

Meeting of the Federal Open Market Committee

December 18-19, 1980

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., starting on Thursday, December 18, 1980, at 3:30 p.m. and continuing on Friday, December 19, 1980, at 9:30 a.m.

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

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

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

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

Messrs. J. Davis, R. Davis, T. Davis, Eisenmenger 1/  
Ettin, Henry, Keir, Kichline, Truman, and Zeisel,  
Associate Economists

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

1/ Attended Friday session only.

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

Mr. Coyne, Assistant to the Board of Governors

Mr. Prell, Associate Director, Division of Research and  
Statistics, Board of Governors

Messrs. Gemmill and Siegman 2/, Associate Directors,  
Division of International Finance, Board of Governors

Mr. Smith 2/, Assistant Director, Division of International  
Finance, Board of Governors

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

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

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

Mr. Smoot, First Vice President, Federal Reserve Bank  
of Philadelphia

Messrs. Brandt, Burns, Keran, and Scheld, Senior Vice  
Presidents, Federal Reserve Banks of Atlanta,  
Dallas, San Francisco, and Chicago, respectively

Messrs. Broaddus, Mullineaux, Mrs. Nichols, and Mr. Rolnick,  
Vice Presidents, Federal Reserve Banks of Richmond,  
Philadelphia, Chicago, and Minneapolis, respectively

Mr. Burger, Assistant Vice President, Federal Reserve  
Bank of St. Louis

Ms. Clarkin, Sr. Trading Officer, Federal Reserve Bank  
of New York

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2/ Attended Thursday session only.

Transcript of Federal Open Market Committee Meeting of  
December 18-19, 1980

December 18, 1980--Afternoon Session

CHAIRMAN VOLCKER. I suppose we are on agenda item 1, which is approving the minutes. Mr. Altmann wants to make a comment.

MR. ALTMANN. With respect to the minutes for the meeting of November 18, we've put in front of you today the revised minutes. I just wanted to call to your attention that there is an addition in the form of a Secretary's note. At the November meeting, if you recall, the Committee approved renewal of the swap arrangements subject to final approval of the specific terms by the Foreign Currency Subcommittee. The Secretary's note merely states that on December 1 and December 17 the Foreign Currency Subcommittee approved the provisions so that the swap agreements are, in effect, renewed. Scott may want to say something about that.

CHAIRMAN VOLCKER. Do you want to discuss your negotiations, Mr. Pardee?

MR. PARDEE. Yes, I'll discuss very quickly the agreement in principle on the two points we wanted to negotiate. One was the elimination of even sharing of risk, which applied to five of the different swap arrangements. The other was shifting to use of an interest rate in the foreign market as the basis for our drawings. That is, we would pay their interest rates rather than ours. Everyone agreed rather quickly, but it was rather complicated in view of the new procedures among the European Monetary System central banks. They all wanted to sit together and discuss it among themselves before they came back. Again, they agreed. The second problem was to find an appropriate instrument in the other countries that came as close as possible to the U.S. Treasury bill. There aren't many countries in the world that have a Treasury bill, but we found in most of them something that was as closely comparable as [possible]. The [major] negotiation on this, of course, was with the Bundesbank. We are now in an end game with them because they don't have a Treasury bill. Indeed, their Treasury tends to borrow at short-term interest rates that are higher than other short-term market rates. So we're coming down to a formula [that is] now based on the interbank rate, with some discount for us since we think that the Federal Reserve is a better risk than German banks are to one another. I'm reviewing this still, but the Treasury seems to think that that's an appropriate basis. And we're having an end game with the French as well, where all of a sudden they have found that they don't have a Treasury bill whereas everybody in the world thought they did. So these negotiations have become very complicated, but I think we can come out reasonably well on them.

CHAIRMAN VOLCKER. Are there any questions about that? If not, we can have a motion to approve the minutes.

MR. SCHULTZ. So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection they are approved.

MR. ALTMANN. We are talking about minutes for three meetings: November 26, December 5, and December 12.

CHAIRMAN VOLCKER. They are not all approved in that motion?

MR. ALTMANN. That's fine; I'll take it as--

CHAIRMAN VOLCKER. I will interpret that motion as including the minutes for all the meetings we've had.

MR. ALTMANN. Fine.

CHAIRMAN VOLCKER. [Next on the agenda is a] discussion of foreign currency operations. A memo was distributed that I believe you have seen. Do you want to give any introduction, Mr. Truman?

MR. TRUMAN. Not necessarily, unless you want it, Mr. Chairman. Do you want to do this before we do the regular report?

CHAIRMAN VOLCKER. I am not looking at the agenda, I guess.

MR. ALTMANN. We have the report on operations first.

CHAIRMAN VOLCKER. Well, let's do that first.

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

CHAIRMAN VOLCKER. I thought all these German marks we were buying were going to the Treasury.

MR. PARDEE. Yes, recently, since we have come close to the limit we have for the Federal Reserve. But at the time of the last FOMC meeting, we still had over \$400 million worth of leeway.

CHAIRMAN VOLCKER. I thought we weren't using it. Well, is there any discussion about this?

MS. TEETERS. I have some questions. We have a limit on how many balances we can hold by type of currency, is that correct?

MR. PARDEE. Marks and yen, specifically, yes.

MS. TEETERS. Does the Treasury have limits on how much they can hold?

VICE CHAIRMAN SOLOMON. It doesn't work like that for the Treasury. Assuming that they have the resources in the Exchange Stabilization Fund, then the decision is made ad hoc. There is not a self imposed limit, assuming the resources are available. Now, the ESF has limited resources which they expand by warehousing with the Fed, up to the limits that we permit.

MS. TEETERS. If they warehouse currencies, against whose target does that go? Or does it go against anyone's?

VICE CHAIRMAN SOLOMON. Well, they bear the exchange risk if they warehouse.

MS. TEETERS. But there's no limit on how much they can warehouse?

MR. WALLICH. We have the warehouse limit.

MS. TEETERS. So it goes against our totals?

MR. PARDEE. No.

MR. WALLICH. No, it goes against our limit on their credit lines with us.

MS. TEETERS. So we have a limit on how much the Treasury can warehouse. Is that it?

MR. WALLICH. Yes, on how much we would lend the Treasury for warehousing purposes.

VICE CHAIRMAN SOLOMON. I think it's about \$2-1/2 billion.

MR. TRUMAN. No, the limit is \$5 billion and they are up to \$3 billion.

VICE CHAIRMAN SOLOMON. There's \$2 billion left.

MR. TRUMAN. Yes.

MR. PARTEE. And these appear in our assets, do they?

MR. TRUMAN. Yes.

MR. PARTEE. These are our assets. But we have a forward contract?

MR. TRUMAN. They appear on our balance sheet as our holdings, but there is an off-balance sheet item which is a forward sale of the foreign currencies back to the Treasury.

MR. PARTEE. We get the yield on them?

MR. TRUMAN. We get the yield for whatever rate is in the swap agreement.

MR. PARTEE. At the German rate rather than the U.S. rate?

MR. TRUMAN. Yes, I suppose.

MR. PARTEE. So we lose what--maybe 6 percent per annum on every one of those we have?

MR. TRUMAN. Well, it depends on what [form] they are in. They are in a double-swap, double-forward so that they are earning about 7-1/2 percent now, or something like that, versus Treasury securities.

MR. PARTEE. I certainly wish I could find a commercial bank that would let me warehouse like that!

MR. TRUMAN. Well, it does affect our profits but as against the alternative of the Treasury holding them, it all washes out.

MR. PARTEE. But they can't, Tony said.

MR. TRUMAN. Yes, [unintelligible] are up against the limit at present.

MR. PARTEE. And this is a well-known device that the Congress knows about?

MR. TRUMAN. Oh yes, they have said so every time.

MR. PARTEE. I mean that we're not hiding anything. There is no subterfuge involved here.

VICE CHAIRMAN SOLOMON. No, I've testified on it before.

MR. TRUMAN. The policy record shows the change in the limits, and the System's annual statement at least indicates the amount that is warehoused as well as the sum of the holdings that are covered by these forward transactions.

MS. TEETERS. So the total volume of marks, say, that we can hold is the \$1-1/2 billion limit we have plus the \$5 billion that is the limit we have [on warehousing for] the Treasury?

CHAIRMAN VOLCKER. That's \$5 billion at the moment.

MS. TEETERS. That's it then? The maximum we can hold is \$6-1/2 billion?

MR. TRUMAN. Well, plus what they could hold outright on their own.

MR. WALLICH. That's on DM, but it isn't our total limit on all balances of all kinds.

MR. PARDEE(?). Plus whatever the Treasury has in the ESF, if you're looking at the government as a whole.

VICE CHAIRMAN SOLOMON. Yes. What is left is mostly SDRs.

MS. TEETERS. That covers all my questions.

CHAIRMAN VOLCKER. Are there any other questions or comments?

MR. RICE. Yes. Scott, I understood you to say that some corporate treasurers were expecting a decline in the value of the dollar early next year. What's the reasoning behind that expectation?

MR. PARDEE. I think there's also an expectation that interest rates will come down. In effect, these are people who would be bringing funds home at the end of December for repatriating, for earnings, or whatever purposes. Say they have their investments in Deutschemarks. Rather than disturb those investments by selling the marks and buying dollars, they have borrowed dollars, say, in the Euro-market--even for one month. They would bring them home and would

repay in January when the borrowing matures. So it's an indication to me not so much of their interest rate sensitivity but of their expectation that the dollar will be weaker against the mark. It is interpreted that way in the market as well, where it was reported.

CHAIRMAN VOLCKER. What is the dollar/mark exchange rate today?

MR. PARDEE. It's just under 1.99. It got up over 2 again this morning.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Mr. Chairman, what sort of rules do we have with respect to moving the other way with this deck of cards in our hands? Is there a tendency as we pile up more reserves to want to peg rather than to smooth or whatever? I'm not quite sure what either of those terms means, but--

CHAIRMAN VOLCKER. Why don't you defer that question until we get on the general subject of holding currencies. Any other comments or questions on operations? If not, we need a motion.

SPEAKER(?). So moved.

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

MR. PARDEE. No. We're clear of the swap lines, and I've reported on our negotiations with respect to the renewals.

CHAIRMAN VOLCKER. We are then to the general questions. Why don't you tell us where the U.S. government stands on numbers anyway, Mr. Truman.

MR. TRUMAN. We have provided to the Committee--it's in the pile in front of you--an update of Table 1 from the paper we had circulated. As Scott just said, the [Federal Reserve] System has \$1.4 billion in German marks, as shown in the first line, and a total [of all currencies] of \$2.1 billion. The Treasury has a total of \$8.8 billion, of which \$5.7 billion is in DM, which covers their Carter note issues [with an excess of] about \$500 million. The grand total is almost \$11 billion. One could in principle set off against the DM holdings or all the holdings the fact that some of these funds were raised, in addition to [sales of] Carter note issues, through sales of SDRs and drawings on the Fund. They gave up those assets in return for DM and we haven't reconstituted those holdings in either form. That would show, at least as far as marks are concerned, that the Treasury and the United States would be somewhat negative, by about \$1 billion, as shown in the bottom line of the first column. And the net comes out approximately at zero on that basis. I'd be glad to answer any questions.

CHAIRMAN VOLCKER. Why shouldn't the Treasury take some of these currencies, buy back the SDRs, and repay the IMF drawings?

MR. TRUMAN. Well, they can't repay the IMF because it was a reserve [tranche] drawing. And the way rules go, that is never repaid

except in the form of further dollar drawings. Not only is there no obligation, there is no possibility of repaying to reduce your [unintelligible], increase your [unintelligible].

CHAIRMAN VOLCKER. Except by other countries' drawings?

MR. TRUMAN. [The reserve tranches] are set up that way. But on the SDR sales, they could do it, and it has been talked about from time to time. I'm sure President Solomon can tell you about taking some marks or some of these other currencies and buying SDRs from a country. We talked in the spring about buying back some of the SDRs we had sold to the Japanese, for example, when they were going through that phase.

VICE CHAIRMAN SOLOMON. It would probably make more sense to do that later on, Paul, when the markets turn around. But, Ted, why does the Treasury carry in its formal balance sheet the IMF drawing of \$2 billion as a negative? We still have \$1-1/2 billion, roughly.

MR. TRUMAN. That has to do with the relationship between the Treasury's general fund and the Exchange Stabilization Fund. The general fund drew from the IMF and sold the currencies to the Exchange Stabilization Fund; [the latter has incurred as] a counter-entry a liability to the general fund. And [to the extent] that gets repaid, that in fact marks up the balance sheet of the ESF. That's one of the reasons it's so big now.

VICE CHAIRMAN SOLOMON. So it's a negative item for the ESF but not to the Treasury as a whole.

MR. TRUMAN. As other countries draw dollars out of the fund, that calls on the credit line of the Treasury [for] advances of funds. And on an annual basis, they settle up with the ESF. At that point, the Treasury has to provide dollars to the Exchange Stabilization Fund. So that's one of the contingent liabilities that the ESF still has.

CHAIRMAN VOLCKER. Are we in the super-gold tranche?

MR. TRUMAN. Oh yes, that is the point. Because we drew in super-gold tranches--or what used to be called super-gold tranches--that is why we don't have to repay.

CHAIRMAN VOLCKER. We don't call it a super-gold tranche anymore?

MR. TRUMAN. It's all called the reserve tranche now. Gold, as you know, was downgraded in the Articles.

SPEAKER(?). Its price went up.

CHAIRMAN VOLCKER. When you're out of the super-gold tranche, is it still considered a tranche?

MR. TRUMAN. It's all called the reserve tranche now.

CHAIRMAN VOLCKER. Up to 25 percent--a quarter?

MR. TRUMAN. Well, what used to be called the gold tranche and the super-gold tranche are both called the reserve tranche.

CHAIRMAN VOLCKER. There is no distinction between the two then?

SPEAKER(?). Even for Chrysler?

CHAIRMAN VOLCKER. Well, we have a memorandum describing some considerations here. It has been a while since I read it. The United States government, in one interpretation, is in a balanced position. That's the way the U.S. Treasury looks at it, anyway. I suppose the only thing one could argue about is whether to include the IMF drawing in that or not. We are close to the top of the limit we set. We still have \$2 billion [leeway], roughly, on the warehousing [facility]. I don't know if the Treasury feels too strongly about who holds the currency, but I think their view--just to put one view on the table--is that we ought to continue operating pretty much as we have been up until several billion more at least. The theory is that it doesn't hurt--or to put it more positively that it may be desirable --to have positive currency holdings against an uncertain future, which raises the question about our currency limit and conceivably the warehousing limit. But that is their feeling about it. The exchange market may be close to a turning point depending upon what happens on our interest rates. What happened last time [is that], as soon as interest rates turned, the dollar went down quite sharply for a while, just on the mere fact of a turn in interest rates even though all during that period, except maybe at the very end, there was a positive differential in favor of the dollar. By the time the positive differential disappeared, if it ever disappeared, the dollar had stabilized. The movement was mostly on the turn, reflecting the fact that there is some expectation that the dollar will get stronger so long as they see interest rates going up. And as soon as they see [the differential] going down, the expectation turns around almost regardless of where the level is. I don't know what is going to happen, obviously. But that is an operational issue posed for us. When I looked some time ago at the foreign currency directive, or wherever these instructions are, I thought perhaps it could stand some rewriting. But I don't think that would have to be done in any event, if it is done at all, before we look at this in terms of these general directives. And there is nothing in here that is inconsistent with what we are doing or have done. I'll open up the floor for comments.

MS. TEETERS. Mr. Chairman, what is the legal basis for our holding the balances? Are there any legal constraints? Do we have legal authority to do it or not?

CHAIRMAN VOLCKER. Well, we obviously think we have the legal authority to do it or we wouldn't be doing it. I think that issue was thrashed out and resolved in the early 1960s when these swaps first began. The specific legal authority is in the [Federal Reserve] Act, which says specifically that we can hold foreign currency balances. I don't think it says much about what purpose we can hold them for. As I remember it's silent on that. I don't know whether Mr. Peterson or Mr. Oltman or somebody else who was around at the time wants to comment on--

MR. OLTMAN. Mr. Chairman, there is authority technically to acquire cable transfers in foreign currencies. As you say, in the early '60s [the issue] was thrashed out to reach the conclusion that we were authorized to acquire currency balances and essentially to set up the various swap arrangements.

CHAIRMAN VOLCKER. This was all done with the knowledge of the Congress, of course; it was developed at that time with the Treasury. The Treasury had pressed the Federal Reserve to do it in the first instance. But it was all agreed to by the Congress; they were fully aware of it.

MR. OLTMAN. It was also noted in the Board's Annual Report at the time that an opinion had been rendered to the Committee that the Federal Reserve could engage in those transactions. It is not any secret legal authority.

