypassing the tax question for a minute, it seems to me that we have another credibility problem to deal with. Up until now there has been a lot of discussion about credibility measured in terms of whether we stick to and hit these targets for the money supply. If one looks at 1981 and assumes that we stick to them and hit them, it seems to me that we are openly facing another credibility question. That is: Okay, we've done all this and we've hit these targets for two years in a row or whatever it will be, so where are the results? The credibility question that ultimately will arise is: Does it work, can it work, or will it work? And if we are looking at a situation at the end of 1981 that looks anything like the forecast, it's going to be even more difficult to justify the kind of policy we are talking about simply because people's frustration levels in terms of [unintelligible] and performance will have been eroded, I suspect.

That's a back door way of getting to the tax question. My instinct is like a lot of other people's. Looking at the sheer numbers and the sensitivity of expectations and all the rest, my gut feeling is that a tax reduction, even a well structured one, would be counterproductive at this time. But at the same time, I also feel that there has to be a way that a tax reduction can be structured in a positive way, along the lines that Mr. Ford and Mr. Solomon spoke of. I am still very intrigued with the idea that somehow or other there should be a way to structure a tax cut that helps us get at the wage question. And I think the pressures are going to be enormous in that direction. I wish I could figure out a way to make some more sense out of it. But my bottom line on the tax cut again comes down to its structure and how it is done. If it's just a straight traditional kind of tax cut, then I would have to resist it.

CHAIRMAN VOLCKER. Mr. Black. And I urge succinct comments by all.

MR. BLACK. Mr. Chairman, we have no serious disagreement with the Greenbook forecast for the remainder of 1980. As for whether this flurry of favorable news we have seen constitutes an upturn that is already in progress or near, we are inclined to doubt that. We think it might be, as Jim Kichline suggested, in part a bounceback from the abandonment of the special credit restraint program. And I don't think we have yet seen the full reaction to the deceleration in the aggregates that we have brought about and that we have committed ourselves to doing. So the main difference we see from the staff's viewpoint is that we have more damping of inflationary expectations and less inflation than they do. As for the reasons, I'd just have to summarize by saying that we have more faith in our post-October 6th actions than I believe the staff does. It's easy to forget, as John Balles reminded us awhile ago, that we had a pretty significant deceleration in inflation as late as the '75 downturn before the aggregates got away from us. I'm also a bit encouraged by the flurry of indicators in the Redbook that we have had some weakening of price pressures at both the retail and the commodity levels. Finally, if the staff is right on its forecast of inflation, as most people seem to think--which I guess is more likely in some ways to be right than ours--then I would be very skeptical that we would have as much strength in the real economy as the staff projects.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. My view is very simplistic. I have been on this Board a little over a year now and my attitude has changed fairly considerably. I've come to believe that inflation is intractable, dangerous, and overwhelms all other problems that we have. I think we are going to have a very slow recovery; I think we need a slow recovery. I don't see how prices and wages are going to come down unless there is pressure on them over a considerable period of time. I hope whatever Administration we have understands the luxury of having the first year of its Administration be one which follows a recession, which hasn't happened in a long time in the past. I hope they understand that they can do something next year that they may not have the opportunity to do any other time. My attitude on a tax cut is that it ought to be geared with inflation in mind. We should ignore questions of equity; we should ignore questions of stimulus. Our policy should be geared entirely to attempting to do something about inflation. I like the idea of doing something about depreciation. I like the idea of trying to offset somehow the social security [tax] increase. I think we have to have some consideration of a tax-based incomes policy. I don't know how that would work. I haven't been able to figure out anything that is practical. Our experience with credit controls leads me to believe that it's hard as the devil to have that kind of situation, so I'm not very sanguine about [devising] one that can work. But I believe some kind of an incomes policy is necessary because I think every single thing we do has to be geared to that one fact that inflation is the most serious problem we face. It's bigger than everything else put together and we've got to begin to get it down over time.

CHAIRMAN VOLCKER. Mr. Guffey. Welcome back.

MR. GUFFEY. Thank you, Mr. Chairman. I'm delighted to be here. Let me just start by saying that we would not differ greatly from the staff's projection on the economy. We think the coming quarter might be a bit stronger than their projection because we start from the premise, regardless of what the Chairman or others around the table may say about a tax cut, that a cut is in train and we are going to get one. We should be talking about the structure of that tax cut rather than whether or not we will or will not have one. Having said that, it also seems to me that we have not made any real progress against inflation as a result of the fact that people are now projecting a very short recession. Historically it's true that we don't see any movement on prices until well after the recovery is under way. What I'm afraid of is that our new procedures have done nothing more than shorten the cycle and that they will not produce an atmosphere that will permit any movement against prices this time. If we indeed have the kind of growth that the staff is projecting, which is modest to be sure, and if we have gone through 3 or 6 months of decline albeit very steep and we get no movement on the price side, then I think it will all have been for naught. That says to me that in the period ahead, since we are the only [game in town], monetary policy is going to have to be fairly restrictive. And we are going to have to face the criticism that Jerry just mentioned, but that's a year down the road. So I'd rather get something working now, even though we could have negative growth in the period ahead because of the tight monetary policy, given that we will get a tax break, and take that heat a year from now. Otherwise, we have will gone through a period that has netted us nothing and we are going to have to start again, whether it's incomes policy or some other type of governmental policy. Maybe that will come to pass, but I would like this Committee at least to put the kind of monetary policy in train that suggests that we may not have positive growth in the period ahead--that we may be looking for a W or a little longer [before recovery].

CHAIRMAN VOLCKER. Mr. Roos. I assume you are going to have a statement of faith.

MR. ROOS. Succinctly, I would say that at a time when both major political candidates seem to be competing for what they can promise in the way of a tax cut, I would strongly support what you have said, even if you have to overkill, in terms of opposing a tax cut until we get through the November [drama].

CHAIRMAN VOLCKER. Does that conclude comments on this general subject? Mr. Winn.

MR. WINN. Paul, personally, I have been surprised at the bounceback. I don't know how many more months it will take to convince me that I'm wrong on that score, but I still have a question mark. But I think we have lost our benchmarks regarding the impact of certain things on economic activity. Take interest rates, for example, and the changes in financing practices that have taken place to offset [the effects of changes in interest rates]. There is all this building being done now with different kinds of financing where the interest rate per se is not as high, but a 10 percent gross kicker is established on top of any interest rate so that whenever we raise the level of rates it doesn't necessarily change the outlook in the [usual] sense of the term. [Lenders] have gone to financing that is not long-term; it's a 30-year commitment with a rollover every five years and a 2-1/2 percentage point change in interest rates either way adjusted over that [5-year] period of time. So there has been a lot of adaptability--in terms financing structures--to changes in rates, just as we have had adaptability in terms of money. I'm impressed as I watch the checks on the money funds flow through our office. When you see a check for $12 million drawn against balances that don't exist, you wake up to what is being measured and what velocity means. There was an announcement this morning by Master Charge about their introduction of new check concepts and plastic money to replace some of our measures [of money]. So, again, I think our benchmarks in terms of what we do [and the impact on] economic activity need to be reexamined.

On the other side, I'm impressed with the sociological changes that are taking place in our society. Part of this goes back to the inflation issue. We ought not miss the polarization that is taking place in society between those who are being pinched by inflation and those who are not. It's no longer just a racial issue; it's showing up in a variety of ways. And that scares me, frankly, as

I ponder what it means down the road. When one talks to doctors and psychologists and others about what complaints they hear [from patients], one finds that finance has suddenly become the biggest factor in their consultations. Personal bankruptcies in Ohio are the third or fourth largest in the nation and they are growing. Again, our benchmarks are lacking in terms of our ability to appraise what is happening on that score. There is a certain segment of our society that is really being squeezed by inflationary developments, and food prices are only going to add to this. So the pressure for a tax cut is going to be very real. The problem is that it won't really address the problem. It will just bail out a few people and the issue will come back again down the road.

CHAIRMAN VOLCKER. We are being squeezed for time, I keep saying. Governor Partee.

MR. PARTEE. I would say first that I think the bottom of the recession has been reached or is very close to being reached and that the economy is probably turning up right now. Secondly, I think it will be a sluggish recovery. The price increases will be so large that there won't be available income to spur more than just a very gradual recovery. We could get a month or two of good retail sales but then I think we will have a relapse and we won't have much of a growth rate. Basically that is what the staff is forecasting. Third, I do believe in the W [scenario], but it's likely to be a W that is a little more extended. I believe that 1982 will be the year of recession, similar to 1958 and 1960-61 when we had two rapid recessions in a period of great concern about inflation and a period of restrained policy in the late 1950s. And fourth, I think the second recession will bring the decline in income growth and, therefore, the decline in inflation. We have to get through this next year, and next year we will have a lot of inflation because of food prices. The years 1960 and 1964 and the 1974-76 period were affected quite a bit by a very favorable bump in agriculture. This year we will not be getting a favorable bump; it's going to go the other way. Therefore, the inflation rate will remain high so long as income growth remains high. But in the '82 recession I think income growth will slow considerably and the rate of inflation will slow considerably. So if we just sort of float along with this and try not to be too expansive or too restrictive and bring about some kind of change in the structure of the system over the next year or so, I think in time what Fred hopes for will be accomplished.

VICE CHAIRMAN SOLOMON. Gee, I hope this room isn't bugged! The Federal Reserve predicts a second recession [after] next year.

