Meeting of the Federal Open Market Committee

May 21-22, 1984

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, May 21, 1984, at 3:30 p.m., and continuing on Tuesday, May 22, 1984, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Boehne
Mr. Boykin
Mr. Corrigan
Mr. Gramley
Mrs. Horn
Mr. Martin
Mr. Partee
Mr. Rice 1/
Mr. Wallich

Messrs. Balles, Black, Forrestal, and Keehn, Alternate Members of the Federal Open Market Committee

Messrs. Guffey, Morris, and Roberts, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

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

Messrs. Burns, J. Davis, Kohn, Lang, Lindsey, Prell, Siegman, Stern, and Zeisel, Associate Economists

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

1/ Attended Tuesday session only.

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Promisel, Senior Associate Director, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Fousek, Executive Vice President, Federal Reserve Bank of New York

Messrs. Balbach, T. Davis, Eisenmenger, Keran, Parthemos, Scheld, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, Boston, San Francisco, Richmond, Chicago, and Atlanta, respectively

Ms. Lovett, Manager, Securities Department, Federal Reseve Bank of New York

Transcript of Federal Open Market Committee Meeting of
May 21-22, 1984

May 21, 1984--Afternoon Session

[Secretary's note: Messrs. Promisel, Henderson, Hooper, and Isard of the Board's Division of International Finance gave a presentation on the external position of the United States and the exchange value of the dollar. See Appendix. The discussion that followed this presentation was not transcribed.]

CHAIRMAN VOLCKER. If we're finished with this, we can turn to the meeting [agenda] and maybe have the Managers' reports today. We need to approve the minutes of the last meeting.

MR. PARTEE. So moved.

MR. MARTIN. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Cross.

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

MR. WALLICH. Sam, what I hear about negotiations with Argentina isn't very positive right now. Is there any time limit in terms of the Treasury's arrangements on when they need to arrive at a letter of intent?

MR. TRUMAN. They formally have only extended their arrangements through the end of this month.

MR. CROSS. Through the end of May.

MR. TRUMAN. But the Latin people who currently have their money involved indicated in public when they announced their own 30-day extension through the end of May that they would be inclined to permit a further extension. So, although the Treasury formally has a deadline and they might even want to keep to it, they are somewhat boxed in by the Latins.

MR. CROSS. The original agreement said only 30 days. Then it was extended by the Latins and by the Treasury for another 30 days. And it may be extended further for another 30 days, according to the Latins, but the Treasury hasn't said anything.

MR. PARTEE. The additional 30 days would put it right up to June 30 and the question of the treatment of the income arises again. And I suppose there's more of it by now.

MR. TRUMAN. The Argentineans have put forward a proposal to the banks to deal with June 30. It involves the activation of the residual amount of their medium-term loan which was negotiated last year, use of a substantial amount of their own reserves, and repayment of the bridge loan done last year and this little $100 million piece that they have left over. Essentially, they would be using $350 million of their own reserves and $150 million left over from the arrangements that were done last year. So, they have offered to the banks already--I'm [oversimplifying] it now--arrangements which by

June 30, if they had a letter of intent with the Fund and all the paperwork had been done, would bring things up to April again.

MR. CROSS. There are a few other things in there.

MR. TRUMAN. There are a few things in there that make that package unattractive to the banks and for the moment they have turned it down. But I, at least, consider it a positive step that in terms of the general negotiations they are thinking ahead. They are 6 weeks ahead of where they were last quarter, if I may put it that way.

MR. CROSS. The encouraging part is that they are talking to the Fund and for the first time have begun to make proposals to the banks about how to deal with it. They are not home free.

MR. PARTEE. Sam, I'm surprised that the weakness of the dollar on the basis of the Continental Illinois situation wasn't greater than what we observed. I'd view that as saying that they were prepared to shift funds among U.S. banks--that is, they didn't regard U.S. banks as a group as questionable.

MR. CROSS. We did not hear a great deal of concern expressed about a spillover into the whole system. Now, the dollar did come down a couple of percentage points during that period, mind you.

VICE CHAIRMAN SOLOMON. But as you pointed out, that was to a large degree in response to the belief that U.S. monetary policy would be easier, whereas what you're talking about is a direct loss of confidence.

MR. PARTEE. A movement back into some foreign banks.

VICE CHAIRMAN SOLOMON. At Bretton Woods over the weekend a couple of people asked me whether there would be a spillover effect in terms of foreign banks' reluctance to fund other U.S. banks.

MR. PARTEE. You said no.

VICE CHAIRMAN SOLOMON. Obviously, I said no. There is that view floating around a bit; that question is being asked in banking circles.

MR. MARTIN. But the focus of the questions is not on one or more individual cases.

MR. TRUMAN. I don't know whether it's in fact happening but, of course, they can move out of U.S. banks and stay in dollars. They can go into Treasury securities as well.

CHAIRMAN VOLCKER. There has been some tendency for U.S. bank rates to go up in London as well as in the United States relative to other rates. It hasn't gone very far. There is a little selectivity in the bank stock market--at least about some banks--but there is talk about it.

VICE CHAIRMAN SOLOMON. My feeling--my hope, I guess--is that the prompt action by the U.S. authorities on Continental Illinois would tend to prevent that kind of spillover [effect]. It's probably realistic to assume that there is a somewhat more alert, more skeptical, attitude abroad and that if there were another situation, we probably would see some more of that.

MR. WALLICH. At the Basle meeting there was considerable questioning, at least by some central bankers, as to the adequacy of our arrangements. There was a considerable lack of understanding about what the Federal Reserve does--providing liquidity on a secured basis--and about what the FDIC does--providing solvency support. And the question really was whether these arrangements were adequate.

VICE CHAIRMAN SOLOMON. I hope you assured them they were.

MR. WALLICH. I surely did.

CHAIRMAN VOLCKER. If they are not adequate, I don't know what else we can do.

MR. PARTEE. I don't either. It's a government guaranteed bank.

CHAIRMAN VOLCKER. There may be some questions about it nonetheless.

VICE CHAIRMAN SOLOMON. There is some questioning by foreign banks--I've heard this in a couple of places--as to whether it is 100 percent risk-free at [every] stage of the process because they are not familiar with the way the FDIC would step in and what would happen. They wonder whether there is some point in time where they would be at risk.

CHAIRMAN VOLCKER. That is intended to be answered in the press release by saying any arrangements--or whatever the exact wording was--

VICE CHAIRMAN SOLOMON. [The guarantee] was so sweeping that they had difficulty believing it. Also, some of them say: Well, isn't the unlimited liquidity commitment of the Federal Reserve limited to the amount of collateral that Continental Illinois can put up?

MR. PARTEE. It doesn't say that.

VICE CHAIRMAN SOLOMON. I know. It doesn't say so because we got advice in the course of our discussion that that would be counterproductive. But on the other hand, there's a heck of a lot of collateral in Continental Illinois.

CHAIRMAN VOLCKER. $40 billion, if you take it all.

MR. ROBERTS. It has to be good and sound.

MR. KEEHN. It's not worth quite that much.

MR. FORRESTAL. A broader question on the LDCs: Has there been any progress with respect to the interest cap situation?

CHAIRMAN VOLCKER. No. That has been greatly exaggerated in all the press reports. I don't think anybody is realistically talking about anything other than protecting against some further sizable increase in interest rates. It's all talk and no action at this point.

MR. KEEHN. There was an article in the paper, maybe today, saying that based on the most recent increase in the prime the four major countries are going to get together and try to form a user's group, if you will. Is that a serious threat or just more talk?

CHAIRMAN VOLCKER. I don't know anything about that, but I know they are very unhappy--understandably so.

MR. TRUMAN. I made one contact on that subject. Our embassy--I'll leave you to judge the quality of the information--regards the statement put out by the Mexicans, Argentineans, Brazilians, and the Columbians saying that they plan to get together, initially on the level of finance ministers and foreign ministers and then subsequently perhaps at the head of state level, as a relatively moderate response under the circumstances. The text of some of that as picked up in the newspapers suggested that there was talk about protectionism and concerns like that rather than a confrontational framework. One never can tell once it gets to the politicians--if it is raised to the level of high politics--what will transpire. It reflects I think both the sense of frustration of these countries about recent events as well as a feeling--which we've been picking up since the conference last spring when we hosted the Latin Americans up in Boston--that the countries are being picked off one by one by the industrial countries and their banks. So they have a sense of wanting to exchange notes from time to time about what is being done to them.

CHAIRMAN VOLCKER. There's no question that the rise in interest rates has depressed the whole atmosphere surrounding these debt negotiations, which were already difficult. Certainly in Argentina and in the others as well, though perhaps to a lesser degree, they have a very great feeling of helplessness. The banks do as well. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Questions?

MR. BALLES. Mr. Chairman, if I may, I would like to ask Peter a question about this movement of interest rates. Peter, given the two factors that you cite for causing the rates to go up--that is, the collision course between private and public credit demands and the fading expectations of some closing of the deficit gap--do you see any particular reason why long rates should have gone up more than short rates since our last meeting? My own hunch is that, based on past performance, it would have been the other way around.

MR. STERNLIGHT. Well, I think some of that collision is seen as taking place in the longer area. The Treasury has continued its program of issuing longer debt. So it was not only that current sense of what is pressing on the market but, with that sense of strong private credit demand, there was some uplifting of inflation expectations there too that I think had an impact at the longer end.

I must say, though, that I share your view of surprise as to the extent to which the yield curve has steepened.

MR. BOEHNE. But hasn't that happened throughout the recovery? Haven't long-term rates retraced maybe 70 or 75 percent of the decline, whereas short rates have moved substantially less than that? It is a little peculiar.

MR. WALLICH. Doesn't that seem to you an abnormality, contrary to the usual tendency of the rate structure to flatten out toward the end of an expansion? Doesn't it seem, therefore, that there is some doubt about what is going to happen to inflation?

MR. AXILROD. I happen to have, Governor Wallich, a rough measure of the yield curve 18 months into an expansion from the trough. I'm not exactly sure but I think it's from the trough of the recession, not the trough of the yields. The spread was about 1-1/8 percentage points and is now 3.2 points, so the yield curve has gotten [steeper]. Looked at on a ratio basis, which is relevant because a ratio takes account of the higher level of rates, it's not so marked. It goes from 122 to 132. Now, that's not very different from what occurred after the 1970 recession going out 18 months. In terms of the absolute spreads it's much different; but in terms of the ratio it's hardly different from the preceding troughs in the '70s. It is different from the experiences earlier; before the '70s the yield curve did flatten more noticeably after 18 months. But it was not so much the case in the 1970 recession, except that in absolute terms this is quite different.

MR. GRAMLEY. Peter, where do we stand on the process of mopping up the additional reserves injected through Continental's borrowing?

MR. STERNLIGHT. When the borrowing first began we still had a fairly high funds rate. To have gone in then overtly to do substantial mopping up could have been seen as a very disruptive factor, I think, and we just let a pile of excess reserves build up. Increasingly in the last few days we've worked down that pile of excess. With the amount we took out of reserves today through some matched sales we have pretty much wiped away the impact of the special borrowing that has occurred thus far and we even made a small allowance for some anticipated continuing borrowing. We have been a little gingerly in anticipating how high this level of borrowing will be in the remaining days. In a numerical sense I think we have just about caught up with that mopping up process now. But in a psychological sense some of the ease that was created because of the earlier buildup in excess reserves is still in there.

MS. HORN. Have we labeled it extended credit yet?

MR. STERNLIGHT. No. It has not been so labeled.

MR. MARTIN. Peter, have you been able to execute these operations while observing the markets performing more or less normally? I realize that's a matter of definition right now--with the 1-point changes over short periods of time.

MR. STERNLIGHT. Well, I'm not sure. Are you asking about the whole range of operations or the particular mopping up of the excess reserves?

MR. MARTIN. The particular mopping up.

MR. STERNLIGHT. That part has gone very smoothly. Once the banking system came to realize they had all this excess, they have been very eager to show us propositions and have us pay them something for the excess reserves that they now see as unwanted. So, that has gone quite smoothly. The market, in general, had developed some greater volatility just because of that massive pessimistic feeling. I think it is calming down somewhat from that, but it's still fairly--

MR. MARTIN. Looking into the immediate future then, is there an implication in that behavior that you just described? Let us assume, or let us hope, that the Continental matter works its way through, that there is a merger partner, and that it's resolved in some reasonable way. Would you anticipate that the 1-point changes and the volatility that we observed in the market, particularly in the long end, will subside? Or is there a situation or an attitude that may resist improving?

MR. STERNLIGHT. I think that would remove one important contributing factor.

MR. MARTIN. We still have the LDC problem.

MR. STERNLIGHT. The budget deficit problem is there too, but I think there is hope that something will go through. And the market is also waiting for clearer evidence of a more reasonable pace in the economic expansion.

