

APPENDIX

Transcript of Discussion Held on August 22, 1983

CHAIRMAN VOLCKER. [This is] a discussion, not a meeting of the Federal Open Market Committee. I circulated [an outline] containing some general questions. [Secretary's note: A copy of the outline is attached.] The first part was more general than the second part, which is essentially procedural. These questions, both conceptual and procedural, keep arising in my mind as I sit here in the meetings and when I have to traipse up to Congress and discuss them. And I thought we might usefully open up the discussion--I don't suppose we'll attempt to come to any particular conclusion today--and see whether we want to carry it on more elaborately or more precisely at some later date.

I think the easier issue to get a grasp on is the procedural one, so let me take that up first. I have had a feeling for some time that this process of making an elaborate and formal projection every six weeks has its limitations. I sit around at these meetings and, speaking personally, find the discussions on the business outlook often less provocative than they might be. There's perhaps a certain natural passiveness [in the tendency] to discuss the outlook only in terms of the staff forecast, which is usually brilliant and solid, but that [practice] is not in itself conducive to the expression of strongly conflicting views that should be explored.

There are two proposals [in the outline] under number 2; let me bring up "b" first and then go to "a." And "b" and "c" are part of the same process. We don't have to reach a conclusion on this today. Would it be a good idea to have a procedure where we would have a staff forecast fully articulated, the way it is now, let's say at the beginning of every quarter? We meet, what, eight times a year? So, four times a year, if my arithmetic is right, we would have the same [type of] forecast as we do now. And when we meet in the middle of a quarter, we would have a staff presentation that would discuss the outlook as we do now, but it wouldn't have to be a fully articulated forecast. The staff could say they feel a little better about things than they felt last time or a little worse and give the reasons. But we'd provide an opportunity for a different view to be expounded, not just for the sake of being different. It could take several forms. [It could entail] the development of some aspect of the economy, either short run or long run, that otherwise wouldn't get the same amount of attention, or an alternative forecast which could come from within the Federal Reserve System, either by the Washington staff or staff of one of the Banks. Or indeed, it could be a presentation, as someone suggested to me, of outside forecasts--a review of a variety of outside forecasts so that we are sure that we are being exposed to outside thinking. I have not thought of anything so radical as having an outsider come into the meeting to expound the forecast, but we could be presented with an interesting forecast or a range of forecasts from outside to put a little different angle or twist on the discussion of the business outlook. I don't think I have anything much more complicated than that in mind in the thinking that I've done

about it. But we might just discuss this a bit. It will be brand new to some of you and I don't think we have to reach any conclusion. But my point of departure is: How useful is it to have a full scale staff forecast every six weeks as opposed to, let's say, once a quarter, which is going to set the framework for the targets for the quarter and what we have in borrowing?

MS. TEETERS. Well, I find [an updated] forecast every six weeks very useful because the constant flow of information gets incorporated into it as we move along. And occasionally, we get a rather major change in the forecast. For example, not this quarter but the one before the forecast changed rather sharply as a result of incoming data. I think it does utilize the full range of expertise that we have in the System. As for outside forecasts, I get enough already. They are literally pouring out of my in-box practically every week. So, I see almost all of the other forecasts and I'm not sure that having a summary of what is being forecast on the outside is going to add much to the information that I have so far.

MR. WALLICH. I share Nancy's feeling in that I'd like to see updates. Now, whether we get the full [package] with the model printouts--nobody can read that anyway--[isn't critical] but the major changes in the rate of growth and prices are. For instance, if we hadn't had a six weeks updating of the forecast, it would have been quite hard to follow the sudden surge of the economy this year. We might now just gradually be catching up with the GNP numbers that are being published.

CHAIRMAN VOLCKER. That I find a little difficult--

MR. WALLICH. As for outside forecasts, I don't know of any that is sufficiently different from ours to be very meaningful. A survey of where others stand and where we stand within that spectrum of others I always find interesting. And I try to get myself data of that kind. It's certainly not difficult to do, but it might be interesting to do it here.

MR. GRAMLEY. I wonder if we couldn't achieve in any event most of what you want, Mr. Chairman, with relatively minor changes in staff presentations. I find quantitative forecasts very useful. There are times when a change in one's perception of what is going on in the world happens. In my case, I have become aware in the past six weeks of a lot of qualitative evidence that the slowdown in housing is going to be larger than I thought it would be. So, I'm inclined to ask myself the questions: What does this mean? How much is it going to slow down the economy? How do I need to take this into account? Those are the kinds of questions the staff is continually trying to address in making a quantitative forecast. The staff presentations we do get I would hardly call recitations of detailed quantitative forecasts. They're inclined to be interpretive. Maybe we could ask the staff to go a little further in that direction in the meetings

other than the quarterly ones. I don't see that there's any need for a basic change in what the staff is presenting to us.

VICE CHAIRMAN SOLOMON. Probably what we should improve is the quality of the discussion after the staff forecasts. I don't know how to do that.

CHAIRMAN VOLCKER. That's part of the effort here. I'm not sure we get that when the staff [has presented a forecast]. It's very easy to sit here and say "Well, it might be a little higher or lower than the staff forecast, but the forecast is all right." That is the typical comment from each member.

MR. PARTEE. Maybe we could have the discussion before the staff presentation. I think it's pretty hard to do it halfway, Paul. The staff, contrary to general belief, does not have a model that they just grind out. What they do is put together their best efforts [to develop] a judgmental notion of the outlook and go through the whole iteration. Whether or not they disclose it to the Committee, they are going to have to do it every six weeks if they have to give us highlight information every six weeks, so--

CHAIRMAN VOLCKER. That's not my problem. My objective is not to make the staff work less hard. It's to get a fresh point of view occasionally.

MR. RICE. I guess I'm in the minority with the Chairman. I think the fact is that the forecast doesn't change that much most of the time over the period of a quarter. And since it doesn't change that much, just a judgmental updating during the meeting in the period between quarters would be enough. It would be enough for me.

MR. PARTEE. Well, that's precisely what we get.

MR. RICE. No, we get a full quantitative forecast.

MR. PARTEE. I call that a judgmental updating.

MR. RICE. Well, without the numbers.

MR. PARTEE. Well, you have to make sure that the assets and liabilities match. After all, a double entry bookkeeping system imposes some discipline; you have to run through it. That's one comment one would have about their forecast this time.

MR. WALLICH. Well, another of these suggestions does appeal to me a great deal and that is to have specific topics, maybe relating to these fundamental [issues] that are listed here or maybe to how we [operate].

CHAIRMAN VOLCKER. The process should be covered in this order, and we're not quite there yet.

MR. WALLICH. Excuse me.

MR. MARTIN. I think there would be real merit from time to time in hearing a forecast presented by chief economists or some other staff person from one of the Federal Reserve Banks under the leadership of that Bank's president who obviously would be present and participating in it. I realize that there are twelve Federal Reserve Banks and four [such] meetings a year, but that surely could be worked out if only by a lottery of some kind. I think it would be well to have that kind of presentation. I don't know if it would necessarily subsume or take the place of the staff presentation--the latter could be in writing or some updates on the highlights could be expressed in writing. I think we might benefit from hearing the point of view from one of the Fed Banks from time to time.

MS. TEETERS. Well, there is a consensus in the forecasts out there. Now, if you want a different point of view, you go to someone like Mike Evans and I don't think that--

MR. PARTEE. Or Gary Schilling.

MS. TEETERS. Even the private forecasters come in with some semi-consensus. There are a few outliers in each one of these and they generally tend to be the same persons.

MR. MARTIN. This is a System comprised of a Board and twelve Banks, and I think from time to time the Banks should be heard from in that context and in that forum.

MR. RICE. That's a very good suggestion. We never hear what the Banks forecast. We don't know what they have. All we know is what the Presidents say.

MR. ROBERTS. You're quite right. We put our forecasts in writing for the purpose of the midyear report. We put our GNP estimates in writing.

MR. RICE. And who sees them?

CHAIRMAN VOLCKER. They're for everybody. They're not always comprehensible.

MR. RICE. More often than once every six months?

MR. ROBERTS. I think the frequent staff updates are very useful. They permit me to compare with my internal research staff estimates and help prepare me for these meetings. I would prefer to see it kept on that basis rather than move to quarterly.

MR. PARTEE. I would have thought, Emmett, that if a Reserve Bank had a significantly different forecast, that would be highlighted by the President in making his or her comments. I've often heard a

President say "Well, ours is a little different." And maybe that could be amplified more when there is a difference. I assume that every Reserve Bank is making a forecast also.

SPEAKER(?). Sure.

MR. ROBERTS. And getting the input of private forecasters.

MR. RICE. But we don't know what they are.

MR. PARTEE. We don't care unless they're different.

MR. RICE. It might be useful some time just to hear the forecast if a Bank has one that is markedly different. I think it would be of interest.

MR. GRAMLEY. If what we want to do is learn what the Banks are forecasting, then we ought to assemble a series of forecasts and put more numbers on the table rather than less. It just seems to me that we're talking at cross purposes here: On the one hand about not having so many quantitative forecasts on the table and not so frequently, and on the other hand about putting some more on the table. I'm not sure what we're trying to achieve with this.

MR. RICE. No, I think what Preston was suggesting was that in the "off" meeting--that is, in a meeting when we're not looking at a quarterly forecast--that perhaps we could look at a Bank forecast or maybe even an outside forecast instead.

MR. WALLICH. Well, I think we're moving in the direction of the Blue Chip [summary of forecasts]. We have a survey of all forecasts, which incidentally I think is updated every four weeks or every month for the most part. And I think there's some merit in seeing how the central tendency moves.

CHAIRMAN VOLCKER. I'm not sure myself that there's much merit in seeing how the central tendency moves. It's usually wrong. But occasionally somebody will have an insight--a little different way of looking at things--that might be useful to take into account.

MR. MARTIN. A different insight and the reasoning that goes behind a forecast that differs from the staff's forecast--

CHAIRMAN VOLCKER. I'm not interested in seeing more forecasts that look just like the staff's forecast.

MR. PARTEE. Well, the trouble is that some things are insights and some things are just poor forecasts.

CHAIRMAN VOLCKER. It's your job to tell the difference.

MR. WALLICH. Well, in that case, wouldn't it be a function of looking at a range of forecasts and selecting some that seem to differ in an interesting way for reasons one can understand--because they have a different view of how the economy functions, or have a monetarist or other view--and then focus on one such forecast. But it would have to be pretty selective. One couldn't just say at each FOMC meeting another Federal Reserve Bank--

CHAIRMAN VOLCKER. I think what you're suggesting is more what I had in mind. But you wouldn't routinize it; you couldn't.

VICE CHAIRMAN SOLOMON. We'd need a supply side President!

MR. PARTEE. A gold standard President--the whole variety!

MR. MORRIS. Could we leave it that if a Reserve Bank has a fundamentally different point of view--and that's going to be very rare--that that point of view might be put on the agenda? I think very often the difference between my staff and the Board staff is that the Board staff is constrained to assume that the rate of growth of M2 is going to be at the midpoint of its range and my staff says it's not going to be at the midpoint but, say, toward the upper end of the range and, therefore, they're talking about larger nominal GNP growth next year. If they had the same assumptions, they probably would come up with the same numbers. But the Board staff does operate under certain institutional constraints, and maybe those constraints ought to be examined. Or maybe we ought to give the staff a little more help on what the most probable outcome will be.

MR. PARTEE. Then you want the staff to give a forecast not associated with the Committee's policy?

MR. FORD. No, but it should be associated with the Committee's average pst deviation from policy.

MR. MORRIS. In recent years the FOMC's target more typically has been the top of the range than the midpoint. It seems to me--

CHAIRMAN VOLCKER. I don't think the staff always takes the midpoint. Do you? I have no faith that they can tell the difference between the midpoint and the upper end.

MR. KICHLINE. Generally, though not always. But we have tried to follow what we would read the Committee--

CHAIRMAN VOLCKER. Yes, if the Committee said it expected growth to be in the upper half, you would have taken something in the upper half.

MR. KICHLINE. That's right. But, even so, I think the point President Morris is making is that what we are doing--or like to think that we are--is conditional forecasting. We try to specify certain

[assumptions] on the fiscal and monetary policy sides, always, but there may be other things as well.

MS. TEETERS. Well, occasionally, such as in February, you provide alternative forecasts, given different assumptions. Maybe that is the sort of thing we need more than we need outsiders--and I'm not putting the Banks with the outsiders. Maybe we need a bit more running of the alternative interest and money assumptions as to what difference that would make in terms of the forecast.

MR. AXILROD. Well, we do that twice a year, Governor Teeters, in conjunction with giving alternatives for the long-run targets. I must say that half the time--I've thought of working up my courage to admit this--because we work off the model all it conveys is that if we have a little more money [growth] we're going to have more GNP now and more prices later. There's really nothing else that comes out of there. It's a bit mechanical.

CHAIRMAN VOLCKER. That's one thing I don't need a staff for, because I look at these things often enough to give me a central forecast without any help.

MR. BOEHNE. I think we basically have a good process here, and it seems to me that very few if anybody else in the economic policymaking business or even in the private sector has an economic intelligence-gathering mechanism such as we do. I think it's really rather good, and we ought to be careful in tinkering with it. What I think I hear you saying, Mr. Chairman, is that you would like to have some differences of views, some differences of opinion. It seems to me that that can be had by encouraging that type of activity where there are legitimate points of view rather than trying to change the basic mechanism that we have. So, where I come out is that we stay about where we are but encourage members of the Committee to come forward with different points of view. From time to time it might well be worthwhile to have a separate more formal invitation, but I would not want it to become a mechanical thing--that the mid-meeting of the quarter is the time for a different point of view. There are times when there are different points of view and it takes some effort to search those out, and I think we ought to hear those points of view. But I'd keep the system basically as it is with a new alertness to opportunities to bring different points of view to the table.