MR. PARTEE. That's just my own personal view.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I can be very brief. I mainly want to get on record on the tax cut question. I don't disagree in any major way with the staff forecast. The only reservation I would have on the staff forecast is the qualitative amendment that was made on the basis of the most recent retail sales numbers. I don't see any basis for a sustained expansion in retail sales, and I don't see anything in the personal income data or wage and salary numbers that would lead me to expect a strong or even a moderately strong resurgence in consumption expenditures. Like most people, I think we are seeing the signs of the early stages of the recovery, a very weak recovery. And anticipating the discussion that is coming up, I don't think we ought to do anything to choke off this weak recovery in its early stages.

With regard to the tax cut question, I'm pleased for the first time to agree completely with what Tony Solomon said, especially his comments on the intangibles. I think that was a very perceptive statement of our situation. So briefly, my position would be that it's simply too late to think in terms of a countercyclical tax cut. But we have to think in terms of tax reform--tax reform in the direction of increasing incentives to invest, incentives to save, and incentives to improve effort. And once an effective rational tax reform program has been developed, I think it would be very important to announce the intent to reduce taxes over a given period in the future. In short, I have a great deal of sympathy for the Feldstein proposal of announcing in advance what the government intends to do with respect to taxes and the tax structure.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I only have two quick questions. If we have no change in tax laws, what is the increase in the tax burden from the fourth quarter to the first quarter?

MR. KICHLINE. If we have no change in taxes?

MS. TEETERS. No, if we have the tax increases that have already been been legislated. How much of the--

CHAIRMAN VOLCKER. As a percent of GNP or something?

MS. TEETERS. No, just what the dollar volume is. We have the social security [tax increase] and something else.

MR. KICHLINE. The social security [increase] is worth $18 billion for the year; part of it is the [higher] rate and part of it is the [higher] base. The windfall profits tax next year I believe is worth $16 billion and bracket creep is worth about $10 billion. So the first digit is a 4; it's about $44 or $45 billion. We have a $28 billion tax cut in our proposal here, so we still have the tax burden rising in 1981.

MS. TEETERS. Suppose we don't have a tax cut? What happens to your economic projection?

MR. KICHLINE. The impact is a decline in real GNP of about 1-1/4 percent fourth quarter-to-fourth quarter and that would mean in that period maybe a tenth or two off the deflator.

MS. TEETERS. So your growth in calendar 1981 would be essentially zero? Is that correct?

MR. KICHLINE. Yes. It may be 1/2 or 3/4 percent--but small, very small.

CHAIRMAN VOLCKER. Mr. Axilrod, why don't you introduce the next subject and then we will [break for coffee].

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

[Coffee break]

CHAIRMAN VOLCKER. If we can come to order, let's see whether we can resolve our business after our lengthy discussion, which has perhaps had some discouraging tinges to it. I was struck in listening that it is quite conceivable, given what one senses is going on right at the moment, that when some of these August-September figures come out they will look a little better [than expected]. I don't think that has any great significance. In terms of the sluggish outlook--nobody mentioned this so I will just mention it--apart from all the other conclusions which were quite general about having to have a fairly sluggish recovery by historical standards because of the inflationary problem and longer-term needs of the economy, I think statistically when we don't have productivity growing we don't have the room for the same kind of recovery that we traditionally have had. If we have a recession, the economy can grow by 4 or 5 percent, even 6 percent, for a few quarters. It doesn't bring us as far up the employment curve as it does when we don't have any productivity growth. And for that reason alone one wouldn't look for the same kind of numbers, sustained very long, that we typically have had in earlier recoveries. But we have problems. I did not detect from the earlier comments that anybody thinks he or she has any totally satisfactory solutions, if I may put it that way. But this Committee does have to proceed on [making] some decisions, and presumably in the framework of our established operating procedures.

At this point, you have two [Bluebook] alternatives before you. That does not exhaust all the possibilities, obviously. I may be wrong, but ordinarily the alternatives we have before us haven't had a gap [between them] that is quite this wide, for M-1A anyway. The reason may be that [the intermeeting period] is a little longer [than usual]. It is probably realistic to have it that wide to make the decision meaningful since the reality does not obey the very narrow differences that we typically are presented with. I would draw your attention to these charts, which I'm sure you have already looked at, that look backwards from the fourth quarter [to] early next year if we do follow one or the other of these paths. They show how [the results] would look against the targets that we have set and reset for ourselves. I was a little surprised when I saw these. I just hadn't quite caught up with the fact that M3 apparently was stronger in August than I had thought earlier. So while I had thought we were rather comfortably in the middle of the M3 range, M3 is within the boundaries but is relatively high [in its range]. And that is one problem, [that we are] testing the high side of our ranges in all three measures except M-1A. That's the situation in which we find ourselves. Would anyone want to take off from Steve's comments or otherwise suggest a course?

MS. TEETERS. May I ask a question?

CHAIRMAN VOLCKER. Sure.

MS. TEETERS. I might qualitatively expect interest rates to be higher. Specifically, where would the federal funds rate be in the third and fourth quarters under "A" and "B"?

MR. AXILROD. Under alternative A we would expect an average level of the funds rate by the fourth quarter of something like 11-1/4 percent, give or take a little. So it may be higher than the level of the last few days by about 1/2 point or a little less.

MR. PARTEE. That's on average for the whole quarter, Steve?

MR. AXILROD. Yes, and we'd expect a further rise--

MR. PARTEE. It would be turning up as the quarter went on?

MR. AXILROD. Yes. And under alternative B the average for the quarter would probably be around 12-1/2 percent. That's assuming that the move toward that level doesn't somehow affect economic activity in the fourth quarter [very] promptly.

MS. TEETERS. And that would produce a mortgage rate of what, about 14 percent?

MR. AXILROD. The mortgage rate we have under "A" would be around 13-1/8 percent, which is not far from where it is now. But if that were wrong, I suspect the rate would be higher. And under "B" I could easily see the mortgage rate moving up between now and year-end --this is my view and others maybe differ--to around 14 or 14-1/2 percent, depending in part on the degree of concern institutions have on whether rates are going to move up even further.

CHAIRMAN VOLCKER. Let me say that we are in a [difficult] position, and maybe we will always be in this position--certainly we were when we met last month and we carefully set the level of borrowings, which is a critical factor and one we have to consider today. But [last month] within two days or something like that the money supply exploded in a way that made that a nominal assumption-- I'll call it nominal--because it was clear that the money supply in the space of two days was way above the path we were talking about and the real decision we made on borrowing quickly became nominal. Obviously, I don't know what is going to happen this time. The assumption is--or as Steve said, "indications are" that money growth in September is going to be weak. "Indications" sounds to me like a pretty strong word. I don't know what indication he has other than a preliminary figure for next week, and these preliminary figures have been notoriously unreliable. But the figure that he is assuming is a decline of $1-1/2 billion in M-1A.

MR. AXILROD. In the week of the 10th we had a $1-1/2 billion decline and [we expect] very little increase in the current week.

CHAIRMAN VOLCKER. All I am noting is that if that did not materialize, whatever we talk about here in terms of the borrowing assumption can change rather quickly. Nonetheless, I think it is significant to focus on that variable. It's a little difficult just in a technical sense in that I think it is fair to say that the federal funds rate that seems to be associated with current borrowing levels is less than one might have expected. So in that sense there seems to a little less restraint with a given level of borrowings than we were assuming last time we were in a borrowing phase, six months ago or whenever.

MR. PARTEE. What is the borrowing level, Paul?

CHAIRMAN VOLCKER. Well, the staff is estimating it this week at around $1.1 billion or so.

MR. STERNLIGHT. This week could average about $1.1 billion.

CHAIRMAN VOLCKER. Yes, actually, it has been well above that. It has been averaging $1.4 billion or something like that.

MR. STERNLIGHT. It was $1.3 billion through yesterday.

CHAIRMAN VOLCKER. And the federal funds rate has been about 10-3/4 percent.

MR. STERNLIGHT. 10.80 percent.

CHAIRMAN VOLCKER. And that is not the relationship that we ordinarily would have thought--

MS. TEETERS. How much of that is a result of the banks being out of the [discount] window?

CHAIRMAN VOLCKER. Well, it may just be that; we don't know.

MS. TEETERS. Everybody has been gone from the window for what, three months?

CHAIRMAN VOLCKER. It may be that or it may just be a gradual change in attitude. Under the new operating technique they haven't been chastised all that much when they are in as they were before. I don't know. It may be that with the passage of time, when they have been in a little more, that the relationship will tighten up a bit. Maybe it's a more fundamental easing; I just don't know.

MR. MORRIS. Well, it's the first time that the funds rate has been above the discount rate for a long time.

VICE CHAIRMAN SOLOMON. The discount officers tell me that they are reluctant, since the banks have been away for so long, to get right back to the same level of disciplined access.

CHAIRMAN VOLCKER. I don't know whether anybody has a sense of what may be going on in that area, but it's a rather significant variable in terms of the way we now operate. Maybe we ought to consider whether--. Well, is it a fair assumption to say that if you haven't been talking to the banks in New York, that probably means nobody has been saying anything to any of the banks? Now, this has only been going on for a month or so or less, so you haven't had much chance to get after repetitive borrowers, I'm sure.

VICE CHAIRMAN SOLOMON. I can't change my mind set that quickly. First of all, the volume of New York borrowing isn't that big. My impression, without remembering the numbers, is that it's not the usual proportion of nationwide borrowing. But we have been in recession. And it hadn't even occurred to me, Paul, that we should start using moral suasion other than the normal level of trying to discourage--

CHAIRMAN VOLCKER. The question is: What is the normal level? I wouldn't think anything more than normal [is appropriate], but I--

MR. PARTEE. We have that table that shows banks about to come under administrative pressure and [the number] is virtually zero as I recall, using the normal standards. There just hasn't been enough borrowing for a long enough time for anybody except the one bank in Philadelphia.