MR. ROBERTS. There are also a lot of shell-shocked investors sitting on big losses. They don't want to buy any more long bonds.

MR. STERNLIGHT. Yes, it's taking increasingly high yields [to attract them]. Some have begun to come back in again, but still in a fairly modest way.

CHAIRMAN VOLCKER. How much do the dealers have left of that financing?

MR. STERNLIGHT. I would say they do not have anything very significant left. It is very hard to measure their positions because so much is hedged against futures positions. Even though they in a sense took down big chunks from the Treasury, they had already made arrangements to sell some of it. I would say their positions now are no more than a few hundred million that could be attributed directly to the financing.

MR. PARTEE. Yet the futures market has functioned okay?

MR. STERNLIGHT. It has, yes. It has also had the volatility.

MR. PARTEE. There must have been some realized losses taken that haven't shown up, as yet anyhow. [Do you know of] any particular situation?

MR. STERNLIGHT. No. There was one day of extremely volatile price movements when the price limit situation was reached and they had to discontinue functioning for a couple of hours. But even that--

MR. MARTIN. That was the only time the limit was reached in that period?

MR. STERNLIGHT. That's the only instance that I recall.

VICE CHAIRMAN SOLOMON. The great majority of dealers have been losing a lot of money for quite a few months; they don't seem to be able to hedge well enough. Most of them are in some kind of net long position and I don't quite know why. I don't know enough about the futures market to know why they can't seem to hedge better. This is what I've heard from half a dozen of them.

MR. PARTEE. I was thinking of the nondealers.

VICE CHAIRMAN SOLOMON. Well, I'm not sure that that was the reason. They argue that as underwriters they were not able to hedge.

MR. MARTIN. But many hedging programs are incomplete. Isn't it unusual that a dealer would hedge completely? Usually hedging means an 80 percent hedge or a 70 percent hedge.

MR. STERNLIGHT. Well, some of them try to get very fully hedged. At some point they live with a certain element of uncertainty because they take down securities from the Treasury. They don't know whether their bid is going to win securities or not, so they probably hedge some of it in expectation that they will win some securities but they may be preparing to have some net long position in the hopes of moving some of it out profitably.

MR. PARTEE. My thought, Tony, has been that the dealers were losing on spot transactions and gaining on the futures, which means that somebody other than the dealers was losing on the futures.

VICE CHAIRMAN SOLOMON. But the overall profit situation of the dealers has been very bad.

MR. ROBERTS. But the relationship they put on the short or the future can determine whether it's profitable to them. They can hedge it but at a loss initially.

MR. MARTIN. Well, when the markets see these spot and futures spreads are not necessarily holding--. You can be completely hedged and if the spreads change, you may lose. There is no such thing as a perfect hedge.

CHAIRMAN VOLCKER. Any other questions?

MR. GUFFEY. Where do we stand on the debt limit legislation? Is that posing great problems for you?

MR. STERNLIGHT. Well, it poses great problems for the Treasury and the functioning of the government. I think they have to begin something in the course of this week because the Congress is due to recess.

MR. GUFFEY. Are they out of money?

MR. STERNLIGHT. They will be out. I think they probably have enough to last beyond when the Congress goes home but not until the Congress comes back. They have to get action by the 23rd or 24th.

CHAIRMAN VOLCKER. Any questions? We need to ratify the transactions. I heard a motion and second. Without objection. We will continue at 9:15 a.m. tomorrow.

[Meeting recessed]

May 22, 1984--Morning Session

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

CHAIRMAN VOLCKER. Any comments?

MR. BOEHNE. Well, I'll lead off. I sense that the recovery is maturing in my District. Several months ago there was unabashed optimism and report after report of rapid increases in sales and orders. But what I sense in the last month or so is that the optimism is more tempered; the sales forecasts are more moderate. Some of the big firms are thinking that there might be a recession toward the end of 1985 and they don't want to get caught again as they got caught last time. I don't mean to imply that people are pessimistic. I just sense some tempering in the optimism, which would suggest to me that the normal cyclical pattern of fast growth earlier in the recovery and slower growth later may be consistent with this kind of anecdotal evidence that I'm picking up. Also, just looking at the numbers, it seems to me that the recovery is not all that unusual, with fast growth in the earlier quarters and some slowing in later quarters. The inventory boost in the first quarter certainly shoved up the figure, but I suspect that if there hadn't been so much leftover caution from the previous recession, we might have gotten some of that inventory buildup earlier in the recovery rather than later. So, just in a subjective sense, there is some anecdotal evidence, at least in my part of the country, that we are seeing some slowing.

The price side seems to be holding up really rather well. There are some cyclical upward pressures in some industries that one would expect. From the reports I get, wages continue to be moderate, although a lot of business people I talk to think that the auto negotiations in the fall will be the key. If we get through that, they see moderation continuing; if that comes out badly, it will be harder for them to hold the line in their own areas.

MS. HORN. Mr. Chairman, I also would talk about attitudes, but attitudes mainly in financial markets. Attitudes are indicating different kinds of strains in financial markets than we talked about yesterday--the international situation, the Continental situation and so on--and are what I call attitudes of excesses in financial markets. They start with some of the kinds of financial contracts we see being invented and being written, such as leveraged buyouts and that whole list of things. It continues in the talk about how banks are running their businesses; I keep hearing more and more that banks around the country are shoving money out the door, if you will. We hear about it from real estate developers; and when you start hearing real estate developers in the Fourth District talk about these things, you know that it's much broader based in the country. Real estate developers are telling us that they can't put any equity in a shopping center these days--that banks are giving 100 percent financing--and that even if they wanted to put equity in, because that's the way they would like to run their business, they can't do it because their competition isn't doing it. And worse than just the leverage problem alone is that the 100 percent financing is short term. They are getting 5- to 7-year terms from a bank at variable interest rates and at the end of the development they are not going to the insurance companies and are not getting the long-term money. So, the specter arises: If you have a lot of unoccupied office buildings that are on 5- to 7-year term loans, what happens when those loans came due? We only have one such building in Cleveland because we haven't had the building boom that other cities have had. But if this is the situation around the country, then this very short-term financing of long-term assets could build to be a real problem.

Another Fourth District story about banks but about banks around the country that I found very interesting was in connection with this recent takeover bid by

the fellow who controls that, needed--I don't remember the exact number--in excess of a billion dollars to make the bid. And for reasons of confidentiality, he didn't want to have a bank form a syndicate to get the loan for him. So, he did what he was advised couldn't be done. He went to thirty-two banks and asked them for lines of credit for a takeover for an acquisition and he wouldn't tell them the acquisition target, and out of the thirty-two very large banks he approached only one refused to give him a line of credit because they wanted to know the name of who was being taken over. Then, on a Friday afternoon, within several hours he pulled down all the lines and made the offer. It is, I think, an indication of how business is being done these days.

The thrift stories, of course, continue and we increasingly hear concerns about the lack of matched maturities--that thrifts aren't being run in a conservative way. In the Fourth District we're beginning to get anecdotal evidence about some of our thrifts that are in very poor condition suggesting that things are so bad for them that there is nothing to keep them from trying to take a big bet and trying to hit a home run in real estate development kinds of projects. Because if they fail to hit the home run, have they really worsened their condition? I guess it has always been true that there is a certain number of portfolio managers who have a very short-term view on investment and manage their portfolios by saying: Let's pick the next takeover prospect. But it seems that one hears about these people prospering now, and I suppose that would be another thing I would add to my list of concerns. Just to complete an incomplete list, one more subject would be the auto negotiations. We're beginning to hear a minority view, expressed by people in the transportation equipment industry in the Fourth District who are really in a position to have very good information, that GM will not be willing to take a strike. They are talking about and hope that they will be able to get a settlement that will tie wage increases to profitability. But the talk that they are hearing is that GM may be unwilling to take a strike.

I guess one could build a very pessimistic case from this list of attitude excesses, if you will, and we could say that the financial contracts of today might be the international debt problem of several years from now. That may be overstated, but I've just been getting so much anecdotal evidence across the board that I do believe we are beginning to see in attitudes a situation that is not inconsistent with rising inflationary expectations. Those are my comments.

CHAIRMAN VOLCKER. Welcome to the world of American banking! Governor Martin.

MR. MARTIN. Mr. Chairman, I would like to pick up on the comments that have been made already by my two colleagues with regard to the labor situation. We had the benefit on May 11 of the economic consultants being in our midst and of the work in that area by Arnie Weber of Colorado, Bob Gordon, and others, coupled with work that has been forthcoming from Kendrick and Dennison and others in the productivity field. That work points toward a rather different labor/management situation, or at least some degrees of difference. We are all focusing on the upcoming auto settlements. position on that, as perhaps everybody in the room knows, is that the auto settlement will not be a leading indicator this time--that there is a special situation there that won't affect steel that much and won't affect construction and won't affect the other major settlements coming along. position stems in part, I think, from a rather more optimistic look at the cost push from unit labor costs. He is a bit more optimistic than our colleagues here at the Board, for example. He cites the restructuring of bargaining--a company-by-company approach--and even the changes in the preparatory stages for these settlements. So, his conclusion was that it is unlikely that the average settlements will exceed the 5 percent range in the next three years. There again he's talking about the inertia in settlements and the fact that these arrangements have a way of holding for quite some time as a precedent. On the productivity side, I would be the first to concede that none of the people that I've cited, including my [unintelligible] has given any reason to be wildly optimistic. On the other hand, there are scattered indications that productivity may come back closer to the trend line of the '50s and '60s [than] the negative or flat trend of the '70s or the staff projection, if I remember it correctly, of something like 1 to 1-1/4 percent. You can find quite a bit of evidence that productivity is going to more in the area of 1-1/2 to 2 percent. If you recall the work that was presented at a previous FOMC meeting on the subject of inflation, productivity, and labor costs, and the relationship in a leading sense between the changes in unit labor costs and inflation, if indeed the slightly more optimistic numbers are true and if and his people are somewhat correct, then you have a different cost/push coming from labor this time and one that is more conducive to disinflation or less inflation.

There is one other area I would like to mention since I don't dare talk about the thrift institutions and how much they're losing today because all of you are quite sick of my attempt to measure that industry. Besides, I think everybody in the room is aware that the three big savings banks in New York City are very much under water, that the thrift industry is now operating in the red, and that they are beginning to run out of the funny accounting practices that they have been participating in. They are quite ingenious; they may invent whole new areas in which they can distort their reporting of loss.

But turning to agriculture, I simply want to mention--and I do this with great humility considering that those of you who come from the regional Banks in agricultural areas undoubtedly are aware from your own Districts of the continued plight in agriculture--the proportion of farmers operating in the red. There was a bank survey showing something like 40 percent of the ag borrowers are operating at zero or in the red. The foreclosure or impending foreclosure numbers out of that ABA survey were 2-1/2 percent of the agricultural borrowers; and 8 or 9 percent were in the so-called distressed category as far as their credit outlook is concerned. So, I would join my Cleveland colleague--I refuse to use these darn District numbers--in talking about the vulnerabilities in the bond market, the LDCs, the thrifts, and agriculture. It's a different recovery in that sense, in my not so humble opinion.

VICE CHAIRMAN SOLOMON. You follow the thrifts closely.

MR. MARTIN. Can't get away from them!

VICE CHAIRMAN SOLOMON. Would you expect the Congress next year, if the thrifts are in the same difficulty, to extend the capital fusion program or whatever that's called?

MR. MARTIN. Yes. I think it will be extended for both the savings banks, which need it more, and the other thrift institutions.

VICE CHAIRMAN SOLOMON. Well, I don't know whether those New York savings banks can continue their present situation as late as that. I would assume they'd need a resolution of that.

MR. PARTEE. For the most sensitive ones, the ones that are most on the line, I think that is probably right. But after that there will be another batch behind them.

MR. MARTIN. Well, the thrift holding company types, such as Financial Corporation of America, are tremendously leveraged and are betting on lower--much lower--interest rates. It's simply a rotten barrel.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I share Mr. Boehne's qualitative view that the economy is probably moving into a more mature phase where we will see some slowing. But if you search the evidence, it's pretty hard to find anything in the statistics other than an apparent plateauing of housing that really suggests that that's taking place. So it looks to me as if the Greenbook is probably about right in its forecast for real economic growth in the last three quarters of 1984. I fear, however, that they may be underestimating inflation for the last half of '84 and for '85. Pres just cited some interesting developments in productivity that I think will ameliorate that to some extent, and I would add to that the increasing foreign competition and domestic competition. I have now reached the point that I don't ever pay list price on anything. I think almost everybody has that same mentality and that's bound to have an effect that had not been there before. Nevertheless, with the tremendous--I would say tremendous, although one could argue--amount of monetary stimulus put out in late '82 and '83 and the pickup now taking place in velocity, it seems to me that we're probably going to have more inflation than in the Greenbook forecast. I think the market behavior, which Karen has reinforced with some interesting anecdotes, suggests that the expectations are just that. As I read the market, we have a little way to go before we get rid of those inflationary expectations.