CHAIRMAN VOLCKER. Haven't we been doing it for 20 years? And our holdings now probably are as big as they have ever been, aren't they? We have had a bigger negative position on numerous occasions. This is as big as they have every been on the positive side. And there's no question about the Treasury's authority to be agents in these transactions either. There is a long record, too, in connection with all of this--I want to attempt to be precise about the words though it has been worded in different ways at different times--that it has always been pretty clear that these operations are done in conjunction with the Treasury. And The Treasury has a particular responsibility in the Gold Reserve Act of 1933, or whatever the name of the Act is, for international financial operations. It has never been pinned down as a precise legal matter, but there are various understandings that have gone on through the years.

MR. RICE. Mr. Chairman, there are formal limits, which I take it have their origin in the instruments that are mentioned in the authorization and the directive and so forth. And then there are informal limits that are discussed in the memorandum. What is the origin of the informal limits on the currency holdings?

CHAIRMAN VOLCKER. Well, I don't know where what you call the formal limits are [located]. They don't seem to be in this directive.

MR. ALTMANN. No, they're in the authorization and the procedural instructions.

CHAIRMAN VOLCKER. They are in the annual authorization that we set down. It's primarily a procedural matter. The annual authorization sets down some general limitations, but there's a feeling that Mr. Pardee shouldn't go off on his own and operate within the general limits in the authorization but that he should be pinned down more closely as an operating matter. That accounts for the emergence of what you call the informal limits, with the Foreign Currency Subcommittee having certain authority in that respect.

MR. RICE. So the informal limits are set by the Foreign Currency Subcommittee?

MR. TRUMAN. No, no.

CHAIRMAN VOLCKER. Well, as you said, they are not exactly informal, they are procedural.

MR. RICE. Well, it's not my language; it's in the [memo].

MR. TRUMAN. Let me try to explain it. In the authorization the limit on the open position in principle is symmetric, so we could be so much in debt or hold so much in the way of balances. That's what the authorization limits. And the procedural instructions govern how much that can change between meetings or certain time periods as we move up to that overall limit that is set in the authorization by the Committee.

CHAIRMAN VOLCKER. The procedural limits are what you are calling the informal limit?

MR. TRUMAN. No, I haven't gotten to the informal limit. What I referred to in the paper as informal limits are limits that have been established within the authorization, within this overall limit which is now \$8 billion, to govern in particular our holdings of balances. But they have been updated and codified on the basis of understandings rather than votes because in some sense--

MR. RICE. Who establishes the informal limits?

MR. TRUMAN. This Committee by consensus. The Committee did it at its last meeting and the meeting before that.

CHAIRMAN VOLCKER. When you say informal, are those recorded [votes] or not?

MR. ALTMANN. No, they have not been formal votes and thus not recorded.

MR. TRUMAN. The logic is that you had a formal vote on the overall limit [specified in the authorization].

CHAIRMAN VOLCKER. We have three types of limits: We have the limit on the overall authorization, which is [voted on] annually; we have procedural limits, which are in the procedural document and cover occasional and particular problems; and we have had discussions where we have informally set limits within those other limits.

VICE CHAIRMAN SOLOMON. And there is a fourth set. When Arthur Burns was here, he would sometimes give a daily limit to the New York Desk. He discontinued that after a while. But there is also some consensus between the Treasury and the Fed and the Desk as to some broad range of tactical day-to-day type limits.

CHAIRMAN VOLCKER. But those are tactical decisions, essentially. I believe we're clear now on the various types of limits that are in [place].

MR. PARDEE. But it is important to know that the limit on how much we can buy in Deutschmarks, which is \$1.5 billion, has been set by the Committee. It's not a formal action of the Committee as is the \$8 billion limit on the open position, but I feel it's equally binding to me as any other action of the Committee.

CHAIRMAN VOLCKER. There's no question that it's binding; it's not going to be changed without another action.

MR. WALLICH. It might be tipping our hand if we published that month by month.

MR. RICE. Mr. Chairman, do we have any notion as to what the right amount of foreign currency balances would be and at what point we would feel comfortable that we've accumulated enough?

CHAIRMAN VOLCKER. Well, that is one of the issues basically before us. And I'm not sure. I don't have any answer for all time. In approaching that question in a rather tentative way, the Treasury did some calculations and looked at the swings in interventions basically. I forget just how they did it; I think it was the gross swings in intervention over the period since 1973.

MR. TRUMAN. They are in the paper.

CHAIRMAN VOLCKER. If they're in the paper, you can look at them there. They show that the swings have ranged, on a couple of occasions, up to \$8 billion.

MR. TRUMAN. Yes.

CHAIRMAN VOLCKER. We actually got \$8 billion in debt, or very close to it, because we were starting from a zero balance--I was there--on only one occasion. It was up to \$8 billion and another time it was not very far from it, I think.

MR. TRUMAN. Well, it's on table 5; the peak was about \$8-1/2 billion, and for--

MR. RICE. It must have been 1978.

CHAIRMAN VOLCKER. Yes, '78 was one of the big ones. What page are you on?

MR. TRUMAN. It's on table 5 in the paper. About two years ago in December, we were at \$8-1/2 billion--that was cumulative intervention--and that was simply all debt, although some of it was financed by Carter notes.

CHAIRMAN VOLCKER. I'm looking at table 5, but I don't see an \$8-1/2 billion total.

MR. WALLICH. It's U.S. totals, \$8.411 billion.

MR. TRUMAN. It's [column] five.

CHAIRMAN VOLCKER. When it's a plus that means we were buying them?

MR. TRUMAN. No, minuses are buying and pluses are sales.

CHAIRMAN VOLCKER. Minuses are buying, okay. So that's \$8.4 billion we sold. Then there's a previous period of \$8.2 billion.

MR. TRUMAN. No, I'm sorry, it's \$5.8 billion. Excuse me, I was reading the wrong column. There is nothing like being helpful! The peak was \$5.8 billion.

MR. PARTEE. That's the U.S. total column, right?

CHAIRMAN VOLCKER. That's what I was looking at.

MR. TRUMAN. Now, the \$8.4 billion was last October. So it's \$8.4 and \$5.8--

CHAIRMAN VOLCKER. So, looking at these figures--there's nothing very scientific about this--they say we've run into fluctuations in both directions of [up to] \$8 billion. And if you consider a normal position at zero, in some sense, it seems natural to be willing to hold at least \$4 billion. I'm talking net now on the theory that if we ran into another \$8 billion drain, it would take us from a plus \$4 billion to a minus \$4 billion. Therefore, \$4 billion sounds like a nice figure not to worry about.

MS. TEETERS. Is that over and above our holdings to cover the Carter funds?

CHAIRMAN VOLCKER. Yes, they are saying on a net basis--

MR. PARTEE. And to cover the swap, I take it.

CHAIRMAN VOLCKER. Yes, starting from this net position that they interpret as roughly zero. They are not saying to go to \$4 billion necessarily. In this version we don't go out to acquire balances. We operate more or less the way we've been operating and deal with disorderly or erratic markets as it seems appropriate. We are willing to do that more or less the way we have been, within that kind of framework. That's one possible approach.

VICE CHAIRMAN SOLOMON. Mr. Chairman, let me make what I think is the positive case for this. I arrived at this view pretty painfully at a time when I was handling this at the Treasury. As a practical matter, we are very reluctant as a government to sell large amounts of gold when the dollar is under attack. If we don't have substantial balances of foreign exchange, which we accumulate as market opportunities offer, as part of this leaning against the wind strategy--I'm not talking about pegging the rates, obviously, and the record shows that we haven't pegged rates--then we have to go into debt immediately. There are various consequences of that. First of all, the markets are constantly aware that we don't have our own resources and that we are going into debt. It affects the credibility of our intervention. There are always speculations on whether we're going to run out of resources and whether the Germans will increase their swap debt [given] that we're dependant upon Germany's good will at that time. I am focusing on Germany because that's usually where the issues arise. Secondly, we would show a better profit position if we had our own balances because then if the dollar weakens, we sell balances and only go into debt when the dollar is much weaker--if we've used up our resources--rather than going into debt immediately. The same [is true] on the up side. So it tends to improve the profit-loss picture; we can't guarantee a profit, but it improves the prospects of one. [We have more] credibility in the markets because

of the independence we have, in terms of not having to submit to any conditions from other central banks or other governments. The fact is that we have more of a say in the judgment as to whether the exchange rate is overshooting or undershooting by a very large amount--again, I'm not talking about pegging--rather than leaving that intervention position entirely to the foreign central bank.

All these factors are very powerful reasons, in my view, why we should accumulate a very substantial position. Now, one can argue: Why not let the Treasury do that? First of all, the ESF has limited resources, even though it can be supplemented by warehousing. But there are limits to that. They can't warehouse more than they have the resources for. Secondly, we have less to say. If the Treasury is going to have the only resources, then the Treasury is going to call the tune on international monetary policy alone. Thirdly, it's very important in terms of the market impact and to the Congress that the Treasury and the Federal Reserve be in this jointly. This has been the view of every Administration that I can remember. Being in that kind of joint position, we both derive strength from the other. Finally, I must say that the previous Congressional objections to a more active policy disappeared at the time of the November 1, 1978 [program] with the overshooting on the down side, when the collapse of the dollar was so strong that Proxmire, Reuss, and the others strongly supported us when we put together the November 1st package. I told them at the time that the implications of that were that we would build balances as market opportunities permitted. They both said they recognized that and they thought that was appropriate. At the time I said that to Bill Miller who was Chairman of the Federal Reserve, and he was supportive.

For a country our size, and with the dollar being the principal foreign currency for transactions and reserves, one can argue not that we need \$8 billion but that we should have \$30 or \$40 billion if we are not prepared to sell gold in large quantities. Now, nobody is talking about [accumulating] that [much]. I think the chances of the market permitting us to accumulate those kinds of reserves [are remote]; it's just out of the question. But it might be feasible to accumulate \$8 or \$9 billion or something in that area. And I would hope that we would go along with the Treasury and would agree to increase the line substantially. The immediate operational question--we don't have to increase the limit too much if there is an understanding that from time to time the limit can be raised--is whether we can go ahead with, say, a \$1 or \$2 billion increase now. But it seems to me that the long-run strategy is what the FOMC ought to consider.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. Mr. Chairman, Tony's statement has rather anticipated a question I was about to raise. Ted Truman's paper was useful and interesting as far as it went. But what I was hoping to find and didn't see--and I wanted some discussion around this table as a minimum if not a study paper--was something on the fundamental purposes of our intervention. In Ted's memo, on the top of page 2, he sets forth three types of reasons for intervening: The traditional aim, prior to 1978, of heading off disorderly conditions characterized by abrupt intra-day changes or wide spreads in bid and ask prices; a bit more than that--countering disorder, characterized by so-called

cumulative exchange rate changes that tend to feed on themselves; or thirdly, the disorder characterized by substantial exchange rate movements that carry rates to levels that are judged to be unrealistic in light of fundamental economic factors. I gather, Tony, we have been more or less in that third mold since the crisis of November 1978 and the \$30 billion support package that was put together at that time. I'm really skeptical about making judgments that are counter to what the market is telling us. Who makes those judgments and on what basis? I guess I'm being a devil's advocate here. I think there's an awful temptation to substitute judgments for market forces. The key question, since the dollar is in the very opposite position today from what it was on November 1, 1978 when it was very [weak], is whether this very broad intervention, which in my view is at least semi-pegging within a range, is still justified. Is it necessary? Is it doing something positive for the national interest? What are the costs related to the benefits?

VICE CHAIRMAN SOLOMON. John, on that I'd say first of all that we simply lean against the wind and let the market pressures show up in terms of the direction. It's the magnitude of the [market] move that we try to lean against in the short run. The record shows that very clearly in the last two years since November 1, 1978. Now, when we get to a situation where we have something like the November 1st collapse, then of course we have to intervene massively. We have not done that. There have been substantial dips in the dollar in these two years during which we simply leaned against the direction. The traders themselves feel that there is a stabilizing influence if the central banks are in. It doesn't mean we have to be in every day. There have been many long periods of time when we haven't been in at all. It can reach a situation, though, where there is a very clear consensus within the government, and even in the markets, that by God this [market move] just has gotten momentum and is out of control, and it's not reflecting the fundamental factors. That still leaves an extremely broad range in which we would, if they were very large movements, simply lean against them. But we would let the movement go in the direction it's tending to go. It does not involve a conception of where the rates should be. It does involve a conception of how far [the markets should move] in either direction, when we begin to get into an area of extreme undershooting or overshooting. But as I say, the only really massive intervention we did was in a short period of time--a two-month period starting November 1st up to December of 1978 --and then [the markets] turned around beginning in January. It is just the facts of life. And the markets themselves like that kind of stabilizing force because there is just too much at stake. Now, in terms of more basic economic considerations, it is also true that if the dollar collapses too far, aside from any financial problems that can create, it really does feed inflation. If the dollar over-values too far--again I'm talking not about making narrow judgments but very broad judgments--it hurts our competitiveness and we end up with major balance of payments problems. So there is some kind of rough sense. Also, the markets really don't believe that central banks are completely indifferent to exchange rates over some broad area. They think we have a target. When we practiced what they call benign neglect, they thought we wanted a continuous weakening of the dollar. No matter what we said, they thought that was what we wanted, in effect.

MR. BALLEES. Well, first of all, I fully supported that November 1978 action, Tony. I'm not questioning the need and necessity of that. What I am somewhat skeptical about is whether we still need the same scale of resources today and ought to be [intervening as actively] in view of the strength of the dollar. I'd make one other comment, if I can get it in here. I have a suspicion, and that's about all it is at this point, that these foreign exchange operations may have more of an impact on domestic monetary policy than has been realized. I mean that in the following sense: I think we probably all view the exchange intervention operations as being in an aggregate sense, sterilized--that they aren't doing anything one way or another to affect the grand total of member bank reserves. What we do on one side, we offset on the other side. But by the same token, to the extent this intervention, this leaning against the wind to moderate the rise in the U.S. dollar without affecting current monetary policy--if that should be the aim--succeeds in keeping the dollar below the level it would otherwise reach, then it follows, based on a study we're now doing but haven't completed, that it must also keep the level of U.S. interest rates below what they otherwise would have been relative to interest rates abroad. I'm talking about the size of the gap. The size of the gap will be smaller either because U.S. interest rates in an absolute sense are somewhat lower than they would have been or foreign interest rates are higher than they would have been. And the reason I think that has to be the case is that the difference between the spot and the forward value of the dollar, based on our studies, tends to be very close to the U.S./foreign interest rate differential. One can track this, and it has been tracked by different people around the System, including the Board's staff as well as our staff. And since that difference between the spot and the forward value follows very closely the two interest rate differentials, thus depressing the spot relative to the forward value, then our interest rates must be depressed relative to those abroad. That is, the interest rate gap will be smaller.

The next point in this line of argument is that, as we've tried to study what has happened to the demand for bank credit and the growth of monetary aggregates this year, we're beginning to believe that the fluctuations in the demand for business loans in this period have had a pretty considerable effect on the monetary base, the multiplier, and ultimately the target aggregates. And if that view is correct--that the business community wants to stay out of the bond market when rates are exceedingly high as they are now--and turn to the banking system, as they've done massively, in demands for bank loans, they create the deposits and create a need for required reserves two weeks down the road. We have to move in and supply the required reserves. And to the extent that that business loan demand is based on the level of interest rates, and to the extent that intervention has, as we suspect, somewhat lowered the level of U.S. interest rates, then the demand for bank loans gets even stronger, if there is any interest elasticity there at all.

In a word, we have a suspicion that intervention keeps rates lower than they otherwise would have been and increases loan demands to higher levels than they otherwise would have been and probably results in more demand for money than would have been the case in the absence of [the intervention]. In short, if this view is correct--and it still has to be confirmed by some more work--then intervention is not neutral in terms of its impact on domestic policy.

CHAIRMAN VOLCKER. Would you like to comment on that suspicion, Mr. Truman?

MR. BALLEES. I'd welcome comments on that suspicion. It's not even a hypothesis yet.

MR. TRUMAN. Well, that analysis is based on the assumption that the forward rate does not move; then anything can happen. As we've sketched out in the paper, depending on where the change comes from, if there's a shift in the market's sentiment in favor of the dollar, if anything that'll tend to push the exchange rate up and we would see, absent anything else, interest rates [come] down. If we intervene under those circumstances, [unintelligible] can sterilize intervention both here and abroad, and let the forward rate move around, if anything interest rates would be higher than they otherwise would be because some of the pressure that would come from that demand for dollar-denominated assets would be taken out of the market by supplying them.