CHAIRMAN VOLCKER. I think we should watch this for a while longer and see--I'm not suggesting any new departure here--whether attitudes either in the Reserve Banks or in the banking world have suddenly changed. But then, it's very hard to know.

MS. TEETERS. The one week that we had very high borrowings we also had very high excess reserves, didn't we?

CHAIRMAN VOLCKER. That was true for one week. It happened in some week in August, I think.

MR. AXILROD. The borrowing was high in the week ending [September] third; and excess reserves were originally extremely high, on the order of $650 million. That was revised down to about $489 million a week later, but that is above average. I might add, Mr. Chairman, that I don't have the borrowing by Federal Reserve District but I do have it broken down by money market banks, which are the 46 largest, and others. In the week of the third, when borrowing was $1.3 billion, money market banks borrowed $800 million. And in the week of the tenth, when borrowing was around $600 million, money market banks borrowed around $400 million. I don't have any breakdown for this week, but that indicates a fairly active use by the large banks, which probably fits with the hypothesis that they don't feel very reluctant to borrow, not having been in for ages.

CHAIRMAN VOLCKER. Well, with that additional element, it's an inevitable uncertainty I suppose. Mr. Balles.

MR. BALLES. I just wanted to ask Steve a question, following up on an observation you made a little earlier, Mr. Chairman. As you know, Steve, there have been some pretty large underforecasts in the Bluebooks we had at the time versus how things turned out for June, July, and August. I just wondered what makes you so optimistic, as it were, that we are going to get very slow money growth in September?

MR. AXILROD. I don't think we are going to get slow money growth over the rest of the year. And whether that [more] rapid growth is going to occur in September, October, November, or December I'd be the first one to say I couldn't really tell you because there is a lot of noise in the month-to-month fluctuations of money growth. The only basis for saying slow growth in September is that we have modestly firm data for the first three days of the month and preliminary data for the next seven, so we have data for something like a third of the month. Those data show an average level for the month below the level in August. So allowing for some rise over the balance of the month--I think there will be some rise--we'd get a very low growth rate. Now, if we get a revision in the preliminary data for the week of the 10th of plus $1-1/2 to $2 billion, like we got last week, and if the week of the 17th shows no coming down from that but remains strong, then it's quite possible that September could be moving up again to very high growth rates. Similarly, we could get downward revisions and get very low growth rates. What I'm saying is that all we have is the first 10 days, of which seven of those days are partial data.

CHAIRMAN VOLCKER. Recent revisions all have been upward, but at some point that pattern will change. So, who knows?

MR. PARTEE. One could also say, Steve, that having had a very big month, which might represent some degree of stock adjustment, the odds are for a period of relative calm the following month.

MR. AXILROD. Yes, that happens often. [I feel fairly comfortable] predicting what is going to occur--that there will be strength sometime in the fall. But in which particular month is almost impossible to tell.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. May I ask: On this anticipated fluctuation in the funds rate for alternative B, let's say that in the model it would average 12 percent. Do you also estimate what the peak pressures are likely to be? In other words, are you anticipating that at times it is likely to hit the 14 percent ceiling [of our current range] and that we'll have to react accordingly?

MR. AXILROD. No, on the assumption that the Committee retained a 14 percent ceiling, we wouldn't see that as an impediment because it's largely been interpreted as an average over the days of the statement week. Therefore, if it were at 13 or 14 percent or even a little above 14 percent on some days, I wouldn't presume [the ceiling] would be an impediment. If we were wrong and there was a lot more demand for money and we are much closer to the ceiling, then it could in fact become an impediment.

MR. FORD. My feeling is in line with what John Balles said. I'm worried that the forecast may once again underestimate the pressures on monetary expansion. And given the fact that we are rapidly approaching the first anniversary of our new policy and are going to be scrutinized very carefully on the fourth quarter-to-fourth quarter performance, I would think we definitely have to get focused on taking a conservative course of action, which would be moving to something like alternative B, possibly even widening the band of allowable interest rates rather than narrowing it.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, I don't want to get into a debate as to whether the New York staff makes better estimates than the Board staff, but I'm fascinated--if I have my figures right--that for the fourth quarter New York has expansion in M-1A of 3.2 percent and the

Board staff has 7-1/2 percent. The same [pattern] is true for M-1B; it's a little less so on M2. If I am reading these right, the differences seem unusually large. I'm wondering if anyone from New York or the Board would want to say anything about it.

CHAIRMAN VOLCKER. They're not operating in a very fast league either.

VICE CHAIRMAN SOLOMON. I didn't know that those estimates were circulated. You're right about the New York numbers. But the difference is not in real GNP estimates. It's almost entirely in our assumption that there will be a reversal in the shift in money demand, wholly for transactions balances--that as people become increasingly sensitized to inflation they will reduce their holdings of non-interest bearing or low interest bearing transactions balances.

MR. MAYO. I find myself much more comfortable with the New York figure. That doesn't mean--

VICE CHAIRMAN SOLOMON. On the other hand, let me point out that the Washington figures have been more correct than New York's for the last two months. This difference in assumption has been there for two months now.

MR. AXILROD. I'm not sure exactly how that 7-1/4 percent got in there, but I probably ought to explain, President Mayo, that it is sometimes difficult to make a distinction between projections and targets.

MR. MAYO. It may be a derivative figure.

MR. AXILROD. And what we have in alternative A is 7-1/4 percent growth in the fourth quarter, which would be the implicit target if you were going to hit 4-1/2 percent for the year.

MR. MAYO. I see.

MR. AXILROD. We would expect that; that's very close to a projection because we like to make projections assuming no changes in interest rates. But we expect some rise in interest rates as I explained even with that. So in the Bluebook where we have the 7-1/4 percent [growth rate], that is the target necessary to hit a particular level over the year.

MR. MAYO. Okay. Well, the fact that they are so different doesn't influence my own opinion, which is that alternative B is the right way to go. I think it's a much more prudent approach, but I found I was covered with curiosity.

MR. AXILROD. I should add that if New York is right and the Committee adopts either "A" or "B," there will be a sharp drop in interest rates.

MR. MAYO. A sharp drop in interest rates?

MR. AXILROD. If money demand is going to be that low, there ought to be a drop in interest rates.

MR. FORD. Let's pray for New York [to be right]!

MR. PARTEE. Sometimes that's what it takes, prayer.

CHAIRMAN VOLCKER. Do you have an opinion, Mr. Mayo, that you are going to give us as to why you have a [unintelligible].

MR. MAYO. My opinion is in favor of alternative B. I do question why there should be any difference in the fed funds range under either "A" or "B." I think [the current range is] sufficiently broad to encompass both of them.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. Mr. Chairman, I didn't comment in the go-around about the business outlook because I really don't know what is going to happen. So it seems to me that what we need to ask ourselves is: Where can we make the biggest mistake? To me the biggest mistake would be to underestimate the possible vigor of the recovery. That's the mistake we have made so far and I think it would be a greater mistake to underestimate than to overestimate. The other mistake is to be too liberal with monetary growth. Given that kind of approach, I think alternative A is unacceptable. Alternative B is just barely acceptable, as far as I'm concerned; I would prefer something less than that. An alternative C of 4-1/4 percent for M-1B would provide more insurance for the year's growth; it would put growth for the year a little above the midpoint, which would give us greater assurance that if we miss, it would still be under the ceiling. That, I think, would require us to set a higher range for the federal funds rate of 9 to 15 percent. If we do that, we should feel free to use the range as necessary to accomplish those goals. That would be my preferred solution. Another less acceptable alternative would be a "B-minus," somewhere between "B" and "C." But I think we ought to go for "C" and watch in the next couple of months to see if these biases that I expressed are being borne out. We do need to do something about the discount rate. It may be too soon right now and [the current rate] may not complicate Peter's life very greatly, but we are in a new environment and I just don't know how the rate figures into the thinking of the banks [about] borrowing. So we might as well start getting that in alignment and keep it there as much as we can. So I think we need to get that up.

CHAIRMAN VOLCKER. Just translating your comments: You're prepared to see a big increase in interest rates right now?

MR. EASTBURN. Yes, I think so.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, to me alternative B defines the maximum growth paths for the aggregates that we can be satisfied with. I'm perfectly willing to accept that. I think the economy in the fourth quarter is likely to be stronger than projected and, therefore, we may see bigger rate increases than the Bluebook is contemplating, but I think we simply have to accept that. However, I wouldn't go as far as Dave and shoot for something more stringent than "B."

CHAIRMAN VOLCKER. I don't know whether it's because different people are talking, but the business outlook suddenly sounds more ebullient than the impression I was left with earlier. Mr. Winn.