I have one other point. It's the main one. I think it is important that we monitor current economic developments very carefully. But at the same time, I think it is important that we avoid giving too much weight to the short-term economic data that we see in trying to set short-term monetary policy. Undue emphasis, for example, upon the strong first quarter of this year could lead to our aborting the recovery if we were to take action related to that. But perhaps more realistically, the economy is going to slow down somewhere before very much longer, I think. And when the data begin to show this weakening, if there is a perception on the part of the public that we are trying to fine-tune the economy to any great extent, that is going to intensify the pressure that we have to ease significantly at a time when such a degree of easing may well not be compatible with our longer-term objective of working down the rate of inflation and getting back to a completely healthy economy. So, my bottom line is that I would not let the latest bit of economic information influence what our policy decision should be today.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. Conditions in the Eighth District are really favorable. I tried to find some weak spots recently and, with the exception of agriculture which I will comment on, there don't seem to be any. There is a general optimism and the underlying momentum of business activity seems to be quite decidedly upward. We took a survey recently of 257 businesses in the District and 73 percent anticipate that their volume of activity is going to be expanding in the next three months. Department stores sales, including those of some national companies, are very strong; they are running about 13 percent ahead. And most of that is real; they don't see a significant amount of price inflation in that. Automobile sales are very strong. We're seeing year-over-year increases as high as 40 percent and in one of my branch cites they are breaking new records. Industrial activity is robust. Anecdotally, we're hearing that the mid-South furniture industry in northern Mississippi is headed for its strongest year in a decade after a long period of tough times. Housing and construction remain strong. People mention their concern about the recent rise in interest rates but [the effect] hasn't shown itself yet.

In terms of prices, there is surprising stability. I had a group of chief financial officers of major companies in recently. They all seem to be concerned about the possibility of price increases but they say in terms of what they buy and in terms of what they get that the price front is very quiet and nothing is really bothersome at the moment. So, there is no acceleration of prices. Demand for loans in the banks in the District is vigorous now after a slow start. I think there are two problem areas, potentially. One is the saving and loan business. Our largest savings and loans are very thin on capital position and are not making any money; and with rising interest rates those that are narrowly making money are going to start losing money. In agriculture we have another troublesome situation, with rain delaying planting. For example, 21 percent of the corn is planted now versus the normal 54 percent, and that affects production. I was in northern Mississippi recently and I would say that the agricultural situation down there could best be assessed as grim. The bankers tell me that farmers who inherited their land, who didn't have debt on the land and who have been good managers, are having a very, very difficult time and can't handle their credits, and they are very concerned. I had occasion to talk to four major national retailers recently and asked them what their sense of the consumer's attitude was. Uniformly they said that business is still okay but that the froth is off. The March/April experience has shaken out and in the latest two ten-day intervals they have had good but slowing business.

MR. KEEHN. My comments would very largely parallel Ed Boehne's. There is a growing feeling from the people I talked with that we are in fact reaching a plateau and that from this point further growth will be tougher and tougher to achieve. Nonetheless, I think virtually all the sectors that I am familiar with are doing better this year than was the case, say, last year. But a lot of them have not yet had an opportunity to recover fully and those are the people who are very worried that the economy may be in an area where perhaps the sustainability of the recovery is getting increasingly fragile. On the price side, there are some price changes going on that may not be reflected in the figures but that could be rather significant for those industries that are operating at pretty high levels. I will cite two examples of this: Liner board for boxes was selling at $300 per ton in 1979, went down to $240 last year, and is now back to $320; oil well casing was $1400 per ton two years ago, $800 last year, and is now back to $1200 to $1300. And during this whole period the list prices were unchanged. It's a way of saying that price increases--in some cases significant increases--are being accomplished but without any changes in the list prices, so these increases may not be reflected in our standard indicators.

CHAIRMAN VOLCKER. What is the list price of something that goes up and down that much but has been unchanged?

MR. KEEHN. I don't know the list price of those particular products but it hasn't changed during this whole period.

MR. PARTEE. They give a special discount. I guess that's what happens. They have a list price and say: If you buy, we'll give you a discount.

MR. KEEHN. They have a list price. But in 1982 no one was selling at list and in 1983 people were selling a little under list. In 1984 they are now selling at [unintelligible] list. Despite this, nobody that I talked to suggests that we have any risks of runaway inflation. Everybody expects that prices will be higher as the year unfolds, but not by a very significant amount. On the wage side, I continue to be impressed by how well people are able to renegotiate their contracts. The industries that are soft are renegotiating contracts of 1 to 3 or 4 percent on a three-year basis. The industries that are a bit tighter are in the area of 3 to 5 percent annually, and again those are on a three-year basis. So, the wage side continues to be favorable and, with productivity increases, all of this I think looks pretty good.

On the agricultural side, I don't know what I can add to the comments I made at the last meeting. Iowa continues to go through a very rugged adjustment phase. Land values there are continuing to go down, interest rates are going up, and for those farmers who are indebted it is a very tough environment. Having said that, there has been some legislation that may ease these problems to some extent. But, net, I would agree with the staff forecast in the Greenbook. I think the [prospect for] sustainability this year continues to be pretty good but I have this feeling that we have reached or are reaching a plateau from which it will be tougher to achieve gains from this point forward.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I think that the staff forecast is right on target. We find nothing in the Greenbook that we would quarrel with. There is a general confirmation of that outlook in the forecast for the Sixth District. Everyone we talked to also agrees that we are bound to see a slowing in the economy during the rest of this year, although the hard evidence really isn't there in our District except perhaps in housing-related industries where there are some definite plans to cut back in investment in inventories and plant and equipment. Labor markets, on the other hand, continue to strengthen, largely because of continuing expansion in the industrial sector. So, while conditions still are looking very, very good and people continue to be optimistic and bullish, I think there is a growing recognition that things are going to slow down. I suppose that is based more on a sense of inevitability rather than on any firm evidence. The trouble spots in our District are pretty much the same as those in the other parts of the country: The thrifts are in bad shape and the agricultural situation I can only describe as disastrous in most parts of the District.

Just as a sideline, I had the great fortune to meet with about ten farmers who had just undergone foreclosure of their properties and I wasn't sure whether I was going to be lynched when I walked into the room or not. Interestingly, their complaint was not about interest rates or about Federal Reserve policy. They were much more concerned about the treatment they were getting from the production credit agents. I understand there is a very definite move on the part of the bank cooperatives and [others], because of funding problems, to be much more selective in the granting of financing, particularly refinancing. But that was the main part of their complaint: that they simply aren't getting the financing and the help they had gotten in the past.

People we talked to, particularly our directors, are very very concerned about inflation. This is more of a gut feeling, I suppose, that inflation is going to pop up again probably by the end of the year; they don't have any hard evidence except in some isolated industries where they are seeing some price increases. On the wage side, the automobile people I talked to--and I talked to them as recently as last week--are indicating that they think the auto settlement could well be a leading indicator and they are concerned about what might happen during those negotiations.

Just one final point: I was a little surprised that the marketplace in Atlanta and elsewhere didn't seem to be very concerned about the Continental situation. There was very little discussion about that in the marketplace. In summary, Mr. Chairman, in terms of policy decisions, I think the staff is right that we're going to see some moderation in the economy and that inflation seems to be pretty well under control. All the indicators that we look at--commodity prices and the price of gold and the exchange value of the dollar and so on--seem to confirm that inflation is not at the moment a very large problem.

CHAIRMAN VOLCKER. If those banks down in Atlanta aren't worried about Continental, I assume they are fully funded.

MR. FORRESTAL. Oh, I didn't say they weren't worried about it. I'm sure they are worried. I think they are more worried about their own fate when regional banking comes along. But there was just very little discussion. I had expected people to call and ask about it and there wasn't any of that.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. First, I would like to support what Bob Black said about not worrying too much about small temporary changes. As I look at our directive and policy record, we've really been through a mini-cycle since the last FOMC meeting. At that time we had not seen fully the weakening of March. It was March 27th or thereabouts when we met. Had we known the March data we might have said: "Aha, things are slowing down." However, in April they picked up again. So meeting now in May we've had the weak March and the strong April and we can just take off from there. The same applies to the aggregates. Had we known the weakness of the aggregates for April, we might have worried about that but now we see that for May there probably is an expansion ahead. So, again, the interim fluctuations don't mean very much. As I listen to the discussion around the table of the tapering off, I ask myself: What is it that businessmen really pay attention to when they evaluate conditions? Is it the rate of expansion of their sales and activity or is it the level at which they proceed? Now, the rate of expansion may be tapering off somewhat but the level that they have reached must be taxing their capacity or be giving them a sense of very high activity at least generally. I think this slowing that seems to be taking over ought to be regarded as a success of our policy--a success in avoiding overheating, to the extent that we've done that. It certainly is not a reason to resume some kind of stimulative policy.

In thinking about what we should do now, we are financially very much constrained. If we wanted to restrain more, we have the situation in developing countries. We have the situation of Continental. I find these things very hard to weigh. The wise advice is to say that financial fragility should be handled by structural devices. And perhaps that is not quite as foolish as it sounds because this is the time to fix the roof--it's not raining. That's the time when one should fix the roof and not wait until it rains again. So, that would mean strengthening the capital of banks, doing something about LDC loans along the lines of our conference for finding ways of limiting the effect of interest rate increases, [imposing] penalties for poor banking. That again is more possible in the domestic area than in the international area where we're dependent on the same banks that made mistakes to continue making loans. So, this disciplinary supervisory action is somewhat stymied. I think this is the principal choice we have to make right now: In terms of economic activity, it seems to me that further restraint is still desirable; in terms of the fragility of the environment, there are obvious fears and inhibitions. How to weigh this, I find very difficult. But I continue to lean in the direction, if I have a choice, of a little more restraint.

CHAIRMAN VOLCKER. I think I agree that it's not raining; there may be a heavy mist, though.

MR. PARTEE. Also, if you have to rebuild the whole roof you worry about how long it's going to be before it rains again.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I'm less certain now about where the economy is going in the near future than I have been at any time since very early in 1983. These recent numbers are to me very, very puzzling. If we really had an almost 9 percent increase in real GNP in the first quarter, the fifth quarter of recovery, there ought to be a sense of euphoria around the nation. Boy, we sure don't hear that here this morning! I can't figure out why the increase in nonfarm inventories in real terms was so very, very large in the first quarter. Clearly, it wasn't undesired. It was not a case of an unexpected slowdown in final sales, yet I have a hard time arguing that businesses are so desperately concerned with shortages or so desperately worried about price increases that they are scrambling to get inventories. I just can't understand it. This number on new orders this morning is very weak. It's a volatile series, as Mr. Kichline said, but there are negatives all down the line. It is just very, very puzzling. A second uncertainty has been added by recent developments in financial markets. I don't have any doubt in my mind that these developments on balance are a significant negative, but I don't know how much. We have had a big increase in interest rates since the last meeting--bigger than I think any of the more hawkish members of this Committee would have wanted at that time. We also have had a drop in stock prices and we don't know precisely what effects those changes are going to have. It may well be that confidence, at least among banks if not nonbanking institutions, has been affected a bit by what has happened with Continental. I think a slowdown is ahead and if I were forced to write down numbers, I probably would write something down very close to what the staff has. If it works out that way, I don't think we should be concerned. We need that kind of slowdown. But, frankly, it could be a little more or a little less, it seems to me.

I would like to make a couple of comments on the price side. One of the things that has happened in the past several months that to me is very comforting is that the increase in the civilian labor force, as a consequence of increases in the participation rate, is finally developing along the lines the staff had forecast earlier. It looks much less likely now that we're going to get down below the natural rate of unemployment in the very near future, as I was worried about earlier. Still in all, I do expect to see some larger price increases relative to wages because in the kind of markets that the staff is forecasting, with the increase in the capacity utilization rate, I think businesses are going to take the opportunity to try to widen profit margins. I would just like to say in closing that developments in credit markets are to me still very, very worrisome. We had an enormous increase in the debt of the nonfinancial sector in the first quarter. The forecast now for the second quarter is even worse. And when I listen to comments around the table, particularly by Karen, about the lack of discipline, I have to conclude that up until very recently at least we have not had much financial restraint. Whether we'll see that as a consequence of developments in the past few weeks I think is still problematic.