CHAIRMAN VOLCKER. Are you all feeling alert? It's not so easy, I'll tell you. Well, we'll continue to ponder on this. Let me go to "2.a," the topic that Henry Wallich alluded to. This is just a question of occasionally--maybe once a quarter or whatever, probably when we are meeting on Monday as well as Tuesday, which we do occasionally anyway--focusing on some particular aspect of interest to policy or the outlook that may be a bit removed from the monetary policy directive.

VICE CHAIRMAN SOLOMON. Some of these [topics] don't have too much bearing--for example, the productivity discussion, probably--in terms of factoring them into monetary policy in a direct way. But one can think of topics that would have a [more direct] impact. One is certainly the deregulation, which those of you in Washington are closer to, expected next year and the year after. The [implications] of that would have a closer correlation with the monetary aggregates and changing banking practices, et cetera. And then there are issues that have an intellectual interest in and of themselves, even though they don't have that close a relationship [to monetary policy]. I have felt all along that we never have had a really good discussion of the stimulative effects of large fiscal deficits as against the interest rate effects, and there are different time lags in that. The doors are open for [unintelligible] need discussion.

MR. KEEHN. I'd certainly agree with that. I think there are some very interesting and important economic structural ideas that may not be directly related to monetary policy but certainly create the environment in which we're making decisions. It's conceivable that we'd have 2 or 3 parts to a presentation that would represent different points of view on an important issue, but I think it would be extremely interesting and very important.

MR. GRAMLEY. Is there anything that we can get from a briefing of that kind that we couldn't get in a document? What we ought to focus on is whether or not this particular group is one in which a group discussion of a subject of this kind is more conducive to learning and the advance of knowledge than getting a detailed staff document presented to us ahead of time. It's hard to discuss productivity trends; it's a very technical subject. I'm just not sure you can sit down with a group like this and discuss productivity trends with much benefit, as opposed to our having a staff study done on productivity trends and reading it ahead of time.

MR. KEEHN. Well, Lyle, I'll bet there are some people in the productivity area who can give a presentation that will provide a level of knowledge from which I can then read a staff study that would have a lot more meaning. Some of these studies lend themselves to a presentation [that would lead to] understanding a bit more easily than perhaps a very thick staff study.

MR. CORRIGAN. Well, I'm not sure on the productivity issue, but on the kinds of things that Tony mentioned, analytical and otherwise, such as issues surrounding deficits, banking structure, and deregulation or the implications of financial phenomena on the international side, I personally think that some collective discussion could be extremely useful.

MR. MARTIN. Well, I think a point can be put to certain kinds of discussion of that sort. Let me pick up on Jerry's comment about the international debt situation. After a presentation and perhaps a paper ahead of time, which would focus our attention again

only more so on a subject of that sort, we could move toward a "what if" mode of discussion. That is to say, we'd discuss what would be the monetary policy implications and the recommendations that might flow out of a series of events. The "what if" technique is one that most private corporations use when there are major series of events that would affect the future of the organization. And we might profit by some preliminary thinking, without any commitments or votes or anything else, as to what our policy recommendation would be if a certain series of events occurred.

MR. WALLICH. It's a sort of contingency planning.

VICE CHAIRMAN SOLOMON. Or it has implications for monetary policy, too, using Preston's example of international--

MR. WALLICH. Well, it seems to me the question that Lyle raises--that we might just as well read a paper--can perhaps be met by relating this more specifically to monetary policy. And there, the members of the group could provide their input. Suppose you postulate that something happens to price stability, to the financial structure, or to fiscal output and ask: How should we respond?

MR. GUFFEY. Mr. Chairman, I'll agree that this has some attractiveness, but I wonder whether or not the forum of a Monday afternoon meeting such as this is the proper place to have assigned a topic and have a presentation made after we have received a paper that might identify 3 or 4 of the issues that we're talking about--fiscal policy and the deficit being one relating to monetary policy. We could actually do something, as we did in Fredericksburg about four years ago now, such as devoting a day or a day and a half or two days to, say, as many as four topics, all of which are interrelated. And we could focus this group's attention on the matters that affect monetary management in the period ahead. I think to do it piecemeal Monday afternoons before a Tuesday meeting over a period of a year, just as an ongoing program, might not be quite as effective because we won't connect them with what we're all about.

CHAIRMAN VOLCKER. Any other comments or reactions?

MR. WALLICH. Well, I think we might occasionally focus not on what we're going to do but on what we have done--do a sort of post mortem and ask ourselves how we would do it differently if we'd known what was going to happen, and maybe evaluate our own performance that way. I don't mean the staff's performance on the forecast; I mean our performance in making monetary policy decisions.

VICE CHAIRMAN SOLOMON. Did we bring down the rate of inflation by reducing the growth of the money supply or by having an intense recession? Hindsight might prove interesting.

MR. WALLICH. We could certainly debate that. Did we do it too fast? Did we do too little? Could we have done it some other way?

MR. MARTIN. I take it these sessions would not be recorded?

MR. BALLEES. I'd just like to add my voice to those who think that this would be a useful thing to do, whether it's once a year or twice a year. Whether we meet on a Monday or whether we do it in a special session, I think there certainly are plenty of subjects that we could quite profitably take up at such meetings and get away from the standardized format of these meetings. Otherwise we focus on the near-term outlook except twice a year, in February and July, when we take a look down the road. I've had some sense of frustration, for example, just in the last month on what seems to be the unclarified differences of views between the Board's staff and my staff on whether or not there has been a basic shift in the elasticities of M1-- something that gets right to the heart of what we're trying to deal with here. What does the evidence really show? We happen to have done quite recently a major study on this--it is circulating and we would like some reaction to it--which [suggests] that the elasticities of M1 have held up amazingly well, with very little change throughout the '70s and right up to mid-1983, despite the introduction of all different kinds of accounts paying rates more and more related to market rates, going back to the days when corporate savings accounts were permitted, etc. And that certainly is at distinct odds with the view that I think prevails among the staff here that has led to considerable skepticism as to whether we could get back in the foreseeable future toward reinstituting M1 as a key target.

Now, this is the kind of thing that one cannot absorb in 5 minutes of quick conversation. And it's hopeless to try to get both sides of that argument presented in the course of one of these meetings. That is a subject that I think is extremely close and important to the decisions we're making on what kinds of targets and what ranges [to adopt]. That would lend itself to a presentation in depth. You name it: Two of our senior staff members who don't agree could present the evidence and try to get on the table some of these disagreements on interpretation and analysis of what history shows. Let's take a good hard look at both sides and try to make up our minds and get off dead center on this issue. That's the kind of subject I would like to add to the list of possible special topics, Paul.

CHAIRMAN VOLCKER. Any other comments? The only reaction I have to Roger's comments is that it would take a lot of work to do any of these things, and to have a big meeting once a year would take one heck of a lot of work concentrated in one--

MR. GUFFEY. A great deal of preparation work could be done within the Federal Reserve Banks as opposed to the staff here. But perhaps you're referring to the logistics of getting some place.

CHAIRMAN VOLCKER. No. I was thinking of the whole process. What we did at Fredericksburg took months and months to--

VICE CHAIRMAN SOLOMON. I would prefer to start off with having one issue discussed on a Monday afternoon and see how that goes, Roger. I think the other more full-blown exercise suffers from too many inputs.

MR. GUFFEY. There are about four or five issues in my mind at the moment that all interrelate and are important to one's individual view of how policy [decisions] should be made in the period ahead--which will be a difficult period--and that I think should all be discussed together with a summary at the end. That's the reason I'm really suggesting one session with an in-depth discussion--more than a Monday afternoon.

CHAIRMAN VOLCKER. Well, let me turn to one part of this, which I'm not sure quite captures [entirely] the flavor of what I have in mind--I'm not sure that anything can. One way of approaching it is the way John Balles touched upon--just to look at it in a very narrow focus. Now, there is a good chance that the Humphrey-Hawkins Act will be rewritten, probably not to take out monetary targeting entirely but to put it in a subsidiary role. Is that a good idea or a bad idea? It's not entirely under our control, to say the least. But it gets into the broader question of whether or not the Federal Reserve tells the country what its objectives are. We can answer that on one level by saying our objective is that M1 should be 5 to 9 percent, M2 should be whatever it is, etc. But then it gets eventually into the questions of: What unemployment rate are you satisfied with? Or what price level are you satisfied with? That, in turn, gets into the question of whether the Federal Reserve should be considering that or whether the U.S. Congress or the President should be considering that. All these questions come at us fairly continuously. And if interest rates go up or if the economy stumbles in the next few months, they will come at us with extreme vigor. If things go smoothly in the next few months, they probably won't come at us for six months but they won't be gone very long. How do we respond to this question? What is our ultimate objective as a central bank? Let me just leave it right there. I'll start it in its most general [form].

MR. MORRIS. It does seem to me, Mr. Chairman, that we should start doing some thinking about this--again this is in the nature of contingency planning--if we're forced into nominal GNP targeting. I think that has a lot of problems associated with it. How should we try to shape it?

CHAIRMAN VOLCKER. Well, let me just be a little more specific on that. I would think the chances are at least 75 to 80 percent that we will be forced to give more GNP projections over a longer period of time. It's just a question of what leverage we have now to shape, as you say, what we should say we're doing.

VICE CHAIRMAN SOLOMON. When we give those projections we would have to say, assuming that fiscal policy does X, Y, Z, and assuming that--

CHAIRMAN VOLCKER. Well, it gets to this question: Does fiscal policy make any difference at the extreme? And what do we say about it? That's another aspect of this. What are our goals [in relation to] the Congress? [Suppose Congress said:] "Let's have a summit session to resolve this and we'll make a change in fiscal policy." How would we change monetary policy? How would we respond to that?

MR. BALLEES. Well, Paul, I'd like first to refer to your two pieces of recent testimony before the House and Senate Banking Committees on this general subject of adding new objectives or being more specific on the GNP or the interest rates forecast or whatever. First of all, I'd like to congratulate you on what I thought were two excellent statements that tried to head off simplistic interpretations by anybody in the Congress or overcoming the idea that somehow all we have to do is press buttons around here and we can come up with some sort of interest rate result or GNP result. I think all the proper cautions certainly were embedded in your testimony. There is one point on which I personally would have gone a little farther, or perhaps differed a bit in trying to respond to the kinds of challenges that were thrown at you. And, of course, this is a view with which everybody around the table might not agree. But I would have felt forced to discuss the fact that, at least in my view, in the long run the principal effect that monetary policy is going to have is on the price level. And that in the long run the principal effect that fiscal policy is going to have is on the real side of the economy--on growth, productivity, the rate of wage increases, personal income, and so on. Looked at in that framework, I think there's a very good theoretical structure to support those other end result conclusions. We have a good reason for denying that the Fed can or should be given any specific responsibilities for bringing about given end results on GNP, whether real or nominal.

CHAIRMAN VOLCKER. Let me explore the implications of that. I think you raised the basic issue. Now, suppose the resolution is passed saying that we must give forecasts on nominal GNP, real GNP, and prices 5 years ahead. Now, do we take Mr. Balles' view and say the price level is the only thing we're really affecting over the long run--that's the long run by definition, the fifth year--so we're just going to project zero inflation 5 years from now?

MR. MORRIS. I don't think that is very relevant to the Committee, Mr. Chairman.

MR. BALLEES. It would be a little extreme to take that position, obviously.

CHAIRMAN VOLCKER. Well, I'm just exploring the logic of what you just said.

MR. BALLEES. Let me explore it one step further. What I would do if I were in your position, is to say: "All right, if you want our view on what is likely to be the result 5 years down the road, here are the assumptions I'm going to make about what you people in the Congress are going to do with respect to the federal budget on the spending and the revenue sides and the resultant deficits. Given those assumptions, this is not something that we at the Fed can do a darn thing about." I would keep hammering that one.

CHAIRMAN VOLCKER. No, they'll permit us to say that.

MR. BALLEES. But here is what the likely results will be in terms of real income, real GNP, the unemployment rate, inflation, and so on.

CHAIRMAN VOLCKER. What are you going to put down for prices?

MR. GUFFEY. I'd like to comment, Mr. Chairman. I happen to agree with John in the sense that in the long run--whether it be 5 years or whatever horizon you want to select--prices are the only thing that a central bank should or can control. So, if Congress wants to change the legislation, then it should be stated specifically that our objective is to bring down inflation to zero over this long run and maintain it at a stable level of zero. But that doesn't, I think, respond to the shorter run in that we have to make some announcements on a year-to-year basis. And it seems to me that the greatest flexibility that quite likely can be achieved for the Federal Reserve is to do its job by looking at a nominal GNP forecast or, if you will, objective. It's unclear to me whether it's an objective or a target or whatever. But to stay away from the real variables and get into the nominal variables [using] nominal GNP is the only way we can truly operate. And in that sense, we can have a subset of prices and real GNP in the short run and even a projection; I guess we could be pressed to the wall on what that means for employment. But it gives us the flexibility to say that if our overall objective is to move inflation to zero over this longer horizon, then it does have some implication for the kind of policies that affect real output, such as fiscal policy and all the other things. To go any further than that seems to me risky.