MR. WINN. Mr. Chairman, I share the concern over the change in the funds rate range in alternative B and I would prefer to see it at 8 to 14 percent. Or, if we are going to move it, I would move the top range as a signal without an intent to use it. But it seems to me that is the wrong way to signal what the staff had in mind. Secondly, I'd remind us of the considerable literature that we have created that is less than three months old on the shortfall and its desirability and so on and so forth and the feeling that we need to perform this time if we are ever going to. I would favor alternative B or something even a little less with a chance to review it after experience. I do not feel that this [decision] is carved in granite and can't be changed, but I'd set out on that course because certainly we have underestimated more often than we have overestimated.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, we had the luxury, relatively speaking, of moving back on track at an even faster rate than we had decided some months ago. Now we face the question of whether we want to overshoot the track or take the wrench of getting back on it firmly. I think we ought to get on it firmly. The economy once more is giving us less unemployment and more inflation. It's painful to think that we are going to move to a mortgage rate of 13-1/2 or 14-1/2 percent, but in an economy with 10, 11, 12 percent inflation, we are going to have to get adjusted to that, bad as it may seem. The economy probably will adjust more easily to it than [we expect] in our gut reactions. So, I wouldn't be too worried about letting rates rise. Alternative B seems about right to me. I would like to see the funds rate move a little higher toward the upper end, [though] not immediately; we need to pause before it goes to 14 percent. And I would like to place more emphasis on M-1B. When M-1A and M-1B diverge as much as they do now, that indicates to me that the factors that differentiate them have gained in importance. And one is in some danger of losing sight of that if one thinks more in terms of M-1A, with its seemingly rather low growth values. If one thinks in terms of M-1B, one gets to fairly respectable rates of growth even under alternative B. So I would like to stress M-1B, at least in our thinking if not in the directive, instead of M-1A.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. The comments so far have been [for a course that is] tougher than I would like to be. I did indicate that I thought the recession had bottomed out; but, of course, it's incorrect to say the recession is over. It just means that the downward movement is over and we are at the low end of the range. And we have seen a pretty considerable increase in interest rates, one that could begin to threaten even a moderate recovery in housing. So it seems to me a little early to blithely expect to see interest rates go materially higher. If one thinks of these numbers for the aggregates as being targets--and I believe that's how we should think of them--and the actual comes out differently, then we should modify our operations. Interest rates go higher than the median here if the aggregates are strong, and they go lower if the aggregates are weak relative to the targets. If one thinks of these as target numbers for the 3-month period of October, November, and December and looks at the charts, alternative A isn't that bad. It's a little high, I think, mainly because I don't like to see M-1B running as high in the range as it is there. So, I would like to suggest an alternative between "A" and "B." I would say, for example, 4 percent for M-1A, 6-1/2 percent for M-1B, and 8-1/2 percent for M2; the latter would be the same as the alternative B number and is more a hope than anything that we would do, actually.

CHAIRMAN VOLCKER. Just give me those numbers again.

MR. PARTEE. I said 4, 6-1/2, and 8-1/2 percent. I do think it's probably time to make a little movement in our broad funds rate range, and I would raise it a point on the bottom and top and make it 9 to 15 percent. Chances are that even under the staff presumption it will be at about 11 percent and probably drifting up, so 9 to 15 percent is not so a bad as an outer limit kind of range. And I would do that on the presumption that these are targets. If the aggregates come in stronger than this, we will move up in that range; and if they are weaker, we will move down in that range from our current 10-3/4 to 11 percent. So, that's what I would prefer. As far as borrowings are concerned, I don't think we should use a figure as high as the one that Peter mentioned as the base, $1.1 billion or something like that. But it probably needs to be quite a bit higher than we talked about last time. I was thinking of something around $600 or $700 million as the base we would start from on the borrowing.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I really only find alternative A acceptable. As Chuck says, we are probably at the bottom of the recession. To take the few indications of reviving growth and use that as an excuse to tighten monetary policy seems to me totally unacceptable. We will create a double-dip recession if we start taking interest rates up as high as we would get them in alternative B. Last fall, which is not very far behind us, mortgage rates in the 14 to 14-1/2 percent area almost completely closed down the housing market. It wasn't an availability problem; it was lack of demand. So, I would strongly support alternative A, and I would keep the funds rate approximately where it is. This just doesn't seem to me the proper time to rock the boat.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Mr. Chairman, all of us are deeply concerned about the inflation problem; I don't think any of us is more concerned than the others about it. And we are trying to find a way to deal with it. But we just have to recognize that if we turn this economy around again and promote another decline in economic activity once the bottom has been reached, this country and the Congress may not have the tolerance to let us continue. I don't think it will. Now, the financial conditions that would emerge under "B" are no longer consistent with the staff forecast. The staff's forecast has mortgage rates reaching 13-1/4 percent by the middle of 1981 and [under alternative B] we are talking about a mortgage rate of 14 to 14-1/2 percent in the fourth quarter. I just think we ought to move slower than this. We will be in real trouble if we push so hard that we choke off any possibility of recovery. I want a slow recovery; I think we all do. But I don't want one that is so slow that the economy ends up turning back down again. So, I'm with Governor Teeters. I would support alternative A.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would opt for alternative B, but with the caveat that the [monetary growth] figures listed in "B" would be the maximum we would accept; we'd accept somewhat slower growth during the period ahead, if indeed the economy or other factors would dictate that. On the other hand, I see no reason to raise the lower bound of the federal funds range from 8 to 9 percent, as suggested under alternative B. I would leave the funds range at 8 to 14 percent. In part my feeling about this stems from the fact that M-1B is more acceptable to me as an aggregate to measure what we should be doing with monetary policy in the period ahead. Looking at the quarterly average for M-1B under "B," for example, we are still talking about a [quarterly average] rate of 7-3/4 percent for the fourth quarter, and that is a fairly high rate of growth. Anything that would exceed that would be troublesome to me. Just to restate my position: I would take "B" but as the maximum; I would accept somewhat lower growth if it did indeed come about. I'd leave the federal funds rate range at 8 to 14 percent because I don't think it makes that much difference. If the rate gets up to around 14 percent, we ought to be talking; we can do that in a telephone call rather than at this time.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I pretty much share the feelings expressed by Governor Wallich and Messrs. Guffey and Morris in that "B" is the maximum that I would like to see us go. We are all torn between the risk on the one hand of choking off recovery with too great a rise in interest rates and the danger on the other hand that we will make no significant progress on inflation. My first preference would be to lean against the inflation problem a bit harder by what I would call a "B-minus." I wouldn't be unhappy if the specifications of "B" were reduced somewhat to avoid overshooting for the year as a whole, which I think we could come pretty close to given the range of error and how things go. Dave Eastburn mentioned 4-1/4 percent for M-1B. I had jotted down 4-1/2 percent for the August-to-December target. That would give us growth of 5.6 percent in M-1B for the year as a whole, pretty close to the upper end of the range. I think somewhere between "B" and "B-minus" is the lesser of the evils, considering the two different evils we have to avoid.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I would prefer Dave Eastburn's alternative C. I would be pleased with John Balles's alternative B-minus. I would begrudgingly support alternative B if that's the best we can get. I wouldn't go with anything more expansive than that. For those who are concerned about higher mortgage rates, if we do anything that would imply the possibility of an explosion in the aggregates, I think mortgage lenders in response to heightened inflationary expectations would increase their rates anyway. If we cut this by having a control on aggregate expansion on the down side, if you will, I think we won't get any higher mortgage rates than we would going the other way. And we would be consistent with our stated determination to give top priority to our concern about future inflation.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, I think the target in Mr. Eastburn's suggestion is probably the appropriate one. We are at a stage where we should make a small move on the discount rate. I have the impression that there is something of a last gasp with respect to the credibility of the Federal Reserve out there in terms of coming within our targets by the fourth quarter. I realize that the ranges are such that we probably can't get all [of the aggregates] into them, but we have to get some of them in and I would suggest that, for whatever reason, those be the important ones. I think Governor Gramley is probably right that if we don't come out about there, we are going to get more specific instructions [from Congress] on where we should come out and we may have less freedom of choice in the future.

CHAIRMAN VOLCKER. Did Governor Gramley say that?

MR. GRAMLEY. Well, I think I said something a bit different.

MR. BAUGHMAN. For different reasons.

CHAIRMAN VOLCKER. I think he had rather the opposite in mind.

MR. BAUGHMAN. He had different reasons, but wound up in the same place. I would like to note also that when we reported to our board of directors last week on the new Regulation A and what we anticipate the guidelines coming along with that will be, we got quite a strong negative reaction. They felt it was a significant retrenchment in our posture at the window. They have been engaged aggressively in the last couple of years in trying to build better rapport between the institutions in the District and the Federal Reserve and feel they have been making considerable progress. They are persuaded that the institutions will see this as a more stringent face at the discount window and that they will have lost credibility with what they view as their clients in that respect.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. I'm delighted to hear that there's so much commitment to our targets and that we're going to have the strength to make sure we get growth within them. I'm a little surprised to hear so many people feel that the fourth quarter is going to be so strong. I would remind you that interest rates have already gotten to the point where they are having some impact on economic activity. Mr. Kichline, for instance, has housing starts for August at 1.4 million but then dropping to 1.2 million in September. And that's just with mortgage rates where they are right now. I don't know how sensitive automobiles are going to be to interest rates, but it seems to me that we don't have very much chance of a big strong recovery in the fourth quarter, yet that is what I hear influencing the [policy preferences] around the table. I'm afraid that alternative B or something even more conservative than that risks putting us in a more difficult position than a path that is a bit more expansive. I don't want to go to alternative A; that may put us in some danger of going out of the range on the upper end. But, you know, New York may be right one of these days. I'm afraid that if we go to "B" or something even more conservative than that, we may get ourselves in the difficult position of having to be too expansive in the fourth quarter. And we will get this stop-start pattern again. With these forecasts being all over the lot, I think we're much better off somewhere between "A" and "B," which gives us much more flexibility. And I really think it is crucial that we retain as much flexibility as we can. So that makes more sense to me than anything else. That will give us an opportunity to look at September and will give us the kind of flexibility we need to get where we want to go through the end of the year.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I favor alternative A for the reasons set forth by Governors Teeters, Gramley, Partee, and Schultz.

CHAIRMAN VOLCKER. End of statement?

MR. RICE. End of statement.

MR. PARTEE. I didn't support alternative A.