VICE CHAIRMAN SOLOMON. In addition to Ted's specific point, there is a more general statement that I think ought to be made. We'd be more independent of the external environment if we had our own resources in terms of [implementing] domestic monetary policy. If we have a very serious decline in the dollar, which goes too far, and we don't have the resources, then we've got to yank up interest rates. And we may not wish to do so. Lyle Gramley [can speak to this], for example; he was on the Council [of Economic Advisors] when this was a serious problem. So I think that is the larger truth, which swamps the technical effects. And even the technical effects, I think, are very easily manageable in an economy as big as ours--and I've talked with Peter Sternlight regarding this and his open market operations.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I agree very much with what Tony has said. I would add that we are really in a very abnormal situation. We are no longer a unique country. We are not pegged to gold and have others pegged to us. We are one of a group of countries whose currencies float. We are the only one that has virtually no reserves; we are the only one dependent on borrowing the reserves whenever we need them. And we have seen that that borrowing can be denied or subjected to conditions. So simply in terms of normalizing our situation in a worldwide float [regime], I think we ought to move toward getting reserves. The immediate prospect may well be that we would be accumulating reserves. That's what we are talking about because the dollar is strong. If the dollar were weak, there would be little point in talking about accumulation. But here we do have the opportunity and perhaps the desirability of slowing down that movement. That depends on how the domestic economy goes. A very extreme case of a country that doesn't want to intervene is the United Kingdom where they are going to sky-high rates that are killing their export industries, because from a monetary policy point of view they can't afford to intervene.

CHAIRMAN VOLCKER.

MR. WALLICH.

MR. TRUMAN.

CHAIRMAN VOLCKER.

The fact is that they don't intervene. That much [is true].

MR. WALLICH. Well, that's a situation that would not affect us. We certainly can sterilize the liquidity generated by intervention. I think it would be wise to avoid the situation that the British are in--a country with a high inflation rate being driven to very high exchange rates and then for the accumulated two reasons, losing competitiveness in exports. We can't, of course, control the rate. There is no question of that. But we can moderate the movement and moderate the extremes.

A further point we have not noted is that we've gone to a monetary control system that produces wide interest rate fluctuations. That means it produces wide exchange rate fluctuations. It would be desirable to have the means of compensating for that in some degree if we are going to inflict this interest rate and exchange rate instability on ourselves and the rest of the world, which I think we have to. Intervention is a natural way of [reducing] the consequences marginally, obviously not totally. Now, we might have losses on a portfolio of accumulated balances. That is always a fear. If we buy as the dollar appreciates, that danger is less. We are buying foreign currency cheap. It may turn out not to have been cheap. So one must not ignore that risk. But I'd like to remind you that we have a risk on the domestic portfolio, too. A few years ago I believe we computed that the then-loss on the portfolio was on the order of \$2 billion. I wonder what it is now; presumably it's no less than that. So we have lived with that situation without a great concern and I think the loss on the foreign exchange portfolio would be a great deal more moderate, given the kind of balances we are talking about.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I just wanted to say that I agree with John Balles about the effect, but I get there in a different way. I think intervention does add to the demand for money domestically because for any given level of economic activity when we intervene to keep the rate from going up, we add to the domestic rate of inflation. Therefore, there's more nominal GNP relative to real GNP than would otherwise be the case. We either have a larger demand for money or higher interest rates, one of the two. The result of an intervention on the up side is either to raise interest rates or inflation, or both, in the United States. And I think we ought to realize that that's one of the costs. Surprisingly enough, I agree with Tony and Henry to a degree, mercantilistic as their arguments are. I'm also a mercantilist and I wouldn't like to see our manufacturers excluded from world markets the way Britain's are being excluded when the pound gets to five dollars. When [the dollar] gets to a really high level, we certainly ought to do something about it. I also agree that we probably need a small amount of [foreign currency reserves]. We can't sell our gold holdings very readily; that's a very good point. So, although we have \$150 billion in [gold] reserves, it's not available

to us because we can't readily sell the gold because of public opinion and so forth. I do not like the idea of accumulating all these marks, as I think you must know. Number one, I don't know what the right exchange rate is. There's always the presumption that our exchange rate somehow has gotten very high. We have a staff forecast in the Greenbook this time that says the exchange rate will rise over the next two years. That doesn't suggest that the rate is all that high when our own professional staff expects a substantial appreciation over the next two years. More than that, though, I'm very concerned about a lack of diversification. We've put all [our foreign currency reserves] in marks. What if something terrible happens to Germany? We have this big stake. So it seems to me that if we were to accumulate--

CHAIRMAN VOLCKER. We don't have any big stake at the moment.

MR. PARTEE. Well, you are talking about \$4 billion. That means--

CHAIRMAN VOLCKER. Well, your comments are relevant looking toward the future.

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. But we don't have a net position.

MR. PARTEE. Yes. I have always felt comfortable because we were covered by a Treasury exposure. Now I find there's no Treasury exposure and we are no longer covered. But my point is--

CHAIRMAN VOLCKER. No, wait a minute. The Treasury isn't covered. The United States is even. There is no extension there.

MR. PARTEE. Well, I didn't really want to comment on that [unintelligible]. I don't think it's proper to have that drawing there, which I didn't realize we couldn't pay back.

CHAIRMAN VOLCKER. One can argue about the drawing, but I--

MR. PARTEE. My point is simply that I wouldn't like to see us get a big stake. If we want to accumulate something that we can buy and sell in foreign exchange markets without the difficulty of dealing in gold, why in the world don't we buy SDRs, not marks?

VICE CHAIRMAN SOLOMON. Then we'd have to sell the SDRs to a government; we'd need to find one that would be willing to buy them.

MR. PARTEE. Aren't they always sellable?

VICE CHAIRMAN SOLOMON. We'd have to sell them to a government in order to get the currencies to intervene in the foreign exchange markets. We can't intervene with SDRs.

MR. PARTEE. I would have thought they would be rather quickly exchangeable.

VICE CHAIRMAN SOLOMON. Oh, no. I had to negotiate pretty hard to get them to agree to the quantities of SDRs they would buy.

Another disadvantage is that we have marks and yen, and if we had the SDRs, a good part of that would then have to be cashed into sterling and French francs, which we normally would not want to intervene in. Eventually, if the evolution of the international monetary system is such over the years that the SDR becomes more and more usable, then the time may come when that's a very practical suggestion. I think it's a rather attractive one in the long run to hold our foreign exchange reserves in SDRs. But there are very practical constraints in the short run. We wouldn't want to be at the mercy of other governments, particularly since they have a limited interest; they're not required in the Fund articles to buy whatever SDRs are offered them, whether we offer them directly or through the Fund. They only are required to have a certain minimum holding and both Germany and Japan are past that limit.

MR. PARTEE. Well, I guess there is no source of generalized purchasing power, then?

MR. TRUMAN. Well, there are two dimensions of the SDR. Thinking of SDR in terms of diversification, one could invest, rather than just in DM, in SDR deposits denominated in marks. That is the diversified investment. We could run those up and run those down, and the effect would be a form of multicurrency intervention. We could buy DM or we could go to the market and convert those DM into a SDR denominated deposit and we would then cover some of our exchange risks. We may worry about the investment side of things after--

MR. PARTEE. You are talking about a market that doesn't exist now.

MR. TRUMAN. True.

MR. PARTEE. Well, since I don't know much about SDRs, I would just make a few comments. One, there is a cost. The cost is more inflation in the United States, which we are committed to resisting, I thought. And we don't know how far these exchange rates are going to drift and how much they reflect differences in competitive shifts, structural shifts in these economies. Number two, I don't like to see a concentration of risk because I have confidence in no country. Perhaps, that's--

MR. MORRIS. Confidence in [none], Chuck?

MR. PARTEE. Absolutely none.

CHAIRMAN VOLCKER. Including your own?

MR. PARTEE. Well, we owe it to ourselves--

CHAIRMAN VOLCKER. I'll strike that.

MR. WALLICH. We can diversify our own portfolio if we want to even in proportion to the SDR, although that's 40 percent dollar now so we have to focus on the non-dollar part of the SDR. But the SDR does contain currencies we are not likely to want to intervene in. So I would say we ought to diversify a portfolio in terms of yen, marks, and Swiss francs, which are the principal currencies we have intervened in, and we probably ought to broaden our scope of

intervention to the smaller currencies to the extent that those markets can take it. And we would get some of the protection that you have in mind, Chuck.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, I would certainly like to support Tony's position and Henry's. One thing we haven't talked about very much and it wasn't discussed much in the memorandum is the fact that the foreign exchange markets are heavily influenced, as are all markets, by the psychology of the traders. And it seems to me that a large DM position owned by the Federal Reserve would be a very stabilizing force for the psychology of the markets. The only reference I recall in the memorandum is one I disagree with. It says that if the United States were to hold a substantial portion of its international reserves in the form of foreign currencies, this might encourage some smaller foreign central banks to shift the composition of their portfolio out of dollars. It seems to me the effect ought to be exactly the opposite. If I were a central banker for a banana republic and I saw the United States building up a big holding of Deutschmark deposits, that would lead me to be less likely to diversify out of dollars.

CHAIRMAN VOLCKER. You've [unintelligible] yourself.

MR. TRUMAN. That was written in the old memo that was attached [to the current one]. That was in the period right after the Carter notes issue. There were stories in the market that the United States was building up foreign currency reserves and that was being seen as a signal at that time of weakness in the general movement to a multi-currency reserve system.

MR. PARTEE. Even we were diversifying.

MR. TRUMAN. Yes, even we were diversifying. We were getting that from the market. That was a reflection of that.

MR. MORRIS. You should have had a footnote that you no longer believe that.

MR. TRUMAN. Well, we've gone down that road and that [view] probably was going on. But it doesn't deny, once you go down that road, that the argument that building a war chest might add to [unintelligible] isn't valid. But the signal we were giving in that period is, I think, itself probably--

CHAIRMAN VOLCKER. Do you have any comments on these observations, Mr. Pardee?

MR. PARDEE. Well, I'm amazed that the discussion came close for the first time since I've known anything about the FOMC to a suggestion by somebody that we should buy sterling on an uncovered basis, given all the support we have given to the pound sterling over the years when it was weak. I'm very much in favor of building up balances, of course, from my own bias as Manager in needing resources when we go into the exchange market. I want to have enough in hand so that I can have an effect on market psychology and on the market. I

think that's the important element: How credible the Desk is at the moment when it appears in the exchange market.

As for the comments about the possibility of pegging, I'd like to reassure everyone, having gone through personally the periods of fixed rates and the unwinding of fixed rates, that I do not want to go back to pegging. I've avoided over recent years any drift in that direction and will continue to avoid a drifting in that direction. This year we have gone through a Deutschemark rate of 1.70 to 2.03. That's 30 points, over 15 percent. It's hard to say that that involves a pegging of the exchange rate even though we have [made] purchases and sales all the way through. So I would like to reassure you on that issue. But keep bugging me because then I can bug others who are likely to drift in the direction of pegging once again.

I like Tony's argument that starting with balances gives us more flexibility, and then we can get into debt. We have lost money on our swap drawings in recent years largely because the first drawing on the swap line was at a very expensive rate and very early in the sequence of operations. And that drawing cost us money when we repaid it. So if we start with balances, on which we might quite frequently be making profits, then we can protect ourselves a little better. The flexibility that that gives us is important. One other argument that has not been raised comes out of the experience we had with the Iranian freeze. There are a lot of countries out there now that are substantial dollar holders who are not our friends, and they may use the weapon of a threat of large dollar sales in the exchange market. When that threat was posed to us last year,

It's not that we necessarily need a war chest or big amounts of money in hand, but certainly having more than we have had [is desirable]. And to the extent that these dollar balances abroad continue to grow, we should think in terms of having larger amounts in hand to deal with these national interest threats on top of the nitty-gritty types of things we have in the exchange markets on a day-to-day basis.

MR. WINN. Scott's comments are what scares me in the sense of the profit and loss being confused with the intervention issues. It seems to me that's the danger of large balances--that one starts to use them in the profit sense of the term rather than stabilization. I'd like to hear the pros and cons of establishing swap agreements when we're not under pressure as a way of doing this intervention versus the holding of large reserves.

CHAIRMAN VOLCKER. I don't know what you mean.

MR. WINN. Well, we protect ourselves with swap agreements so we can get funds if we need them rather than--

CHAIRMAN VOLCKER. We have the swap agreements now. The question that is being raised is whether to rely entirely on them when we're going to be on the selling side of the market. When selling foreign currency, do we want to go immediately into debt, which is the implication of relying entirely on a swap?

MR. WINN. That's right.

CHAIRMAN VOLCKER. Well, it just comes back to the points that Tony was raising. I think the most important point is that [without foreign currency reserves] we do lose flexibility. No question. We've had a lot of arguments with the Germans over the years when we were dependent upon them and they were telling us how much of the swap we could use.

VICE CHAIRMAN SOLOMON. The profit-loss factor, which I mentioned and Scott mentioned, is only an incidental one in the sense that--

CHAIRMAN VOLCKER. I'm not even sure it's true.

VICE CHAIRMAN SOLOMON. There's a view on the Hill, that if the intervention is accurate and reflects the fundamental factors, then we won't end up losing too much money; we'd probably make money. It's a political fact of life to try, and it's attractive as well not to be in a loss position where that's possible. But that doesn't influence or dictate in any way when we intervene or the scale of the intervention.

CHAIRMAN VOLCKER. In an area where one purpose blends into another at times, I think we ought to be as clear as we can be on what we have been doing. In particular, I think those three sentences [describing the purposes of intervention] at the top of page 2 are a good characterization. For a long time, we have presumably followed number 1, which might be quite episodic. I think irregularly on both the up and the down side, we have paid some attention to number 2. So far as number 3 is concerned, the only clear incident of that was on the down side in November '78. And one could raise the question whether it isn't appropriate now in the [other] direction, but nobody has argued that case. I almost would be inclined to argue it at times, but I don't think intervention is all that powerful in affecting some of these things in most instances. I'm not raising that issue, but I just want to be clear that [late 1978] is the only time I think it has been raised and has been followed as a matter of national policy. I don't think that was at all inappropriate. But I don't think there has been any question of pegging all during this period. I don't think that's at issue on anything we are talking about at the moment. Obviously, we don't have to set down a policy that is good for all time, and it's very hard to do so in this area because conditions change.

Specifically, we are in a situation where the Treasury, unless we want to change our minds, has access to something like \$2 billion through the warehousing facility. We are pretty close to the top of the so-called informal limit that we set for ourselves on marks. I think the diversification point that a number of people have wondered about is a reasonable one, but the market is basically a mark market. And we're stuck with it to a degree, although it's worth thinking about that a bit. I would guess, but I could easily be wrong, that we are nearer to the top of any dollar rate than the bottom of any dollar rate. I could be wrong--if the Russians march into Poland and our interest rates take another sizable increase or whatever. But I'm not sure how much more room we are going to need. I just did some arithmetic and, if I exclude the Fund drawing--if I don't calculate that the way the Treasury did--we are just over \$1 billion long in marks.

SPEAKER(?). That can disappear in 3 days.

CHAIRMAN VOLCKER. That's right; that's not terribly much. I would think if you're persuaded by the general arguments presented and [agree with] what is clearly the Treasury policy at this point, it probably would be wise to increase this limit, let's say, by a billion dollars. What's the limit we have in the other currencies now? There is a limit on yen, isn't there? Is it \$500 million?

MR. PARDEE. Yen has a \$1 billion limit and we've only used some \$400 million of that. And then there is a \$500 million general limit [on all other currencies] of which we've used about \$300 million. That's mainly in Swiss francs.

MR. TRUMAN. Mr. Chairman, if you want a suggestion, it is a little hard on the Desk to have all these individual currency limits. One approach might be to do away with them and add things up a little differently. You could add \$1 billion or whatever you wanted and deal with an overall limit as to what the understandings are about and what's available in diversification. That might simplify the accounting in New York. I don't know whether that's right or wrong.

MR. PARDEE. On these matters, I'm just as happy having the individual [currency] limits.

CHAIRMAN VOLCKER. I don't think it hurts right at the moment to have the individual limits. Now, as I understand it anyway, nobody is talking about buying currencies for the sake of building a war chest. It is all a by-product of what we're doing for other purposes; and it does govern the flexibility we have for intervening for other purposes. We don't have much room for buying any more marks for our own account, if we don't raise that limit.

MR. WALLICH. I do think that the diversification argument is very important, and we ought perhaps to build that in from the start so that we not only have limits on [individual] currencies but an [instruction to] the manager. I don't think one can be rigid about it because it might make one buy currencies that one doesn't want.

CHAIRMAN VOLCKER. Yes, we can't buy yen now unless we really adopt a different policy that says we want to build up a war chest in yen. That would involve just going into the market for the sake of buying yen. I don't think we want to raise that issue today. That is not to say that if the yen turned weak, we couldn't buy some. But I don't think we want to buy it when it's strong.