CHAIRMAN VOLCKER. A whole series of questions arise here. But suppose we get asked--I was asked or volunteered last time, though it didn't go very far. Suppose Congress is rewriting the Federal Reserve Act, not just the Humphrey-Hawkins Act--though it doesn't make any difference what legal guide it is in--and we are asked to rewrite the charter for the Federal Reserve. In 25 words or less, what is our objective? What do we say to that?

MR. BALLEES. A zero rate of inflation in the long run.

MR. GUFFEY. That's right.

MS. TEETERS. Mr. Chairman, I happen to disagree with this idea that all we are affecting is prices. I think we affect both real output and prices. And I think we--

MR. GUFFEY. In the short run.

MS. TEETERS. And the long run too, because I think long-run levels of interest rates determine a lot of things in the economy--how much [growth] we're going to have or not have. I see our function as doing a balancing act between how much we let prices rise relative to the cost in terms of increased real GNP or how much we depress real GNP in order to lower [inflation].

Now, these five-year forecasts are pure unadulterated cop-outs. First of all, we can't project that far out; and the work we've done here shows that the error in our ability to achieve [the forecasts] increases dramatically beyond about 18 months. It's like the official forecasts that the government does on where the budget is going to be. If you ever look at them, the budget is always balanced in the fifth year; and it never happens. So, what you've done is to take a short-term forecast and [assume] average rates of growth and you do everything you can to get whatever objective you want to come out with. And I don't see that they have any relevance whatsoever because they never occur. If you look at DRI's long-range forecast, it is an average rate of growth after 18 months and they put in the average length of the business cycle since the end of World War II. That's all they are. We really don't have much more capability beyond that. Another way of coping with this, which might be very interesting, would be to do GNP forecasts once a month instead of twice a year and publish them because then we would convey more of the uncertainty about our ability to do this and how much the GNP [outlook] changes and how much our idea of what we're going to do changes. So, increasing the frequency [of our forecasts] and [showing] the frequency of the changes in it gets away from the idea that we can control the whole world, which is the view they have up there, I think.

MR. MARTIN. Would you publish the forecast or the [unintelligible]?

MS. TEETERS. Sure.

MR. GUFFEY. I'd like to suggest that what I've just laid on the table is not a forecast. It is an objective stated in the law. It probably would require an amendment or deletion from the Full Employment Act of 1946, which gives us stated objectives of full employment and stable prices. Those are inconsistent in my mind. We speak of the trade-offs in balancing discretionary policies and I agree that that must take place in the short run. But if our overall objective is to move to zero [inflation] over some time horizon and

maintain it, then we move to the other, and I'm suggesting nominal GNP.

MS. TEETERS. No, it's just by getting out of the situation.

CHAIRMAN VOLCKER. Well, let me raise this question just in curiosity. How many people would think our objective ought to be zero inflation--thinking whatever is in your mind as to what that implies--over something that I will conveniently call the long run, which is between 5 to 10 years?

SPEAKER(?). Mr. Chairman?

CHAIRMAN VOLCKER. Regardless of whatever else goes on now, that's our objective.

MR. WALLICH. That's a precondition for succeeding in anything else.

MR. FORD. That is measured by what: the CPI?

MR. BOEHNE. May we talk or are we just voting?

CHAIRMAN VOLCKER. Well, you're just voting at this stage and then we will talk. But I haven't expressed the question right. I mean a zero on the wholesale price index and very close to that on the CPI.

MS. TEETERS. Regardless of what it costs?

MR. PARTEE. Regardless of the--

CHAIRMAN VOLCKER. One can't quite say regardless, but that that is our [unintelligible] objective, and that basically we think everybody else is going to be responsible for everything else.

MR. GUFFEY. I don't think a central bank can handle that objective.

CHAIRMAN VOLCKER. Let me just get a showing of hands now.... There's a great discrepancy between [those in] Washington and the rest of the country.

MR. BOEHNE. Well, I'm in the rest of the country and my hand is not up. I have some problems with it. I think this notion of the long run is somewhat equivalent to the mathematician's notion of infinity. It's a nice theoretical concept, but does not have a whole lot of relevance to the real world that we live in. It seems to me that we are always living in a series of short runs and we never get to the long run. In a theoretical concept, sure, at some point out there that we never reach we could have zero inflation or 2 or 3 percent [to allow] for quality improvements and frictional

unemployment. But the fact is that we never get there. We're always banging the pendulum back toward the middle. If it gets too far one way, we bang it. It just seems to me that it's totally unrealistic to think of monetary policy in the economist's view of the long run because we never get there. So, my hand didn't go up because I think it's a nice concept in a textbook or in a model, but it just doesn't bear very much resemblance to the world that I live in and that I think everybody else lives in.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. I'm trying to remember what my math professor taught me about the relevance of the concept of infinity and I'd just like to part company with Ed starting there. Even in mathematics infinity is a relevant concept, especially in space calculations. I would say that we should shoot for a zero [inflation rate] properly measured over a period of time. And if we are going to be pressed to say something about GNP, as we clearly are, if I had to face the fire right now, I'd be inclined to go for a nominal GNP goal on the grounds that over time it's the duty of the central bank to provide sufficient money to allow the economy to expand at whatever we could agree is its natural rate, without inflation, whether we're talking about the short run or the long run. Even in the short run, I think it's very relevant. I'll bet you that when we get around to tomorrow morning a lot of people are going to reflect on the fact that [nominal] GNP grew 13 percent in the second quarter and real GNP supposedly grew 9 percent. Over time that just is not sustainable. The economy is surging. And if we had a long-run nominal growth target that said we don't want nominal GNP to expand in the double-digit range ever, even coming out of a serious recession--I'd be willing to throw that on the table just for discussion--. We might allow some variation, but why should it ever be double-digit when we know the natural growth rate of the economy over time is somewhere between 2 and 4 percent? So, if you're pressed, I would say that your retreat position ought to be to talk about nominal GNP and then continue to keep the pressure on [Congress] to recognize the fact that we only affect nominal variables in the near term and perhaps in the long term as well.

MR. MORRIS. Mr. Chairman, the one thing I would suggest, if we're going to have a nominal GNP target, is that it ought to be a range rather than a point because I don't think we know enough to set a point as a target. For example, for the current year we are now projecting 10.7 percent nominal GNP growth. I think earlier in the year, if we had had a point target, we would probably have projected something like 9 percent. That was what I was thinking of at the time. Now, the question is: Does this mean that we should currently follow a much more restrictive policy in order to move [GNP growth] back toward 9 percent? Given the fact that the inflation numbers have come in so well--probably better than we would have anticipated--in that kind of situation there's a little more room for real growth than there would have been in an economy in which the inflation numbers came in much worse than we expected. So, we'd be prepared to move

within that range depending on the mix between real and inflation that makes up that nominal GNP gain. But we should never get stuck with a point estimate on a nominal GNP target.

MR. WALLICH. I think the long-run concept is a helpful one because we have to find a way of differentiating ourselves. We want to have a special function where we're not criticized by the Congress continually and compelled to coordinate. We've got to be somehow functionally different. And one reason for that could be that we take a more long-run approach; a central bank traditionally does that, compared to the people who have to face elections. We can also limit ourselves to the nature of the objectives we'll go for in determining growth, determining unemployment, and so on. There's never a resting place; we can never get unemployment down low enough. And we should surely never raise it deliberately because it's falling below target. So, I think sticking to the price objective in the long run is a fairly safe posture that will give us a chance to do our job.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. I think Congress is pressing us toward a desirable goal. I believe that we tend to be too short run oriented. I would like to see us be long run oriented and accept objectives such as zero inflation. If we're not standing for that, I don't know who else is. And I think it's desirable. I think often in our short-run responses, which tend to be erratic as I review the past, we are counterproductive and create perverse results. If we had a longer-term perspective, we could stay in the right direction. So, I'd like to see us move that way.

CHAIRMAN VOLCKER. Just to explore the point: Does that mean that if we had to make a 5-year forecast, you would just start out with the presumption that in the fifth year inflation is zero?

MR. ROBERTS. Sure. Why not? It's an objective.

MR. MARTIN. Arguing the other side, I think the why not, Ted, is that we deal in a real world in which there are imperfections in the pricing process and the allocation of reserves process and the changing nature of foreign competition and its impact, much of which is positive as far as prices are concerned. Given the present level of unemployment and the difficulty of employing a segment of the people who are in that very unfortunate category, over time if we were indeed to bend our efforts to achieve zero CPI inflation, however measured, we would have a resultant unemployment level that would be destructive to the social fabric of this country.

MR. ROBERTS. Well, that might be true. I disagree with you entirely, however. I think the best rationer of resources in the economy is the free market. And I think the best way to compete internationally would be to have a zero inflation level. If we want

to subsidize sectors of the economy, we should do that explicitly and let people recognize what they're going to pay for it.

MR. MARTIN. But the subsidies are built into our society. Those subsidies are not going to be taken away. Those imperfections are not going to vanish. The government impact in the allocation of resources is a constant; it is a parameter. We have an imperfect world; we can't have a perfect price level in an imperfect world.

MR. ROBERTS. Different point of view.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, having a zero rate of inflation as the objective, at least as I construe the objective, does tend to be [in the realm of the] theoretical. On the other hand, if we don't keep that at the forefront of our thinking in the policy decisions that are made in the short run, it seems to me we lose a lot of the discipline that's necessary to keep inflation at least at a relatively low level. And I do think that low inflation has to be the most important factor in sustaining real economic growth over time. Now, that's not to say that in the short run we don't have to take account of the real world. But the danger I see is that in the concern with the immediate one loses sight of the longer-run objective. If that is stated as the objective, using the five years gives room for adjusting a little in the short run. But it brings the discipline. If we set a 3 to 4 or 5 percent rate of inflation as the objective, it's going to turn out to be 10 or 15 percent.

MR. MARTIN. [Multiply] by two.

MR. BOYKIN. I just don't believe that. If you look at what has happened, going back to October of 1979, the one thing that we have done is to bring down the rate of inflation. Now, you can argue about what the cost has been. The cost has been very significant. But is that cost excessive in terms of what the costs would have been otherwise?

MR. MARTIN. I don't think the choice is between zero and infinity. I think the choice is between zero and some rate that's less than, let's say, the average rate of the last couple of years.

MR. WALLICH. Well, one has to realize that the goal is not going to be achieved. As an objective, it gives us a place to stand. Now, when we begin, if we only reach 2 percent inflation and we had aimed at zero, I fully agree that I would be quite satisfied. But if we started with 2 percent, somebody else would outbid us with 4 percent because that would get a little more growth, and pretty soon we would be at 14 percent. So, we might as well start with a clear objective. I'm not saying this is something that will be reached.

MR. MARTIN. My clear objective is 2 percent because I think it would result in enough employment that it would be a more realistic objective.

MR. PARTEE. I would feel that it could be 2 percent or it could be zero. But the most important thing is to make sure it's always 5 years away, like the long run! You know, I'm speaking halfway seriously. Assuming that the economy is dynamic, we could always say that whatever unsatisfactory result we had, we ought to plan to get rid of it over a reasonable period of time. And that could be, say, 5 years, although there might be some other number of years that would be analytically better. And then we'd try to develop a policy to get rid of [that unsatisfactory result]. And it makes a lot of difference to say we have as an objective a zero rate of inflation in 1988 or to say we are shooting toward a reduction in inflation to zero over the next five years. [In the latter case] then next year it would be five years, and the year after that it would be five years and one would always then maximize the choice that could be made to get the best combination of output and structural and price results within that kind of [tradeoff].

MR. RICE. Would you be willing to specify a rate of growth at the same time?

MR. PARTEE. Yes, I think one can do that.

MR. RICE. Say, a rate of growth consistent with the long-run growth potential of the economy, whatever that is?

MR. PARTEE. Well, [growth] ought to be more than that between now and 5 years from now because we're well below the optimal use of the economy now.

MR. RICE. I would have no problem if you people were willing to state what you consider to be a maximum rate of growth along with a zero rate of inflation five years out.

MR. PARTEE. We could always determine this equation pretty easily. That's a--

VICE CHAIRMAN SOLOMON. So our report card in five years would show we failed on both.

MR. PARTEE. It would necessarily do that, I think.

MR. RICE. Exactly.

VICE CHAIRMAN SOLOMON. I don't really understand--we do live in a political world--why you believe that it's perfectly appropriate to have objectives that we fail on and never reach.

CHAIRMAN VOLCKER. I don't understand that either.

MR. PARTEE. That's an analytic--

MR. ROBERTS. That's a common approach in other enterprises, where people say: "I have an objective and I either meet it or I don't." There are variances and they are either controllable or they are not. We could go back, for example, to Congress if our inability to meet that objective was due to something they did and say: "Here are some reasons why we couldn't accomplish this." And that might be good public policy.

MR. BOEHNE. Like a 10 percent unemployment rate.

MR. RICE. Yes, we'll get a D-. Mr. Chairman, getting back to the strategy question you raised, if you see a 75 percent chance of there being some legislation requiring us to state specific objectives in numerical terms, I suppose the question is: What sort of compromises would you want to work out?

CHAIRMAN VOLCKER. If we get this legislation, I might say we'll be sitting around here arguing about precisely this: What do we put down for a number 5 years from now?

MR. RICE. The question I'd like to raise is: Are we better off trying to find some way of accommodating to this or should we oppose it and try to resist it as long as we can until it actually [becomes] the law? I would favor trying to stonewall it to the very end. If they're going to pass some kind of legislation that's difficult [for us], I myself wouldn't want to offer them any help.