MR. RICE. I know you didn't, but you gave reasons for favoring alternative A.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I'll try to be almost as brief as Governor Rice. I think we can best hit the balance we're looking for, in terms of both the credibility of policy as perceived by the markets and the country on one hand and our concern about aborting the modest recovery, by an intermediate solution. I'd like to suggest something that isn't too different from what Chuck Partee suggested. I think we ought to have borrowing of $700 million, 4-1/4 percent for M-1A, 6-1/2 percent for M-1B, and 8-3/4 percent for M2.

CHAIRMAN VOLCKER. What was that last one?

VICE CHAIRMAN SOLOMON. 8-3/4 percent. Even though I'm indifferent on whether we have 8 to 14 percent on the fed funds range or the extended one, I think it's unnecessary to extend it, and we may be giving some policy signals unintentionally. I don't really see much advantage [to changing it]. On balance, I would say we ought to stick with 8 to 14 percent.

Let me say a word about my feelings on credibility. I'm sorry to take longer than I intended but [let me say a few] more sentences on this. When I talk to people in the markets, they are not questioning our credibility or the steadiness of our policy at the moment. There is a vast underlying skepticism that we will stick to this policy later in the year or early next year, but at the moment I think they are impressed. They have seen a very substantial rise in interest rates as the aggregates have moved up and they have not seen us try to stop that. So I don't think we have a credibility problem at the moment. We have the constant suspicion that we will buckle at some point but [market participants] don't feel we have done so or are in the process of doing so at this point. If the projections turn out to be anywhere close to accurate and we take these intermediate targets and and the borrowing level we've talked about, I think we will end up with interest rates somewhere in this range in the short run. And if necessary, we can tighten up later in the year when the pressure comes on. So that is what I would [do].

CHAIRMAN VOLCKER. That's everybody, isn't it? I confess I am a little struck by what seems to me a contrast in some of the policy judgments, or aggregates judgments, and what I took to be the tone of the earlier discussion, which was highly restrained in terms of a forecast of ebullience in the business world and somewhat skeptical of full faith in short-term movements in the aggregates. I approach this with a feeling of some concern about [how we will] come out of this meeting right at this stage. We've had a very high August, to be sure. We've had several months that were very high, but August was particularly high. There is some hope that September will show a leveling and a possible turn in the business situation. I think it's probably [going to be] a real turn, if a real turn encompasses the idea of a W, with a rather weak middle of the W.

I was somewhat concerned that we would come out and say, in effect, that we're throwing down the gauntlet and that we would make damn sure that we would meet our targets in a very acceptable way and take all the risks on the side of interest rates and the economy. I think that's a real implication of "B." I don't think we can in honesty adopt "B" without saying: Okay, beginning tomorrow or whenever we will go out and in effect force interest rates up. And I would have great reservations about that kind of approach. On the other hand, I don't feel quite comfortable with "A," given the way those charts look, particularly the M-1B chart, which a number of other people have mentioned. I think Governor Partee's comments are correct. We look at these as targets--and God knows what's going to happen--but we haven't got the short-term control mechanism that guarantees we're going to meet the targets. That much has been demonstrated by recent experience. But we do bias the [decision in an effort to meet the targets]. I would pick up in Governor Partee's comment, which has been seconded by the comments of a number of others, that the best thing we can do is to aim someplace in between "A" and "B." I think that's consistent with not taking much of an overt step at the moment. We'll see how the money supply figures develop. That may be as early as when we get a revision in the preliminary [M-1A] figure. But certainly we keep getting surprised by these [numbers] in one direction or another as time passes. I don't know what projection is right. But if the number comes out high, I think any of these alternatives imply that [market conditions] could get tighter and borrowing would go up. If it comes out as favorably as New York suggests, I suppose it would go the other way. If it comes out as favorably as New York suggests, it probably means a weaker business picture than many people have in mind and we might get a rally in the markets. In those circumstances, with that kind of aggregates picture, I'm not sure that would be undesirable.

So, consistent with what a number of people have said, but certainly not everybody, I would play it neutrally at the moment. That's what we did last time. It lasted for about two days until the money supply figure came out high [unintelligible]. I hope another $9 billion increase doesn't come along and throw us off course quite so quickly as last time. But [ongoing developments] are what we would be guided by to a considerable extent. I don't know what neutrality means precisely, given this borrowing discussion we just had. I believe you've assumed $800 million with alternative B, Steve, and that seems to me low if we really wanted to get to alternative B.

MR. WINN(?). Don't we have to have a discount rate assumption, though, to make that borrowing assumption?

MR. AXILROD. We assume the present discount rate.

CHAIRMAN VOLCKER. Well, at the moment, we assume the present discount rate. That doesn't say the discount rate wouldn't go up if the funds rate moved significantly higher. Presumably, we would maintain some relationship [between them]. I'm not saying the present relationship is all that bad--I don't think it is all that bad--but if [the spread] got substantially wider, the discount rate question would certainly arise. As I say, I don't quite know what neutrality is. I think a figure as high as $800 million or perhaps $700 to $800 million or someplace in that area might be consistent with neutrality in the short run. In that way I am picking up something Steve associated more with "B" than with "A." But in terms of the targets, this implies amid all the uncertainty a change in trend, and if there's anything to the longer range interest rate forecast, I'm not sure we want to go quite that far. By the longer range interest rate forecast I'm talking about the quarter. That's not a very long range, but it's beyond the next two weeks. I don't know what it really does imply; we have these different estimates.

MR. AXILROD. I might add, Mr. Chairman, that when we were writing "B," which was Friday afternoon, we were not aware that banks were going to be quite as willing borrowers as they were.

CHAIRMAN VOLCKER. Well, I'm obviously affected by the most recent evidence, which may be false evidence. But it sounds to me as though right at the moment anyway a little higher level of borrowing--

MR. PARTEE. It's very temporary, I think.

CHAIRMAN VOLCKER. Well, there's some evidence for it. I don't think it's just a phenomenon this week. What are those borrowing figures in the recent week? You just had them.

MR. SCHULTZ. But they are going to be distorted by Labor Day, I think.

MR. AXILROD. The borrowing has run--

CHAIRMAN VOLCKER. It was over $1 billion in the week of September 3 and I don't remember what the funds rate was then.

MR. AXILROD. It was 10-1/2 percent and then it dropped to 10.22 percent and borrowing to around $600 million.

CHAIRMAN VOLCKER. My impression is that, more often than not, these borrowing figures have been higher than what we normally associate with the equivalent federal funds rate.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. But obviously there's an area of uncertainty.

VICE CHAIRMAN SOLOMON. Mr. Chairman, may I make a suggestion, building on what you've said? If we go for what you call a "neutral" or what some of us have called an "intermediate" solution, we might take a leaf out of what we did earlier in the year but on the opposite side. We might say that if the aggregates come in somewhat lower than the intermediate targets, we won't adjust the reserve path accordingly but would accept that.

CHAIRMAN VOLCKER. [We wouldn't adjust the path] quite so quickly anyway.

VICE CHAIRMAN SOLOMON. [Yes, not] quite so quickly. We would accept them. So if the opportunity offers itself, we'd err on the side of not pushing in reserves.

MR. WALLICH. Do you mean that we should then reduce the nonborrowed reserve path or not reduce it? If the aggregates are weak, I think the analogue to our earlier action would be to reduce the path.

VICE CHAIRMAN SOLOMON. That's right.

SPEAKER(?). That's what he said.

MR. PARTEE. Without limit? That's rather wide open; it could mean zero, -5, -10.

VICE CHAIRMAN SOLOMON. No, it brings us out to somewhere [unintelligible] than if in that situation we had put in "B."

MR. MORRIS. We would be tolerant of errors on the lower side. That's--

MR. PARTEE. Remember, we did say last October and throughout the next several meetings--as I recall, the number was 4-1/2 percent--"or somewhat less." But it was only somewhat less; if it were significantly less, we would move against it.

CHAIRMAN VOLCKER. Well, we obviously have some difference of opinion and I am proposing that we come out someplace in between. These numbers do not lend themselves to easy averaging without coming up with rather small fractions. And when we get down to the last quarter, I think it becomes fairly irrelevant. We have heard two averaging proposals. Mr. Solomon was a 1/4 percentage point higher than Mr. Partee on two of the numbers. Have we ever used a number with 1/4 for a period this long?

MR. ALTMANN. I don't recall that we have; I'm not sure. Steve might know.

MR. GRAMLEY. May I ask, Mr. Chairman, to what specific periods Mr. Solomon's and Governor Partee's numbers refer? I wasn't quite sure. August-December?

SPEAKER(?). August-December.

CHAIRMAN VOLCKER. I think we're all talking about the August-December figures.

MR. PARTEE. No, mine is September-December.

MR. GRAMLEY. No, Governor Partee says his was September to December.

MR. PARTEE. The base month is August and the last month is December. That means we're talking about--

CHAIRMAN VOLCKER. I assume we're all talking about the same [period as in the Bluebook alternatives], which is August to December.

MR. BLACK. Mr. Chairman, I think a very good case can be made for using quarterly averages for two reasons. One is that our targets are set in terms of quarterly averages, and the second is that the figures look a little better in a sense. If, for example, we were to hit the 5-1/4 percent midpoint that we originally had, it would require a rate of growth in M-1B of only 3 percent between August and December. But it would require 4.9 percent between the third and the fourth quarters because August was very high. If we take the 5-3/4 percent midpoint that we talked about earlier, that would involve 4.8 percent growth between August and December but 6.8 percent between the third and the fourth quarters. That is, what I'm doing is assuming a steady progression from August to December.

CHAIRMAN VOLCKER. I'm not sure what the significance of that is.

MR. BLACK. Well, we set our targets in quarterly figures.