MR. WALLICH. There is an issue in terms of the [overall] magnitude of balances; we should remember that we have a limit on the overall open position--that is our total risk exposure--of \$8 billion. So at one time we must have contemplated being in debt [to that extent].

CHAIRMAN VOLCKER. We did and we were, I think.

MR. WALLICH. So I think one has to see the limits we have put on the [individual] balances in the light of that limit we have already set for overall risks.

MS. TEETERS. Are you suggesting that we raise that limit too, Henry?

MR. WALLICH. No, I'm just saying once we have decided that we can afford to be in debt up to \$8 billion, we shouldn't be too worried--if we say we can take the risk of \$8 billion--about having \$4 billion.

MR. TRUMAN. \$8 billion.

MR. WALLICH. No, I mean we are talking about \$4 billion in balances now.

MR. PARTEE. You don't want to make it \$8 billion?

CHAIRMAN VOLCKER. I don't want to make it \$8 billion, but I want to remind you that \$4 billion is smaller than \$8 billion. Somebody should be looking at the foreign currency directive and the other [foreign currency instruments] anyway before the March meeting, and I think that might be an appropriate time to look at any of these limits. I accept the other arguments. I'm just saying as a practical matter that we ought to give ourselves enough leeway to operate on a continuing basis now; looking forward, so far as I'm concerned, if the conditions were right, we could raise those limits if it became necessary. But I don't think we have to raise them so dramatically now that they would probably be bigger than what's necessary, or in some sense desirable. I would propose for the moment that we raise the mark limit by \$1 billion; we can raise it further if you want to, but I'd be satisfied with that. I think we have enough leeway in the other [limits] should conditions change. Against the background that these general considerations are persuasive, and recognizing that [the current limits] are low in terms of the numbers that some people have suggested, we can have an understanding that if it's desirable, we'd look at it again either in terms of the warehousing or the System's [overall] limit itself. But I suspect that just raising the [mark] limit by \$1 billion is probably enough to take care of this for a foreseeable time period.

MR. ROOS. By doing this, though, we're not signaling any encouragement for more intervention than we are [doing]?

CHAIRMAN VOLCKER. No, definitely not. No, this implies no change in policy in the exchange markets at all as I see it. Now, it may involve some modification of policy in another sense in that we may end up holding more balances than we have ever held before. But it doesn't imply any operational change in terms of what has been happening in the exchange market. It implies that we're willing to give the Desk enough leeway to continue the kind of [operations] they have been doing, that's all.

MR. GRAMLEY. Mr. Chairman, if we raise the limit on D-marks by \$1 billion, if we decide to [acquire] that whole amount, we have to raise the limit on total balances, excluding yen, do we not?

MR. TRUMAN. Yes, I would assume so. You would raise the total from \$2 billion to \$3 billion and then the DM limit would be going from \$1-1/2 billion to \$2-1/2 billion.

CHAIRMAN VOLCKER. I don't know what "the total" is. Which limit is that? I thought the overall [limit] was \$8 billion.

MR. GRAMLEY. The [informal limit relating to the] overall total currently is \$2 billion excluding yen.

MR. WALLICH. [It's \$1-1/2 billion] for D-marks and \$500 million for other [currencies].

CHAIRMAN VOLCKER. By putting on these special limits, we have caused ourselves a bit of a problem in that sense. Obviously, if we raise the mark [limit], just to conform we have to raise the overall limit we now have, which seems to be expressed excluding yen. That is \$2 billion, which implies we have \$500 million for other [currencies] of which we only have what--about \$200 or \$230 million or something?

MR. PARDEE. \$233 million.

MS. TEETERS. May I ask if I'm correct that if we raise this, then we have an extra \$1 billion for ourselves for marks and there is still \$2 billion of leeway on the warehousing? So does that give a total of \$3 billion of leeway at this point?

CHAIRMAN VOLCKER. Right. That is correct.

MR. TRUMAN. For the United States.

MR. RICE. Is there any reason for stating this excluding the yen?

CHAIRMAN VOLCKER. I doubt it at this point.

MR. TRUMAN. The reason for the yen being separate, as was explained in the paper, was that the last time around on this, in 1979, we were contemplating buying a lot of yen to help the Japanese. It turned out that we didn't do that. But [the yen limit] was set up outside [the total informal limit] at that time.

CHAIRMAN VOLCKER. I don't think there's any particular purpose in stating it that way now, but we better be careful about what we're doing. If we change it, what would you [recommend]? We could change the overall limit to \$3.5 billion including yen, I guess. Right? Is that the arithmetic implication?

MR. TRUMAN. We could do that, but then the limit is pretty tight on yen if you ever want to buy any more because you have this, in effect, limit of \$500 million [on other currencies].

MR. PARDEE. Nobody [has said] let's sell them! I'm not sure I want them any more.

MS. TEETERS. Mr. Chairman, I'm not opposed to accumulating balances, and these seem like like reasonable increases in the amounts. I would say, though, that I am disturbed about the fact that in this most recent episode with the mark and the dollar we've done all the intervention. Granted, we needed the marks to pay off our Carter bonds and all the rest, but the Germans have done literally

nothing as far as I can figure out. And that bothers me in terms of how effective our policy is.

VICE CHAIRMAN SOLOMON. Well, I spoke with the other day to get his feeling of the situation. I'm just passing this along. Their view is that

CHAIRMAN VOLCKER. Including the repayment of swap drawings.

VICE CHAIRMAN SOLOMON. And in that they include the repayment of the swap drawing by us; that's the way it shows up on their books. They're afraid that if they draw too heavily on their reserves, they will increase the pressure on the D-mark. Secondly, through the Ministry of Finance [they are] selling D-mark denominated assets to the OPEC countries. They also feel that this is a temporary situation--that there will be a turnaround because they keep pointing to their inflation rate of 5 percent, compared to ours. They appreciate a modest amount of intervention by us, and they feel that what we are doing now is modest. They are not asking us to do a large amount of intervention. We really have made this decision in terms of our own interest, although checking with them to make sure there is no objection. [It's the same] when the situation is reversed; we expect cooperation from them. But if the Germans wanted massive intervention and we were opposed to that, it's understood that we wouldn't do it. If the Germans wanted no intervention, obviously I think we would respect their wishes unless we ourselves had a view that we were losing competitiveness to such an extent that we insisted [on intervening] to protect our own interests. But that's their view on the amount of intervention. They feel that the [intervention] also has more effect on their domestic money supply. We don't seem to have those [effects] for reasons that we can go into detail some other day. But more effects on their domestic money supply arise when they do the intervention. So, that is their view.

CHAIRMAN VOLCKER. Well, I think the consideration raised is a relevant one. I feel less eager--I've never felt eager about intervening anyway--but there was the excuse of repaying the debt, which the Treasury felt very strongly about, complementing the other reasons. That reason is gone. And if the Germans don't want to intervene, that affects the eagerness with which I want to intervene as well. So that has an influence on the [issue]. Consistent with our past practice, do any of these limits have to be written down and voted on, Mr. Altmann?

MR. ALTMANN(?). I don't think so.

CHAIRMAN VOLCKER. I think we ought to have a subcommittee, whichever the appropriate one is, look at this directive. Among other things, they can straighten out these [limit issues]. The simplest thing to do is to leave everything the way it is at the moment so we don't find out that we are doing something we don't intend. But we do have to [raise the limit on] the total as well as the mark, I think, to be consistent here. So, we would have to raise the [informal] overall limit ex yen to \$3 billion and the mark limit to \$2.5 billion. That leaves [the framework] exactly the way we have it with the implication of another \$1 billion in marks, which I think is what we intend at the moment as a kind of holding action here until we

straighten all this out. If that's agreeable, and I don't hear any opposition to it, we will just assume that. I also judge just as a matter of guidance that should something happen--I would guess that this amount is adequate, but it's a very uncertain world--we would have to discuss it if we want to go above this amount; but I don't hear strong [views] that that's an impossibility. Given the circumstances, [that issue] might arise.

MR. GUFFEY. Mr. Chairman, I'd like to ask a question. What is the limit or what constraints are there on our warehousing for the Treasury? Is that based upon the Exchange Stabilization Fund availability?

MR. TRUMAN. No.

CHAIRMAN VOLCKER. Well, I think we ought to be clear on this. I want to make it as much as possible dependent upon a constraint of the Exchange Stabilization Fund because it could be construed as a form of Treasury borrowing from the Federal Reserve which isn't covered by the other prohibitions on their borrowing. We need the justification that it is the Exchange Stabilization Fund's lack of assets, not a general lack of funds on the part of the Treasury, that gives rise to this.

MR. TRUMAN. The \$5 billion rough order of magnitude originally came from the amount of Carter notes that they have outstanding. In fact, [the Treasury] wanted more than that. The notion was that as they reconstituted those DM, which they can't absorb into the ESF, they would warehouse them. So that's how we got to the \$5 billion that exists now. Other kinds of claims, as the Chairman said, happened in the past--like claims on the ESF where they might want to help out a country or something like that through their own lending. They might not--

CHAIRMAN VOLCKER. I had not recalled that this had been explained to the Congress, but you [say it has].

MR. TRUMAN. Well, it's all in the public--

CHAIRMAN VOLCKER. It's in the public record, I take it.

MR. TRUMAN. It is in the public record in those terms, relating to warehousing on the one hand to help out the ESF in general when it gets into emergency situations. And the \$5 billion limit is related loosely to that but explicitly to the Treasury's obligations.

CHAIRMAN VOLCKER. The Treasury is aware that we want a justification in terms of the ESF capacity to hold [these funds], not just that they find it convenient to park them with us.

MR. GUFFEY. Well, is there any leeway at the moment?

MR. TRUMAN. There's \$2 billion left.

MR. GUFFEY. \$2 billion left?

MR. TRUMAN. They do hold quite a lot of DM for their own account, obviously. They have, for whatever [reason], balances of \$8.8 billion of which--

CHAIRMAN VOLCKER. They have given us a rationale as to why they have to warehouse this in terms of the capacity of the ESF. I think we have to insist on some reasonable rationale for that. Okay, with that understanding, we will proceed and Mr. Kichline will talk about the economic scene.

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

MR. ROOS. May I ask a question, Mr. Chairman? I noticed, Jim, that you're now basing your Greenbook projections on assumed M-1A growth. I'm a little curious in view of the fact that M-1A is probably the most volatile and least predictable aggregate in the short run. Why do you use it as a predictive device?

MR. KICHLINE. Well, I assume that when I answer, you're going to say "Why not use M-1B?" So, why don't I wrap the two together. In our view, they're both better than the other aggregates in the sense that we want something closely related to transactions demands. I think one could make a very strong case that over time the preferable aggregate to look at is M-1B. In our forecast, even though we have assumed M-1A, the Bluebook specifies the M-1B numbers that go with it. So, in effect, we have a consistent forecast. If you prefer looking at M-1B, it's the equivalent growth rate for M-1B that's in the Bluebook.

MR. ROOS. In other words, there is no significance to the shift?

MR. KICHLINE. No, it's of no significance in terms of influencing the forecast because the equivalent M-1B is specified in the Bluebook.

CHAIRMAN VOLCKER. We have a bit of a timing problem as well as a great big substantive problem. We're going to have to terminate the meeting at 5:30 p.m. or shortly before. I don't know how far we will be able to go on this whole matter of next year's targets at this time and I'm not sure it's desirable to go too far. As a technical matter, can somebody inform me if these targets we present for next year are supposed to be consistent with the plans of the old Administration, not the new Administration, as I assume? Is that correct as a technical matter when we write the Humphrey-Hawkins report?

SPEAKER(?). I think that's probably right.

MR. PARTEE. It's related to the President's Economic Report isn't it? And that would be the old Administration.

SPEAKER(?). I think it will become irrelevant before we've started.

CHAIRMAN VOLCKER. That may be the technical requirement, but it has a certain air of unreality about it. The reality is that one would like to know something a little more definitively about the

plans of the new Administration before we make up our minds on this in a final way. It may not be useful to talk in anything other than quite general terms. The very general question it seems to me is what kind of strategy anybody has to achieve satisfactory economic conditions consistent with a decline in the inflation rate and how that balance is reached under unknown factors, budgetary and otherwise. Views of the economic outlook get mixed in that, but I think it may be desirable to discuss the economic situation in that very broad policy context as well, which leaves me in a slight dilemma as to what to do yet this afternoon. If I let Mr. Axilrod talk, he's going to say that [his comments] will result in using up the time, I presume. Maybe that's just as well.

MR. AXILROD. Now may be the best time [for my comments]. I think that would just about do it.

MR. ROOS. Paul, if we do choose to postpone until some future time our discussion of the longer-range strategy--

CHAIRMAN VOLCKER. No, I'm not suggesting that. I'm just saying that I don't think we can be very definitive about it. On this schedule we would open the meeting tomorrow morning with that discussion.

MR. ROOS. Well, I was just going to ask: After the study of operating procedures is completed, is the plan to give the FOMC a little more time than usual to chew over it because it seems to me--

CHAIRMAN VOLCKER. When are you expecting to have something for us on that, Mr. Axilrod?

MR. AXILROD. At the February meeting. We were assuming that there would be an extra day at the February meeting.

CHAIRMAN VOLCKER. Does that mean that it's all going to be sprung on us that day or are you going to distribute something in advance or what?

MR. AXILROD. Well, if God's willing, we will distribute something a week or two in advance. That is our plan, but this is a very large--

CHAIRMAN VOLCKER. Well, we also face some uncertainties. We are very close to the point, which is relevant even to our short-term decision, where these numbers are going to go all over the lot presumably. It's conceivable that we may need another meeting here in January. I don't know that we have to decide that, but it may be a good idea to keep that in mind for a variety of reasons.

MS. TEETERS. Have you thought of the possibility of requesting a delay in the Humphrey-Hawkins Report pending new Administration policy?

MR. ROOS. I think that might be seen as a sign of weakness.

CHAIRMAN VOLCKER. I haven't thought of it. Let me say that I hope it's not necessary. You still have time, Mr. Axilrod, so why don't you proceed and then we will start with a mixed discussion of

what the general tenor of policy might be in the light of comments on the economic and inflationary situations.

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

CHAIRMAN VOLCKER. I will be looking forward to all your comments tomorrow.

MR. SCHULTZ. Our course is clear, you know.

MR. PARTEE. It's crystal clear.

[Meeting recessed]

December 19, 1980--Morning Session

CHAIRMAN VOLCKER. We had an introduction to our problems yesterday. I'd like to go around and get comments. It would be useful if people commented on their proposals in relation to how they see the business scene and what they think they are accomplishing-- what the implications of their proposals are in that respect. We obviously don't have to settle, and I don't intend to settle, what the targets should be next year. They inevitably will be influenced by the larger setting in which we find ourselves with respect to fiscal policy and other matters, which is somewhat uncertain at this time, as well as what approaches are going to be taken in other directions psychologically and really. But it might be interesting to see how people reconcile our various concerns at the moment not only against the background of the real economy, but the rather enormous technical problems we will have in knowing what the M1 numbers will mean, in any event, for some indefinite period of time. Mr. Morris.

MR. MORRIS. I have been giving a lot of thought to this after reading that horrendous Bluebook, and it seems to me that the guidelines for next year ought to meet three criteria. First, I think we have to keep it simple. And having failed [unintelligible], that means immediately that we should not have guidelines for M2 because I don't think there's any way in the world that we can explain to a simple-minded monetarist press a 2-1/2 percentage point increase [from the tentative range] in the guideline for 1981.

CHAIRMAN VOLCKER. Let me just interject. I don't know how the staff arrived at that conclusion. I have not seen the analysis, and I'd want to look at it fairly closely; I think we all would.

MR. MORRIS. Well, I think it's because there is a large cyclical component in M2 because of its interest-rate sensitivity. And that does not make it very suitable for [use as] a long-term guideline. Would you agree with me on that, Steve?

CHAIRMAN VOLCKER. There's a cyclical element in M1, as we saw this year.

MR. AXILROD. I'm not so certain, President Morris, although of course I would tend to prefer a narrower M to a broader M because of [the former's] closer relation to income over time. But if I might just take a minute on your question, Mr. Chairman, we came to the conclusion in two ways that intersect. One relates to the public's demand for assets based in part on this year's experience and how we think the public would respond, given our projection of interest rates next year. And secondly, going through the credit picture we asked: Would the credit demands expected to come out of that nominal GNP and this conservative allowance for growth of thrifts and banks satisfy them? They need [how] much in deposits in order to meet these kinds of demands? It was the intersection of those two strands of analysis [that led to our conclusion].

MR. MORRIS. But isn't it true that in the first year of a business expansion M2 typically grows much faster relative to M1 than in boom periods?

MR. AXILROD. Yes, but that was in a period, President Morris, when interest rates were generally low and deposits were subject to ceiling rates. We have a very different situation now, with most of the movement in M2 and M3 occurring through these money market accounts and saving certificates that are at market rates. So there's more of an institutional volition in them than there used to be.