CHAIRMAN VOLCKER. Well, just in terms of where we are, I guess I have in effect conceded that if they don't state it as an objective for some kind of vague assumption for 5 years, we'll provide them with some 5-year numbers in a range.

MR. RICE. Well, then will we come back to the--

CHAIRMAN VOLCKER. But we won't state them as an objective. That's where we now stand.

MR. FORD. Based on?

MR. RICE. What do we call them if they're not objectives?

CHAIRMAN VOLCKER. Assumptions, projections, forecasts.

MR. RICE. Projections with or without a given policy?

CHAIRMAN VOLCKER. Well, we get back to the fiscal side, which is the main alternative. The last time we discussed this, you told me fiscal policy didn't make any difference--not you; I'm speaking of "you" collectively. Governor Gramley.

MR. GRAMLEY. I want to say a couple of things first about the abstract proposition and how to implement it. I would start out agreeing with the long-run proposition that we ought to focus primarily [on prices]; theory suggests that what happens to the money stock primarily affects prices and not output. But I think that the long run--and I don't think it's irrelevant--is 50 years, not 5. But it may have the following kind of relevance: We always ought to be very careful, whatever we do, to make sure that we focus enough attention on what our policies are going to do to prices over a long period.

Let's try to put this in the context of the decisions we've been facing as a Committee in recent months. I don't know of any forecast that projects a continuing substantial decline in the rate of inflation beyond the middle of 1984. And, if we were so single-mindedly in pursuit of a zero rate of inflation, I don't think we would ever have turned around in the middle of 1982 and provided for the kind of environment that has encouraged the recovery in the economy. We would have single-mindedly kept going in trying to bring down the rate of inflation. I just don't think we can do that; I don't think we can have any specific objective for a rate of inflation 5 years from now without putting it in a context of what is happening to the economy now and what is feasible over the next 5 years.

VICE CHAIRMAN SOLOMON. I agree with that 100 percent. There is nobody in this world--certainly not in the financial community--who believes that the rate of inflation, which is presently around 4 percent, let's say, is going to be 3 or 3-1/2 or 2 percent over the next 3 or 4 years. All the assumptions are somewhere in the 5 to 6 percent range, and yet people assume that we are making a very sincere effort. I just don't see that as being realistic at all. I come back, I suppose, to the other aspect. I don't think that it's credible or even that it would be accepted. We'd be laughed at if we said our only legitimate objective is price stability because we all admit that in the short run there is a tradeoff. Nobody is going to believe, based on some kind of [abstract] theory that there's no employment impact as we pursue our objectives over a 5-year period. People just won't understand that kind of assertion. I don't think we can get away with it, and I'm not sure it's even right. I think it's more credible to take the line that the Chairman did in his testimony, which says we don't have control of all these factors. I'd hammer away at that as long as we can rather than take the [position] that over 5 years we have this one objective that [Congress] should charge us with, which is price stability. Over the long run we can have any level of unemployment with price stability as well as we can have any level of unemployment with varying levels of inflation. Sure, it's a sound theoretical proposition, but I don't think it's a credible one. I don't know what we should do. If I were asked to give forecasts, assuming they come off this objective business--you've given that away, I guess--then I think I would have to say the forecasts are subject to certain assumptions, such as what is happening to fiscal policy, what is going on in wage negotiations in the country, and a

few other factors. I would never give an unadulterated, unconditional forecast or assumption for the next five years.

MR. BALLEES. I'd like to come back and deal with this matter of the short run versus the long run for a few more minutes. Even for those who are of the point of view that we're always in a series of short runs and we never get to the long run, I would add the following caution: Sure, you can say that in the short run there's a tradeoff between inflation and unemployment; I think there's a lot of history in this country, including the history of the last decade for example, that shows that it's very dubious whether that tradeoff can or should be exploited at least by us in the central bank, because the cost of trying to take advantage of that tradeoff may well be a procyclical monetary policy and a continuation of a business cycle ad infinitum, for reasons that I think can be pretty well elicited from a study of what has gone on in the last 10 years in this country. If we start with an expansion of monetary policy, trying to take advantage of this tradeoff, sure, we can pump up aggregate demand; and nominal GNP will rise and so will real output, and unemployment will go down and for a while nothing will happen on the inflation front. But, sooner or later, because these lags between money and prices are long, we do get rising inflation. Then we feel we have to pull in our horns and be more restrictive. And when we have tried to do that, I challenge any one of you to show me when in the last 10 or 12 years we have ever had a soft landing. When we moved to a posture of restraint because inflation was thought to be a big problem, what happened? We had a recession in the early 1970s; we had a recession in the mid-1970s; we had a big fat recession in 1981-82--in fact, some [observers] take it clear back to 1980. Every time we finally have to adopt a posture of restraint because inflation is getting too strong, then we take [the cost] in real output, in a rising unemployment rate, and so forth. That's exactly what has gone on in this country for the last couple of years. You can say, yes, in the short run there's a tradeoff. And I say to you that's a time bomb, and if you try to exploit that very far, you'll just guarantee a repetition of business cycles and the old boom and bust phenomenon.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Well, I'd just like to respond to Tony's comment earlier that a zero [inflation objective] is not credible. I'd make two points: One, I don't know how 5 years crept into this as being the horizon for the long term for moving prices to zero and maintaining stable prices [thereafter]. Maybe I inferred that. I don't know what that horizon is, but it seems to me that a central bank of this country or any other country can have no other ultimate objective but to create price stability. What we have been operating under is a legislative directive that does require us to try to control things that are not within our control, such as full employment. What I'm really suggesting is that what might be written into this legislation, wiping out the earlier legislation, is that the ultimate objective-- the single task of the central bank--is to reach

price stability over the longer run, whether it be 5 years or 50 years. I don't know what the [right] horizon is. Now, that does not mean to suggest that there are not tradeoffs in the short run. That's the reason I had suggested earlier focusing on nominal GNP, which gives the Fed a little flexibility to operate and use discretionary policies in the short run. That seems to me to be most appropriate. To say that a long-range objective of a central bank is not to move to price stability seems to me to run directly against the reason for a central bank existing. I think it's just as basic as that.

VICE CHAIRMAN SOLOMON. Yes, I would agree that you can offer that as a tautology, but I don't think that's really the issue here.

MR. GUFFEY. Well, I think it is. It's a starting place in my mind to get to what the Chairman asked: How is he to respond to the [Congressional] Committee and try to direct--

VICE CHAIRMAN SOLOMON. Well, that's a first sentence. That's like [saying] we're all patriotic Americans.

MR. GUFFEY. Okay, let's not lose it, though. That's my point.

MR. WALLICH. I think the zero inflation objective is in danger of getting a black eye because it's being misinterpreted. It doesn't mean that we say we're going to zero inflation in 1988 and if we get to 1987 and have 6 percent inflation that we're going to do it all in one year. It means we are moving in the direction of less inflation so long as there is inflation, and we do that gradually. We say we won't do it in 1 or 2 years but we will try to reduce the rate of inflation to zero over 5 years. That gives us a great deal of flexibility. We'll probably never get there and we should make it clear that [implementing] this [objective] is subject to having a well working economy; it's not going to be done with 10 percent unemployment. It is giving a priority to this objective and stating [that it is] a condition for the economy to be working well, because in the long run we're not going to have much growth if we have high and variable inflation and we're not going to have much productivity and full employment. It's this more modest way that I'd like to see the price stability objective stated rather than say we're going to hit zero growth in the CPI in 1988.

CHAIRMAN VOLCKER. You leave me with a practical problem. It's a little difficult to say all your nice words, which I happen to agree with, and not put in zero for 1988 or 1989 or--

MR. MORRIS. I think the answer, Mr. Chairman, gets back to Nancy's idea, which I agree with. Certainly we all accept price stability as a long-run objective. When we get to the point of talking about nominal GNP objectives, I would agree with Nancy that we can't go beyond two years; there are going to be many instances, including this one, in which a zero inflation target is not feasible

within the two-year span. We can still accept that as a long-run [objective], but the kinds of concerns the Congress has relate to much shorter spans of time than 5 years.

MR. MARTIN. As soon as we express the zero inflation objective, however the time period is to be set or slipped, the first question the Chairman is going to receive, I believe, is: What level of unemployment does that entail?

MR. GRAMLEY. I think the question is not so much whether we have an inflation objective 5 years from now of 2 percent or zero or 5 percent or whatever, but if we take a sufficiently long period of time, like 5 years, our objective ought to be to move toward a lower rate of inflation than what is now prevailing. It's the direction of movement that's important, not any specific number we're going to get to later. I don't see why the idea of targeting on nominal GNP over a 5-year period is all that undesirable. It seems to me that if the central bank is supposed to work toward reducing the rate of inflation, and if it's important to get the expectations of the public working for us, then from the standpoint of national policy--not just monetary policy, but national policy more generally--the idea of committing strongly to reducing the rate of growth of nominal GNP over a period of time makes very good sense if we want to bring down inflation.

VICE CHAIRMAN SOLOMON. Yes, but don't you have to give it not just for the 5th year but for the 2nd, 3rd, and 4th years?

MR. GRAMLEY. We may need ranges to do this.

VICE CHAIRMAN SOLOMON. In our discussions here we're all assuming that at the very best inflation will be no higher next year than 1/2 point higher than it is this year. Right? Now, how does one accept that?

MR. ROBERTS. Who would have thought it would be 3-1/2 percent in the second quarter?

VICE CHAIRMAN SOLOMON. No, he's saying that it should show a progression of reductions.

MR. GRAMLEY. I could fit that into a range.

MR. BOEHNE. Can't we express this uncertainty with some fairly broad ranges? Just taking some examples: Suppose we have a five-year target for inflation of 0 to 5 percent and we have a target for unemployment of 4 to 7 percent. I'm not wedded to those numbers, but suppose we have a range--a tolerance range--that we think might be realistic. It has the concept of uncertainty and the concept of the tradeoff in the short run, yet we haven't really betrayed a kind of long-run idealism.

MR. PARTEE. Somehow we have to make adjustments for the failures that will occur--the crop failure that may occur sometime in the next 5 years, maybe currently, or the OPEC oil price increase that may take place, or the really miserable fiscal policy that may materialize, if it hasn't already--failures that will give us reversals. That's why I said I really think [what is needed] is a moving 5-year average to get us into a policy planning mode that will let us always be working at getting the rate of inflation down, but not by a step-by-step progression over 5 years. The thing we have to look at relative to the year when inflation was 10 percent is that something happened over which we didn't have any control. But once that occurs, then we have to be working down toward zero again--zero is probably too low--but to a modest rate of inflation of the kind that could be [consistent with] quality [improvement] factors.

MS. HORN. I agree basically with what Lyle said and what a number of other people have said that in the long run we're aiming for zero inflation or price stability, and that might be a little greater than zero. But isn't the way to get there a decreased level of nominal GNP as time passes? And, yes, we're going to have to make adjustments, but don't we have in our mind that the trend line of nominal GNP should be decreasing over the 5-year period? Isn't that a statement that we should make, understanding that as accidents happen and situations come along we will adjust around that line and that we're not shooting for it on an annual basis? It seems to me that's in some sense what we've been doing here, or at least I've had that in the back of my mind as we've been making policy.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Well, I tend to be a bit eclectic about these things. I certainly think that price stability should be the preeminent goal of the central bank, but I don't think we can or should attempt to state it in a way in which that is the only goal of the central bank. I certainly don't think it would make good sense, in any time frame that I can conceive as being relevant for making policy, to state boldly that zero inflation is a goal in and of itself. As a matter of fact, I think that would be a bear trap. I don't think it would have any credibility, as I think Tony said very well. But, even if it did, irrespective of fiscal policy and everything else, I think a central bank has an equally important goal, and maybe it isn't as explicitly recognized, and that's financial stability. Put aside for the moment fiscal policy and deficits and crop failures. All those other things can be very important, but in any context that I can conceive of, the other thing that the public and the Congress and everybody else look for from the central bank is financial stability. It's hard to define that. Obviously, that doesn't necessarily mean a stable M1 or stable interest rates, or whatever. It's almost a state of mind rather than a statistic. I think it would be a big mistake to frame goals in legislation or otherwise that ignore that part of our existence that I think people do look very, very directly and importantly to the central bank for.

I also have very, very serious questions, even in the intermediate term of 5 to 10 years, about this proposition that says monetary policy, however defined, only affects nominal variables. I have a great deal of difficulty with that. I know that if you read a hundred years of monetary history things seem to work out that way, but I have a great big question there. Being eclectic, if I were put to the wall in terms of having to try at least to build if not to convey a better mousetrap, I certainly would try to do it in a way that preserves the highest degree of flexibility for the central bank because I do think that the major part of our problem is and always will be coordination with other arms of economic policy--coordination that I think is a safe bet will not be forthcoming in most cases. That would lead me, if I were forced to do something in statute or otherwise different than what's there now, to move in the direction of paying more explicit attention to nominal GNP. But even in doing that, I personally would be inclined to do it in a context in which there were enough other things there--maybe even money and credit targets associated with nominal GNP objectives so as to leave the greatest possible amount of flexibility, whether it's for one year or five.

MS. TEETERS. I was going to make Chuck's point that we seem to have lost sight of where a lot of the inflation comes from. We have had several supply shocks and we could probably face another one if we have a crop failure. And that's very difficult for us to deal with because if we prevent the price level from rising or prevent the wage level from rising, basically that means a redistribution of income to the agricultural sector and to the retirees who are indexed to the CPI. So, once we have that sort of shock, there's a problem in trying to unwind it. If you look back at 1973, the [rise in] agricultural food prices transferred a full 1 percent of the nominal GNP to the agricultural sector. There was no increase in real output, and three years later finally their nominal and real were back together again as a share of the total. So, there are income distribution problems when we're dealing with inflation.