CHAIRMAN VOLCKER. We set the annual targets that way, but--

MR. BLACK. Yes, but it's difficult to know what to do with August to December because we don't know what the configuration of the last quarter will be. And the figures I use just assume an equal progression.

CHAIRMAN VOLCKER. I'll let Mr. Axilrod comment. But it seems to me a lot more convenient operationally to talk about a monthly target than a quarterly target that is so much affected by what has already happened.

MR. AXILROD. We tried to blend this in some sense by having the operational target go from month to month, but trying to get it so that it results in the quarter-over-quarter growth that the Committee wants.

CHAIRMAN VOLCKER. Obviously, one can express it either way.

MR. AXILROD. In general I have a little trouble with the quarterly average because if one took that quarterly average extremely seriously, whatever we put in there for the fourth quarter implies one real wrench to hit it. If we go off [target] very early in the quarter--if the pattern month to month varies from what we have in here--in the last part of the quarter we really have to wrench it around to hit the target. It is true that the quarter over quarter will vary, but it makes for a much more orderly procedure in relation to markets to do it that way.

CHAIRMAN VOLCKER. And we're stuck, unless we make an extreme assumption, with the fact that the quarterly jump is going to be fairly sizable because August went way up. Even if growth is level from now on, we'd get an increase of some magnitude in the fourth quarter. That's a fact of life. But if we were concentrating solely on quarterly figures--while mechanically we can rationalize one with the other--I think we'd tend to get more abrupt changes than we really contemplated in setting the target.

MR. BLACK. But that assumes we don't do anything about a bulge that appeared early. Then we'd have to wrench it later. But if we take action promptly, we don't necessarily have to wrench it later.

MS. TEETERS. But we have taken action. After all, bill rates are up quite a bit.

MR. BLACK. I'm talking about in the future, Nancy. My personal feeling is that we're not going to have as much upward pressure on rates as people think because I don't see that much strength in the economy. But that's a guess. We really can't forecast that with any degree of certainty.

CHAIRMAN VOLCKER. Well, if we took these--if I may so term them--more hawkish views and if we were honest with ourselves given the range of probabilities, we would be saying that we've got to go out this week and take a rather overt step to tighten up the market. That may not be necessary, for sure. That's what we don't know. Now, [doing] that may turn out to be wrong if the economy is very weak, and we might have to retrace the step. And that's one of the things that I think we would be better advised to avoid.

MR. GUFFEY. There's an alternative for that, Mr. Chairman, is there not? [We could adopt] the alternative B [growth] rates and drop the borrowing assumption from $800 million to perhaps $700 million, thus increasing the nonborrowed reserves to make up the total. That would not push up interest rates early in the period necessarily. It would give us a bit of time to view what is happening to the aggregates.

CHAIRMAN VOLCKER. I may just be talking about a gut feeling, but I tend to share the view that Steve first expressed: That if there's a risk here, it's going to be on the high side rather than the low side. I'm just going by recent experience; that's the way it has been. That could well be wrong. I have no problem with starting out with $700 million or something in that range. But I do have a feeling that starting out in that range and putting a lot of weight on [growth rates] as low as those in "B" may delay for two weeks what you're talking about. I think the odds are that at some point we're going to have to put [interest rates] up quite overtly and strongly. We may have to do that even if we went with "A." If we went to an "A+" we might have to do it. I can't guarantee [anything]. All I'm saying is that we have a stronger case if [growth in the aggregates] did get high. Obviously the higher the monetary numbers are, the more protection one has in a sense--the more explanation one has for why the market is reacting the way it has and why we have reacted the way we have under those circumstances. I don't think we have much [protection] if we're demanding that September be practically flat, which is what the staff is projecting. And I hope that's what it is. But we're also demanding that October and November be [almost] though not quite as flat. Obviously there's an arithmetic difference between these, and the way one falls in the spectrum is what we're talking about. But I would want a little more justification, in terms of the aggregates, for the kind of interest rates some of you are talking about before I saw those interest rates in the market. We are talking about an M-1B that I quite agree is a little higher than I'd like to see ideally. Just rationalizing, M-1A doesn't look so bad under these alternatives. M2 we think is going to be a little high. There's not much we can do about it. M3 is a little higher than I'd like to see it. But just weighing the risks, and against the background of the business [conditions] discussion that we had, I would like to have a little more evidence that the aggregates are fully running in excess of reasonable targets before very overt moves are forced. That's what it comes down to. Mr. Corrigan, did you comment? You didn't.

MR. CORRIGAN. Since I got penalized for my double-dipping before--

CHAIRMAN VOLCKER. I thought I counted and we had everybody.

MR. PARTEE. Well, you thought he'd used up his turn.

CHAIRMAN VOLCKER. Did I miss anybody else?

MR. BLACK. I didn't say anything, Mr. Chairman, but I will--

CHAIRMAN VOLCKER. I'm sorry. I deprived all our double-dippers. I added up wrong. There are more people here than I thought.

MR. CORRIGAN. Well, I'm not sure I can add anything much to what has already been said. This is a nasty dilemma. One point that hasn't been mentioned, which does loom somewhat large in my mind, is the fact that how we end up in 1980 is going to have a bearing on how we start 1981 as well. And that at least has led me in the direction of "B," but that's not a very powerful feeling at this time because of the uncertainty. The other thing that is bothering me about this quarter is that it's a quarter in which we are probably going to have even more problems with numbers because of all the news reporters and everything else. We could be a bit more in the blind than we usually are. I just wonder [about that] in terms of the interval we're looking at now, if we did something like Mr. Solomon has suggested in the very near term. If we do get continued rapid [monetary] growth in September and early October, I think the credibility issue will become very real. Market rates are going to move up anyway, and we'll have the worst of both worlds. Maybe there is a middle ground: Perhaps in the context of something like Mr. Solomon has suggested, the quarter as a whole could be looked at again at the next meeting and we could operate more with an eye on the next month until we see where we are.

VICE CHAIRMAN SOLOMON. That's what we've been doing the last few months, in effect.

MR. CORRIGAN. I think that's right. But as I would look at it, I tend to think we're at or near a pretty critical crossroads. All I'm suggesting, within the framework of some sort of compromise, is that maybe we can get September under our belt and keep a little more open position on the fourth quarter until we see where September comes out. That's because if September [growth] really is modest, I don't think we're necessarily talking about the kinds of pressures that people are so concerned about and that I'd be concerned about.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I really made my main point. I come out around "C," [which some speakers have proposed]. The main point I want to get across is that there's a lot of repetition in these figures. And if we say we want to hit that midpoint of 5-1/4 percent, for August to December that translates to about 3 percent but for the third quarter to the fourth quarter it's a great deal more than that, about 4.9 percent. That doesn't sound so bad.

MR. PARTEE. You're talking about M-1B, Bob?

MR. BLACK. Yes, M-1B. And if we hit the 5-3/4 percent midpoint, that would give us a quarterly growth rate of 6.8 percent, which sounds fairly high. But that translates into growth from August to December of 4.8 percent if you assume equal [monthly] increments.

MR. PARTEE. All you're saying is that August is a big month.

MR. BLACK. That's what it amounts to. And I'm saying that without much growth, because August was so high, we can get a good quarterly growth rate with figures that look scandalously low on an August-to-December basis. That's the point I wanted to get across.

MR. PARTEE. You still have a [unintelligible].

CHAIRMAN VOLCKER. I think that's right, but you're playing with arithmetic in a sense. The question is what we want to do in a substantive sense.

MR. BLACK. The other point I was going to make is about credibility. If [monetary growth] comes in as high as a lot of people expect, I think we're going to have a pretty serious problem. We may have not only high inflation but high interest rates as well. Whereas if we [hit our target], I think we're going to see some effects on inflation and we may end up just with higher rates, without as much inflation. But this route is going to give us both.

MS. TEETERS. How would you formulate this to make it a neutral policy until the next FOMC meeting? What numbers would fit a neutral policy for the next month?

MR. MORRIS. What do you mean by neutral policy--no change in interest rates?

MS. TEETERS. No, I'm just saying that I would like to see things rather calm until we have a better idea of what is going on out there. I agree with Jerry: Things are too uncertain to try to set a policy at this point that's going to carry us through December. So, if we could find some way to wait a month without rocking the boat in any way and get a little better idea as to whether some of these [developments] are real or transitory, that would be the wise thing to do.

MR. PARTEE. Well, I sort of disagree with Jerry. We're trying to set a target path that we think is acceptable. If the numbers come in high, then markets are going to have to tighten; and if the numbers come in low, markets are going to have to ease. It's a target concept rather than a projection concept that we should think about when we're specifying these. So I don't see why we can't state, as suggested in the Bluebook, the target growth rate we would like to see for the last four months of the year.

CHAIRMAN VOLCKER. My comment about neutrality relates to how we come out of this meeting right now, not for the next month. I don't think we can ignore what is happening to the money supply for the next month. As I said, we take a chance whatever target we set. If next week's figure comes out to something like a reduction of $1-1/2 billion it doesn't apply to anything we have said here. But if it comes out significantly different from that, we're already beginning to diverge under any of these targets. I guess one can argue it any way. My particular problem is that I think ["B"] is a bit unrealistic --that may not be a good word because anything can happen, including the New York projections, in which case it wouldn't be at all unrealistic--taking the broad range of probabilities. We probably wouldn't be neutral coming out of this meeting with alternative B.

MR. WALLICH. Neutrality has many meanings.

CHAIRMAN VOLCKER. I talked abut neutrality with a very particular meaning: What is the level of borrowings that we start off this track on, recognizing that it will change if within the week these figures begin deviating substantially from whatever target we set.