CHAIRMAN VOLCKER. Well, let me say that this is going to bear more analysis.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. When we are going through it, I don't think we are aware of it.

MR. MORRIS. Well, that is my first principle anyway, Mr. Chairman: Keep it simple.

MR. PARTEE. Because M-1A and M-1B are not good, we are going to throw out M2?

MR. MORRIS. Well, I'll explain. The second criterion is that the '81 guidelines have to be lower than the '80 guidelines, if only marginally.

VICE CHAIRMAN SOLOMON. Lower than the guidelines or the performance?

MR. MORRIS. Lower than the guidelines. And third, we have to have something that we have a reasonable shot at hitting.

SPEAKER(?). That's true.

MS. TEETERS. You've just wiped out two--

SPEAKER(?). That wipes out the whole thing!

MR. MORRIS. Those are my three simple criteria. This leads me to the conclusion that we can only do two things: One, have targets only for the M1 measures; or alternatively, go to a bank reserves target. And with respect to the M1 measures, I think the targets should be exclusive of the impact of NOW accounts and we should explain the divergence later rather than try to put an estimate in the targets initially. We've learned from the 1980 experience to date that we don't have a very good basis for estimating and I think we'd be in a stronger position to explain it later. And particularly because one of the M1s is going to be lower and one is going to be higher, it seems to me that the explanation might be easier to make than otherwise.

Now, I'd like to emphasize a point in reference to the New England NOW account experience. [Our Bank is] about to publish an article, which is very relevant to this discussion, that shows the initial impact of the NOW account in New England by states. The story is, as you wouldn't be surprised to hear, that the rate of penetration in NOW accounts is a function of the number of institutions that decide to offer NOW accounts and the terms upon which they are

offered. In the case of Connecticut and Vermont for example, they both got NOW account powers at the same time. At the end of the first year, there were about 8 NOW accounts per 100 households in Connecticut and only 4 in Vermont. So the penetration rate in Connecticut was twice the rate of Vermont. In Connecticut, 62 percent of the institutions were offering NOW accounts, but in Vermont only 27 percent. In Connecticut, 27 percent of the institutions were offering free NOW accounts, and in Vermont no institution was offering a free NOW account. So here we have a case of two states in New England whose NOW account experience in the first year was very different depending on the way in which the institutions decided to go about offering NOW accounts. That is why I don't think the New England experience gives us any basis for estimating how rapidly NOW accounts are going to grow nationally; the differences within New England were enormous. And that's why I think we ought to use the M1s as targets, exclusive of the NOW account effect.

CHAIRMAN VOLCKER. Part of the trouble is that we can cite that as a target but it's an abstract notion; and we will not know, even when we get the data, what the adjustment should be.

MR. MORRIS. Yes, but that gives us an element of strength, Mr. Chairman, because nobody else knows it either.

CHAIRMAN VOLCKER. That's right, but one can argue quite realistically that we haven't got much of a target because nobody knows what it is, including us. Now that may be an advantage, but I don't think we ought to give--

MR. MORRIS. Alternatively, it seems to me the only thing we can do is to go to a reserve growth target.

CHAIRMAN VOLCKER. Well, I don't think that helps either, if I may say so. [I don't know] how long this [conversion to NOWs] is going to take, but the reserve growth is just an image of the Ms. And to the extent the Ms are distorted, the reserves are distorted. I don't think we can escape the problem. We can make it different visually.

MR. PARTEE. But it does blend M-1A and M-1B.

CHAIRMAN VOLCKER. But it blends them in some proportion of their actual change, which is subject to all the [uncertainty].

MR. PARTEE. That's right.

MR. MORRIS. I'm not saying these are perfect; I'm saying that they are the least bad of the alternatives.

CHAIRMAN VOLCKER. I understand that, but let me just take a minute. We have a lot of people to talk yet. What do you see going on in the economy? What are you trying to accomplish, particularly when you say these targets should be tighter? What do you visualize? [The staff says] we're going to have an expansion. Do you want an economic expansion? Are we going to affect inflation? What are we going to do?

MR. MORRIS. I think we're headed for a flat year. In the first quarter, we are going to have a mini-recession and the money supply is not going to grow at all. Did you want to get into what we are to do in the [short run]?

CHAIRMAN VOLCKER. No, but I obviously have to decide to wind this up somehow.

MR. MORRIS. It's hard to answer that question without getting into the policy for the next four weeks.

CHAIRMAN VOLCKER. Things overlap, obviously, but looking at the year as a whole, give us some indication of what you conceive of as the appropriate strategy of the Federal Reserve and what that means. Let me put it specifically. If you accept the analysis of a very tight money supply figure or if you make a proposal of a money supply figure, I would be interested in knowing whether you are willing to accept the consequences or see as a consequence of that extremely high interest rates, perhaps higher than we have now. Do you not mind if we have a recession, all things considered, if that's the price we have to pay? Is that what you're talking about or not?

MR. MORRIS. I think the implication of even a modest revision in the Ms, say 1/2 of 1 percent, would be that we would have to be willing to accept a year of no growth or very little growth in real terms.

MR. RICE. Is this a downward revision from the targets we chose in July or is it a downward revision from the actual money growth we experienced?

MR. MORRIS. I would say that we have to establish the '81 targets on the basis of the '80 ranges and not on the basis of where we happened to end up at year-end.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think the behavior of the economy in '81 is going to be determined more than anything else by what happens to inflationary expectations. If we can somehow or other convince the public that we are dealing effectively with inflation, or trying to, I think expectations are going to improve and we may have even more [growth] than the staff is projecting, although I certainly agree that we're likely to have a dip in the first part of the year as the staff is projecting. But I think we'll have more real growth, and I hope less inflation, in the last half. This point is made very well in paragraph 9 of the Bluebook. And I would like to emphasize that, because to me the key factors in determining the outlook are the people's inflationary expectations and how the public views the stance of Federal Reserve policy. Because I feel so strongly about that, I'm concerned about the possibility of base drift, although we thought we had eliminated it when we went to the Humphrey-Hawkins Act and got away from the quarterly shifting of targets. I am concerned that that could be a factor.

As I know all of you noticed as you went through the Bluebook, most of it is written as if we would use as our jumping off place the actual behavior of the aggregates--where they actually ended

up at year-end. And like Frank Morris, I would make a pitch that we should avoid doing that at this time. My reason, if we use strategy I, just to take an example, [can be seen] in the charts that I distributed yesterday. I suspect most of you probably don't have them before you now, but I have shown the long-run targets for '80 on the left-hand side of each of those first two charts, in the first case for M-1A and in the second case for M-1B. We have adjusted those ranges for the ATS and NOW accounts as we think they actually affected those [aggregates] during those years. And then there is a second cone on each chart, which uses as the end points the end points that the Board's staff has shown in strategy I. But, of course, the base was the actual behavior of the aggregates, which is quite different from what you would see if you drew the cone to the midpoints. And like Frank, I think we really ought to eliminate this base drift.

So I would suggest that we put the jumping-off place as the midpoint of the targets for 1980, although one could certainly argue that it might be moved up somewhat so long as we had it within that 1980 range. I worry that if we don't do something like that, then our critics are going to confront us with pictures like the one I've drawn here, though maybe in a different form. And I think that could be rather damaging to our credibility. So far as setting the '81 targets, if you look at charts 3 and 4, you'll see what I would like to see us do. I think the most reasonable thing is to reiterate the targets that we selected in July, lowering these effective rates by 1/2 percentage point in both cases. The cones on the right show what we would have in the case of both M-1A and M-1B if we came down 1/2 percentage point.

MR. WALLICH. Excuse me, Bob. I don't understand the concept underlying the midpoint base. That's not really the route on which we'd be going. You'd have the aggregates expanding rather fast from a level at which they are not. So they would not actually, with respect to the future, expand that fast.

MS. TEETERS. But if you look at chart 3, Henry, where the money supply is held flat into next year, we are hitting the midpoint of that range.

MR. BLACK. Yes, I think [I could] address it a little better, Henry, when we get to the short-run part, which I was not going to go into here. But we obviously have to take off from where we are. And what I would suggest for the short run is that we try to move the aggregates back somewhere within those ranges, or whatever ranges we agree on, which as Nancy points out does not involve much growth for the first three quarters of the year. But if you go back and look over a longer period of time, back to August and September, it involves ironing out the excess. Viewed in reference to that longer period of time, that's not a very restrictive policy particularly.

CHAIRMAN VOLCKER. What do you mean it's not a very restrictive policy? If I may pursue that, on your own chart the midpoint of the new range you have--I don't know what that growth rate is, but it looks like 2 percent a year or something--

MR. BLACK. Well, it's even less. It depends on how we come back; it can even be negative, Mr. Chairman. But what I was saying--

CHAIRMAN VOLCKER. Well, given what has happened, all I can say is that we have had no real growth in GNP this year. We've had a money supply increase of 6 percent or thereabouts and we have ended up with 20 percent interest rates. What interest rates are you going to end up with, Mr. Black?

MR. BLACK. Well, I think we're in a downturn right now. And I would guess--

CHAIRMAN VOLCKER. I'm not talking about the next three months; I'm talking about the year as a whole.

MR. BLACK. Well, I think one of the main reasons rates are high is because we have put out what the public perceives as too much money. If we show that we are going to deal with that, I would expect interest rates to come down largely in response to the elimination of part of the expectations effect problem.

CHAIRMAN VOLCKER. You think that's going to affect the federal funds rate?

MR. PARTEE. People won't demand as many federal funds.

MR. BLACK. Yes, I really do. I think that's the main reason rates are high. But that's certainly a debatable point. In any case, I would recommend that we stick with the ranges we decided on before. And I've shown that in the form of cones on the last two charts. That brings down the effective [growth] rate by 1/2 or 1 percentage point. I think it would be unwise to widen the range as Steve suggested-- although I know exactly why he suggested it--because our critics would say we were trying to obfuscate or that we really didn't have any targets in mind. And, of course, we do have targets in mind, but we don't know exactly what the figures are; I realize that. I'm sympathetic with that and also with what Steve perceives as a great deal of difficulty in explaining this NOW account effect to the public or even to those of us in this room. I find myself getting confused every time I go around on it! So when we announce the targets we decide on, [I would] express them in terms of effective rates as the staff is advocating and as Frank advocated. I would differ a little from Frank in that I'd put out a statement at the time saying that it looks to us as if the actual figures for M-1B might run, say, 2 percentage points higher. And if [the adjustments turn out] as expected, then the ranges we are setting for M-1B really ought to be tilted up about 2 percentage points or whatever the incoming evidence suggests. And similarly, in the case of M-1A we would suggest that the rates might come in around 4 percentage points [lower]. If we don't say something like that, the people who are trying to track what we are doing on a week-to-week basis--and I'm talking about professionals here to a large extent--are going to see incoming figures that are affected to whatever extent they will be by the NOW accounts. And if they try to plot those figures in cones or what have you that haven't been adjusted for what these likely [NOW] effects are, then they're going to reach incorrect conclusions about--

MR. MORRIS. Well, that's the advantage of my proposal because one is going to be low and one is going to be high.

MR. BLACK. I understand that. But I'd favor being a little more open than you suggested, although when we are so confused here there's certainly some argument for perhaps not being that open. But I do think the data will be misinterpreted unless we at least make some mention of that, as we've always done. Mr Chairman, when you testified on this, you said that we would have to adjust these data. And I believe we ought to say it even a little more strongly than we have in the past. People are going to be tracking them and the figures are not going to look like our targets--even assuming we get perfect success--unless we have told them something about how the targets have to be adjusted. It's going to be confusing as the devil. I'm under no illusions that it will be simple, but I just don't see any alternative to doing that sort of thing.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Mr. Chairman, I'm going to address my brief remarks to the year 1981 in a broader context than usual. And I'm going to base my analysis on three fundamental factors that seem clear to me. One is that there has been an unusually strong indication that the public as a whole places inflation at the top of its list of priorities requiring attack by the government, by agencies such as ours.

CHAIRMAN VOLCKER. If I may just interject a comment, my perspective may be somewhat different. I am impressed by the number of comments I hear along the lines of: "If this is what dealing with inflation means, I'd rather have inflation."

MR. ROOS. Well, I don't disagree with you. But I brought a letter that I received last week from a builder in our area. The gist of it was: "I'm going down the tubes; I'm going broke. But please, Mr. Roos, express to your colleagues my hope and desire, in spite of my personal anguish, that you stick to your guns because until we resolve the fundamental problems, we are going to have a repetition of this periodically."

The second factor that I recognize is that there is an enormous degree of disillusionment about the ability of the Federal Reserve to act responsibly under these circumstances. I don't base that merely on cocktail party or locker room conversation. When the St. Louis Democrat, which is an ultra-conservative newspaper, and the Post Dispatch, which is a liberal newspaper in our area, both editorialized that perhaps we all ought to be impeached, I think there is a degree of disillusionment with us that hasn't existed for some time.

The third factor that I would inject into my analysis is the fact that, fortunately, we are no longer the only game in town in that the incoming Administration appears to be willing to base its policy on tough measures, if necessary, to deal with inflation. So we won't be the sole recipients of any dissatisfaction that might occur with some rather bitter medicine that may be needed. I think the issue we have to address, as you very clearly set before us Mr. Chairman, is: Are we willing to tolerate--and in fact contribute to--a certain amount of further economic distress in the months and the year ahead if that is necessary to break the back of inflation? And I would say yes. If these are the choices we have, I would opt for gritting our

teeth and being willing to support a monetary policy that might bring even greater pain than presently exists if that is necessary to get over the hump and to restore some long-range tranquility, if possible, to our economy by reducing inflation.

Specifically, I would recommend a policy of gradual reduction in the rate of growth of money based on our announced targets of last year. I'd reduce those targets by maybe 1/2 percentage point this year and say we are going to persist with this for several years to come, enunciating this in simple yet forthright terms. And I'd say that it might cause further trouble but we are willing to do this in order to meet the longer-term objective of reducing inflation. In doing this we should concentrate on a few of the Ms or perhaps a reserve target. We should make it as simple as possible, even though we will have to state the difficulties involved in projecting the effect of NOWs on the aggregates. I'm not as despairing as some of you seem to be about our ability to explain to the public what we are trying to do. I think there has been a tradition in the Federal Reserve, as in other central banks, to play the game in a rather secretive and mysterious manner--to put out little signals here and there, hoping that participants in the financial markets would be able to reach some conclusions through this less-than-forthright statement of what we are trying to do. I think the greater candor we can express, the better we will achieve our purposes. We must do whatever is necessary to improve our ability to achieve our announced targets, and I think that involves a very agonizing reappraisal of our operating procedures and operating techniques. I hope that we will take whatever time is necessary to review how we can improve our ability to achieve the goals we announce because I think our credibility depends upon that. Finally, I believe we should make a greater effort to communicate more effectively with the public--to sharpen up our public information techniques, if you will--because there is a feeling abroad that we don't always address clearly and candidly what we are trying to do. A lot of people who are criticizing us don't understand the issues. I think that can be clarified by making an intelligent and planned effort to communicate, just as any industry or any institution attempts to do from time to time when it's in trouble. All these things are part of achieving an improved future; I think the monkey is very much on our back to face up to these challenges.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEs. First, it is fairly obvious that the winds of change are blowing hard. If the Administration proceeds, for example, with its widely publicized plan--I don't know whether it's a trial balloon or what--for possibly declaring a national economic emergency, we can hardly make firm decisions, and I know you don't intend to today, on 1981 targets. We don't know what steps that plan might involve. I suspect we will know a lot more when we reassemble in February about what lies ahead in terms of other parts of economic policy of the new Administration.

My comments first on the near-term outlook: I suspect we have already loosened some powerful potions of restraint; and I would expect a mild downturn in the first half of 1981, as does the Board staff. Our staff does as well, although we are not quite as pessimistic in terms of the decline in real GNP as is the Board staff.

But I suspect we are in for a decline and that it's too late to avoid it. One thing, unfortunately, that we didn't see in the downturn earlier this year was any progress at all on the inflation front. And that has to be a source of great concern. Hopefully, as has already been expressed, we won't be the only game in town as we move into 1981. It could strengthen our hand somewhat if we got some better performance on the fiscal side.

Moving to the various options that are open on which M to look at, this is a real horse and rabbit stew, and I don't have any magic answers. But I do have some thoughts on which are the least undesirable, I guess.

MR. SCHULTZ. Which is the horse and which is the rabbit? That's what we need from you!

MR. BALLE. I'll give you the conclusion and then the supporting arguments. All things considered, I would look mostly to M-1B. The reason is that I think it's going to be less sensitive to the shifts out of demand and savings deposits than M-1A. When we look at the New England experience, we find that in the aggregate--this may not be true case by case, as Frank has pointed out--that about two-thirds of the funds going into NOW accounts came from demand deposits and one-third came from savings. On the basis of the national ATS experience, today it appears that about three-fourths came out of demand and one-fourth out of savings. Based on some work we have been doing--

CHAIRMAN VOLCKER. How do you conclude that?