CHAIRMAN VOLCKER. Looking at prices, one of the irritating things is that we changed to this new consumer price index about 18 months ago--the beginning of 1983, I guess. The old measure has been running about 1 percent less at an annual rate than the one we now use. If we hadn't changed that index we'd be looking here and saying: My goodness, consumer prices were only up 3-1/2 percent recently. And, of course, that is what social security and wages are indexed to.

VICE CHAIRMAN SOLOMON. Is that mostly the rental equivalency?

CHAIRMAN VOLCKER. It has to be. That's the only thing they changed.

MR. KICHLINE. Yes. The CPIW went up 0.2 percent in April and, as I mentioned, the all urban went up 0.5 percent. Virtually all of that difference is indeed attributable to the different treatment of housing.

CHAIRMAN VOLCKER. It's about a 1 percentage point difference as I remember so far this year, or maybe over the past 12 months.

MR. KICHLINE. Yes.

VICE CHAIRMAN SOLOMON. In the right context, that's worth making public because I haven't seen that anywhere.

CHAIRMAN VOLCKER. It's right there in the second paragraph of the release but nobody ever looks at it.

MR. KICHLINE. Actually, in the last 3 months the compounded annual rate on the old basis is 1.3 percent and on the new basis it's 4.3 percent.

CHAIRMAN VOLCKER. [Unintelligible] we publish those figures --they say a 1.3 percent rate of price increase!

VICE CHAIRMAN SOLOMON. On this question of prices, what I find strange is that people are expecting somewhat higher inflation levels--you hear a lot of worries about it and explanations about what is happening and why we don't see much investor demand--but at the same time those same people would admit that they don't expect inflation to hit higher than half of what it was in the previous two recoveries. I'm talking about the great majority of them; there are a few [exceptions]. We hit rates of 12 to 14 percent in the two previous recoveries and you don't hear people in the financial markets or industrialists I speak with expecting it to go to more than roughly half of that. But that seems to get lost. It's a perspective that I think is a terribly important development. It holds out some promise that during the next recession it will dip and in the next recovery we'll be able to hold inflation at lower levels than this. So, I don't know why there is so much fear of inflation. I have the sense that it is almost a rationalization of the reluctance on the part of investors to buy. They are more agnostic. They don't have any sense of confidence but [say] that their reluctance to buy is so significantly motivated by fear of inflation.

MR. ROBERTS. Don't you think, Tony, it's that pervasive fear of the deficit, right or wrong, that makes people think that?

MR. RICE. Don't they relate the deficit to future inflation?

MR. ROBERTS. Yes, that's my point. I don't necessarily agree with that, but that's what everyone says to me--that the big deficits mean big inflation ahead.

MR. RICE. It's hard to imagine what could be influencing long-term investment now if it's not inflation. Maybe they just--

VICE CHAIRMAN SOLOMON. Institutions don't hold securities the way they used to; even longer-term investors don't think in the same terms that they used to. Therefore, they just don't want to sit with big paper losses because it looks very bad and it reflects on them and hurts their position in these various institutions where they work. So, even if they are fairly confident that inflation is not going to go up to anywhere near the previous levels, they don't want to be seen sitting with substantial paper losses in their portfolio.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I have just a couple of comments, Mr. Chairman. I share the view--it's just a hunch--that the edge may be coming off the speed of the recovery at this point. I'm compelled to that conclusion even though I'm not sure that it can be backed up by statistics as yet. On the farm sector that has been mentioned, obviously, in a substantive way the situation is a mess. The only point I would add is that I think it is at or near the point where the political implications of it, broadly defined, could get very testy. For example, I hear, as I'm sure others do, stories of people saying: Well, if you're going to cap foreign loans, you better cap farm loans. Certainly, in my District we have had a couple of situations involving the closing of small banks because of bum agricultural loans in the context in which the treatment of depositors is different than in the case of Continental. And I think that is just another manifestation of how this problem could really start to close in on us. I continue to get very frequent reports of sharply different--or what is perceived to be sharply different--treatment of farm credits by various regulators, which reinforces the view that the process is in some sense discriminatory toward that particular class of credits or that particular class of banking organizations.

CHAIRMAN VOLCKER. What reports are you getting?

MR. CORRIGAN. I hear this directly. The feeling is that right now the FDIC examiners in particular are really playing hardball on these [agricultural] credits, and in a way that comes back to you as being unreasonable. I'm not sure whether it's true or not, but certainly that attitude is there.

CHAIRMAN VOLCKER. But is it clearly designated by agency? Does anybody else sense that?

MR. BOEHNE. Yes. The FDIC is the SOB on the block right now in my District as far as a regulator--for these kinds of reasons and for what the banks regard as nitty gritty kinds of stuff.

MR. BLACK. It always has been in our District.

MR. GUFFEY. In the Kansas City District I think it is probably more the Comptroller, and that's perceived to be a fallout of the Penn Square situation, which the Comptroller's people are so skittish about.

CHAIRMAN VOLCKER. On agricultural loans in particular?

MR. GUFFEY. On agricultural loans as well as energy loans. But the perception, as I hear it, is that the Comptroller's staff is very, very tough.

MR. PARTEE. Nobody is hearing that it's the Federal Reserve!

MR. CORRIGAN. When they talk to somebody else, they probably say the same about the Federal Reserve!

MR. BLACK. Remember, we are reporting on our own Districts.

MR. BOEHNE. We just don't have that many state member banks out there.

CHAIRMAN VOLCKER. Well, we're going to have to take some further initiative in this area. I'm sure the concern is real, and I don't know what we can do other than forbearance. But I think we're going to have to make some more specific arrangements to make sure that we are forbearing appropriately.

VICE CHAIRMAN SOLOMON. Is the rate of foreclosure on farm land still the same as it was a few months ago?

MR. GUFFEY. It's much higher.

MR. CORRIGAN. It really has picked up. Mr. Forrestal made the point that the PCAs--the Production Credit Associations or whatever they are called--for whatever reasons clearly have a liquidity problem in their own right. I don't fully understand it, Bob, and maybe you do. And because of the rate of foreclosures growing out of that, one hears--and I've never heard this before--concerns that the PCAs and the banks will be forced to dump land on the marketplace to such an extent that the price of land could really be driven down sharply. It's awfully hard, particularly with farmers and agricultural bankers, to read through all the static they throw out. But my sense of it is, Tony, that once you cut through all the static it's quite real in terms of the degree of concern.

MR. ROBERTS. Well, from a regulatory policy standpoint, what I'm hearing is that, as Jerry said, they have land on which they would take a big hit if they were to put it on the market. They are saying that the sensible thing is to live with that for a while, and they are asking for forbearance. Good bankers--

CHAIRMAN VOLCKER. I don't think that would cure the problem.

VICE CHAIRMAN SOLOMON. Well, the wheat picture looks a heck of a lot better. Contrary to expectations up until last week, it is now viewed that the Soviet Union is going to have a big crop failure again due to the dry weather. Wheat prices have moved up 3 percent in the last few days and they are going to go higher as that gets confirmed more and more. I don't know to what extent improvement of wheat [prospects] will make a significant change.

MR. CORRIGAN. Wheat prices have a long, long way to go before it could make any real difference in terms of profitability. It certainly will help cash flow. But the price has a long way to go before even middle-of-the-road operators reach the point where they can grow wheat profitability.

MR. PARTEE. We can inquire, of course, about PCAs. But I must say I've been hearing for years that the typical situation, say, out in Roger's area or in the middle West was that the banks kept the good loans and the PCA made the bad loans. If the banks are now complaining about their portfolios being poor, can you imagine what the PCA portfolios must be? They must be rotten.

MR. ROBERTS. We've had some PCA failures--big ones--up in the Northwest.

MR. FORRESTAL. That is one of the reasons why the PCAs are taking the harder line. A lot of these agents in the past have been very close to the farmers and were really pushing the money out to them. And now that is being changed.

MR. MARTIN. Well, let me clarify my figures of 8.7 percent in distress and 2.5 percent in imminent foreclosure. That's an ABA survey published in January of '84, so it's ex post and is prior to some of the increases in rates. The lag effects of the most recent interest rate increases are not in those data.

MR. CORRIGAN. I want to make two other quick comments. On the wage side, I don't disagree with anything that has been said. But I would note that from an employer point of view in the Twin Cities in the first quarter of this year we have seen a very perceptible bidding up of salaries in the technical area for the first time in I guess three years. I don't know what to make of that at this point, but it certainly is there as a new development, at least in that very particular marketplace.

MR. MARTIN. I think that's going on, but also what is going on are changes in work rules and the ability to assign workers by shifts and the ability to redefine the job so that the job is not strictly defined by the unions.

MR. CORRIGAN. No, I'm not talking about union stuff yet, Pres. I'm talking about white-collar technical people--computer people and so forth. The only other point I want to make goes back to Karen Horn's observation about financial practices because I think anecdotally she put her finger right on what is at least a very, very pressing problem quite apart from stability and quite apart from the Continental situation. Implicit in what Karen was talking about is that these are practices that probably can only be validated by inflation. And in some ways that's the most troubling aspect of all about those practices. I would simply observe that quite apart from any particular situation, including Continental, what we are seeing in terms of practices and instruments--interest rate swaps and other things--is a situation in which the kinds of exposure and the kinds of contingent liabilities that are sitting out there in size may not be totally understood even by those who are playing in the markets. And worse than that, they may not even be fully understood by us. Needless to say, this is not a point in time when we can afford to be blindsided. I don't know what we do about it. But I certainly think that we have to sharpen our focus on these developments and make sure that we at least understand what is going on.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Over the last couple of weeks I've had an opportunity to meet with individuals involved in the energy sector--those in discovery and development as well as suppliers for that industry. The story, simply told, is that there is some modest activity in drilling beginning to come back. Just to cite some numbers: At the height two years ago, late '81 to '82, there were around 46,000 rotor rigs working in the United States. That dropped to 18,000 and is back up to about 22,000. The important part of it is that these were very, very large statistics in that industry. It is clear that the price of putting a well down and bringing petroleum products for sale is now low enough that the numbers are beginning to work and it's beginning to be attractive again to go out into the field to discover and bring in energy products. But the suppliers of that industry are still flat on their back. Those who have survived are barely surviving. They are concerned, of course, about higher interest rates because they have a very high carry of inventory to supply the industry.

I also met with our Thrift Advisory Council. They have a concern about the increase in interest rates that they have seen. Most of them readily admit that they are on the margin of being profitable or nonprofitable, that the increase in interest rates quite likely will put them back in a nonprofitable position, and that they cannot survive for a very long period of time without help, merger, or something else unless interest rates come down a bit.

Lastly, in the agricultural area, I have a couple of numbers that I'd like to cite because Pres has thrown a couple out. As of the end of April, for example, 4.2 percent of all farmers and ranchers have gone out of business in the last six months, and that's 2-1/2 times what would be considered the normal rate. That number is those who have gone out of business as a result of financial stress; the total who have gone out of business as a result of financial stress plus death and other normal things is about 6 percent of all ranchers and farmers. This is as a result of the developments, essentially, within the first quarter of 1984. Another 5.4 percent of all ranchers and farmers have experienced partial liquidation because of financial stress, which has come about among other reasons because the land values dropped in the first quarter of 1984. The best information we have is that land values have dropped an additional 6 percent. They are now on average about 22 percent below the peak of 1981. And that, of course, is the collateral by which much of the lending took place in the agricultural sector back in better times. The important point, it seems to me, is that the agricultural banks that we survey and work with are liquid. They just can't find creditworthy borrowers to take down that money. Although they have money, they are not prepared to extend more money to the agricultural sector. It seems clear to me in talking with people in that industry that lower interest rates are not a solution to the agricultural problem. That is, without an increase in commodity prices we're going to see the situation continue to deteriorate. The fact of the matter is that the average rate to the agricultural sector now is about 14 percent. That doesn't change greatly when rates go up or down in the financial markets. So, we could drop that rate 3 or 4 percentage points and on the margin it would help certain farmers and ranchers. But by and large it has to be an increase in commodity prices in the period ahead that will salvage this situation; interest rates are not the key to it.

Turning to a couple of other industries: In the aircraft industry, we have a number of very large participants in the Tenth District and they have had an uptick in their business. As a matter of fact, Boeing and Buick both have announced plans to expand their facilities, largely in Wichita, Kansas. The auto industry, which employs a large percentage of workers in the Tenth District, is going full out with a second shift.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I have a slightly different view in the Dallas District than what I'm hearing this morning. Either I don't understand the situation or I'm talking to the wrong people! We seem to be maintaining our economic recovery and are showing steady improvement overall. Roger mentioned the energy sector. It is not increasing spectacularly, but nevertheless it has been increasing steadily. Our Texas manufacturing output is growing steadily; it's not as fast as the rest of the nation, but it is growing. Our housing permits in the first quarter were below a year earlier and this is primarily because of declines in multifamilies. I think that's healthy because our area has been very overbuilt. And our retail sales have been growing from a year earlier in most of the District.