MR. WALLICH. That's really the old funds rate technique in an aggregates version. That is, we immediately allow the funds rate to respond to any change in the aggregates.

CHAIRMAN VOLCKER. We would be allowing the borrowings to respond, that's right. I don't know any way of running this technique without having a--. Well, let me put the question to you. Do we have a conclusion for somewhere between "A" and "B"? I will leave for later exactly how to compromise those numbers. Does a borrowing level of $750 million, just to take the midpoint of some that have been mentioned, and something in between "A" and "B" attract a spectrum of support?

MR. ALTMANN. People could raise their hands.

CHAIRMAN VOLCKER. I guess so.

MR. GRAMLEY. What aggregates would you associate with this?

CHAIRMAN VOLCKER. Between "A" and "B."

MR. GRAMLEY. If you start out with "A" and then go halfway between that and "B," that's $700 million on borrowing. To go a little further to $750 million--another $50 million in borrowing--means it's so close to "B" that I am getting very uncomfortable. I'm not at all sure that we might not end up with 14-1/2 percent mortgage interest rates on average in the fourth quarter. And that just seems to me to be too big a wrench.

MR. ROOS. Mr. Chairman, it seems to me on the basis of the opinions that were expressed that the compromise would really be [halfway] between the [midpoints] of "A" and "B" and the midpoint between "B" and [the proposed] "C." A lot of people expressed an opinion of wanting to go further than "B." That would bring us up to "B" at the very best in terms of the compromise.

MR. PARTEE. I think you have to isolate the voting members.

CHAIRMAN VOLCKER. I would like an expression of general opinion on a mid-course between "A" and "B."

VICE CHAIRMAN SOLOMON. Everybody or the voting members?

MR. PARTEE. I agree with Lyle's comment, by the way, on the borrowing level. I think $750 million is too high.

CHAIRMAN VOLCKER. The voting members. I said someplace between $700 and $800 million. I don't feel I can judge that with any accuracy. I'm not so sure that $800 million couldn't turn out ex post to imply a little easing.

MR. GRAMLEY. I'd agree with you if we could just get the sense of it and split it right down the middle between "A" and "B," recognizing that we really don't know whether the recent level of adjustment borrowing has been unusually high and will stay high or whether it will come back down again. If we had that general sense without [being precise]--if we took a range for adjustment borrowing of $600 to $800 million and gave the Desk and Steve Axilrod some flexibility to deal with it depending on what actually happens--I could live with that.

VICE CHAIRMAN SOLOMON. Do you want that much flexibility, Peter?

MR. STERNLIGHT. Well, it's an important part of the Committee decision. I wish we were better able to give you guidance to know what the relationship of the funds rate and borrowings is.

CHAIRMAN VOLCKER. You referred to this borrowing level before, Steve. Do you just want to repeat what you said?

MR. AXILROD. Mr. Chairman, I was assuming that if the Committee wanted to start off in a posture where in some rough sense the pressures in the money market weren't terribly different from what they have been in the last week or two, I would think an average level of borrowing of $600 million is way too low. An average level of $800 million might just about be consistent, given the fact that borrowing has been running high in the last week, with not much change in money market pressures. If my interpretation of what the Committee means by neutrality to begin with is right--that is, basically money market pressures about as they have been, taking everything relevant to that into account at least initially--then I would think a number between $700 and $800 million would about do it. We would technically write down $750 million in the path, but if borrowing were coming in high, we'd adjust the nonborrowed reserves down a bit and vice versa. We could just as well do that with a $600 to $800 million range. We'd write down $700 million and if $750 million looked right, then we'd lower nonborrowed reserves in the course of the week. If $650 million looked right to give a money market sense as it has been, we'd raise them a bit. We can operate with that kind of flexibility, and that may be best given this developing uncertainty about what particular level of borrowing is "right."

MR. GUFFEY. Are you making those comments based upon a weekly horizon or for the five weeks?

MR. AXILROD. My memory going back three or four weeks ago--well, I wasn't here but from the discussion I heard--three weeks ago there was an expectation of a rather high funds rate, say, around 11 percent, with borrowing around $400 or $500 million. That didn't develop. Banks were much more willing to borrow and the funds rate only got up to 10-1/2 percent. We expected this week a funds rate between 10-1/2 and 11 percent, closer to 11, with borrowing around $750 million. Well, banks very promptly went in and borrowed $1.7 billion when the funds rate got to around 10-7/8 percent, again indicating a greater willingness to borrow. So, therefore, we should provide less nonborrowed reserves. I think there is some uncertainty. If I had known the level of borrowing on Friday when we wrote the Bluebook, I would have raised both the $600 and the $800 million to get to the point where "A" was a tick toward ease and "B" a tick toward tightening to start with.

MR. GUFFEY. My question is: If the Committee decided on a "B" or "B+" target for the aggregates, would you construct the path based upon a borrowing assumption of $750 million for five weeks?

MR. AXILROD. If the Committee decided on "B," no. I would assume that borrowing consistent with this discussion of somewhere between $600 and $800 million is neutrality. I would assume [for "B"] it would be somewhat above $800 million.

CHAIRMAN VOLCKER. There's a little confusion, I think, because Steve, if I understand it correctly, has changed his mind from the time that the Bluebook was written, given the extra week's experience of relatively heavy borrowing with relatively less pressure on the money market than would have been expected.

MR. AXILROD. With uncertainty.

CHAIRMAN VOLCKER. So I'm taking that into account in my own comments. Let me put the issue to you again in a general way. We'd have to focus on the borrowing level a bit more precisely and we'd have to resolve the fractions even if this proposal for roughly halfway between "A" and "B" commanded enough general support. But the borrowing level is biased a bit higher than the Bluebook says is consistent with those alternatives, based upon the comments that were just made.

MR. SCHULTZ. You want raised hands on that issue?

MR. PARTEE. You want preferences or can live with?

CHAIRMAN VOLCKER. I guess "can live with."

MR. PARTEE. That was a wise decision, I think.

MR. ALTMANN. Seven, not counting yourself.

CHAIRMAN VOLCKER. I think it's pretty clear, without going through any other exercise, that we're not going to get a larger feeling for any other number. Let me just bear in a little more closely. Halfway between is literally 4-1/4, 6-5/8, and 8-3/4 percent on the aggregates, right? The main difficulty with that, as I see it, is the 5/8ths. It looks like a half-size, as they say.

SPEAKER(?). You're an awfully small person!

MR. AXILROD(?). Mr. Chairman, the staff [unintelligible] if you adopted 6-1/2 percent [for M-1B].

SPEAKER(?). And 8-3/4 percent at least [for M2].

CHAIRMAN VOLCKER. If we literally wanted to avoid quarters--it would lean a bit toward "B"--I'd take Governor Partee's numbers of 4, 6-1/2, and 8-1/2 percent. Let me say a word about the funds rate range. We're right in the middle of [the current range]. As Tony Solomon and some others said, why fiddle around with it at this point?

SPEAKER(?). Right.

CHAIRMAN VOLCKER. I'm inclined to say 4, 6-1/2, and 8-1/2 percent and $750 million. But I have no strong argument against the alternative, which I suppose is 4-1/4, 6-1/2, and 8-3/4 percent. That just puts in quarters.

VICE CHAIRMAN SOLOMON. I'll go with either.

MR. PARTEE. I don't care. It seems to me that our actual experience is usually broad enough that it looks rather funny to be putting down quarters as targets. But I would accept the quarters.

MR. SCHULTZ. I think you're probably right. It looks better without the quarters. And those numbers are a bit more conservative, which seemed to be where people wanted to move to a little.

CHAIRMAN VOLCKER. That's obviously closer to B. And with a $750 borrowing assumption--

MS. TEETERS. We could round up instead of down, gentlemen.

MR. SCHULTZ. I hope we don't lose anybody.

MR. ROOS. Mr. Chairman, I'm disturbed, not so much even about the figures as this: I thought we had agreed, and that all thinking that has ever been expressed about targeting aggregates [suggests], that we had to set long-term targets and stick with them.

Trying to fine-tune, as I think this discussion is demonstrating that the majority in this Committee is dedicated to, for 30 days in order to have some effect on interest rates I think is a reversion back to very thing that we abandoned last October. It makes intelligently targeting on aggregate growth and on reserves an impossibility. This whole conversation reflects, at least as of this moment, that we've thrown in the towel on our noble expressions and intentions of last October 6th. We're right back to trying to control interest rates and trying to move from moment to moment, which is what has been happening in this Committee as long as I've been sitting in these meetings. This is where we have gotten into trouble in the past; whenever we've been faced with a difficult decision we've always said, in effect, let's wait another 30 days or another 60 days. We procrastinate. And that is why, I think, we are in the inflationary situation in this nation that we find ourselves in today. I apologize for that.

MR. PARTEE. Larry, we're within the targets.

MR. SCHULTZ. Mr. Roos, I don't want to engage in an argument, but I think we're doing exactly what we said we were going to do on October 6th. If you recall, we announced that the former policy had been that we looked at the aggregates and at interest rates and we put more emphasis on interest rates; but now the policy was going to be that we would look at the aggregates and at interest rates but we would put more emphasis on the aggregates. At no time did this Committee ever say that interest rates would be ignored.

MR. ROOS. Fred, we can't do both at the same time and accomplish both objectives if they're incompatible. I'm being--

MR. SCHULTZ. You'll pardon me if I respectfully disagree.

MR. PARTEE. And I would point out, Larry, that we're well within the targets that we specified in January and respecified in July for three of four aggregates. M2 is a trifle [above]. But I don't think the concept has been violated.