MR. BALLE. If you are talking about the national ATS experience, that's from the study we have done in our shop.

MR. PARTEE. Of the experience in California or the whole country?

MR. BALLE. The whole country.

MR. PARTEE. That seems different from the figures we have.

MR. BALLE. Yes, it does. It will. We'll be glad to share how we got there. I don't have the time to get into the details now, but that's the way it looks to us. We've also have been doing some work with demand for money equations based on data that go through 1979, which we are also about to circulate to the staff of the Board and the Reserve Banks. And it looks to us as if the split will be more like 9/10ths out of demand and 1/10th out of savings. These updated money demand equations give considerably different results than the ones that have been used heretofore by the Board staff. And we'd be anxious to share the technical evidence with you and get your judgments on it.

In any event, based on what I have seen so far, I'm leaning pretty strongly toward the view that M-1B is going to be more reliable by a considerable margin than M-1A. By the same token and for the same reason that Frank stated, I am very suspicious about placing much reliance on M2. The big jump shown in the [M2] range in the Bluebook apparently Steve has based on what is expected to happen to interest

rates in 1981; at least that is my guess. And, of course, what will in fact happen to interest rates is highly conjectural at this point. I'm afraid we're in a situation where, with this big expansion we have had in the content of M2, that aggregate is going to be very interest sensitive. In the days when we had the old M2, some of you may recall that I argued quite strongly on a number of occasions that M2 was a superior target to M1. I can no longer say that because of the interest sensitivity we have in the new M2; that's because it now includes money market mutual funds, for example. Now, with regard to the ATS and NOW account issue, I don't think that source of uncertainty is as serious as some might believe, and I would come out pretty much where Frank did. We can monitor the actual growth of the NOW accounts. We can set ranges, which I think is what he was suggesting. And I believe that's one of the options set forth in the Bluebook--that we abstract from the NOW account growth and then monitor the month-to-month developments in NOWs. We could set the target within the range [for the year] based on incoming evidence on how NOWs are actually growing in practice.

CHAIRMAN VOLCKER. Just to repeat: [The actual number] is not going to tell you, from anything I know, where the money is coming from. There is no way we can know. We can make guesses.

MR. BALLEES. I'm not sure that we couldn't ask for information from a sample of banks, for example--

CHAIRMAN VOLCKER. We will ask. According to the ones we've talked to, the most they can tell us, if they tell us accurately, is that they understand they have a frequency distribution ranging from 10 percent to 90 percent out of transactions balances, which makes me a little suspicious about what data we are getting. The most they can tell us is where the check came from to establish the account. That doesn't tell us what the ultimate substitution is. It may give us a clue, but I am very suspicious when those results come in over such a wide range as they do. As I understand it, they have made an estimate of 2/3rds from the sample of banks that literally ranged from 10 percent to 90 percent in one direction or another; the arithmetic average came out to around 2/3rds on the initial deposit. But that is not a statistic which fills me with enormous confidence.

MR. MORRIS. That's a great quality, Paul, that no one can tell--

CHAIRMAN VOLCKER. No one else can tell either. I fully agree with that. Nobody else can tell any better than we can.

MR. BALLEES. Well, Paul, it's better than nothing. And the alternative is nothing.

MS. TEETERS. Isn't there another [option] that will reduce [the uncertainty]? If we took as our target M-1B plus savings, that would cover most of the sources we think the funds are coming from. It would be a new concept in some ways, but it's also the one behind which we put reserves.

CHAIRMAN VOLCKER. Yes. The logic of that is impeccable, but the only trouble is that there are a lot of independent influences on

savings deposits that make them unstable. If it weren't for that, then we'd have a fairly easy answer.

MS. TEETERS. How unstable?

CHAIRMAN VOLCKER. Pretty unstable. Savings deposits have been going up and down a helluva lot in the past year. If that weren't going to be unstable, then I think you'd have a good answer.

MR. AXILROD. May I make a clarifying comment on M2, Mr. Chairman, extending that?

MR. BALLEES. Yes, please do.

MR. AXILROD. Since about the middle of last year or longer, we have been projecting a much higher M2 growth than the Committee has been targeting, consistent with the M1 growth and what we expected in nominal GNP. So this is a sudden change from what the staff has been indicating is likely to happen to M2. And on the question of interest sensitivity--though it's a phrase that means different things to different people--from our point of view, M2 in a sense has less interest sensitivity without fixed ceilings on interest rates. [When] ceiling rates disappear, institutions can adjust to the market. As market rates go up, we are not seeing a substantial reduction in flows into those types of deposits; and as market rates go down, we are not seeing a substantial increase in those flows. So interest sensitivity in that sense is lessening. And what we are seeing is that these flows are more responsive to what the institutions for one reason or another think they need in order to maintain competitive positions and to meet credit demands. That's essentially what is at the base of our projection of a further fairly sizable increase.

CHAIRMAN VOLCKER. I hate to make this even more complicated, but I am afraid it is pretty complicated. What the banks are fearful of, given a decision to make interest rates on NOW and ATS accounts the same as those on savings deposits, is that they are going to get a massive shift from savings deposits into ATS and NOW accounts because from the standpoint of the customer there is no disadvantage to it. And the banks don't like it, of course, because their reserve requirement is higher when the customer makes that shift. I don't know whether that's going to happen, but we have gotten frantic letters from the ABA and many state bankers' associations saying that they expect that is just what is going to happen. They are going to have an enormous exodus from savings deposits into NOW or ATS accounts. If that happens, these past relationships may be all off because we haven't had that [particular] relationship before. They may not be, but I just don't know.

MS. TEETERS. But if that happens, then M-1B is going to become interest sensitive.

CHAIRMAN VOLCKER. I don't know whether I'd say interest sensitive, but it's going to skyrocket. Your solution would take care of that if there were no independent influences working on the savings deposits.

MS. TEETERS. But that's true of any of these. It's a matter of going to the one that is the least unstable.

CHAIRMAN VOLCKER. I agree.

MR. AXILROD. I don't mean to take too much of the Committee's time, but in response to Governor Teeters, one of my less fortunate suggestions to the Committee a couple of years ago was to introduce an aggregate called M1+ when we had this very problem with ATS transfers. That was going to be demand deposits plus savings deposits. And that happened to be introduced at a time when savings deposits began to drop sharply because market rates were high and savings deposits were subject to a ceiling rate. So the Committee was confronted with a series that was declining very sharply and it wanted it to increase a little.

CHAIRMAN VOLCKER. At the present level of market rates this may be the way to hit the target. Well, we're complicating the job for you, Mr. Balles.

MR. BALLEES. Just to wind up my comments, I'm going to be interested to see if someone else can come up with something better than M-1B. And I'd be willing to listen to the arguments for a reserve target. Obviously we are choosing among the lesser of evils, and it's going to be a very difficult year. Coming back for one more comment on the very near term: As I said, I think we have already set loose some powerful forces of restraint and that is obviously showing up in key sectors of the economy like housing and autos. And we've simply already missed our announced targets for [1980]. I wouldn't take any Draconian action at this time to try to get back within them in a near-term timeframe. In terms of the period immediately ahead, I would recommend the specs shown in the Bluebook under alternative B for November to March, and I wouldn't let the federal funds rate go any higher than 20 percent, which is where it seems to be right now.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. To pick up on the criteria questions, I did feel that Steve's talk highlighted the problems and the complexity of explaining this multiple set of targets and, therefore, I strongly share Frank's criterion number one, which is that we should narrow the number of targets we aim for, preferably to one target. With regard to the volatility of the transfers of funds between the different categories, we also have been making some serious efforts to try to determine in our District how much shifting of funds there will be. And on the subject of the number of institutions offering NOWs, we have done some stratified samples of thrifts to see how many institutions are offering them, compared to the New England experience. We found in one survey that out of a stratified sample of 60 S&Ls, at a minimum 56 are going to offer the account immediately from day one, out of the box at the turn of the year.

CHAIRMAN VOLCKER. When you say NOWs, do you mean NOW or ATS accounts?

MR. FORD. NOWs, or share drafts.

MR. PARTEE. Savings and loans, he said.

MR. FORD. Yes, I'm talking about savings and loans. We didn't do the credit unions, although in talking to Jerry last night I

was very interested in what he had to say because we are both coming up with similar feelings in our Districts. That is, given what we see from surveys of the thrifts and the amount of pre-emptive advertising of NOWs, share drafts, and so on, I'm afraid we are going to be overwhelmed and that the New England experience is likely to be less relevant than some of us had thought earlier. We expect to see an accelerated learning curve on the part of the consumer, which therefore highlights everything you have been saying all year long, Paul, about the problem of M-1A versus M-1B. It says to me that we have to come up with some sort of measure that averages them. So I tend to lean, again on the choice among evils theory, toward some measure that averages the two, [perhaps on a] total reserve basis, which Chuck said might be [a blend of the two], recognizing that it, too, has many inadequacies. So, I'd go for the one target approach. I don't think you or anybody else on the face of the earth can possibly explain all those adjustments, which I agree are relevant, that the staff came up with. We just can't explain all of those adjustments for four different targets. We have to pick one thing and try to explain it and simplify it with regard to how hard to come down on policy.

I think by the time we meet in February we may find ourselves again worrying about missing all the targets on the down side. If my guess is right about where the markets are going, as John Balles and others said, we're leaning on so much stringency now that even though the immediate figures still show the economy surging, except on housing and autos, we are going to pay for this stringency and we're going to pay before the next meeting of this Committee. I think it's more likely that we will see something similar to what we had early last year--though I wouldn't say it will be an exact replay--than that we will have to worry about the aggregates running away. So for the immediate future, my feeling is that we can have a reasonable set of growth targets like one of the [alternatives suggested], but I'd hone in on one [variable] rather than all of them.

And we are likely to find that our problem is that the economy will cool off. I don't think there is much we can do about it between now and early next year. Whatever is going to happen is already built into the policy we've been making. Then the question will arise next February, if we do get some relief due to a cooling of the economy, what we should make of it in terms of setting the year-over-year target. I end up, bottom line, being a little optimistic in that if the stringency we've put on bites within the next 90 to 120 days, bringing many of the numbers down so that we are starting to worry about the numbers being too weak rather than too strong, we may then have an opportunity to set targets for the whole year to catch up a little on this base drift. That would make us more credible, [particularly if] backed up, hopefully, by a Reagan strategy that deals with the other things we have to worry about, like the deficit and so forth, which you have been giving speeches about. So I come out wanting to pursue a very moderate growth policy for the next 90 to 120 days, but narrowing down to one target. I have a slight preference, amidst all the anxiety about which one to use, for a total reserve target. That's about where I would leave it at this point.

CHAIRMAN VOLCKER. Mr. Wallich.

MR. WALLICH. I think we should make every effort to avoid a replay of 1980, with a sharp drop in interest rates which misleads everybody as to what our policy is, and then probably a replay of what happened this fall. I don't think there is a way of forming meaningful expectations in that environment because if we have a weakening of the economy in the first quarter or first half, as I would expect, then the aggregates will slow and interest rates will come down. And a few hundred monetarists in some sectors of the press will say that we are tightening terribly, but the other 220 million people will perceive this as an easing because they can get credit again at lower rates and they will say the Fed has given up. So I think we have to let the facts speak rather than bank on generating expectations. I would say, therefore, that we should undershoot our targets, whatever targets we set, if necessary; to do otherwise would mean to force in reserves and to push down interest rates sharply. That doesn't mean we shouldn't have some decline in interest rates, just not anything like what we had in 1980. That would also have a beneficial effect as far as the dollar is concerned. The dollar wouldn't make that down-trip to the extent it did and that, in turn, would have some beneficial result with respect to inflation, although I think the gains for inflation from a high dollar are not all that strong. The reason is that the price of oil is fixed in dollars, unfortunately, and [the value of] the rest of our imports isn't very large. I think we should look very closely at interest rates and use them to monitor the meaning of the aggregates. I have a suspicion that the way we are doing things now we are getting in our own way by generating a cyclical movement in interest rates and monetary aggregates--so-called instrument instability. And the level of interest rates is one way of judging what it is we are really doing--provided, of course, that we look at real interest rates.

As to the strategies to follow, I would lean toward 1 or 4. Those are the tight strategies. I'm aware that these are going to be very different from what the Administration is going to present, both the current Administration and also very likely the next one. And they are very different from what the market thinks about 1981. So we may have a problem reconciling that in our Humphrey-Hawkins presentation with what the Administration is proposing, which is something we have to do under the Humphrey-Hawkins rules.

As for the techniques, [accepting] base drift versus starting at the midpoint, I have a sense that we are not likely to get the full shift in demand that is implied in our projections. We may get some. We may get all, but if we don't, these targets are going to be extraordinarily tight because they are predicated on getting the full 3 percentage point shift. Now, tolerating a bit of base drift here may be an antidote. Otherwise, if we don't get the shift, the straightforward thing to do--if it weren't so devastating in terms of expectations--would be to raise all of our aggregates by a couple of percentage points or whatever the shift implies for M-1A and M-1B. I would hate to do that. We have here a means of equivocating a little. If we do move from the old base, the last quarter '79 base, it means that the present targets would involve slightly higher rates of growth, but not as sharply higher as those in Bob Black's first chart. For instance, M-1A of 3 to 5-1/2 percent would become under that calculation 4.3 to 5-1/2 percent; and M-1B instead of 3-1/2 to 6 percent would become 5.5 to 6.8 percent. These, I think, are reasonable to tolerate. If we do raise the M2 target, however, then I

would say we don't have that much leeway to tolerate past overshoots and perhaps then we'd better go back to the old base and try to grow from the midpoint as Bob Black's charts suggest.

Again, I think we have to put more weight on interest rates than on the aggregates. My preferred aggregate is still M-1B; it conceptually makes the most sense. But it will be looking pretty bad and its interpretation will be enormously difficult. I think we should simultaneously state M-1A as a compromise, but neither inspires any reliability. M2 inspires little reliability. I've never felt that was a very good indicator. Bank credit isn't going to be a good indicator because the share of bank credit in total credit is going to fall drastically, according to the flow of funds analysis, from something like 40 percent of total funds raised to something like 20 percent of total funds raised. This has to do with the bunching of credit recently at banks as a result of a drop in bond issues and a drop in the use of commercial paper. So bank credit, too, may not be a good indicator. One is left with the idea that we need positive real interest rates; that idea is gaining ground internationally and I think we ought to move in that direction. Thank you, Mr. Chairman.

MR. FORD. Excuse me, Paul. May I ask one clarification question? Did you say that you would or would not allow the base drift? It sounded to me as if you said on M-1A and M-1B you would allow base drift and on M2 you wouldn't.

MR. WALLICH. Sorry, I was obscure. I would say that if we don't raise the M2 target, then I would accept base drift. If we raise the M2 target and make that very conspicuous, then I would have second thoughts about accepting the base drift.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I'd like to start with the premise that for the long-run 1981 target the most attractive approach to me is strategy I, which has some implications. And you've asked that each of us speak to that. I would agree with those who say that we do have some powerful forces in place, that we are quite likely at or near the turning point, and that the first quarter will be a negative figure and perhaps a fairly substantial one. First of all, that doesn't bother me very much. It seems to me that what happened in 1980 is that the so-called recession had no impact on prices, and that is an experience that I hope we'll avoid this next time through. It seems to me we do need a downturn; we do need a washout. And I would be prepared to do what the Federal Reserve needs to do to accomplish that, having well in mind all of the pain that comes from that. As for the alternative, I think there is no alternative at all for the nation in the long term.

Secondly, the prospects of hitting the targets under strategy I may be quite good in the first half of the year with this downturn we have spoken about. And there's another factor that may come into play: If indeed the Administration comes out on January 20th or soon thereafter with a program in which there is some fear, if you will, or some realization by the public that we really mean business, there are two possible results. One is that there will be some euphoria and we won't get the dip that I just predicted. The alternative, and what I think is more likely, is that we will see a withdrawal from the market

--something similar to what we saw after the credit controls went into effect earlier in 1980. In other words, we will have no problem hitting the targets simply because there will be little or no money growth. Having said that, it seems to me our important task in 1981 is not to duplicate the 1980 effort and permit interest rates to drop.