On the agricultural side, our information says that District farmers are better off this year than last year and that prices for both crops and livestock are generally higher than a year ago. Now, I would condition that statement by saying it's a little better in a very bad situation overall. We have not seen the kind of liquidations that others talk about in the Midwest. In talking with some of our people involved in that industry, they do fear that it is coming but it just hasn't come. In looking at agriculture, it's pretty hard to talk about it if you don't talk about the weather because that is awfully important. Our District is pretty well divided between places where it has rained and where it hasn't rained. The southwestern part is reminiscent of the dust bowl of the '30s. Sustained winds are greater than they have been in the last 37 years; whatever little grass there is coming up on the ranges is being blown away by the wind when it comes up. There are liquidations going on. We did have some good rain over the weekend; I don't know how widespread that was, but among those who got rain I'm sure the sentiments are better today than they were last week.

Subjectively, my sense of the state of the economy on a broader basis is that it's possibly a little stronger even than the staff forecast. I know it's our job to worry and be concerned but that we may be coming into a slowdown is what we've been looking for, it seems to me. I think we would acknowledge that the rate of growth in GNP in the first quarter is not sustainable. I think what is happening is what I, at least, would like to see happen overall. The question, obviously, is whether the economy is really turning down or gradually tapering off. But I don't sense the same degree of concern in our area that I'm hearing [here]. Commercial real estate, which has been very strong, is down a bit but is still going along at a pretty fast pace. Projections are that vacancies in office buildings in Dallas that are either up or being constructed will be absorbed in a three-year period. In Houston it is much more difficult; they are projecting about an 8-year period to absorb what they have. But one still sees holes being dug and new announcements coming along.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Out in the West, the picture of strong spots and weak spots really hasn't changed at all since I reported on that at the last meeting. I continue to be mystified, I guess, by the fact that business confidence for some months has not been as good as the business statistics. The thing I wanted to call attention to this morning is that even prior to the Continental Illinois crisis, I had gotten some very strong protests and indications of concerns from small and medium size banks--particularly those represented on our five boards of directors--about the policies of the FDIC. The concern is what those policies will do to the availability of bank credit among the community banks or regional banks, given the modified purchase and assumption cases, which have meant less than full coverage for uninsured deposits in a number of small banks that have closed down in our District. The fear of these bankers is that they will begin to lose deposits to the large banks--that whatever customers they had with deposits of more than $100,000 will run to safety now. I'm afraid that fear has been considerably exacerbated by what is going on, for obvious reasons. They understand why it had to be done in the Continental Illinois case but they aren't much consoled by the thought of what it will do to them. As a result, their confidence in their ability to supply local credit needs in the future is considerably shaken.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I think the staff projection is quite appropriate to use for planning purposes by the FOMC. It does tend to make the future look a lot more favorable than the recent past, but maybe in fact that's how it will work out. I've been impressed in the last six weeks by the growing number of uncertainties, however, about what is occurring on the inflationary side. I would say my gravest concern, which, of course, we can't really evaluate, is the Persian Gulf. If oil shipments from there are closed out, as they might well be, that is going to have major repercussions that are very hard to see but that might well turn out to be of an inflationary character. Incidentally, Tony, I think the main reason that we're not getting these projections of double-digit inflation is that people aren't factoring in a big increase in oil prices such as occurred in 1979 and which had a major effect on the rate of inflation that most countries experienced in the 1980-81 period. If you were to add a 50 percent increase in oil prices, say, I think you might get a much higher inflationary expectation from the surveys. In any event, there's just no way of evaluating that except to recognize it as a problem and a problem on the inflationary side, if it occurs.

I get a little worried when Bob starts to talk about dust bowls. Of course, the other thing that has given us some inflationary trouble in the past was a major crop failure. On the other hand, if it's only half of Texas, I think we're probably all right. It takes a much wider dust bowl than that to give us major difficulty. On the other side, I think the major negative--and it's awfully hard for me to evaluate--is the uncertainty of financial markets. Karen talks about the leveraged buyouts. Those leveraged buyouts, as I understand it, are usually leveraged 4 or 5 to 1. They depend on an interest rate assumption and are very sensitive to the interest rate assumption. If you put interest rates up 2 points on the 4 or 5 parts that are financed, it raises great questions about those leveraged buyouts. I noticed that Lyle mentioned the stock market has declined. I just looked it up in the Greenbook and the NASDAQ index is off 25 percent. Did you realize that? Those are the kinds of stocks that are in leveraged buyouts. And a major decline in that market has occurred since the late 1983 high. I'm inclined to agree with Jerry that for these deals to work out there has to be more inflation. And if there isn't more inflation, they're not going to work out. The question is: Which is going to occur? Will there be more inflation or will the deals begin to fail and the people begin to pull back? On that point I would make the observation that I don't know that we have had much restraint on the part of lenders for a long time. I don't know if that was true during the last cycle either. There was very little restraint on the part of lenders.

VICE CHAIRMAN SOLOMON. Let me make a comment on that. I got worried about the amount of financing going into leveraged buyouts, so I sent a team of supervisors to all the leading New York banks to look at that. We came to the conclusion that there were 8 banks, and 4 particularly, that were being too aggressive and too optimistic in their assumptions on the amount of credit they are extending on leveraged buyouts, which we went over loan by loan. And we counselled them to be cautious. Whether it will do any good or not, I don't know, but we took that initiative. And we came to the conclusion that the biggest point of vulnerability was not so much on the interest rate assumptions but on the--in some cases--very optimistic assumptions on the cash value of those parts of the leveraged buyout companies that they were going to try to unload immediately if the deal went through. In some cases the banks were giving financing equivalent to 100 percent of relatively optimistic assumptions. And in that connection, although only slightly related, I've had reports that some of the European banks that participate in the lines of credit for financing big takeovers are beginning to pull back a little. Two of the European bankers told me that their medium sized banks that have been participating in these syndicates are beginning to get worried and are pulling back in the financing of some of these big American takeovers.

MR. PARTEE. I think there's a good chance, Tony, that that's what is going to happen--that they are going to pull back. I think they are counting on good value there; that's why I made the point about the 25 percent drop in NASDAQ prices on average. They are talking about selling and the value is dropping in the market for those [companies]. I think they may well pull back. In fact, I'm inclined to think that we're now reading the views of the recent past rather than the current period. I believe that the Columbus offer was withdrawn yesterday. I read in the paper this morning that that was cancelled. A lot of those deals are capable of being cancelled and certainly new ones may not be generated at the rate they were before, if people are quite uncertain about the future.

That brings me to my second point about the financial markets and that is that although lenders may not be so conservative and restrictive, I think maybe borrowers could be more sensitive because everybody is on floating rate loans, including the farmers. We've had quite a rise in rates quickly and that reminds people that rates can go up pretty high. They have had experience with 20 percent rates in the past. So, there isn't any kind of limit that one mentally puts on how high rates could go. I think people are likely, in an effort of self-preservation, to be more conservative about the credits that they demand in the future. In summary, I would say that the negative here is the possibility that the financial market will be much less buoyant than it has been for credit and that that may give us less spending than we're anticipating. I'm not predicting a financial collapse or anything like that, but I just think that people will pull back because rates have gone up so much and so fast--not so much, really, as so fast. And we just haven't seen the effects of that on planning and on expectations where we have past data and past decisions. So, I think there's both an inflationary threat to the forecast mainly from the Persian Gulf and there is also a prospect that we could come in below the forecast mainly associated with the financial markets. For our own purposes, I think we can use the forecast.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. We don't sense in New England the kind of change in attitudes that I've heard from Philadelphia and Cleveland and other places. I think the mood is still very buoyant and that may reflect the fact that we're primarily capital goods producers and the capital goods sector is doing extremely well. I've compared the rate of growth of capital goods orders in this expansion to the expansions that began in '71 and in '75 and it is very much stronger. We have a real capital goods boom underway, which ought to augur well for productivity in the future. We think the staff forecast is a pretty good forecast but if it's wrong, that it probably is going to be wrong on the low side in terms of the growth rate.

CHAIRMAN VOLCKER. That big boom is all electronics.

MR. MORRIS. Right.

CHAIRMAN VOLCKER. I'm skeptical of the productivity improvement. Mr. Solomon.

VICE CHAIRMAN SOLOMON. All I will say is that in my area I have a sense that on the one hand things are very, very strong and that at the same time there are enormous financial uncertainties and very poor profits in the financial markets, particularly compared to the last couple of years. It creates a very mixed feeling. I would assume that the staff forecast is most vulnerable to financial shocks --virtually the same thing you said, Chuck. The staff forecast seems very reasonable in the absence of financial shocks, but I think there is an increased possibility compared to previous cycles that it could be upset by something happening. For planning purposes I think one has to go with something that basically tracks the situation and previous experience in recoveries. And that seems to [be true of the staff forecast].

CHAIRMAN VOLCKER. If we have no other comments, we'll turn to Mr. Axilrod.

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

CHAIRMAN VOLCKER. Let me say a few words before we have the coffee break. I don't like quite a lot of things I see these days, whether in the real economy or more particularly in the financial economy. I certainly think attitudes are very volatile and I wouldn't bet on the economy slowing down all that much. I have one hypothesis but it could change very rapidly. If you forgot about the financial side--and I'm not sure I'd propose it anyway--it might take somewhat more aggressive action than we've taken before to bring the economy to a suitable path. And I might argue that that's the best thing in the world for the S&Ls, for the farmers, and for others--to take it in the short run and have some hope that they are going to get out of this situation over a period of time. But, unfortunately, I don't think that course of action is open to us. I look at this financial market as being on a knife's edge. I don't believe all this business about policy at this point working at the margin with a nice little rise in interest rates slowing things down here and there. We have a financial market that for better or worse works by bankruptcy. And when the economy is getting strong, people are going to make leveraged buyouts and they're going to make construction loans without any takeouts and for full value and I don't see any sign of that stopping gradually. In some ways it seems to increase as the economy gets better, whatever happens to interest rates, until all of a sudden something happens and then it may go [whirling] in the other direction.

The biggest sign we have of something not working at the margin right now, I think, is the LDC situation. They are all going to survive together or they are all going to go down together. If they go down together, we will have a reaction in our financial system and in our economy that I think at the very least is going to be very difficult to cope with. We have this strange situation. Karen starts off today by saying bankers are shoving money out the door; you hear that all over the place. I'm sure they are engaging in financial practices of a type that probably would send the fathers of some of these bankers whirling in their graves. There are things you never heard of in the banking system on the one side; and on the other side we have this other force coming on. If you want to see a group of ashen-faced bankers, sit down in a group and talk to them about the Continental situation and possible repercussions for the funding of their own banks against the background of this LDC situation and what that might mean in terms of their own behavior and policies. I don't think it is occurring at the moment, unfortunately--I don't know, maybe some of this is going on--but what it could mean is a sudden change in attitudes. I hope it's working gradually at the margin, to some extent, and maybe it is. I don't see any evidence yet but this is very recent.

My bottom line is that we've run out of room for the time being for any tightening, given this situation. I don't know for how long. I don't know what is going to happen in the weeks or months down the road, either to the economy or to the aggregates or these other things. I don't have any sense here that we should be easing. But I do think we have to be concerned about a very potentially volatile and actually volatile set of attitudes here and elsewhere. This Continental situation is rather enlightening in the sense that we have a government guaranteed institution at the moment which nobody much wants to fund anyway. There is no doubt that it has caused a lot of looking at other banks and we don't see that strongly evident in the market now. When we see it strongly evident in the market it will be too late, in my opinion, to keep it under reasonable control. We're pretty close to the edge of that now. So, I'll leave you with those thoughts and go have some coffee and orange juice.

[Coffee break]

CHAIRMAN VOLCKER. Well, we can proceed. Governor Rice.

MR. RICE. Well, Mr. Chairman, you said much of what I was thinking and I agree with everything you said.

CHAIRMAN VOLCKER. End of the story?