CHAIRMAN VOLCKER. In the best of all possible worlds, I could be lowering these targets just for the sake of imagery. But let us not forget that M-1B is obviously specified too low and we chose not to change it at midyear. But some of that discrepancy between M-1B and M-1A is coming out of savings deposits. We don't know how much, but it is. I think we can say unambiguously that it's too low relative to what we thought we were setting at the beginning of the year. Well, we have a proposal of 4, 6-1/2, and 8-1/2 percent, with $750 million on borrowing and keeping 8 to 14 percent on the funds range.

MR. GRAMLEY. Do we understand this as halfway between "A" and "B" but with the numbers just rounded to 4 percent and so on?

MR. SCHULTZ. It's a bit more toward "B."

CHAIRMAN VOLCKER. Let me just raise one further point. It's the point that Mr. Solomon raised earlier, which is a point I don't think we can quantify. But we have operated before when we were either high or low in a way that implied some tolerance for shortfalls or overshoots. When we were high we said "or somewhat below," implying more tolerance for shortfalls. During the summer, in fact for two months--maybe we shouldn't have but we did--we said if [monetary growth] comes in high, we will be tolerant of an overshoot. I could well see adding a tolerance of an undershoot to some degree here. I don't know that we can specify that arithmetically. But what we would be saying is that if the numbers come in unexpectedly low--that would mean total reserves were coming in low--we would be slower about making any adjustment that might otherwise be made in raising the nonborrowed reserve path to make up for the shortfall. That's just the opposite of what was done--

MS. TEETERS. That is moving very close to "B." You've rounded the numbers down and then tolerate shortfalls.

MR. PARTEE. I think it's worse than "B" because if what we've seen in the economy is a little bubble, we could be very slow to have an adjustment to it. We are not out of these ranges. I don't see the basis that we had last summer for doing that, when we were clearly below the ranges, or last fall when we were very concerned about being over the ranges. We are within them.

MR. CORRIGAN. Yes, but we don't have much room for error. That's my problem.

MS. TEETERS. That's just a function of being in September. We've nailed ourselves down on the end of December and that's--

MR. CORRIGAN. Yes, but September to December is a very short period in terms of controlling the aggregates.

CHAIRMAN VOLCKER. No, we haven't got a lot of room. We have more room for undershoots in a purely target sense than for overshoots.

MR. PARTEE. But we most recently had a big month, and that's the only thing you're saying: That we had a really big month. When we had a small April, the shoe was on the other foot and that dropped us right below our target ranges.

CHAIRMAN VOLCKER. But that's when [we did this]; it was following that very low month that we adopted the opposite [approach].

MR. PARTEE. But we were below the ranges.

CHAIRMAN VOLCKER. We were below the ranges.

MR. MORRIS. But we had a lot more time in April [to reach our annual targets] than we have in October.

MS. TEETERS. The fact that there is an end point to this shouldn't be what decides this. We could change the specifications to the middle of next year, which I understand the Committee did when it had a rolling base. But to over-fight to make it in the last four months just for appearance sake, regardless of what happens in the real economy, seems to me the epitome of foolishness.

MR. MORRIS. If we're in a position where we don't think the guidelines make sense, I think we ought to change the guidelines.

MS. TEETERS. But we're within them.

MR. WALLICH. Yes, but [the aggregates have been growing] at higher rates than compatible with the guidelines. And we're within them because we're making up for a large shortfall. So if we continue at this rate of speed, we're going to overshoot. Our question is precisely: Do we want to get back on track by making a slight bend or a significant bend in the rate of growth?

VICE CHAIRMAN SOLOMON. Chuck, my suggestion carries forward on what Henry just said. I don't understand why you say that a very minor nuance--that if the opportunity arises, we tolerate an undershoot--is worse than alternative B.

MR. PARTEE. Because it just means that there's a very lagged response to an unexpected weakness in market terms. That's what it means. And I would point out that for these last four months of the year we're talking about growth rates of 4, 6-1/2 and 8-1/2 percent; those aren't fast. They are within the ranges, I think.

MR. WALLICH. You're not including August?

MR. PARTEE. No, and I'm not including April either. August is water over the dam and April is water over the dam. We're talking about the next four months.

CHAIRMAN VOLCKER. M-1B would be right at the top of the range [for this year], I think.

VICE CHAIRMAN SOLOMON. But Chuck, if there is a weakness in the figures, the markets will reflect that. Therefore, we have a small delay in not correcting the undershoot but it isn't as though we're going to be pushing up--

MR. PARTEE. But we'll take out the reserves and that will mean that the money supply will be low. And there won't be a self-correcting operation.

MR. WALLICH. Even though I would like the consequences of that action, I don't think it is a good principle. I didn't think it was a good principle when we did it [when monetary growth was] on the way up, so I shouldn't like it on the way down. It's really getting back to a funds rate target.

CHAIRMAN VOLCKER. I thought you liked those.

MR. WALLICH. Okay, but [unintelligible] a given rule. Given that option, I'm not proposing to go back to that.

CHAIRMAN VOLCKER. We can always consult, so let's not make that part of the proposal. I, frankly, would be delighted if the money supply comes in so weak that it provokes a consultation as to what to do about it. We'll cross that bridge when and if we come to it.

MR. WALLICH. In that case, wouldn't it be helpful if we raised the lower limit of the funds rate?

VICE CHAIRMAN SOLOMON. You don't want to target on the funds rate, you just want to raise it!

CHAIRMAN VOLCKER. I have no great objection to raising the lower limit on the funds rate if that's what the Committee wants to do. It's not accomplishing anything; I'm persuaded by the point that Tony made earlier. But if that's really important to somebody and it convinces them to join in this consensus then--

MR. AXILROD. Mr. Chairman, the discount rate is 10 percent. In some sense that's a fairly effective lower limit because if [monetary growth] gets weak enough that borrowing gets to zero--

CHAIRMAN VOLCKER. No, I don't think it's very substantive whether we--

MR. AXILROD. It's going to be a problem for [a funds rate of] 8 percent.

MR. PARTEE. You can bet that long before it got down to 8 percent we would be consulting.

CHAIRMAN VOLCKER. For that reason, I'm not disturbed by raising [the lower limit of the funds range] to 9 percent either. It's purely a cosmetic question.

MS. TEETERS. I'd like to see the range kept at 8 to 14 percent. That gives us the maximum amount of range for it. I'd hate to signal by raising [the lower limit] that we were tightening policy. If it's meaningless, then why do it at this point? I think it will be taken as a signal in the market that we did some tightening.

MR. PARTEE. Technically, it wouldn't be [known to the public] until the policy record came out since they never test either end of this.

CHAIRMAN VOLCKER. I think it's virtually inconsequential except that somebody is going to read the policy record a month from now and see that we raised the lower end of the band by 1 percentage point and will wonder what that means, if anything. I'm back to 4, 6-1/2, and 8-1/2 percent, 8 to 14 percent with a feeling of virtual indifference on my part about that, and $750 million. Are we ready to vote?

MR. GRAMLEY. Can we again have some interpretation of this? This is almost "B," and I thought we were starting out with some sort of compromise between "A" and "B." Plus you were almost willing to increase the lower end of the funds rate range and that's even further toward "B." And I'm just getting uncomfortable.

CHAIRMAN VOLCKER. I guess you're uncomfortable about the borrowing. All I'm doing is accepting--because I tend to agree with it--that the borrowing specifications in the Bluebook are a little low based upon what we know now. So I'm just adjusting for that.

MR. AXILROD. When you asked the question, Mr. Chairman, I was assuming that $750 million was the midpoint around which there could be some variation. With nothing else changed--that is, if the paths were all working about like this--if the funds rate was going up very high and if borrowings were $750 million, there would be a certain freedom within the very first week on that interpretation such that borrowings would be lowered because that would be an indication that the demand for borrowing was not as high as we thought. So I think we would be interpreting it along the lines of what you were saying, Governor Gramley.

MR. GRAMLEY. Okay, thank you. That helps me.

MR. PARTEE. It's really a $700 to $800 million range, or something like that.

MR. AXILROD. Yes.

MR. PARTEE. That's a better way to think of it.

CHAIRMAN VOLCKER. Ready.

MR. ALTMANN.

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

MR. ALTMANN. Eight for, four against, Mr. Chairman.

CHAIRMAN VOLCKER. I suppose we ought to eat, and we're going to eat right here. Oh, one quick thing. We need somebody to be second in command after Governor Schultz to act on freedom of information requests. Governor Coldwell used to do this and we've had no alternate since Governor Coldwell left. We have to repair that oversight. It has not proved to be a heavy responsibility. Governor Partee, who serves in that function for the Board of Governors, has agreed to serve in that function for the Open Market Committee, if the Committee so agrees. Do I have a motion?

SPEAKER(?). So moved.

SPEAKER(?). Seconded.

CHAIRMAN VOLCKER. Without active dissent, Governor Partee will be the alternate.

MR. ALTMANN. Now that that has been accomplished, I might say that I have just recently denied a request which is likely to provoke an appeal.

MR. PARTEE. Well, I'm certainly glad that Governor Schultz is here!

CHAIRMAN VOLCKER. But that doesn't get to Governor Partee. Do you have a question, Peter?

MR. STERNLIGHT. I may have missed it, but I don't think you formally approved the Open Market Desk's [intermeeting] operations.

CHAIRMAN VOLCKER. Well, we don't want to overlook that. Without objection they are approved.

MR. PARTEE. What would happen if we didn't? Is it any good for a loss or a gain?

MR. SCHULTZ. Well, we might have to talk about "Peter who?"!

END OF MEETING