I also thought back over the oil shock problem. The amount of readjustment that was necessary was fairly massive, and it wasn't only short run. If we had tried to do it in a year or a year and a half, I'm convinced that we would have put the whole world into a major depression because we had to convert capital equipment to more energy conserving operations. Looking back, we can quarrel a little about some of the timing, but I don't think we could have done that adjustment in a period much shorter than the 10 years that have passed since then. As Chuck says, we're going to live in a world in which we have supply shocks of one type or another that we can't anticipate. And if we're going to pledge ourselves to offsetting them totally, we're pledging to be in a constant state of recession, as near as I can see it.

MR. WALLICH. Bear in mind that between the first and second oil shocks, the whole world changed its mind. That is, we were all

pretty accommodative of the first oil shock and by the second we had learned the lesson that it was too costly and resulted in too much inflation, and then countries were much less accommodative.

MS. TEETERS. But we couldn't have done in 1974 what we did in 1979. We had to have a period of time in which to conserve energy, to change the base of the capital stock, and a few other things. The timing probably was about right--to accommodate it in the first instance and crack down on it in the second.

VICE CHAIRMAN SOLOMON. Well, even though I agree with your general proposition, I'm not sure I agree with the ideal timing of oil [unintelligible]. I think it could have been earlier and we would have had a faster adjustment.

MR. KEEHN. I think I heard earlier, perhaps incorrectly, that there was an agreement by this group that fiscal policy really doesn't matter. It seems to me that it really does matter. In my view, the problem here is that we have a fiscal policy that is irresponsible and running out of control. The Congress has a problem and they are understandably trying to shift the problem from their desk to our desk. I think we ought to be very reluctant to accept that responsibility. And, idealistically perhaps, I'd be in favor of setting as the broad objective that we are trying to develop policies that will provide an environment of price stability. To state as an absolutely overriding objective that we're going to seek zero price increases over any period of time might be difficult and objectionable. But I certainly think we should state as our objective that we are planning to reduce price increases over a period of time. And I think that we should adopt goals and policies that are broad enough, and ranges that are large enough, that we can have plenty of room for operating latitude. But we'd make a terrible mistake to accept any goals and objectives over which we don't have some real, direct control as a way of taking on some responsibility that is basically not ours, but rather is that of the Congress.

CHAIRMAN VOLCKER. Mr. Black. I'll get to the fiscal policy question in a second here.

MR. BLACK. Mr. Chairman, as we approach this [unintelligible] in Congress, it might be helpful to draw a distinction about one of the three different groups there. The first group would be Reuss and Patman types of professional Fed baiters, and there's nothing we can do other than hope that they don't persuade other members of Congress that this is the word. Then we have gold bugs like Kemp, and there's nothing the Federal Reserve can do about that other than contribute to the dialogue that suggests that it really can't work the way they think it ought to. So, what we're really talking about is this third group of people in Congress, most of whom seem to me to [believe] that we can have some important impact upon the economy [by] manipulating real economic variables in the short run to achieve desirable objectives. I think the way to deal

with that group--and that's the only one that we can practically deal with--is along the lines that you did in your testimony before the Fauntroy Committee, where you tried to talk about what we can and can't do.

When we come to a meeting like this, we see very clearly that there are a lot of differences of opinion among the members of the Federal Open Market Committee about what we realistically can do and what we can't do. As Bill Ford put it several meetings back, and you agreed with him when he said it, Mr. Chairman: "Isn't the argument between those who think we can manipulate real variables over the long run and those who think we can't?" And that's what has come out in this discussion today. I feel we really can't; I'm in the majority on that, but others have a lot of differences of opinion there. So, my preference would be, of course, to state that a zero rate of inflation is what the central bank ought to aim for. And I would add one other element, and that is to try to avoid [springing] monetary surprises that the economy doesn't expect. But that's not something that everybody here is going to agree on. So, as a practical matter, if we are confronted with the necessity of suggesting what our goals ought to be, which you seem to think we will be, I believe the only thing we can get any great consensus on is along the lines that Lyle suggested of aiming at a lower rate of inflation over time. That's compatible with my one great objective and I could meet him at that common meeting place.

MS. TEETERS. I had one other comment. There's some question raised here about how we communicate with the public. I think we've done a lousy job of it. I think we did a better job in our most recent testimony when we talked about velocity and the relationships with money and nominal GNP and the rest of it, but basically one has to be able to read the code. One has to know that "slightly greater pressure on reserves" means increased borrowing. The most fought over decision in this room is never [stated] in the directive. The borrowing assumption has been [the key decision] the whole 5 years I've been on the [Committee], and we never tell anybody about it. We're really not being open and honest. And what we've done has created a whole profession out there who interpret this obscure document of ours to the rest of the world. About 50 percent of them are alumni and they get it wrong. It seems to me we could be much more open about what it is we're trying to do and how we're actually operating day-to-day monetary policy. And I will repeat: I see no reason for keeping the directive secret for six weeks. And the recent leaks only reinforce my position on that point.

MR. FORD. You have two "Hear hears" down on this end.

MR. BOYKIN. Is the real problem, Nancy, the fact that we are not saying it or is the real problem the results of what we're doing?

MS. TEETERS. I think a lot of the problem is the fact that we are not telling the public what we're actually doing.

MR. BOYKIN. Being in the hinterland where I am, trying to listen to what you might be hearing in Washington, it appears that all the efforts currently underway are an expression of dissatisfaction with the Fed because of the results of what has happened to the economy. When you get to the Congressional or the fiscal policy side, these seem to me to be attempts to make the Fed conform to the wishes of those in Congress who are being "irresponsible." It seems to me that we find ourselves in the position of trying to minimize all the bad that everybody else is doing.

MS. TEETERS. Well, I think two things are going on here. One is a short-run problem--not telling anybody what we're doing. And certainly, the events of the past three weeks--

CHAIRMAN VOLCKER. Look, I just have to interject here. I totally disagree with this. The one borrowing figure that you're concerned about people see published every Friday. We can't be more explicit than publishing a figure that says borrowings last week were \$797 million and excess reserves were so and so.

MS. TEETERS. Then why was the market so upset the past few weeks because they didn't know what the Fed was aiming for?

CHAIRMAN VOLCKER. They're always going to do that, whatever we tell them. They're going to say: What are you going to be doing tomorrow?

MR. GRAMLEY. I do think, though, that we're going to be faced with a demand by the Congress to be more forthcoming. It seems to me that there is a strong trend in the Congress in that direction and then the question is: How should we try to shape the real--

CHAIRMAN VOLCKER. That's different than on the operating decisions, though.

MR. GRAMLEY. Right, but how should we try to shape the request in ways that minimize the damage to us? I think the answer is clearly to be just a bit more forthcoming and I suggest that perhaps what we ought to do is set some objectives for nominal GNP--nominal only. To go beyond that is very risky.

MR. FORD. Yes, I agree. What do you say? Are you putting [it in terms of] a ceiling or a range?

MR. GRAMLEY. I would use a range. I have my program for optimality for the next five years--for 1984 to 1988. I'd start off with a nominal GNP range of 8 to 10 percent for '84 and get down to 6 to 8 percent--a 1/2 percentage point [reduction] per year. That conforms with the Administration projections for real output at 4-1/2 percent and a string of 4 percents and inflation that starts at 4-1/2 percent and tracks down to 3 percent. That's a reasonable hope for the economy. It's a range that we may have to revise at the end of

1984 if it doesn't work out; we can tell [Congress] that we're going to have to reinitialize each year.

MR. CORRIGAN(?). Base drift.

CHAIRMAN VOLCKER. I don't think we can get by with that as a practical matter. We might get by with saying we will put the emphasis on nominal GNP, but immediately they're going to say: Divide it up. What do you think that means for prices and real growth? We might get by with that being the subsidiary, but we're not going to--

MR. GRAMLEY. They're going to push in that direction.

VICE CHAIRMAN SOLOMON. You have 3-1/2 percent [inflation] for next year or the year after. What happens if next year we hit 5-1/2 percent? What would you say then?

MR. GRAMLEY. We reinitialize. We say things didn't work out the way we anticipated. They don't always. We warn people ahead of time that when we set an objective for nominal GNP we might not make it. We certainly don't know in any precise way how that GNP is going to be distributed between prices and output.

VICE CHAIRMAN SOLOMON. Not only is it intellectually dishonest, but I don't even believe that having a long-range price stability target requires us to project a continuous reduction in the rate of inflation every single year. That's not realistic. We can have a long-run objective of price stability and still recognize various price rigidities in the economy, such as changes in the oil supply/demand situation or other things. We don't project automatically a half point [reduction] or whatever it is every single year. Wouldn't you agree with that?

MR. GRAMLEY. I don't disagree at all. What I'm saying is that I think Congress is going to force our hand to be more forthcoming on something. Then the question is: What can we do that will be least damaging from the standpoint of the Fed and least damaging from the standpoint of the formulation of economic policy generally? And I think the answer lies in focusing on the variable among the nonfinancial variables that is the most immediately amenable to influence by the Fed, which is nominal GNP, and then capitalizing on the fact that if our objective is to reduce the rate of inflation over time, we ought to alert the public that what we plan to do is to bring down the rate of growth of nominal GNP to a rate that ultimately will be consistent with price stability. No, I don't think we can promise that we're going to have growth rates of nominal GNP that are going to be half a percentage point less year after year; that's quite unrealistic. I don't expect that.

MR. BLACK. That meshes very nicely with what we've been saying ever since we started our October 6, 1979 procedures except that we're now only suggesting talking in terms of nominal GNP rather

than [monetary] aggregates. I would prefer to talk in terms of the aggregates, of course, but this is certainly compatible with what we've always said.

CHAIRMAN VOLCKER. Well, let me shift, for a few minutes anyway, to the other part of the equation. I suppose we would all agree in varying degrees that fiscal policy has some effect on the economy. That's not the question I want to explore. What are the implications of fiscal policy for monetary policy? Quite concretely, just imagine that Congress comes in some day--say, after they come back from their recess--and says: We're going to pass a [\$50] billion tax increase, all other things equal, but we expect a little quid pro quo from monetary policy. What do we say?

MR. MORRIS. Good. What they're really interested in is interest rates, and we tell them that if they increase taxes by \$50 billion or so, interest rates will go down.

CHAIRMAN VOLCKER. How much?

MR. WALLICH. Well, if we told them--

MR. RICE. We know the direction.

MR. MORRIS. We know the direction of movement.

CHAIRMAN VOLCKER. [Congress would say]: I'm not satisfied with that, Mr. Morris. You tell me they're going to go down by 2 percentage points and I'll sign off. Are you going to guarantee me that they're going to go down 2 percentage points?

MR. PARTEE. A guarantee is what they want.

MR. WALLICH. Will they take the responsibility for the inflation that results?

MR. PARTEE. Inevitably.

MR. WALLICH. We'd have to raise the money supply by 3 percent, let's say, and over time that will give us 3 percent more inflation.

CHAIRMAN VOLCKER. They'd probably take that.

MR. PARTEE. And get voted out of office.

MR. MORRIS. Yes, but we're not going to trade off an increase in the money supply for a reduction in taxes.

MR. PARTEE. All right. But that's the question, I think.

MR. MORRIS. Now, that doesn't--

MS. TEETERS. What I think we really want to look at--or at least what I look at--is what the standardized structural full employment deficit surplus is relative to the economy. In my own mind the proper place for that to be is someplace around plus or minus 1/2 percent of potential GNP. If they come back with a \$50 billion tax increase, that still leaves us with a growing structural deficit that gets out of hand. It is not enough. Now, I happen to agree with your point and I know it's terribly difficult to sell. But if they reduce the deficit, interest rates will come down automatically. But that doesn't give us much bargaining [leverage] when we get to a summit. So, we really have to figure out more or less what we're willing to pay in monetary policy to get some correction in the fiscal policy.

MR. ROBERTS. If they start increasing the deficit, interest rates--

VICE CHAIRMAN SOLOMON. I'm being semi-facetious and semi-serious: I'm not sure we actually have to give them a number.

SPEAKER(?) I don't think we do either.

VICE CHAIRMAN SOLOMON. We could say, of course, that to the extent they reduce fiscal deficits, that's obviously an anti-inflationary action. We will carefully assess that and we believe that that would give us room for easing monetary policy to a degree.

CHAIRMAN VOLCKER. What does that mean--higher monetary aggregates?

MR. MORRIS. Lower interest rates.

MR. RICE. Lower interest rates.

VICE CHAIRMAN SOLOMON. Because if they're taking anti-inflationary action, we will not necessarily get higher monetary aggregates with lower interest rates.

CHAIRMAN VOLCKER. You're interpreting Federal Reserve easing to a degree as lower interest rates?

VICE CHAIRMAN SOLOMON. Yes.

MR. ROBERTS. No expectational factor at all?

VICE CHAIRMAN SOLOMON. I think that's what they're looking at, yes.

CHAIRMAN VOLCKER. All right, now let me just pursue this.

VICE CHAIRMAN SOLOMON. I haven't studied these deficits.

CHAIRMAN VOLCKER. I understand, but let me pursue it a bit. They say: You're going to give us lower interest rates. In their terms, it's you're going to give them to us. I say, yes, I think that's the direction in which rates will go. We may not have to give them 2 percentage points but they say: Yes sir, but are you going to tell us that the full powers of the Federal Open Market Committee are going to be directed toward assuring that there is a noticeable decline in interest rates when we're going to go through all this political agony of--probably realistically--a \$15 billion tax increase?