MR. RICE. Not quite. No [unintelligible], however, just "but in addition." I agree that the state of financial markets right now is such that it practically precludes any significant tightening. But apart from that I think the appropriate policy stance at the present time is especially sensitive to what the economy is doing and what it is likely to do in the short run. Now, I certainly agree with Bob Black and Henry that we have to keep the long run constantly in mind. But I think Lyle is right: There is a good deal of uncertainty as to what the economy is actually doing right now. If the staff is right that it is slowing down at a very significant rate--and I think the probability is on their side--that, of course, would suggest not moving in the direction of further restraint. But it could well be that the economy will not decelerate as rapidly as we expect, in which case it may actually need some further encouragement in that direction by increased pressure on bank reserves. But I don't think so. I think that the recent run-up in interest rates has been sharp and is almost certain to have a significant slowing effect on the economy and that any further tightening at this time would run the risk of overkill. So, I would think that the prudent posture for policy right now is as you suggest, Mr. Chairman, to hold steady--to have no significant easing or tightening but to maintain the degree of restraint that the Committee called for at its last meeting.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I can ditto that. I think we ought to stay where we are. The financial side alone justifies that but even if the financial side were less fragile, I would still advocate no change because we've had a substantial run-up in rates and I would want for real sector reasons to hold where we are and see if, indeed, the economy is slowing. I agree with what has been said by you and Governor Rice.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I agree. I think we ought to go for alternative B and $1 billion of borrowing and leave the fed funds range as it is. I think that is a prudent position to take.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I would agree with what Tony has just stated; it is precisely what I had in mind. I do have one question, however. I know the federal funds rate isn't under our total control but I would have expected after the discount rate increase, when the fed funds rate was running about 10-1/4 percent, that the one half point increase [in the discount rate] would have put the funds rate at about 10-3/4 percent. It has been running less, about 10-1/2 percent. I would not object to seeing that rate around 10-3/4 percent at the present time. I think that is consistent with what alternative B and a billion dollars of borrowing would imply. I would ask the question of Peter or Steve if that is a correct perception.

MR. STERNLIGHT. Well, we've said time and time again that that's a rather loose relationship. I would think the funds rate would run around 10-1/2 percent but I couldn't dispute strongly that it could turn out often at 10-3/4 percent. As to why after the discount rate the central tendency was an increase of only a quarter of a point, I think that could well be because the discount rate move was fairly well anticipated about that time and in part already had been built into expectations. [Unintelligible] what you are looking for as a response.

MR. MARTIN. Peter, my question about the $1 billion in borrowing is: Now that contemporaneous reserve requirements have been more understood and more adjusted to, what implication for excess reserves does $1 billion in borrowing have?

MR. STERNLIGHT. I'm not sure I'd place it any differently. Clearly at the beginning of CRR we were getting a particularly heavy demand for excess reserves. That seems to have settled down a bit. We seem to be getting excess reserves reasonably close to the $600 million level that we're putting in the path now. As to the significance in the restraining impact of different levels of borrowing, I'm not sure I'm able to discern enough yet to give a better answer.

MR. MARTIN. We talked about $1 billion and $600 million in borrowings and excess reserves, respectively, last time in the face of the adjustments. Do you feel there would be no difference in the federal funds rate at around 10-3/4 percent. Is that fair?

MR. STERNLIGHT. Well, 10-1/2 percent.

MR. MARTIN. 10-1/2.

MR. STERNLIGHT. I think it's a loose relationship.

MR. AXILROD. There's another point to add. I don't think we know what is going to happen in the banking system in the next several weeks, in the wake of this Continental business. It may be quiet and it may not. If it isn't quiet, I think there is some possibility that banks will become more conservative in the management of their own reserve positions, conserving access to the window and maybe holding a few more excess reserves. We could find holding [excess] at $600 million and [borrowing at] $1 billion gets us even higher funds rates because the banks' general attitudes have shifted, in which case I think some allowance ought to be in there for that.

CHAIRMAN VOLCKER. I think that's possible.

MR. MARTIN. We have language that would handle that or we could compose some language--

MR. AXILROD. --that would handle that situation.

VICE CHAIRMAN SOLOMON. I'm assuming what Peter has told me: that we have been catching up with the lag in the last week through our matched sales operations for the borrowings at the Chicago Fed. So, once the psychological situation changes--barring that reaction from the banks that Steve is talking about--I'm assuming that within 4 or 5 days more, maybe a week, we probably will be back up to the more normal levels that our policy and our nonborrowed reserve path indicate--namely the 10-1/2 percent area.

MR. STERNLIGHT. Well, I think the catch-up occurred even more rapidly. I should fill the Committee in, Mr. Solomon. Late yesterday afternoon the funds rate moved up to the 12 percent area or even higher and it has been at 10-1/2 to 11 percent this morning. In fact, we're having to put back a small amount of reserves today; we had some revisions in the path. I think we accomplished that catch-up and maybe slightly more than accomplished it in what we did yesterday. So I think it is back to--

VICE CHAIRMAN SOLOMON. Why did it catch up so quickly?

MR. STERNLIGHT. Well, we did get this change in the path that reflected a number of revisions in required reserves for this whole period totalling some $260 million; I think that was figure. And in the matched sales we did yesterday we got a lot of offerings and we did about $5 billion out of $8 billion offered thinking that we would just be taking away some of the unwanted excess. But I think when all the shouting was over the banks suddenly realized that they were not as flush as they had thought when they were making aggressive offerings to us in the morning, and they saw themselves as still having some need. Also, apart from Continental, one has to think of the borrowing during this period, which has been averaging about $750 to $760 million. So I think it was to be expected, if we're going to be on path as we go toward the end of the period, that some greater firmness would work itself into the market as this period winds up. I wouldn't have guessed that that would happen late Monday afternoon; I would have thought it would occur maybe Tuesday afternoon or Wednesday. But it seems to be happening a day earlier than I had estimated.

CHAIRMAN VOLCKER. It looks like we'll get a decline in Continental's borrowing and it might actually disappear tomorrow, but it doesn't reflect any better position. They are getting prepaid for this credit card [sale] and drawing more on this backup line. If we want to get them out tomorrow, maybe we could. It doesn't reflect any basic improvement in their position.

VICE CHAIRMAN SOLOMON. It does reflect a slight improvement from 6 days ago.

MR. RICE. It means they have stopped losing deposits.

CHAIRMAN VOLCKER. Not much. Compared to 6 days ago they got $2 billion from the FDIC; they are getting a large amount of federal funds from one semi-governmental institution; they are getting paid $750 million today by Chemical for the credit card business. Add all those up together and I don't think you get much [improvement]. Plus they got more from the line banks.

VICE CHAIRMAN SOLOMON. But after that initial run-off of the overnight money, they were expecting to lose about $900 million to $1 billion a week. And I don't see that deterioration. Do the numbers add up to that?

CHAIRMAN VOLCKER. Well, we don't get the numbers that closely. I think there has been some further deterioration; it's not basically better.

VICE CHAIRMAN SOLOMON. Did the Federal Reserve Bank of Chicago end up funding the FDIC?

MR. KEEHN. No. [The FDIC] put cash in.

CHAIRMAN VOLCKER. It's holding. I don't know that one can be very precise about it. There were no very marked reflows. I don't want to interrupt the conversation but they were losing their correspondent funding among other things; they pretty much lost it. Any encouragement in that avenue might be helpful, but it comes from a lot of small banks and they just lost it. They were very heavily dependent upon foreign funding and they still get a little, but they don't get anything like they were getting before.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I would certainly agree that the circumstances are such that it would be very appropriate to continue the present course and I agree that alternative B is the appropriate alternative. If we were going to go to one side or the other, I would tend to lean a little toward "C" but primarily on "B" with a borrowing level of $1 billion. The question in my mind is whether we ought to attribute this to any extent to the financial situation. On the one hand I would say that might be a mistake because that calls undue attention to the problem. But having said that, I think perhaps by doing that we preserve an alternative--that with the passage of time if this thing unwinds, we can withdraw that caveat and keep an option open to ourselves. I think for right now alternative B would be the appropriate alternative.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. I too, Mr. Chairman, think that the appropriate course for policy at the moment is steady as you go, the status quo. I would have reached that conclusion even in the absence of the Continental situation or the other financial market conditions. I think we need a little time to digest both the actions in the marketplace and our own actions. It's probable, as the staff has indicated, that we will get a slowing in the next quarter or two, and with the aggregates behaving reasonably well I don't think we have any particular reason to tighten at this point. There certainly is no case to be made, in my judgment, for any loosening. So, I would opt for alternative B with borrowing of a billion dollars. I think we might have a little more flexibility if we were to opt for a federal funds rate range more in line with alternative C, 8 to 12 percent. But basically alternative B is the one I would opt for.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I too am in favor of alternative B as is. My preference is not to have language in the directive that talks about "while taking account of [un]usual financial strains." We do that anyway, and my personal feeling is that having that explicitly in the directive would perhaps elevate even further the concerns that Tony and someone else spoke of before--that the basic course of monetary policy is going to be undone by these developments. The only other point I would make is that we have eight weeks until the next Committee meeting and we are at a point where it seems to me that over that eight week period something of consequence [might occur].

MR. MARTIN. Excuse me, Jerry. Don't we meet on July 10-11?

MR. CORRIGAN. Yes. I think it's eight weeks.

MR. BERNARD. It's seven.

CHAIRMAN VOLCKER. One thing we ought to be sure of!

MR. CORRIGAN. In any event, whether it's seven or eight, my hunch is that we're at a point where something of consequence is likely to happen in the intermeeting period. I don't know whether it will be on the up side, down side, back side, or front side, but it seems to me that something is going to happen here and that without altering the directive in any way we may have to be more sensitive to the need for consultation between now and the 10th of July.

MR. BLACK. We are not ever front-sided; it's always back-sided.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I'm not far from where everybody else is. But one of the things I would like to point out is that both the Bluebook and Steve's comments indicate that we might well find, if we vote for "B," that long-term interest rates have overreacted and in fact will come back down again to where they were roughly speaking, say, three or four weeks ago. That, I think, would be unfortunate. I'm not at all sure that the current level of interest rates in long-term markets is not the right level for where we want the economy to go in the future. If I'm wrong and the economy starts to slow, that drop in interest rates will be welcomed and everybody will love us. If on the other hand, a higher level of rates--the present level or somewhat higher--is needed and we let interest rates go back down to where they were four weeks ago, we are going to get blamed the second time around for pushing them back up and that would be unfortunate. So, what I would like is "B" with a tiny minus on it. I think we're going to have to give the Chairman a lot of discretion as to how he runs policy in any event between now and the next meeting. But I would be inclined to talk about a borrowing range of $1 to $1.2 billion with the idea in mind of using the upper end of that range as needed, probably in the latter part of the period if interest rates on long-term securities begin to come down significantly. I like Roger's idea of thinking of a federal funds rate that might go up as high as 10-3/4 percent to achieve that objective. I do think it is a good idea to take out that language about unusual strains. There is concern developing that we are going to throw [away] everything that we've gained so far. I don't think that's true and I don't think it has to be true. And I think that language would give people ideas that they shouldn't have.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I would be more inclined to go closer to "C" myself in trying to look through the immediate problem to the longer term, which I recognize is difficult to do. But I do think there are even broader considerations than Continental, and my view of the strength of the economy and so forth would lead me toward "C." I would go ahead and take that step now and make whatever adjustment might be necessary as future events unfold. But I think the risk to the economy is greater than the risk to one or two financial institutions.

CHAIRMAN VOLCKER. Those risks are not exactly separable in my mind.

MR. BOYKIN. Well, I would say that what happened to the economy and what we went through in trying to bring down inflation was considerably more difficult; it represented dislocations of a much larger segment of this economy than what we're looking at right now. Therefore, I would guard against what I perceive to be the [risks in the] broader picture.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, in the absence of the Continental situation I would have supported alternative C because I think the economy is still very strong. Since it is a long time until the next meeting, I still don't have a high degree of confidence that we can get through with an 11-1/2 percent cap on the funds rate. But I would assume that if the situation arose, we would have a telephone conference call anyway, so I would support "B."

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, we are all worried about a lot of things, and more people seem to be worried about the state of the financial markets than about anything else. I don't think we ought to overlook that. A lot of this seems to stem from some doubts on the part of the market that we're going to be able to deal successfully with inflation over the months ahead, and we obviously have to pay some attention to these transient factors that are present right now. But my caveat would be that we not let this deter us unduly from our basic longer-term mission. I lean a little toward "C" but the difference between "C" and "B" is not as great as usual and I would be perfectly comfortable with "B." But the most important thing we should do is to try to get some agreement if we can as to what kind of action the Desk will take or as to when you would call a conference by telephone in the event that these aggregates behave in a way that is way outside what is now projected. That's a more important part to me than the "B" or "C" part.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. I think the indications of future inflation are weak. I think the relationships among and between many of the aggregates this time are somewhat different and alternative B has the logic of giving us time to observe the lagged effects of the very substantial changes in interest rates we've already had. And, in order to add an element to the discussion that we have all been a little too polite to enunciate, I will say that we are in such an intense political environment at the moment, with so much scrutiny from the Hill and elsewhere about what we are alleged to be doing, that holding to the course--if that's what alternative B with $1 billion in borrowing and $600 million in excess reserves means--is called for both for economic and political considerations. So, I would vote for "B." Obviously, the Chairman and our associates on the Desk need some flexibility. It seems to me that excess reserves possibly ought to be $500 to $700 million because of our uncertainties as to how the Continental situation and other developments will affect borrowing levels. I would not quite go along with Lyle on this, but I think the borrowing range ought to be $900 million to $1.1 billion for the same reason.