Therefore, I would join with Henry Wallich in the belief that there will be a time in the first quarter and maybe through the first half when interest rates will be more important to me than the targets. We can tolerate the lesser money growth that I would expect to happen and manage interest rates on the down side a bit more than might be acceptable to those who would want to follow our procedures strictly. There have been a couple of comments having to do with base drift; I would not opt to correct for the base drift. That is to say, I would center the targets for 1981 based upon the projections that we announced in July of 1980. I would go from that point forward and accept what happens, hopefully on the down side, and the base drift might correct itself by our getting some low growth. It seems to me that there is presently a window that the Federal Reserve can move through in anticipation of Administration programs coming on to help us for the first time in the years that I've sat with this Committee. The prospects are that if we adopt strategy I, which incorporates this rather large downward shift in the demand for money--I don't know whether that will occur or not, but it may not need to occur if these other things come to pass--we will have a window to move through to do our part and we perhaps will have another player on the field to help us. I would hope that we would take advantage of it and not wash the economy out to a very long and deep recession but accept one and do those things necessary to achieve [our objectives].

CHAIRMAN VOLCKER. Mr. Rice.

MR. RICE. Mr. Chairman, I'd like to make some general remarks first about the economy and then about long-run strategy. With respect to the economy, it's clear that economic activity is still lively. That is indicated by the most recent data we've seen on industrial production, capacity utilization, employment, retail sales, the average workweek, and GNP. We're in a quarter where we expect GNP to increase at a rate in excess of 4 percent. We have seen the latest data, of course, and they obviously add up to strength, with housing starts holding up and real disposable income not slipping very much. The major areas where we see weakness are in business capital outlays and nonresidential construction. Despite this strength in the economy, it's difficult to see how this expansion can continue much longer in the face of interest rates as high as we are experiencing currently. Consumer demand, which has provided the main support to this expansion, seems unlikely to hold up as inflation continues to place strains on household budgets. And it's hard to see how households can continue to increase real spending as real disposable income slips, particularly at a time when the saving rate is already low. Therefore, I'm inclined to accept the staff forecast as the most probable outcome.

However, I do have two concerns. The first is that the saving rate, while low, may go lower as consumers try to maintain their living standards. That, of course, would impart continuing strength to the economy and that strength could possibly continue further into 1981 than we currently anticipate. Now, if we have

underestimated the consumers' tenacity, that would suggest that inflation may become worse and interest rates may have to go higher. And ultimately, we may have in reaction to this a sharper deceleration than we would like to see. The other concern is that the current monetary restraint and the current high interest rates, particularly if continued longer as I'm sure they will be, may generate unbearable strains in the business sector. If that continues and becomes severe, rather than a moderate drop in economic activity in the first half of 1981 as projected by the staff, we may well see a very sharp decline that becomes cumulative. And we could find ourselves in or headed toward a severe recession. And, of course, if that happens, we will see the kind of thing that Henry fears a great deal: We'll see interest rates fall sharply and will probably find ourselves in something of a replay of 1980.

Given all this, I think the best we can hope for is an outcome that closely approximates the staff's scenario. And I think a policy should be established which would maximize the likelihood that we will get only a moderate contraction or moderate slowdown in 1981. If we adopt a more restrictive policy than is being currently pursued, I think we'll insure that we will get a sharp contraction, which will result in the downturn and the sharply lower interest rates that we're concerned about.

With respect to the question of whether we should adjust our growth targets downward from the ranges set in July or from the growth actually experienced in 1980, I think we should move in the latter direction. We have been through a year when monetary growth contracted sharply, even declined absolutely, and remained sluggish for a while and then we've seen explosive growth in money, with growth rising above the upper limits of the targets that were established. Clearly, we don't know as much about money demand as we need to, and that's an understatement. So it would seem to me a mistake to start with targets that we already know to be unrealistic and to a degree mis-specified. So I would start with the actual results that we will have seen in 1980 and shave off [some] from that rate of growth. I would like to see actual growth targets that have an upper limit somewhere around the actual growth rates we experienced from the fourth quarter of '79 to the fourth quarter of '80 and, as I said, I would shave off from there toward a desirable midpoint. This would bring us somewhere in the vicinity of strategy II. It seems to me that following the strategy I that is suggested in the Bluebook would be much too constraining for the economy. If we are to believe the numbers, we would be buying some possible credibility with the hope of influencing expectations, with a large sacrifice in real GNP in 1981--nearly a 1 percent decline in GNP--and with no effect on the projected inflation rates. If we take strategy II, which seems more desirable to me, we get only a 0.2 percent higher inflation rate in [1982] and 0.4 percent more in [1983]; and output is 0.4 percent higher by 1983. So I would be more comfortable with strategy II as a means of achieving a moderate contraction in early or mid-1981 rather than risking a more severe recession later on with all the attendant instability in interest rates.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, on just a technical point first, I'm not unduly concerned about tolerating some base drift, maybe even

a lot, because I think not accommodating some base drift runs a risk that the brunt of [the effects] will hit particularly hard early in 1981 when perhaps we will least want it. In terms of our basic posture, I think it has to continue to be one that is consistent with a reduction of inflation and is understood as being that. The near-term outlook for the economy, I think, is fairly well-defined in the sense that we are going to have some reduction in activity in the first half of [next] year. In my view, however, the amount of the reduction is open to some considerable question. We have major uncertainties in oil. We have major uncertainties regarding how long interest rates will stay in their current range and certainly the longer they stay there, the more significant the implications. And that does involve some very real dangers to the economy and the financial system. We have the uncertainty of budget and tax policy. I, too, draw some consolation from the fact that there appears to be some momentum on that side, but I'm not by any means sanguine yet. We have short memories. We had coordinated economic programs in November of '78, October of '79, and March of '80, and I think the public is pretty wise at this point and business is pretty wise. If indeed there is to be a very strong and credible assist coming from the fiscal side, it has to be one that really meets the test. And in some ways the critical part of the test is perceived to be the expenditure side of the budget where making real inroads, as we all know, is very, very difficult. So I'm still not quite sure how much weight to put on what may or may not come out of that process. I'm hedging my bets until I see a little more about it.

In terms of monetary policy, let me just say a word about the 1980 performance. Certainly there are aspects of the performance, particularly the volatility, that I'm not happy with. I don't think anyone is. But at the same time, I think we make a serious mistake in going around to the extent we do with our tail between our legs in terms of the overall performance of monetary policy in 1980. When I look at the targets and at where I think we are coming out now, with any kind of appropriate adjustment for NOW accounts or ATS problems, I think our record in fact is pretty darn good. In some sense I think we make our own problems with the editorial writers and others by perhaps being unduly sensitive and defensive about what seems to me a pretty credible--and indeed in some ways remarkable--performance looking at the year as a whole. So I'm not about to be too apologetic about that.

In looking ahead, broadly speaking I would hope we could keep the focus in terms of aggregates more or less where it is. Having said that, I should also add though, Henry, that I don't want to get trapped in a cage with your 200 monetarists either. And that, too, requires walking a bit of a thin line. The thinness of the line in 1980, for what it tells us, does suggest to me that if there was a mistake, the mistake was probably in the second quarter in chasing the money growth rates down too fast and letting interest rates go down too fast. To whatever extent it's possible in 1981 I think we should try to target something we can hit with a little better success in the short run than we did in 1980.

When I look at that in the context of Mr. Morris's simplicity criterion, I have a bit of a problem, because my hunch--and it's just a hunch--is that the NOW account/ATS account impact on M-1B is probably going to be larger, and maybe significantly larger, than the

estimates contained in the Bluebook. I conclude that for three reasons. First of all, I think the sameness of the Q-ceilings on passbook savings accounts and the NOW-type accounts is very important. It's very important particularly when, as the Chairman has suggested, the impact of that is likely to aggravate the shift out of savings deposits into M-1B. So maybe the two-thirds/one-third [estimate] is also wrong. Also, consumer sensitivity obviously is higher now than it was in New England or even in New York. And finally, the competition factor is very real. The thrift industry is looking upon these types of instruments as a bit of a salvation in the short run, where they can get their hands on money at the expense of commercial banks. While it's expensive money, it is cheaper than other money that's available to them right now. So my hunch is that they are going to go after that business very, very aggressively and force commercial banks--even those who might not want to go after it--to respond in kind. My conclusion--and again I can't document it any better than anybody else--is that the risks in terms of the possibility of larger flows from savings into these types of instruments are on the high side. If I'm anywhere near right, that could put actual growth of M-1B during 1981 almost out of sight.

Having said that, I do agree with those who say that it's impossible to explain all these shifts away; but I don't think it's impossible to explain that they're there without trying to quantify them. Because of that, I would be prepared to give a lot more weight for the time being to something like M2 or perhaps Nancy's version of M2. My willingness to go in that direction would be perhaps somewhat greater if it weren't for the information in paragraph 11, page 9 of the Bluebook that says the broader aggregates are going to grow faster in 1981 than we thought they were. But I don't fully understand what's implied in that paragraph, and I for one would like to see some further analysis of it, particularly in a context in which the scenario we're looking at might be one where interest rates in the first half of the year decline by, say, 500 or 600 basis points from where they are now and then level off for the balance of the year at some relatively high level. If that were the framework of interest rates, I'd have to ask myself whether in fact we are as likely to see the kind of shift that the staff is suggesting in paragraph 11.

The other thing that [concerns me is that] I know we can't monitor these shifts very well, but I'm not sure how much we can monitor at all what in fact is going on. Wherever one comes out in terms of the relative emphasis to put on the Ms, that doesn't fully solve, and maybe it doesn't even begin to solve, the related problems of how to conduct operations. That's because these very same shifts in deposit categories, particularly shifts from savings accounts into NOW accounts, are going to produce a huge impact on reserves as well. Basically, I think we have two alternatives. One is to stick with the current procedures, constructing the reserve paths more or less as we do, perhaps in the process giving more weight to M2. But I'm not fully persuaded that that's necessarily the best thing to do. I was struck, for example, by the question that kept entering my mind during 1980 as to how the lagged impacts of what we did in a given week or a given couple of weeks on those reserve paths and interest rates affected growth in the Ms three or four months down the road and the extent to which that in itself contributed to the sharp short-run swings we have seen. And partly for that reason I'm still a little intrigued about the possibility of rethinking the use of total

reserves during this difficult period of transition as more of an operational target than in the past; we might do that at least on a quarterly average basis or something like that. I recognize all the problems associated with that. But it would raise the possibility that we'd be talking a little more directly about something that we may be able to hit on a quarterly average basis. And in that context I would use M2 or something like that and interest rates as Henry has suggested, more as informational variables than as operational variables. That covers a lot of turf. But because of the many uncertainties that we all have, I would like to think that maybe what we could do today is at least to narrow this down a bit. Also, Mr. Chairman, you suggested yesterday that we may need a meeting in January before we get down to the real hard [sell] of picking the numbers. And I wouldn't object to that.

CHAIRMAN VOLCKER. Mr. Gramley.

MR. GRAMLEY. Mr. Chairman, I, too, see signs that the economy is catching on to the fact that interest rates are awfully, awfully high and that there's a lot of pain out there. And we are getting some weakening. I don't see signs of an imminent recession in the numbers, but I agree with the staff that we are going to get a moderate drop in economic activity in the first quarter and probably in the second quarter, too. And the outlook for growth in real terms over the whole year is very, very poor. The reason it's poor, I think, is basically because we have adopted targets for growth of the monetary aggregates that in a world with 10 percent or so inflation, just don't provide any room for real growth. And I don't think we ought to back away from that. That's what we've been trying to achieve with our policy this past year. I'm not at all convinced that we should be sure the efforts of the new Administration are, on balance, going to be anti-inflationary in 1981. They may be or they may not be. I'm prepared to accept a weak economy. Like several other people, I want very much to avoid the kind of volatility we had in 1980. I don't think we can absolve ourselves from some responsibility for what happened. It wasn't entirely the Fed's fault by any means, but I do think we went way too far in pushing up interest rates last spring. We would have been much better off if we had tried to hit our monetary targets over a somewhat longer period. If you think about monetary targetry generally, I think you have to come to the conclusion that monetary targetry works best when the demand for money is stable. During the postwar period there hasn't been any period in which we have had greater instability of money demand than the years since 1974. And next year, at least with respect to two of the aggregates, M-1A and M-1B, we simply do not have enough information about the demand for money to know where [to set the targets for] those two aggregates. If, for example, one were to take the range we had for M-1A in '80 and subtract 1/2 percentage point from it and then take the staff's estimate that the growth of M-1A will be reduced next year by from 1-1/2 to 6-1/2 percentage points, the range for next year that is consistent with that uncertainty would be -3-1/2 to +4 percent. And we have a reasonable chance of--

MR. SCHULTZ. Are you sure?

MR. GRAMLEY. About the same chance as we had for hitting the range in 1980.

MR. PARTEE. That's right.

MR. GRAMLEY. For M-1B the same exercise would give us a range of 4-1/2 to 9 percent. I think ranges like that are ridiculous. And I think the public would so regard them. Yet if we put out the kind of ranges we have been putting out in the past couple years, there is almost no hope of hitting them. So if we are going to continue to play the game of monetary targetry for 1981, we have to find a monetary aggregate that is not going to be moved around so much by shifts in ATS and NOW accounts. Now, I see some thinking going in the other direction in the comments of Governor Wallich, President Guffey, and President Corrigan; and if the whole Committee wants to go in that direction, I would certainly strongly support it. But if we want to stay with monetary targeting, I think the way to go is with either M2 or Governor Teeters' suggestion of M-1B plus savings deposits. And if you don't like the fact that savings deposits have been very volatile, then what you could do to counterbalance that would be to add all small time deposits. Then the aggregate would be M-1B plus savings deposits plus small time deposits. The logic there would be that this year when we have seen very steep declines in savings deposits, we have seen accelerated growth in small time deposits. And, conversely, when saving deposits have picked up, growth of small time has ceased.

CHAIRMAN VOLCKER. What have you left out of M2 in there?

MR. GRAMLEY. Well, it leaves out of M2 money market mutual funds, RPs, overnight RPs, and Euro-dollars.

CHAIRMAN VOLCKER. Why? I guess I would ask, if you go that far, why would you leave those out?

MR. GRAMLEY. I'm not sure we should. But if the argument is that we need something against which reserves are held, this would at least be a start in that direction. And I would hope as we go into this year that we take carefully into account Henry's suggestion that we think about what real interest rates are. And I hope we try to shoot for monetary targets over a longer period in recognition of the fact that if we try to chase the money supply too closely in the short run, we may end up pushing interest rates much further than we want and much further than is consistent with a fairly stable pattern of growth in economic activity. And, finally, I by all means do not want to correct for base drift. We ought to start from where we are rather than try to make up early on for mistakes that may have been made in the past.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. Well, I'm going to argue that short term we ought to look pretty carefully at interest rates and long term we ought to get maximum flexibility. We have a very tough situation here, a real dilemma. We have put the economy through all this agony and we don't want to [waste] that if possible. On the other hand, as a friend of mine said: You were sending a message to the country prior to November 4th, but since then there hasn't been anybody there to receive it. So we do have a little problem about what we're doing at this point in time. It seems to me that the policy of the new Administration is really critical: the psychology they generate, what

they can do about credit demands to allow the private sector to re-liquify, what long-run program they can come up with that looks credible on balancing the budget and getting the economy going. Obviously, monetary policy has to do its part. But one good thing about all this is that we are very effectively proving that monetary policy can't do it all. And maybe that is going to have the effect of getting us a little more help.

But if monetary policy is going to do its part, it seems to me that we've talked so much about reducing the growth of the aggregates to non-inflationary levels over time that we somehow have to stick to that approach. Everybody looks at that and thinks about it and I believe we have to continue on that path. I, too, would ignore base drift. If we don't start from where we are, we will really have problems. I see no way to make it work.

So far as what we target on, internally maybe we can develop some better single target but externally I would argue for putting a lot of targets out there for the simple reason that I haven't heard anybody make a very convincing argument that there's any single aggregate that is going to work very well. And it seems pretty clear to me that we really don't know how they're going to work. So I'd put out an M-1A and an M-1B, adjusted for the NOWs because I don't see how we can [operate] if we don't. I don't know what to do with M2 at this point, but surely we can find some way to massage that so it doesn't look too bad and is consistent. I guess what I'm really arguing for the long term is flexibility. We don't know what the Administration is going to do. We don't know what the next month or two is going to bring. We can't have very much confidence in any one of these aggregates, as I see it. So it seems to me that we ought to be thinking about a family [of targets] and the point of view--the way that the public looks at this situation and the kind of signal we are going to send short term. It's just amazing to me that banks seem to be willing to pay almost anything for money if they think they can sell [the funds] for more money. There are no institutional constraints at all and what we are doing is trying to affect the credit demands of individuals and businesses out there. It just doesn't seem to me that putting interest rates any higher at this point is going to accomplish very much. So I would argue that we ought to look at the level of interest rates at this time and we ought to put more emphasis perhaps on targeting the funds rate short term than we might ordinarily do. I am not willing to give up the procedure that we are using. I think it does make some sense to argue for heavy emphasis on monetary aggregates over time. But there are times when interest rates become very important and ought to receive more emphasis, and I think now is one of those times.