VICE CHAIRMAN SOLOMON. Actually, \$15 billion doesn't buy anything.

MR. PARTEE. Maybe 10 basis points.

CHAIRMAN VOLCKER. [They'll say:] Then why should we do it?

MR. GUFFEY. You have to start from the premise that interest rates are going to be higher if they don't do it. And if our objective is price stability some time in the longer run--

VICE CHAIRMAN SOLOMON. It gives us more room to encourage interest rate reductions if they are taking that kind of anti-inflationary action. But I don't think under any conditions that we can give them an order of magnitude. It depends on so many other factors, obviously.

MR. WALLICH. Well, if one could engage in some fine-tuning, one could say we'd raise the rate of money growth for a year because the tax increase will have some downward impact on the economy. The decline in interest rates that comes from that will not completely offset it, so there is some net downward response by the economy. If one dares to fine-tune, monetary policy can offset that [response]. But we must not get trapped into a permanently higher rate of money growth. Everybody understands that that means more inflation.

SPEAKER(?). Maybe, maybe.

MR. PARTEE. This can get to be very complicated though, Henry. It depends on the kind of tax increase. You remember in 1968 when we very, very desperately wanted a tax increase to help finance the war in Vietnam we got a 10 percent surtax in the middle of 1968 and then the Chairman or the Board or the Committee--I'm not sure who--came as close as they could to promising a reduction in interest rates if that 10 percent surtax went in. It went in and I'll be darned if interest rates didn't start to go up rather than down. And it was a great, great political problem. So, we do have in modern history a representation of the kind of trap that I'm sure Paul has very much in mind.

MR. GRAMLEY. And the worst part of that story is that we led the parade with a decline in the discount rate. We kept--

MR. PARTEE. We went out to Minneapolis and got them to cut it.

MR. GRAMLEY. We kept trying to pump in enough money to make sure that interest rates didn't go back up. The 10 percent surcharge had no fiscal restraint effects at all. The monetary stimulus had a lot. We ended up with the worst of all possible worlds.

MR. BLACK. Wasn't that the occasion on which Hugh Galusha said that was not a vast [decrease] in the discount rate but rather a half vast [decrease]?

MR. PARTEE. I think we only got a quarter.

MR. BLACK. Wasn't that the occasion?

CHAIRMAN VOLCKER. It's not clear to me how I can participate in this subject.

SPEAKER(?). You must tell them about 1967.

CHAIRMAN VOLCKER. [Unintelligible] the tightening we've been doing, the heck with it.

MS. TEETERS. It wasn't big enough.

MR. PARTEE. Well, I don't know. People trotted out the permanent income hypothesis to explain why it hadn't had much effect. You can say that to a Congressman, you know: This didn't really do anything because it didn't affect permanent income.

CHAIRMAN VOLCKER. I'd get the same answer I got before. Fiscal policy, then, shouldn't affect what we do.

MR. RICE. I don't agree with that. It's bound to affect it. If we do get a substantial deficit reduction, there is room left for reducing interest rates. And I think we should use that room.

MR. GRAMLEY. I think there's a difference between what we [can] do and what we [can] say. I agree with Emmett completely. I don't see how we could possibly talk about major changes in fiscal policy and say: Well, we're just going to ignore it. That's just not an acceptable way to look at it analytically, or empirically either, as far as I know. On the other hand, we can't promise Congress anything. If we do, we're likely to end up trapping ourselves into committing the Federal Reserve to a course of action that later on we'll regret. And we're going to send you up to explain that too!

CHAIRMAN VOLCKER. That's the only thing that's perfectly clear!

MR. RICE. But I think we could possibly spur them on without promising in blood, which I think is Tony's point.

VICE CHAIRMAN SOLOMON. We could point out that long-term rates will respond on their own and we would encourage short-term [rate reductions] as long as we can see that the inflationary situation is still under control. I don't see how we could give them a number or an order of magnitude.

CHAIRMAN VOLCKER. It doesn't work. Who else has some wisdom to cast on these subjects? Well, the obvious point, just relating it to the discussion tomorrow--and somebody raised it before, the fiscal policy side in particular--is that we have all these forecasts of inflation going up, except our staff's, and I guess they are retreating a bit.

VICE CHAIRMAN SOLOMON. Yes, they've moved it up.

MR. KICHLINE. We can't control the weather.

CHAIRMAN VOLCKER. Making it unanimous, we all want to get to price stability. We're facing a barrage of forecasts that say we're going to go [away from] price stability by a trivial amount in the [near] term or by a larger amount over the next two or three years. Now, if I listened to all of you earlier, we ought to be tightening up [over time], except for the [immediate] operational decision. But it sounds to me, if that long-term [objective] is meaningful, that we ought to have at least a little more chance of getting things on a more satisfactory trend. Am I misreading this earlier [discussion]?

MR. BLACK. That's a real good starting point; I hope you lead off with that in the [morning].

MR. ROBERTS. Right on!

VICE CHAIRMAN SOLOMON. Well, I'd like to dissent.

MS. TEETERS. Yes, so would I.

MR. PARTEE. Yes, I don't know about that.

MR. GRAMLEY. Well, I could agree in principle. That would be a very good idea not to let any supply side shock get built into the underlying [inflation rate].

CHAIRMAN VOLCKER. Well, that supply side shock is a bit of a cop-out. Except for Jim's, all the forecasts were that way before the weather got hot.

MR. GRAMLEY. But that may well be a problem we have to face in 1984. It may well be that instead of food prices going up 7 percent or so at retail, they will go up twice as much.

CHAIRMAN VOLCKER. That may be, but I'm not facing that. Forget about this food thing. We're facing a situation where prices are going up because the economy is recovering and there are a lot of temporary [upward] influences--the dollar is going to come down and so forth and so on.

VICE CHAIRMAN SOLOMON. Most people in this country, if they're no longer fearful of inflation continuing to increase and getting into the double digits, have it down in the 4 to 6 percent area. I'm not talking about the FOMC necessarily, but most people in this country seem to reflect that.

CHAIRMAN VOLCKER. We're not most people.

VICE CHAIRMAN SOLOMON. [I] would argue that in today's conditions we already have a such a high level of real interest rates that we would not [want to] tighten further at this point. I just don't see that it's realistic for us to pin ourselves to a 5-year target with a track in the 2nd, 3rd, and 4th years that we're not going to be able to follow or come anywhere near.

MR. CORRIGAN. If we're at a point now where the cyclical low in the inflation rate is--pick your own number--3-1/2 to 4 percent, and we're talking about the inflation rate moving up in 1984 to 5 or 6 percent, depending on whose numbers you look at, is there any realistic chance to expect that the inflation rate in a cyclical upturn can "stabilize" at 5 or 6 percent? Or are we looking at a situation whereby the very dynamics of the process inevitably involve the cyclical peak in inflation being 10 or 12 percent with the central tendency being halfway between the current cyclical [low] of 3-1/2 to 4 percent and the cyclical peak of 10 percent? In that case we're saying that the long-run average rate of inflation is 5 or 6 percent rather than 0 to 2 percent. That in some sense or other is what was being talked about in the earlier discussion. From my perspective, at least, that's the real dilemma. Because if we are looking as far out into the future as we can and see a situation in which the inflation rate is going to vary cyclically between 3-1/2 and 10 or 11 percent, I think the implications of that in terms of interest rates and the behavior of the economy and everything else are pretty darn lousy.

VICE CHAIRMAN SOLOMON. I think you're going into an unnecessary extreme of pessimism. It's very likely that wage decisions can stay in an area, even with a total business cycle recovery, that's compatible with 4 to 6 percent inflation. I don't see that the American labor movement is going to take the bit between it's [teeth]--. If we do our job with a certain degree of vigilance, then I don't see that we have to think in terms of going back up to the 10 to 12 percent inflation level.

MR. CORRIGAN. But even by that you're saying that the long-run rate of inflation in your little model is something like 4-1/2 percent.

MS. TEETERS. Also, Jerry, I think the world oil situation is very different than it was in the last two cyclical recoveries.

MR. CORRIGAN. I don't think--

MS. TEETERS. We'll get some of it back, but I don't think that we're going up to full capacity.

MR. CORRIGAN. Both of those points are good points. I'm not predicting the kind of thing I just mentioned, but it's a clear danger once you've experienced it, even though oil and other things had something to do with it. I just don't think we can afford to dismiss the possibility that once we get to whatever the number is--6 or 7 percent--that we will then have the [inflationary] momentum built in. It almost guarantees that that kind of very unhappy situation could result.

MR. ROBERTS. Well, I know it's partially cyclical, but we have an environment out there that I think is an opportunity of a lifetime to start toward price stability. Businessman after businessman tells me: When I put in a little price increase, it gets knocked down. And yet his margins are good, his unit volume is expanding, and his profits are good. If ever we need an appropriate monetary policy, which is how to keep the prices down, it's now--on top of this situation.

MR. MARTIN. It's not only the price experience, Ted. I think you'd agree that it's the changes that have been made internally in company after company after company: They are cutting down staff; there are concessions by the labor unions and by the work force. The potential for productivity in the next few years is very different from that in the years of the 10 or 12 percent inflation.

MR. RICE. But some price increases are beginning to stick--the recent aluminum price increase, for example.

MR. ROBERTS. The commodity prices are coming back. One fellow told me it would soon be back to cost. We're going to have that sort of thing; but the price competition is very vigorous in any business I can find.

MR. MARTIN. Some prices are sticking and some are not. Lumber prices came cascading back down.

CHAIRMAN VOLCKER. Let me just ask a nice neutral fellow like Mr. Kichline. What did you think of what AT&T agreed to apparently?

MR. BALLEES. 15 percent.

MR. KICHLINE. I think it's a good agreement.

MR. PARTEE. For whom?

MR. KICHLINE. In the climate--in the context of the discussion here--I would view it as a good agreement. I don't have a lot of detail. But pricing it out, I think it is something in the area of 16 percent over 3 years: a 5 to 5-1/2 percent wage increase now; 1-1/2 percent in each of the two following years; and a COLA that's worth something like 75 percent of the CPI, but once a year. There are two COLAs involved. So, if you assume 5 percent inflation--

CHAIRMAN VOLCKER. The COLA is only worth 75 percent?

MR. KICHLINE. Something like that.

VICE CHAIRMAN SOLOMON. And also, they have a very high level of productivity.

MR. KICHLINE. Now, in the communications industry in total--the last numbers were for 1981 with preliminary numbers for 1982--productivity has been going up year in and year out at something like 6 percent per year. That's an industry in which 16 percent doesn't look that bad.

CHAIRMAN VOLCKER. All right, you say 16 percent, which is apparently the wage part of the settlement. What's the rest of it going to have to--

VICE CHAIRMAN SOLOMON. The second and third years it's 1-1/2 percent plus the indexation.

CHAIRMAN VOLCKER. I know, but what about pensions?

MR. KICHLINE. My understanding was that they did not get very much on employee benefits. That's the area that's a little fuzzy. The company, I think, had been pressing for the employees to pick up more of the cost of health care and other things, and they gave up on some of that. But on some of the key issues that the union was desperately concerned with--namely, employment security--it's our reading that the company retained its options. That is, they've agreed to retraining in attempts to place affected employees but in a sense did not lock themselves into work rules that would make it very difficult for the future. And I view that as very positive.

MS. HORN. I would underline that. It seemed to me that the issue that the company really won on was the work rules issue, which was the issue they could not afford to lose on. That's an industry that is changing rapidly and a company that is changing rapidly, and I think that was a significant step toward increased productivity and keeping--

CHAIRMAN VOLCKER. Did they get some positive work rule changes? I didn't see that anyplace.

MS. HORN. No, I wouldn't say that. They avoided some very bad ones.

CHAIRMAN VOLCKER. They avoided some bad ones.

MR. PARTEE. Let's assume that it is 5-1/2 percent and that productivity is rising 5-1/2 percent in the telephone [industry]. Is 5-1/2 percent a good settlement as a standard-bearer for the country as a whole?

CHAIRMAN VOLCKER. I didn't say it's [not] a smart one, but I think it's a bad one.

MR. KICHLINE. Zero unit labor costs are bad?

MR. PARTEE. No, 5-1/2 percent.

CHAIRMAN VOLCKER. I don't know. Nobody else is going to go looking at the productivity in the telephone industry, assuming it's there. They are going to say that the telephone workers in the bottom of a recession settled for 5-1/2 percent and they want more than that.

MR. ROBERTS. But if they didn't get job security and they don't have the productivity, they won't have a job. I think that comes across.

VICE CHAIRMAN SOLOMON. Besides, I don't know if it's that much of a standard-bearer because the manufacturing industries and unions think of it as being a regulated situation and quite different.

MR. PARTEE. I do think people would view it as something to exceed--that the telephone industry is a dull industry and [other workers] ought to do better.

CHAIRMAN VOLCKER. It's getting unregulated.

MR. MARTIN. It used to be a dull industry; now it's a competitive industry.

MR. CORRIGAN. Part of the productivity problem, though, is that every businessman or woman we talk to will tell us that their productivity has grown like gangbusters. Even in industries that are suffering, they're talking about these great increases in productivity. I don't know who is holding productivity down in the aggregate statistics, but at the micro level it's grown like the devil every place.

CHAIRMAN VOLCKER. What inflation rate are you assuming when you say that the wage increase is 5-1/2 percent?

MR. KICHLINE. A 5 percent CPI increase.