VICE CHAIRMAN SOLOMON. The political environment is going to get even tenser later in the year.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. It seems that we're sliding somewhat inadvertently into net borrowed reserves [targeting] from what I understood to be a gross borrowing posture. I think there is a substantial difference. If at any given time the Desk sees borrowing moving one way and excess not changing, they have to make up their minds whether they are going with borrowing or are going with net [borrowed reserves]. So, I hope we're going to differentiate between gross borrowings, which is what I think we've done so far, and net free reserves as the conversation seems to be going. As far as the levels are concerned, I think we ought to raise the gross borrowing level a little precisely to avoid a relapse in the markets, which would give a false signal. In a sense the markets have done our work. I don't think one could have anticipated these increases at the time of the last FOMC meeting. So there is justification, I think, for a wait-and-see attitude but not for an attitude of appeasing, which could be misinterpreted in many ways today. Also, I think one ought to hesitate a little before one takes for granted that financial fragility is necessarily a cause for relenting. The rule about the lender of last resort operation is to lend freely but at a high rate. In the case of the thrifts and the LDCs and the farmers, I see that the nature of the fragility is related to the level of the interest rates. In the case of Continental it isn't quite clear to me whether they would be in a more fragile state if interest rates were a little higher than now.

CHAIRMAN VOLCKER. I don't think they would be. Let me dispose of that. I think the Continental problem is independent of the level of interest rates. I do not think the LDC problem is and, therefore, I don't think the concern about the banks or the banking system is.

MR. WALLICH. I would interpret you as saying that it's worthwhile to make that differentiation as to where the fragility lies. The Continental situation is not so sensitive to it, but other aspects are. As far as the funds rate is concerned, it would seem to me that this is a good opportunity to make the range a little more symmetrical around where we expect it to be, so I'd raise it to 8 to 12 percent. Hopefully, it [would] move to 10-3/4 percent rather than 10-1/2 percent or below. This puts me at "B minus," as it were, as far as the alternatives are concerned.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Since I come from earthquake country, I'm used to aftershocks, and I think we may well see some aftershocks from the big increase in interest rates we've had since the last meeting. We may see some aftershocks from widening concerns about LDCs and about the posture of thrift institutions, not to mention Continental. So, while basically I would start with alternative B, I would be hopeful that we could have the flexibility that Jerry Corrigan recommended and be able to move. If we had to move away from "B," I would think it would be in the direction of "B plus." I think this is a time when we should err temporarily on the side of more liquidity than our long-term game plan would call for in view of all these financial fragilities.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I'm for alternative B in part because it is consistent with a long-term strategy to bring the aggregates, particularly M1, to the midpoint of their ranges by the end of the year. I would like to see us end up the year with M1 at the midpoint of the long-run range given how strong the economy is and how velocity is going. I think it is important to end up there because inflationary expectations are heating up and are a very serious matter in future inflation as well. I'm for "B" now. I have a nagging feeling that it may take more than that in the future to end up where I would like to end up at year-end. But for the moment I view it as consistent with where I'd like to be.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I think "B" is all right. I would point out that "B" has specifications for a number of aggregates and that if the aggregates run stronger--which they might well do in the case of M1 particularly and are already doing in the case of M3--then the question arises as to what to do if they are strong or well above the path. There is language in the directive left over from last time that deals with that and speaks of greater reserve restraint if there is more substantial growth in the monetary aggregates.

Now, I think we are all talking about financial market conditions in one way or another as a paramount feature of our discussion this time. I wouldn't support the prominent and extreme billing given to any unusual financial strains in the very first part of the operating paragraph in the directive. On the other hand, I think we could put in a more general phrase about financial market conditions late in the paragraph. That is, it could go down where we are saying that in either case--if we decide to ease or to move higher in terms of rates because of the behavior of the aggregates--such a change would be considered in the context of appraisals of the continuing strength of the expansion, inflationary pressures, financial market conditions, and the rate of credit growth. That also has a desirable attribute in that it includes things other than the Continental problem. We have had a very bad couple of months in financial markets and, indeed, a repetition of that could well give us trouble in an unknown way. It could be a futures market that breaks or something like that. And financial market conditions is a term that could encompass all of that.

I don't think we ought to bias the borrowing number toward tightening, as Lyle suggests. I would buy Pres's $900 to $1100 million. I guess I would have assumed that $1 billion means $900 to $1100 million and that there's not much difference from what we now have. I also wouldn't want to prejudge long rates. Lyle made the point that long rates shouldn't be permitted to come down. Well, I think they have gone up quite a bit more than one would have expected as a result of a run toward short instruments in a time of great uncertainty. Should the uncertainty unwind in the weeks to come--which is a possibility, I think, as Steve pointed out--that could mean that people who ordinarily would be in the longer market would commit themselves and we could get a decline in long rates. And I wouldn't resist that. I think it would be a natural market process that ought to be accommodated.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. I prefer alternative B and I would hope that we could widen the band on fed funds to 8 to 12 percent in order to be able to focus on the monetary aggregates if what Chuck is talking about should develop. I hope, even though we have flexibility to deal with financial crises--which certainly ought to be the case--that if we use that, we continue to [neutralize] the excess reserves that are created.

MR. PARTEE. I didn't speak on the topic of the funds rate. If we were in a normal situation, I think the top ought to go up too. But I think it would be taken as a bad signal. And, in fact, [the range] doesn't restrain us. If the aggregates run strong, all it does is suggest that we have a telephone conference call. So, I don't think it's worth the risk to raise the funds rate range at this time.

CHAIRMAN VOLCKER. Well, there is a broad area of consensus here, and we can turn to the wording. But let me make one comment about the financial uncertainties or whatever we want to call it. I think it's extremely unlikely that they are going to go away in the time period we're talking about. Continental may or may not be handled; that's going to be difficult in itself. But what I don't think is going to go away is the background of concern about the other banks against the fact that we are entering a crucial period on this debt problem in Latin America. Argentina does not look good from any external signs. We have a funding to do with Mexico which should go well objectively, but in this atmosphere I'm not so sure. One of the problems is the interest rate problem. Brazil--depending upon whom you believe--doesn't look too bad. But the Argentine situation is very much in jeopardy. Venezuela is fooling around. Maybe I'll be wrong, but I don't see that the undertone--it's more than an undertone--of concern is likely to evaporate in two or three weeks. I think the sense of knife's edge or fragility is going to be with us for a while. We [are not likely to] get Continental settled and some of these other debt problems behind us, at least in people's opinion, for some months. Getting Mexico more or less semi-permanently taken care of would change the atmosphere. But I think that's some ways down the road at this point.

So far as the language is concerned, we have exactly the same numbers that we had before if we take "B" for M1 and M2, which is nice; I guess we're forced to raise the M3 number to be reasonable and I suggest 10 percent. I feel rather strongly that we should make some mention of reality out there--that we are affected by financial market conditions and the conditions of the banking system are part of that. It's appropriate to say that we do [take that into account]. Having no mention of it in the directive seems to me misleading, in fact. The minimum we can do is what Governor Partee suggested. I personally would probably do more than that, but I think that's the absolute minimum--the recognition of the problem. In a close reading of what we had last time, the directive is slightly biased in that we're more apt to tighten than to ease. I would make that symmetrical and put "mights" in both parts of that sentence. I think "might" is probably more appropriate than "would," given the other caveats.

VICE CHAIRMAN SOLOMON. The asymmetry derives just as much from having "somewhat" lesser restraint, whereas we don't have "somewhat" in the--

CHAIRMAN VOLCKER. Yes, I didn't even notice that. Should we put "somewhat" in both places?

MR. PARTEE. That's probably the practical thing.

CHAIRMAN VOLCKER. Our Secretary is a little bothered by the English in the first sentence. What we can do is make two sentences. Before we just said "seeks to maintain pressures on bank reserve positions judged to be consistent...." When we say "maintain existing pressures," which is I assume what we're talking about here--I'll get back to that precise numerology in a minute--it might just be a little better to make two sentences: "The Committee seeks to maintain existing pressures on bank reserve positions. This is expected to be consistent with...." Let's put a "somewhat" in front of "greater reserve restraint might" and in front of "lesser restraint might." I would just emphasize the qualifying clause a little more; [instead of a semicolon] I would put a period there. "In either case such a change would be considered only in the context of appraisals of the strength of the business expansion, inflationary pressures...." If we adopt the Partee suggestion we would put in there "financial market conditions, and the rate of credit growth." I would be perfectly happy to write a separate sentence about that.

VICE CHAIRMAN SOLOMON. I would go for Chuck's version because there is already a widespread feeling in the markets that we are giving enormous attention to the situation in financial markets. I don't think that we're misleading the markets if we do it in a more low-key way. Therefore, Chuck's approach strikes me as better. We are very vulnerable to the charge--and I don't think the charge is justified--that we're departing from anti-inflationary policy for a temporary reason like Continental. Maybe there are a couple of people who feel that alternative B represents primarily that consideration. But I think many of us here feel that we'd be going for alternative B anyway, without the Continental situation.

MR. BOEHNE. I agree with Chuck's suggestion as well.

MR. PARTEE. If you wanted to sharpen it just a little, you could say the sensitivity of financial market conditions.

MR. CORRIGAN. I don't think so. I'd leave it the way you have it.

MR. ROBERTS. It says appraisals of--

CHAIRMAN VOLCKER. Well, I don't know that there are any more comments. It's not the way I would do it, but I think it's acceptable. I was playing around with a sentence such as "The Committee recognizes the operational implementation of policy might need to be modified in the light of unusual financial strains should they develop." I think that is the fact of the matter.

VICE CHAIRMAN SOLOMON. What do you mean--should they develop further? You're going to alarm the hell out of everybody!

MR. RICE. I'm not so sure. We put out this press release which seems to me to indicate a very deep involvement in this whole thing. Now we come along with a statement to the Desk and we try to ignore it. I don't think that's really very prudent.

VICE CHAIRMAN SOLOMON. We're not ignoring it if we use Chuck's language.

MR. GRAMLEY. Remember that the public is going to be seeing this after the whole period is over. And they will know what we have done. Hopefully we will be remembered by our deeds rather than our words. And they're perfectly aware of the fact that we have been involved in a heavy way.

MR. RICE. But they realize that; they read our words very carefully. And if they don't see any acknowledgment, they'll wonder what--

MR. MARTIN. Of course, the real Fed watchers will compare the two operational paragraphs and say: Aha! They added "financial markets".

MR. GRAMLEY. Not only that, they will say: Aha! They have a "somewhat" before "greater restraint," and they used the word "might" instead of "would."

MR. PARTEE. And somehow or other they have broken it into three sentences.

MR. MARTIN. It's a living for those guys.

VICE CHAIRMAN SOLOMON. It's a good living.

CHAIRMAN VOLCKER. I would not change the federal funds range --just on the grounds that other people are going to [read it as a tightening]. I can never be sure whether these [directives] are going to be released on the regular [schedule], given the Congressional interest in them. I don't see any operational significance in that but it will be read subsequently as a tightening. I don't think that's what we mean to convey, so we shouldn't bother doing it.

MR. MARTIN. I agree. I think it's a hazard to signal another 1/2 point after the outcry from [unintelligible] and other people for the last 1/2 point.

CHAIRMAN VOLCKER. Well, forget about this financial market conditions part for the moment. Is the rest of this all right? We break up the sentence and start a new one with "This is expected to be consistent" and we put in 6-1/2, 8, and 10 percent [for M1, M2, and M3]. We use "somewhat greater reserve restraint might," which is of absolutely no policy significance. Make it a period after that. The sentence looks a little long; I mean nothing by that. I would put in the word "only," if that's all right. I can live with this other suggestion. I think we have to make some acknowledgment of [financial market conditions] in there; it is unrealistically little to me, but so long as there's something--.

MR. AXILROD. Mr. Chairman, just for clarification, I assume that still somehow implicit in all of this is a sense that there is some leeway for carrying out operations under "existing" if something disorderly occurred or if financial strains developed. That's what was bothering us when we put this in.

MR. PARTEE. Yes, I see your point. Those are caveats having to do with a further tightening or an easing.

MR. AXILROD. So, I think we need some sense here that--

CHAIRMAN VOLCKER. That's what I would have done in my other sentence saying that the operational implementation might need to be modified. This is precisely what I was after. If we do it the other way, we're just leaving it understood, I think.

MR. CORRIGAN. Which is fine.

VICE CHAIRMAN SOLOMON. It's clearly understood.