VICE CHAIRMAN SOLOMON. Putting aside commodities for a moment or any possible oil price increase, I think the inflationary push--the initial manifestation--is going to come more from the ability of industry to get even higher margins by putting forth price increases as sales pick up and capacity gets near [full] utilization. Then labor will follow in a year or so and start pressing for wage increases greater than productivity increases. At the moment, unit labor costs are probably not rising significantly at all.

MR. ROBERTS. Don't forget that almost every major industry is really affected by import competition, which is making them not raise those margins as much as they otherwise would. That's another thing that's a universal chorus that we hear: that the foreign competition is just deadly.

MR. WALLICH. These very high profits, which surely must be an incentive [for workers] to raise [their wage] demands--

MS. TEETERS. Are they high or just rising rapidly? After all, they were very depressed.

MR. WALLICH. I mean that the share of profits in GNP is abysmal but the rate of increase is terrific.

CHAIRMAN VOLCKER. Well, does anybody have any more comments? John.

MR. BALLE. Well, Paul, this is backing up to where we were 10 minutes ago. You asked a question. I don't think you got a very good answer from anybody, at least from what I heard, on this very tough question of: If the Congress says to you they are willing to increase taxes by \$x billion, what are we going to do? I find that a very tough one to handle and I only got a little glimmer of how you might be able to [respond]. I think I'd try to hang my hat on the full employment budget concept. Sure, the literature of economics is full of talk about getting a better mix of fiscal/monetary policy. And a lot of learned observers of the economic scene say that what we need is tighter fiscal policy and easier monetary policy and not such an extreme case of a highly stimulative fiscal policy and a highly restrictive monetary policy. But if what [Congress] is talking about is a \$15 or \$20 billion tax increase, that is still going to leave us with an extremely large full employment deficit in the federal budget, and we would consider it imprudent to be more expansive in the rate of growth of the money supply until we get to the point where the full employment budget is actually in surplus or we at least have a far smaller deficit than the figure that would exist even with a \$15 or \$20 billion tax increase. And, therefore, we would not propose to ease up at this time until we are a lot closer to a balance in the full employment budget.

CHAIRMAN VOLCKER. Well, the trouble with that argument is they would say: Well, then, we'll forget about it. If you're not going to do your part, then why should we go through all the sweat in the year before an election?

MR. BALLE. Well, I think it's a good answer. While I wouldn't guarantee it, you've already said that if they were to cut--I forgot the numbers you used but it was some big drop in the federal deficit of \$70 billion or \$50 billion, I think--

MR. MARTIN. He said take \$50 billion, for example.

MR. BALLE. You said in a qualitative sense that it's almost certain long-term interest rates will come down a couple of points.

CHAIRMAN VOLCKER. I didn't say almost certain, John. Mr. Kichline has an astute econometric analysis to prove that after the fact.

VICE CHAIRMAN SOLOMON. There is a different tack you can take, Paul--that you were thinking of tightening, and then afterwards you could say that you couldn't carry a majority at the FOMC meeting.

MR. CORRIGAN. You could always raise the discount rate now so you could lower it then.

MR. PARTEE. I think the Greenbook shows at 6 percent unemployment--

CHAIRMAN VOLCKER. We could raise the money supply so we could tell them they wouldn't want us to be more expansive than this, [unintelligible].

MS. TEETERS. The full employment [deficit] as a share of GNP is rising by about what--1/2 percent for the forecast period?

CHAIRMAN VOLCKER. Why in this Greenbook do you keep calculating the full employment deficit at [a] 5 percent [unemployment rate]?

MR. KICHLINE. That's the official number.

MR. PARTEE. It's at 6 percent in the footnote.

CHAIRMAN VOLCKER. I know. But why don't we put 6 percent in the table?

MR. KICHLINE. We have both.

CHAIRMAN VOLCKER. I know you have both, but my question remains: Why in the table do you put 5 percent?

MR. KICHLINE. It's the official series.

MS. TEETERS. It's the official number.

MR. KICHLINE. We could easily eliminate it.

MR. PARTEE. That is done per my request of a couple of years ago.

CHAIRMAN VOLCKER. I didn't know we had an official series.

MR. MARTIN. We'll change the official--

CHAIRMAN VOLCKER. We'll make it official Federal Reserve or official FR Confidential.

MR. MARTIN. 6 percent.

MR. PARTEE. Anyway, in the forecast it's \$106 billion in the fourth quarter of 1984.

CHAIRMAN VOLCKER. That's for 6 percent or 5 percent?

MR. PARTEE. That's for 6 percent. So, if it gets down \$20 billion, we only have an \$85 billion full employment [deficit].

CHAIRMAN VOLCKER. Well, the practical political problem is that they will say: We're not going to bother doing anything. That seems like a big deal to them.

MR. BALLEES. Well, it seems to me the practical answer, Paul, is what you already gave before: that that would very likely reduce interest rates. If they want to get interest rates down, this is the most promising way of doing it.

MR. MORRIS. But they have a \$100 billion problem and not a \$15 billion problem.

CHAIRMAN VOLCKER. Well, we'll send somebody else to negotiate with them. I'd like to have an executive session. Mr. Coyne--. [Secretary's note: The executive session was not transcribed.]

[Session recessed]

Suggested Topics for Item 1 of
the Agenda for Monday, August 22

1. Conceptual and presentational issues arise from recent efforts in Congress—in connection with the budget process and the monetary policy oversight hearings—and elsewhere to have the Federal Reserve specifically declare its "objectives" for nominal GNP, real GNP, and prices. Congressman Fauntroy has held hearings on a bill to that effect (with Chairman Volcker testifying), and the process of deliberation and discussion can be expected to continue, with further responses from the System needed.

a. Conceptual issues

(1) Over the longer-run, under existing and reasonably foreseeable conditions and given the policy tools at its disposal, how should the Federal Reserve construe its responsibilities for the nation's economic objectives of reasonable price stability and economic growth? If the Federal Reserve has a special responsibility for the price level over time, what is an appropriate quantitative objective? To what degree should that objective be balanced against economic growth (is there a trade-off)? How would the longer-run fiscal outlook affect the stance and objectives of monetary policy over time?

(2) Over the shorter-run, and taking account of experience of the past decade, how should policy adapt to possible trade-offs between, for example, economic growth and price stability, in light of exogenous shocks (such as the oil price increases), the stage

of the business cycle, or international concerns?

What, if any, trade-off do you see between fiscal and monetary policies in the near-term?

b. Presentational issues

(1) Should ultimate economic goals be given clearer expression in conveying FOMC policy intentions to the public through, say, a specific numerical statement of objectives (with respect to prices or nominal or real GNP) over an extended period--e.g. 5 years?

(2) Or should expressions about ultimate economic goals continue to be limited to general qualitative statements, with numerical specifications for "projections" only a year or two ahead.

2. Possible procedural improvements in the flow of economic information might be considered as part of a continuing effort to make the meetings as productive as possible and also in the context of sharpening, if needed, consideration of longer-run issues as they interact with and shape current policy.

a. Should there be a special meeting devoted exclusively to long-run structural considerations--e.g. productivity trends, fiscal policy outlook, changes in financial structure--and how they affect possibilities of real growth, price stability, and monetary and credit targeting over an extended time horizon.

b. How often should numerical economic projections be updated--every meeting, less frequently (with more qualitative assessments substituted)--and what should be the forecast horizon?

c. Should presentations to the FOMC include, at least on occasion, forecasts or qualitative assessments from alternative sources?

Notes for F.O.M.C. Meeting
August 23, 1983

Sam. Y. Cross

Since your last meeting the dollar has experienced a very sharp rise and fall, leaving it now only slightly higher on balance against most foreign currencies than it was five weeks ago. Against the German mark, whose exchange rates were the most volatile, the dollar rose almost 6 percent to a 9 1/2-year high of DM2.7440 before falling sharply within the last two weeks to end with a net gain of just 1 percent.

The dollar's rise accelerated in the second half of July as fresh evidence of the strength of the U.S. economic recovery--seen in marked contrast with relatively weak performances abroad--heightened anticipation that growing private credit demands would soon clash with the financing needs of the U.S. government and force dollar interest rates higher. As U.S. domestic markets prepared to absorb the Treasury's large quarterly refinancing, uncertainties about the extent of expected interest-rate rises were transmitted to the increasingly nervous foreign exchange markets. Publicized reports about the payments difficulties of Brazil and other sovereign borrowers also contributed to anxieties over the implications of higher interest rates and prompted some buying of dollars as a safe asset.

Against this background, the dollar ratcheted upward in unsettled trading, meeting less resistance as it passed important benchmarks that it had not been able to sustain before. When the dollar broke through the psychologically important level of DM2.60, many corporate treasurers apparently moved to cover dollar needs that they had postponed and this added to the dollar's upward momentum. Major market makers became less willing to perform their normal positioning function causing the market to lose resiliency and to become subject to sharp rate movements. In these circumstances, the U.S. authorities entered the market in coordination with foreign central banks to restore orderly trading conditions. In these concerted operations foreign central banks sold \$2.4 billion, while we sold a total of \$254.1 million of which \$182.6 million was against German marks and \$71.5 million against Japanese yen. Our operations were conducted, on four trading days, at times when the dollar began rising sharply during U.S. trading hours, and were shared equally between the Treasury and the Federal Reserve.

The intervention started at a time when conditions were deteriorating and markets were becoming progressively more disorderly. It succeeded in cushioning the dollar's rise, and trading became more settled in the early days of August. But the dollar moved higher again after statements by German officials were interpreted to mean that the German authorities would not raise interest rates to protect their currency, an action which many had come to expect. After consultation with Bundesbank officials the U.S. authorities decided not to intervene.

After hitting its highs on August 11, the dollar reversed course at the same time that prices in the domestic bond market began to turn up again, in response to a reversal of market sentiment and expectations about a further rise in U.S. interest rates. With many exchange market professionals once again positioned the wrong way, the dollar's movement quickly acquired momentum, and at its lowest point last week, the dollar had fallen in terms of the German mark by about 5 percent in as many trading days.

These experiences have left several impressions on participants in the foreign exchange markets. One is that central bank intervention in the present environment is not likely to stop a strong rise in the dollar or, for that matter, its fall. In part, this is a healthy recognition by traders that the central banks are, as they have often said, prepared to intervene mainly to counter disorder in the markets and will not often try to resist fundamental trends in exchange rates. Another impression is that monetary authorities in the major European countries are willing to accept some depreciation of their currencies vis-a-vis the dollar, rather than jeopardize what they view as still tentative recoveries in their own economies by following U.S. interest rates upward. The absence of immediate fear of inflationary consequences, in view of weak domestic demand in these countries and relatively restrained commodity price increases, has contributed to this attitude, which has become much clearer to people in the market following recent official statements and actions in Germany, Switzerland and the United Kingdom.

Following the volatile movements of exchange rates in the past several weeks, market participants are still trying to assess their implications and the outlook for the future. The recent fall of the dollar suggests that there may not be much support for it at the higher levels. But the fundamental causes of the recent moves remain little changed, and views about the future course of interest rates are still uncertain. Thus the conditions underlying recent exchange rate volatility have not disappeared and the possibility cannot be excluded that we will have more episodes of similar character. Indeed it is not much of an exaggeration to say that, aside from significant changes in market expectations about interest rate prospects, almost nothing really happened to cause the dollar to rise and fall so sharply.

In other operations, the Bank of Mexico repaid on August 15 another \$310 million on the combined \$1.85 billion B.I.S.-U.S. credit facility, using the proceeds of an IMF drawing. Half of this amount was paid to the U.S. authorities, \$54.25 million on the special Federal Reserve swap line and \$100.75 million to the U.S. Treasury. The remaining \$1.2 billion of the entire facility is being repaid on schedule, August 23, in part using monies which the Mexican central bank had placed on deposit with the B.I.S. earlier. This final payment to the U.S. authorities comprises \$395.3 million to the U.S. Treasury and \$214.8 million to the Federal Reserve. The B.I.S. facility is now fully paid off and closed out, and of course the regular Federal Reserve swap of \$700 million was paid off earlier.

On July 26 the U.S. Treasury paid off the last of its foreign-currency denominated securities, or Carter bonds, amounting to \$607.3 million equivalent of German marks. The Treasury used marks warehoused with the Federal Reserve to cover this repayment, thereby eliminating all balances warehoused for the Treasury.

F.O.M.C. Recommendations

There are no outstanding swap commitments that will fall due in the period September 3, 1983 through October 14, 1983, which includes the first 10 days following the next scheduled meeting on October 4, 1983.

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
AUGUST 22-23, 1983

Domestic Desk operations since the July meeting of the Committee have aimed to achieve the slight, further increase in restraint on bank reserve positions agreed on at that meeting. Market sentiment tended to reinforce the Desk's stance, reacting to news of further strength in the economy, heavy Treasury cash needs, and continuing above-path growth in M1. In this setting, interest rates rose appreciably through much of the period, reaching a peak around August 8 to 10 when market confidence was at a particularly low ebb. Since then, information suggesting a more moderate pace of economic expansion, abatement of money supply growth and a pause in the Fed's move toward restraint encouraged a notable brightening in market atmosphere, and most of the earlier rate increase was reversed.

The M2 and M3 measures turned out weaker than expected in July, at annual rates of about 6 1/4 and 5 percent--each somewhat under the 8 1/2 and 8 percent paths for June to September sought by the Committee. The weakness was most pronounced in the non-M1 components of these broader measures, while M1 growth of about 9 percent somewhat exceeded the indicated June-September pace of 7 percent. Early August data suggest a slowdown in M1 from the July rate, probably accompanied by some pick-up in the broader money measures.

Typically, the Desk aimed for weekly nonborrowed reserve levels consistent with adjustment and seasonal borrowing of \$700 million and excess reserves of \$350 million. In practice,

borrowing levels somewhat exceeded the objective, averaging a little over \$900 million, while average excess reserves slightly exceeded \$400 million. In addition to the slightly higher-than-expected demand for excess reserves, the relatively high borrowing levels reflected a tendency for banks to use the window fairly heavily in the early part of most statement weeks. Moreover, even though the Desk moved to meet projected reserve needs fairly fully and promptly, there was a tendency for reserve factors to fall short of estimates more often than not. On a couple of end-of-week occasions, the substantial borrowing early in the week was a factor leading the Desk to be content with nonborrowed reserves somewhat short of path.

Against this background typical Federal funds trading rates worked up from around 9 1/8-1/4 percent just before the last meeting to about 9 5/8 percent or a little over in the last two full statement weeks. In the current week, the rate has edged off to about 9 1/2 percent.

Attainment of reserve objectives generally called for the Desk to supply reserves over the period. The System bought about \$2.1 billion of bills outright from foreign accounts, particularly in the latter part of the period. In part, the sizable availability of bills from those accounts reflected the currency support operations undertaken by several foreign central banks. Reserves were also supplied temporarily through System repurchase agreements on a couple of days and a pass-through of foreign account repurchase orders on numerous occasions.

Market interest rates followed a see-saw course over the period, with a modest net rise on balance. Sentiment was cautious to gloomy much of the time, and indeed seemed to reach particular depths shortly after the Treasury's large refunding auctions in early August. At that point, rates on Treasury coupon issues had moved up sharply in the preceding couple of weeks, but investors had little appetite for the securities that the dealers had just bought in substantial size. Factors weighing on sentiment included the strong business news, the information that M1 was pushing above its newly defined and "liberalized" monitoring range, a sense that the Desk was at least tolerating and perhaps encouraging continued firming, and not least the sheer size of the Treasury issues themselves. Pronouncements of well-known market commentators predicting higher rates ahead reinforced investor determination to stay on the sidelines.

The mood changed in the second week of August from abject despair to relief and even a bit of cautious elation. Rather quickly, the high yields that had developed began to look quite attractive. News of the flattening in retail sales in June and July was a significant psychological plus, soon reinforced by smaller-than-expected increases in money supply and a sense that the System was content not to press for firmer conditions for the time being. From August 10 to 20, the market recovered most of the price declines of the preceding few weeks. Long-term Treasury bonds rose a net of about 20 basis points over the period, but had been up as much as 75 basis points

around August 8-10. The Treasury's new refunding issues, which had all been trading below issue price a few days after the record sized auctions on August 2-4, commanded premiums of 1 to 4 points by the end of the period. The Treasury raised most of its net new cash during the period in the coupon market--\$13 billion out of \$18 1/2 billion, the balance being raised in bills.

On balance, bill rates rose quite modestly over the period, with declines in the last couple of weeks nearly offsetting the increases through early August. Yesterday, 3- and 6-month bills were auctioned at about 9.18 and 9.29 percent compared with 9.07 and 9.26 percent just before the last meeting. Other short-term rates showed only small net increases over the period, although major banks raised their prime rate 1/2 percent to 11 percent on August 8, at a time when market rates were temporarily at a peak. The retreat of rates on CDs and other short-term bank funding costs since then has lessened the pressure for a further rise in the prime rate which had looked like a good bet earlier this month.

Corporate bond yields showed similar increases to intermediate- and long-term Treasury issues, even though corporate issuance was on the light side. Tax-exempts also had comparable increases in moderate activity, with housing related issues especially in evidence. The tax-exempt market has continued to be selective in its response to the WPPSS default. The WPPSS issues themselves have been severely impacted and trade erratically in a speculative market. Other Washington State issuers have had to pay somewhat more for their borrowings

just because of their location, but the tax-exempt market in general seems little affected.

Returning for a moment to the current state of market confidence and expectations on the rate outlook, there now seems to be a rough balance and a trading range that could persist for a while. Dealers and investors are cautious, but rates climbed high enough so that some investors have found them attractive. Market seers seem to be pretty well divided. There are those who still anticipate further significant rate advances as private credit demands in an expanding economy bump against a voracious Treasury appetite. But others are convinced that rates are likely to head down--pointing in some cases to factors like low inflation and probable moderation of business gains, or in other instances to the recently slower growth in various reserve measures. This is what makes markets.

Finally, I'd like to report that the Desk recently began trading with two dealers that had been on our primary dealer reporting list for a considerable time--Crocker National Bank and Refco Partners. We are also on the verge of adding another dealer to the primary dealer reporting list--Manufacturers Hanover Trust. That will bring the number of reporting dealers back to thirty-six.

James L. Kichline
August 23, 1983

FOMC BRIEFING

The information now available on the economy points clearly to a substantial further rise of real GNP this quarter. Employment and output rose strongly in July following the sizable monthly gains in the preceding few months, and final sales generally have been well maintained. The staff's forecast entails an increase of real GNP of about 8 percent annual rate this quarter, followed by 5 percent in the fourth quarter and around 4 percent in the quarters of 1984. This is not much different in pattern from the staff projection presented at the last meeting of the Committee, although the levels of activity are higher throughout the forecast owing to the upward revisions to last quarter and this quarter.

The slowing of activity this fall and winter projected by the Staff is attributable in part to the expected influence of inventory investment. The shift to only a small inventory decline in the second quarter following a massive run-off in the preceding quarter contributed appreciably to measured growth, and this quarter a further swing to moderate accumulation of inventories also should boost real GNP; the data for July suggest output was greater than sales. However, the level of borrowing costs, prospects of limited price increases, and short delivery times all provide incentives to constrain inventory growth. The

staff forecast allows for stocks to rise in line with sales which means that the kick from inventories wanes later this year and especially in 1984.

A much more important element than inventories in recent and prospective developments is the behavior of consumers. During the second quarter, consumer spending rose at the exceptional and unsustainable rate of nearly 10 percent in real terms. A good deal of the spending increase occurred in April and May, with retail sales excluding autos changing little in June and July. Auto sales, however, have continued to move higher even though dealer sales incentives appear to be diminishing. We expect consumer spending to continue to be supported by strong gains in employment and income in the near term, as well as by the nearly \$30 billion tax cut that took effect last month. But one constraint on spending increases is by the historically low 4 percent personal saving rate last quarter. The forecast contains a little increase in that saving rate over the balance of this year, with consumer spending next year tracking gains in disposable income.

In the housing sector there is accumulating evidence of a slowdown in the making given the higher level of mortgage rates prevailing in the market. Although the ceiling rate on FHA-insured mortgages was reduced 1/2 percentage point effective today, the rate is still above that at the time of our previous

forecast and conventional rates are higher as well. Housing starts in July were about unchanged from the month earlier, with single family starts down for the second consecutive month while the often lagging multi-family starts continued to rise. Qualitative reports point to an appreciable reduction recently in mortgage loan applications, an increase in contract cancellations, and builder concerns about sales that we expect to show through in lower housing starts over the balance of the year. The forecast has some growth in the housing sector next year consistent with the projected downward drift in long-term interest rates.

Business fixed investment still seems poised for further appreciable expansion and should provide some impetus to overall economic growth, especially next year. Orders for producers durable equipment look good on average and we foresee a continued strengthening of outlays for equipment; at the same time the worst of the drag from the energy sector seems to be about behind us while the declines in the nonresidential building area are expected to have run their course soon.

For both the government and net export areas there is little new to report and we have not made significant changes to the forecast.

On the price side of the forecast we have added a few tenths to projected inflation rates for both this year and next. There were two main factors behind the upward revision, one being

the higher level of activity and thus reduced slack in the forecast and the other being the deterioration in the farm sector. We are now projecting food price increases of a little more than 7 percent next year, but it could get worse depending on the weather.

Finally, I might note that the CPI for July was released this morning. It shows an increase of 4.8 percent for all items and 6.7 percent for all items excluding food and energy .

FOMC BRIEFING
Stephen H. Axilrod

August 23, 1983

The strategic decision at this meeting about whether any further adjustment is needed on the degree of restraint on bank reserves—and if so in what direction—can be evaluated from the narrow perspective of the behavior of the monetary aggregates during the June-to-September short-term targeting period or from a broader and longer time perspective looking into the fourth quarter and beyond.

Tendencies of the aggregates thus far this quarter in relation to their short-term targets do not seem to suggest the need for any particular or significant adjustment in pressure on bank reserve positions. If the bulk of weight is to be placed on M2 and M3 in that evaluation, there is indeed some argument for a slight lessening in the degree of reserve pressure. These aggregates have been running below their short-run target paths, but that may be the result of special factors (e.g., the enlarged availability of U.S. Government balances as a source of funds to banks last month) that diminished for a time the aggressiveness with which banks offered managed liabilities. M2 and M3 are expected to grow more rapidly over the weeks immediately ahead, though to date the data appear to be lagging our expectations. On the other hand, M1 growth has remained a shade above its short-run path, though the growth rate does seem to be abating further as best can be judged from early August data. Given the usual range of error around projections of the aggregates,

there appears to be no compelling technical reason to adjust the three month specifications contained in the last directive, even though the blue book does show minor adjustments in relationships among the aggregates based on present trends.

I should note in this context that growth in the income velocity of M1 does at last seem to have turned positive, though remaining relatively low as compared with earlier cyclical experience in the second and apparently also in the current quarter--and is expected to remain low in the fourth quarter along with a projected moderation in GNP growth. There has been, incidentally, a more rapid and cyclically "normal" growth in the velocity of old M1A--currency and demand deposits--thus far in the expansion phase of the current business cycle. Through the first three quarters of the current expansion in economic activity, growth in M1A velocity has been only a bit lower than the average of five postwar expansions (excluding the expansion beginning in QIV 1949, still influenced by stored up liquidity from World War II, and the one beginning in QIII 1980, distorted by the introduction of NOW accounts on a nationwide basis). Velocity growth in the current cycle has been largest in the second and third quarters, when shifts out of demand deposits to MMDAs and Super NOWs were not likely to have been a distorting factor on M1 growth. It is hard to come to any firm conclusion about policy implications from those facts, but they might suggest that the present M1 does contain savings elements that drag down its velocity growth and that the relationship between pure transactions money and the economy is not radically different from earlier periods.

Any need for a change in restraint on reserve positions over the next few weeks would seem to depend at this time less on recent behavior of the aggregates and expectations over the very near-term than on an assessment of future behavior looking into the fourth quarter and beyond. We have projected, judgmentally, some little further rise of interest rates into the fourth quarter, consistent with the GNP projection, followed by a tendency for rates to decline in 1984. This rise is not inconsistent with models I've looked at--from the Board and from Reserve Bank economists--though two of the equations do suggest a larger rise of interest rates than we have projected judgmentally would be needed to restrain M1 to within the 5 to 9 per cent long-run path for the second half of this year, given the staff's GNP forecast. On the other hand, all those models from which an M2 estimate can be derived suggest little trouble in hitting M2 at around current interest rates.

Looking even further ahead, into the year 1984, our projections indicate a tendency for nominal interest rates to decline, not rise further--which may seem a bit surprising, given (a) the continuing growth of real GNP at a rate not very different from that evident in the second year of earlier expansions, (b) the failure of the federal budget to turn less expansive as the economic recovery continues, and (c) a presumed increase in the expected real return on capital on the part of businesses in face of the strong increase in consumer demand for their products (which should make business willing to borrow at higher real and presumably therefore high nominal rates). Nonetheless, there are several reasons for anticipating some decline in nominal interest rates next year, both short- and long-term.

First, our projection of inflation remains quite moderate and is on the low side of current forecasters; if our projection turns out, long-run inflation expectations in the market may diminish again (they may have recently risen as the economy strengthened), dragging nominal interest rates down with them. Moreover, a moderate price rise will work to keep the growth in nominal income within a range that might be comfortably financed by the Committee's money targets, and thus keep upward pressure off short-term rates.

Second, our projection does call for a marked deceleration in consumer spending next year, which may affect perceived needs for new capacity and hold down any increase in the expected real return from business investment in plant and equipment. Under the circumstances, businesses might not be prepared to borrow at higher real, and by implication, nominal rates than now.

And third, we continue to expect a large, indeed increasing, net inflow of capital from abroad to supplement domestic savings and permit expansion of real purchases by domestic sectors in excess of the nation's output--which works at least to dampen upward pressures on interest rates.

There are obvious risks that all three reasons for expecting nominal rates to decline next year may not work out. For instance, the budget could be even more expansive. And a change in the attitudes of foreign investors should not be neglected as a possibility. If foreigners should become less willing to supply their savings to us--either because economies expand more than expected abroad or because there is simply not much capital left abroad that will move for safe haven reasons--this could

well place upward pressure on our interest rates. One route would be through the upward impact on our domestic price level of what could then be a very substantial depreciation of the dollar. Another route would be if a diminished U.S. current account deficit here--spurred, say, by greater economic growth abroad--was not accompanied by a concomitant increase in the propensity to save by U.S. domestic sectors to permit the domestic investment and the budget deficit consistent with projected real GNP growth to be financed at around the assumed interest rates.

These brief comments on broader influences on the longer-run outlook for interest rates together with the somewhat uncertain interpretation of and prospects for money (not to mention GNP) over the near-term all seem to suggest, not very dramatically, a cautious or "wait and see" approach to monetary policy over the near term.