MR. GRAMLEY. Well, but that modifier says "considered in the context." I think it's better to drop that "only" and say "considered in the context of appraisals of" these three things. The "financial market conditions" gives you the caveat to lean in an operational sense in the direction of less restraint if that seems to be necessary because of unusual financial strains.

CHAIRMAN VOLCKER. This sentence really refers to changing [the degree of restraint] in response to the movements in the aggregates.

MR. PARTEE. I think that's correct.

CHAIRMAN VOLCKER. I think it stands on its own feet and that's fine so far as it goes, but it does not take care of Mr. Axilrod's problem. I guess we could leave it understood.

MR. PARTEE. We could also do something with that last sentence, Paul. "The Chairman may call for Committee consultation if unusual strains develop or--"

MR. GRAMLEY. Well, we don't want to imply with the directive that he has to call for a telephone conference to deal with a developing problem that may require instant action. I'd make the point that we didn't have special language in the previous directive, which did not prevent the Desk and the Chairman and Steve from working on what was necessary. I don't think this language is going to hinder us in that respect either.

CHAIRMAN VOLCKER. I think we can also say if it really becomes necessary, we will have a consultation and we can have one. And we may well want one sometime during this interval.

MR. BOEHNE. Well, over the last eight weeks we seemed to have had enough flexibility to deal with the problems and we didn't even mention financial conditions [in the previous directive], so--

CHAIRMAN VOLCKER. I think Steve is technically right but it should be understood. It would be a better or [more] complete directive to put something in there, but if it's understood and we can all live with it--. I think it ought to be understood.

MR. CORRIGAN. I'd like to leave it understood. As far as this consultation issue, under the circumstances it's not difficult to think of a dozen circumstances in which we might want to consult that have nothing to do with the federal funds rate band and that should be understood too.

VICE CHAIRMAN SOLOMON. The question in my mind, which is not relevant to our decision here, is that we look like knee-jerk reactors in the sense that the first time we put in financial markets as a thing we consider to modify our behavior is after the Continental Illinois situation. Many of us, including the Chairman, certainly were worried about the financial market situation and vulnerability of the banking system before this month of May '84.

CHAIRMAN VOLCKER. It became a little more operational.

VICE CHAIRMAN SOLOMON. Okay. It does seem to me, though, that you and I are putting more emphasis even on the LDC debt situation as being a constraint on our operations rather than the Continental situation. I'm wondering just in the longer term, more as a philosophical speculation, whether maybe we ought to consider having that in there even if Continental settles down. I'm saying we should not take it out in the next directive.

MR. ROBERTS. We always have it in when a $40 billion institution fails!

VICE CHAIRMAN SOLOMON. That's another way of making my point. We look like we're reacting to something that caught us by surprise.

MR. PARTEE. Sometimes we've even said "international and domestic credit market conditions." I think it can last for a while. If we put it in as we've been talking about, it's a soft reference and so it can remain.

CHAIRMAN VOLCKER. Let me just clarify the so-called Continental problem, as it is in my mind. Continental is probably manageable with difficulty; $40 billion institutions are difficult to manage. Having two or three $40 billion institutions is a horse of a different color. If we have two or three, I don't think we're going to stop at two or three.

MR. GUFFEY. But that event would not be determined by interest rate levels necessarily.

CHAIRMAN VOLCKER. Well, it is in the sense that that's where the LDC problem comes in. I think that is the cloud overlying many other banks--not Continental, which happened to be largely a domestic problem. The underlying concern about the other banks wouldn't be there if we didn't have this international debt problem.

MR. GUFFEY. Well, that's my point. The LDC problem is more directly affected by the interest rate movements.

CHAIRMAN VOLCKER. That's correct.

MR. GUFFEY. More so than is the Continental situation or another $1 billion or $40 billion bank problem.

CHAIRMAN VOLCKER. Well, the other $40 billion bank problem is going to come because of the LDCs, if it comes. Again, 1 or 2 percentage points on interest rates in and of itself doesn't make or break that problem. Psychologically it may, given where we are in the negotiating scenario.

MR. GUFFEY. The only point I wanted to make is that the LDC problem has been with us and has been recognizable over the past two or three meetings, so the language proposed to go in the directive on recognizing the financial market stress has to be tied essentially to the Continental situation.

CHAIRMAN VOLCKER. I don't--

MR. ROBERTS. I think it's a very modest mention of a major problem and people would be very surprised if we don't pay some attention to it.

VICE CHAIRMAN SOLOMON. Oh, nobody's saying we shouldn't. All I'm saying is that I don't think we should take it out if Continental settles down. And in a sense I'm sorry we didn't have it in earlier.

MR. GUFFEY. I would agree with that, Tony, but the question of whether to put it in now just because of the events--

MR. PARTEE. If we had several Continentals, the operational reference here to maintaining existing pressures on bank reserves would be modified.

CHAIRMAN VOLCKER. Mr. Axilrod has found a bit of time honored boilerplate. We can do what we feel like in the light of financial distress.

MR. AXILROD. The existing directive has had in it since February at least: "The Committee understood that policy implementation would require continuing appraisal of the relationships not only among the various measures of money and credit but also between those aggregates and nominal GNP, including evaluation of conditions in domestic credit and foreign exchange markets." All that modifies policy implementation.

MR. PARTEE. All that's in there now?

MR. AXILROD. Forever. It's only--

CHAIRMAN VOLCKER. We have ample authority.

VICE CHAIRMAN SOLOMON. That's what is in the policy record?

MR. AXILROD. That's in the existing directive, in the long-run part of it.

MR. BOEHNE. Right, we never look at that [except when we consider the long-run ranges].

CHAIRMAN VOLCKER. I think we have to put something in the boilerplate, which nobody reads anyway. I guess there's no mention of this whole range of problems. Steve is proposing a sentence. I don't know whether it has to be precisely this, but let me know if you agree in general. "Recently, day-to-day market conditions have reflected considerable sensitivity to potential liquidity strains, as highlighted by the problem of one large bank, and to uncertainties about the financial and budgetary outlook generally." That's an accurate statement. It is one of the versions.

MR. PARTEE. That sounds right to me. It goes in the financial paragraph?

MR. AXILROD. Yes, it's proposed to follow the last sentence on the discount rate. We used the word "recently" to get away from the discount rate.

CHAIRMAN VOLCKER. Well, where we are, just to repeat: "..., seeks to maintain existing....This is expected to be consistent with etc., "somewhat greater reserve restraint might....In either case such a change would be considered only"--I would prefer to leave that in. Then it says "financial market conditions and the rate of credit growth." We leave in the 7-1/2 to 11-1/2 percent [range for the funds rate]. All this is with an understanding that that bit of long-range directive language that has probably been with us forever covers the situation where if we need some flexibility in light of financial market conditions, [we have it] whether or not we are responding to different aggregates or growth or whatever.

VICE CHAIRMAN SOLOMON. I'm not sure I understand why you want the word "only."

CHAIRMAN VOLCKER. That depresses the--

MR. PARTEE. Aggregates.

CHAIRMAN VOLCKER. --the speed with which we react to the aggregates.

VICE CHAIRMAN SOLOMON. So you're going to have "a change would be considered only in the context of appraisals," right?

CHAIRMAN VOLCKER. Right.

VICE CHAIRMAN SOLOMON. That sounds to me that we're less quick to let the influence of the continuing strength of the business expansion, inflationary pressures, etc., etc. come through in terms of the monetary policy.

CHAIRMAN VOLCKER. I'm not sure I understand what you're saying. It says--let me take the optimistic side--if the aggregates look a little weaker than this and if the economy seems to be moving ahead and the inflationary pressures are strong, we wouldn't be very quick to react. If the aggregates are going up and the financial markets are in turmoil, we wouldn't necessarily be all that quick to tighten.

VICE CHAIRMAN SOLOMON. I don't read it like that, because in either case it is referring to the change in the aggregates. Such a change--namely, a response to the aggregates--would be considered only--. So you're basically limiting it.

MR. PARTEE. Well, I think it supports what would be your position, Tony.

MR. WALLICH. It seems to say that we wouldn't respond to the aggregates at all unless there were these other features and I don't think we want to preclude that completely; we just don't want to rush after them.

VICE CHAIRMAN SOLOMON. I find the word "only" confusing. Do you see that differing interpretation? Is there any great advantage in putting in only, which the Fed watchers will look at and wonder what is happening?

CHAIRMAN VOLCKER. It seems pretty clear to me.

MR. PARTEE. I think it's implied. We have a list of things we're going to look at before we let the aggregates move us. It already says that. To add the word "only" doesn't add much; on the other hand, it may not be necessary.

MR. WALLICH. Do you mean if there were no change in the economic situation from now and the aggregates were going very fast suddenly--which they might do--that we wouldn't respond at all?

MR. PARTEE. It doesn't quite say that. It says we would consider all these other things before we responded.

CHAIRMAN VOLCKER. I think that is correct.

MR. CORRIGAN. I certainly don't have any problem with the substance of what we're talking about because I think it's the only thing we can do. But again in the context of possible contingencies I certainly don't want to rule out the possibility--which we're not--that we might have to firm a bit sometime between now and July 10th.

CHAIRMAN VOLCKER. It's not ruled out and it's not meant to be ruled out.

MR. CORRIGAN. I understand that. But the point I wanted to make was more that the basic purpose of this directive, as I see it, is that it's a framework for a continuity and a discipline in the policy process. I don't want to diminish all the current problems but I don't want to see that lost with an endless string of adjectives and qualifiers either.

VICE CHAIRMAN SOLOMON. So what are you saying?

MR. CORRIGAN. I'm saying [this is] fine, but let's not lose sight of what this really is.

VICE CHAIRMAN SOLOMON. Okay. But I thought the practical implication of what you were saying was that you don't want the qualifier "only" inserted, which we didn't have in the previous directive.

MR. CORRIGAN. I don't have a problem with it because I think I know exactly what it means.

MR. PARTEE. But I think one can read it to include that alertness.

MR. BOEHNE. I don't think it adds anything to communication or flexibility. I happen to like the sound of it and I think we can keep it in.

VICE CHAIRMAN SOLOMON. I don't want to make a big deal out of it; it's not. But if a Fed watcher sees "only" this time and not before, does this imply that earlier we were more responsive to the monetary aggregates and now we're less responsive?

MR. BLACK. I think that's the way they would interpret it.

MR. PARTEE. That's what I say: It's not inconsistent with--

VICE CHAIRMAN SOLOMON. My long-term policy.

CHAIRMAN VOLCKER. You ought to be delighted! Shall we vote?

MR. GUFFEY. Is "only" in or out?

CHAIRMAN VOLCKER. In.

MR. GUFFEY. I don't have a vote, so it's all right.

CHAIRMAN VOLCKER. Are we ready?

MR. WALLICH. I'm startled by the implication of this "only" now. This is a declaration in principle that we are changing our attitude toward the aggregates at this time.

MR. PARTEE. It would be considered in the context--

CHAIRMAN VOLCKER. We're going to be very careful in the context of all this stuff.

MR. WALLICH. I think that really means something more than I had understood. That's very difficult.

MR. PARTEE. I have a marginal preference for leaving it out.

MS. HORN. I have a marginal preference for leaving it out.

MR. ROBERTS. So do I.

MR. BOEHNE. So do I.

VICE CHAIRMAN SOLOMON. Can we have a show of hands?

CHAIRMAN VOLCKER. I think we're cheating if we leave it out.

MR. MARTIN. Let's leave it in.

MR. GRAMLEY. Well, we can have it understood.

CHAIRMAN VOLCKER. We have more things understood.

MR. WALLICH. If we said "would continue to be considered" in the context of all these things, then it would indicate that we're not changing anything.

VICE CHAIRMAN SOLOMON. We weren't reacting that mechanistically to the aggregates before this and no one seemed to feel dishonest by not having the word "only" in at that point. I don't know; I wonder if people are going to overread.

CHAIRMAN VOLCKER. I'd be delighted to have them read that we take a second look in terms of all these things.

MR. MARTIN. So would I.

VICE CHAIRMAN SOLOMON. Instead of saying "only" could we say "such a change would naturally be considered"?

MR. PARTEE. Or "such a change, of course, would be considered only in the context of"?

MR. WALLICH. "Would continue to be considered"--

VICE CHAIRMAN SOLOMON. It's not going to influence my vote anyway, of course. It's a minor point. I don't want to make a big issue out of it.

MR. MARTIN. Let's vote.

CHAIRMAN VOLCKER. I think it's a relatively minor point. All it is meant to convey is that before we move we should stop, look, and listen a little more strongly than before. That's the way I feel. It's a question of whether you feel that way or not.

MR. MARTIN. I certainly do.

CHAIRMAN VOLCKER. Let's vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes
President Boykin	No
President Corrigan	Yes
Governor Gramley	Yes
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. Okay. The meeting is over.

END OF MEETING