CHAIRMAN VOLCKER. We have a bit of a time dilemma. At the rate of speed we are going, we're going to continue this afternoon. I haven't any great inclination to speed the meeting up all that much because people have things to say. I think we might as well have a coffee break now and continue after the coffee break and we'll see how fast we go after that.

[Coffee break]

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Paul, this morning I feel as if I have been sitting with a group of blind people describing a passing scene and I'm starting to lose confidence in my seeing-eye dog. I would like to try not to repeat what has been said [since I] share many of their feelings. But I'll pick up a little on our credibility problem in trying to find how we go from where we are to where we ought to be [in terms] of having a realistic target. It seems to me that several things might be said on that score. First, we are where we are and there's no use trying to assume some other basis; we have to go from where we are. But we could aspire still to get back into what we think would be appropriate target ranges that have some relationship to what we've decided in the past. The critical issue is the time period that we say it's going to take us to get there. It may not be within the year; it may take us longer than that to work in that direction. But that at least should be in our statement. Second, we should recognize that we are dealing with a number of variables here. We tend to concentrate on the Ms. And I think the shifts that Jerry was talking about have effects on the velocity of money and at least we ought to get that more into the conversation, not that we understand what's happening on that score. We have price developments and we probably should pay a little more attention to some of these than we do. For example, I got nervous about commodity market developments and the speculative activity and the credit being used in some of these areas. Maybe we should be somewhat more vocal on some of these things rather than ignore them.

CHAIRMAN VOLCKER. What do you mean by that? We shouldn't permit speculative loans?

MR. WINN. No, it's not that, but maybe we should take another look. We don't have control over the margins in all areas, but I'm not sure those are all proper in this kind of environment. On the output side, I have a gut feeling that the year may turn out to be stronger than we're expecting rather than weaker. I say that for several reasons. One is that we may have a sharper decline in the first part of the year than some of us are expecting. But what strikes me is the underlying demand that is building up in a number of areas, from autos to office space and certainly housing. If attitudes change and the environment changes, we could have a sharper snapback in some of these areas than many of us are expecting.

So, I would still stay with trying to address our concern about prices through our targets. I would not try to confuse people by shifting, although I recognize all the shortcomings of the present measurements that we have. I would build the targets from where we are, but with regard to what we thought our targets zones would be. And I'd accommodate the concerns of Henry and others in this area; maybe we ought to think not of a symmetrical zone around the median point, but [aim] somewhat on the lower side--perhaps 2/3 below and 1/3 above it. That may help us a bit in terms of the kinds of pressures that will build externally should the numbers fall short during the early part of the year. And hopefully doing it that way will avoid some of the pressures for a very sharp reduction in interest rates should the quantities fall short of [our targets]. I'd talk a little about our hope to be back in that zone over a period of time. And that doesn't have to be fourth quarter-to-fourth quarter; it could be somewhat longer. You will recall, Paul, our visit with some business people [in my District]. I interpreted them as recognizing the pain,

but they didn't really see any other show in the works that would help us relieve it. While some of them were feeling [the pain], they weren't suggesting that we remove it. In spite of the outcries we're getting in other areas, I think we ought to try to balance that with [unintelligible] across the board.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I've practically forgotten what I was going to say!

CHAIRMAN VOLCKER. Do you want to wait?

MR. PARTEE. Let me make two points. One is important-- perhaps old hat, but important. And that is that we all ought to recognize that in our discussions around this table in the last couple of years we have greatly shifted [our views about] what we expect monetary policy to do. Traditionally, what we want to do is to keep pressure off markets so as not to have excessive demand. We were discussing as recently as a couple of years ago questions of what constituted excessive demand and what was full employment. I well remember that John Balles had a rather elaborate analysis of full employment in terms of utilization rates for industry and employment and unemployment numbers. And it seems to me now we have gone far, far away from that. We no longer care what employment is so long as it's plenty low. We now say that in addition to seeing to it that monetary policy doesn't lead to a situation in which demand presses against inflation, we are going to work to reduce inflation through monetary policy, [which] increases some costs in the economy. That has to be the implication of our policy. In that context, I think we need to have a view of how weak an economy we are prepared to see over this one or two or three-year period that we are talking about, as we look at the longer-run outlook. We have a pretty good idea at the extreme of what the economy may be like, because we have an example in Britain. There is a lot of similarity. There's a lot of similarity in the posture of the new Administration and the posture of the Thatcher government when it came in. And there may be a lot of similarity in terms of the budgetary results between the two. And yet [see what] it has produced. I think a question that we really ought to discuss seriously is how deep can we expect and how deep are we prepared to see a recession go. I read in the paper this morning that a good many of the English pubs are in danger of closing because of lack of business.

MR. SCHULTZ. That brought it home to him!

MR. PARTEE. I was trying to think of a counterpart, Fred, for the United States. Pubs aren't so important here. And I decided that it was professional sports. So maybe we'll be in the same position the British are when professional sports teams go out of business. I say that not too lightly because I think it is an area where people get a sense of inflation in excess with the multi-million dollar contracts.

As far as I'm concerned, we really ought not to plan a policy that produces less than zero growth. I really don't want to follow the British [model] over a period of time. And zero growth, I'm afraid, is probably associated with a pretty fair sized expansion in

the monetary aggregates. We have this cosmetic, psychological problem with the aggregates, and I don't know how we can get out of the box. I fully agree with Lyle that there is a great deal of uncertainty here and to have an equivalent range now means we have to go from -4 to +4 percent or something like that. And as a matter of fact, I agree with Bill that there is going to be a very big competitive situation in the market for NOW accounts and that we might well miss on the other side.

In thinking about all that, first, I wouldn't want to make up for the overshoots in the aggregates. If we have to state this properly, perhaps the way Emmett has done it is the right way: To state that last year the aggregates were a little strong in real terms, abstracting from this NOW account problem, and we certainly wouldn't want them to be any stronger than that; we would like to see a lower rate. That would be one reasonable way of addressing that problem. Or, we could--after all there's no particular importance to the midpoint of the ranges--extend the ranges. We are not so far above the top end of the ranges and we could say that we have been at the top end of the ranges and, therefore, to the extent we can get [monetary growth] down to fall more within the ranges, we would do that. That's a possibility, too, Paul; that might be looked at.

This is a preliminary discussion, so I would suggest that as the staff focuses on this over the next month they take a careful look at total reserves. I believe there may be some averaging advantage in total reserves. After all, a good many of these NOW accounts are going to come from passbook savings, which has a 3 percent reserve requirement. They are going to go into a 12 percent reserve requirement. But some amounts are going to be coming out of demand deposits where the effective requirement has been higher than 12 percent, I think. In any event, somebody ought to take a look to see whether the possible range of variation would be somewhat narrower by using growth rates on total reserves as an approximate target for policy. It also associates well with what we say our operating procedure is, so it has that advantage. The disadvantage is that it doesn't mean a damn thing to anybody except those 200 economists that Henry mentioned. We ought to have a real market implication somehow that comes from this, assuming that we can't do anything more than speak in rather subjective terms about the traditional monetary aggregates. I'm wondering whether we ought to take another look at what we could postulate in terms of a financial number that we would look at in judging the reserve growth along our target path, and whether it could be credit. Bank credit happens to have been within the range during 1980. And maybe bank credit expanded to include the other institutions, so-called institutional credit, is a variable for which we could give a quantitative notion of what we think would be appropriate and related to our objectives.

CHAIRMAN VOLCKER. It's about the same as M3, isn't it?

MR. PARTEE. It is pretty much the same as M3. The reason I wouldn't go for M3 is that people would say we are just moving to another monetary aggregate and one that no one has ever paid any attention to. I think if we talk about credit flows and limiting credit flows to a reasonable range, we would be talking about something that people could understand. I don't mean that we wouldn't say something subjectively about narrow money and broader money. But when it comes down to it, this is quite within the scope of the

Humphrey-Hawkins Act, which as you remember refers to the targeted rates of increase in "monetary and credit aggregates." So it is quite possible to do it and still be legal in connection with Humphrey-Hawkins. That is one possible variant I would suggest: To emphasize total institutional credit growth, which will be understandable to people generally and to associate [that with the aggregates] conceptually, as a way of approaching [policy] without following slavishly the idea of holding to the midpoints of the 1980 ranges. Those were established really a year and half ago now, and I think that [approach] would be a mistake.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Frankly, I don't find any of these strategies acceptable. We're not getting any decrease in inflation and any one of them leads to at least a 1 percent increase in unemployment next year. And we still have a fairly rapidly growing labor force, with lots of young people and minorities and so forth that won't be accommodated in that situation. I happen to agree with Chuck: We really are choosing how bad we are going to make the economy rather than anything that is positive at this point. However, I am also impressed by the 15 percent projected CPI for the first quarter; I worry about that because last year CPI numbers in that range caused panic, and rather severe panic, and led finally to putting in emergency credit controls. Given those considerations, I think we have to choose between a variety of unsatisfactory alternatives. I don't think we can achieve either alternative I or IV if we're worried about our credibility. With the inflationary forces that are loose in this economy, it is going to be impossible to [achieve] those targets. We might have a chance of achieving strategy II or III; besides, they are certainly the least damaging in terms of employment and output and we don't lose anything basically on the inflation rate. So I would opt to stay as near as we can [to those].

Maybe the best way to handle the public relations problem in terms of M-1A and M-1B is simply to extend the current ranges and use the [explanation] that we're above them and are coming back into them. However, I would lobby strongly for the idea of at least looking carefully at M-1B plus savings. If savings are too volatile and if what Jerry worries about happens, savings are all going to move into M-1B. Then whatever volatility is left will just move into M-1B. So that doesn't seem to be a reason for not using that particular [aggregate] at this time. We should at least find something that we can work on. I would also point out to you that this projection probably contains as much as any of us knows about the Administration's program. It has the \$35 billion tax cut; it has what I think is our own good judgment that they won't get the nondefense [cuts]; and we still get a zero rate of [economic] growth. So I doubt we are going to get very much stimulus out of the Administration, certainly not over and above this [tax cut].

As far as base drift is concerned, I think that's asking too much. If we take [off] from the midpoint of the old ranges and try to bring the new ones down from that, that is a restriction on the rate of growth of money supply that we'd never be able to accomplish given the way things are going now. And I urge you to be very careful. We could create a very, very severe problem at the rates of interest we now have. Obviously, people are hurting and it's not just [affecting]

automobiles and housing. People can't make decisions with rates this high. And I would caution that we should decide how far we're going to let rates drop, depending on what develops, rather than have some preconceived idea that they should be kept at a certain level throughout the year.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I don't think we do any service to the country let alone ourselves if we present long-run targets that are almost impossible to explain with these screwy numbers, no matter how much fine print and explanation we give. I feel we would be perfectly justified and would get a reasonable reception if we said that we have a year of transition ahead in which there are going to be major and unpredictable shifts in NOW and ATS accounts and, therefore, during the year ahead we'll be targeting a broader monetary aggregate. Then we would publish once a month the results of our broader aggregates. Of course, the components that make up M-1A and M-1B are still in those published numbers, but we don't have to publish them as such. People can reconstitute them but there would be a difference in press treatment. We've examined pretty carefully whether there are substitute targets. We looked even at the monetary base; we looked at total reserves. I, at least, came to the conclusion that those alternatives were worse than simply targeting a broader aggregate in this year of transition. I feel also, as Lyle Gramley does, that we didn't help inflation any by letting interest rates go to such extremes as we did this year. It doesn't help to go to 20 percent for one or two months and then down to 10 percent for a couple of months. I think we have to pay much more attention to real interest rates and factor that more into our policy decisions. I also agree with quite a few people that we have to accept the base drift--that the targets for next year would be incredibly restrictive if we started the new range from the the midpoint [of the 1980 range].

MR. PARTEE. From the midpoint, yes.

VICE CHAIRMAN SOLOMON. I tend to place enormous emphasis on this problem of communicating something simple, as Frank Morris said, and also targeting something that will enable us to have a better track record this coming year than we had [this year]. I think targeting a broader aggregate is easier to defend than what was presented [in the Bluebook]--coming out with targets for M-1A and M-1B as well as the broader aggregates. That's all I have to say on the long range.

CHAIRMAN VOLCKER. Mr. Smoot.

MR. SMOOT. Thank you, Mr. Chairman. It's probably appropriate as the only First Vice President here that I go last except for you. Are there others left?

MR. MAYO. Yes.

MR. SMOOT. Excuse me.

MR. MAYO. That's all right. I had my hand up long ago, but I didn't get noticed.

MR. SMOOT. I would be in agreement with those who expressed the view that the 1981 targets have to be lower than the 1980 targets. And I would endorse strategy I. There is a consensus, as I read it and see it in the [documentation], that we have a soft first half coming. And as President Ford outlined, that's going to make it possible to achieve those lower targets for that period and give us some time to think about the second half. I have heard some [comments] that we should be reluctant to let interest rates decline as rapidly as we did in 1980. However, I haven't heard anyone suggest yet that that may have been all right but perhaps we should have moved more promptly when the aggregates started to come in very strongly, rather than tolerate as much of the strength as we did and that, therefore, we may have higher interest rates today than we otherwise would have had. So I would put that on the table for consideration.

You mentioned, Mr. Chairman, that you are hearing people say: "If this is what dealing with inflation means, I'd rather have inflation." I suspect that means: "If this is what dealing with inflation is via monetary policy only, then I'd rather have inflation." I think that simply indicates the extreme reluctance within the economy generally to make the kinds of adjustments that are really necessary to deal with the inflationary problem that we have. There are less painful ways, I'm sure, to handle this. And there are more equitable ways. In that regard, everything I have read about strategy conflict--and I think we have some here between monetary policy and fiscal policy and between labor union policies and other policies--is that we have to speak as strongly as we can on the resoluteness of the Federal Reserve in this endeavor. When we are involved in these strategies of conflict, people have to believe that we mean to carry out our stated strategies or certainly we will lose.

Finally, two minor points. One is that I would agree with those who have suggested that we look at some aggregate other than M-1A or M-1B, or M2, on the order of perhaps an M1-C. I don't endorse [any alternative] wholeheartedly at this point, but it is certainly worth further staff consideration. My second point is that on ATS and NOW accounts, there is some evidence in New Jersey that about 20 percent or maybe a little more of the money that went into NOWs came out of ATS accounts. We are doing some further work to try to highlight more of what that was all about. But, of course, to the extent that those kinds of transfers took place, that would have no effect on M-1B. Thank you.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, Messrs. Schultz and Corrigan gave quite a bit of my speech, so I can shorten it up. But I must join very strongly with what Jerry had to say [about our performance], and maybe even more strongly than he said it. If our record in meeting the targets for 1980 is the temperature gauge one is going to use for our success or failure, I think we got a B in the course. The reason we didn't get an A is the volatility; I feel very sensitive about that and agree with what has been said here. But if you look at the monetary aggregates--adjusted for OCDs as I guess we call them now, Steve--we are within 10 percent of our ranges on all four of the Ms. If we got so statistically crazy as to average all of our target results with some sort of weighting, we could prove that we were within the targets for 1980!

SPEAKER(?). I'd like to see that.

MR. MAYO. You know how statisticians are! Anyway, even if one acknowledges that we are outside of our ranges, we are less outside of our ranges than are I believe most, if not all, of the countries in the western world that have set up monetary targets. All the chips aren't in for this year, but I think that's a fair statement if not a completely accurate statement. Having said that, I agree with Jerry's point that there are too many apologists around, including I suppose most of us on some occasions when we feel on the defensive and spend more time pointing out why we didn't do this and didn't do that and what went wrong than we do explaining the positive side of this. We didn't have a failing record for 1980 by any stretch of the imagination.

Point two is that I share Fred Schultz's question mark about the extent to which we are going to get real relief from our "only game in town" syndrome during calendar year 1981, despite the sincere and I think conscientious intentions of a new Administration, which still hasn't gotten its act together. I hope it will get its act together. We have to do something in terms of a coordinated policy but until they put out their statements in January, there isn't much more we can do other than what we are doing today, repeating [that desire for a coordinated policy] in discussing the background for our problem in February. There is uncertainty in both directions from precipitous action by the new Administration, one of which is being considered seriously and obviously has congressional support. The other is whether they are going to jump in too fast and jeopardize the entire program or whether they will take a more reasoned approach, with all of the adequate staff work that requires, and meld these two things. We won't know for some time yet.

As for the outlook, I think we will have a recession, though not as steep as in the second quarter of 1980, but I fear a little more during the first half of 1981 than is implicit in the Greenbook. That may make our [success] in controlling the aggregates seem a little better, but [that could provide] a false sense of security. I hope we handle it a bit better despite what I said about the basic adequacy of our record. We have to keep our eye on the ball and dig in.

I also don't think there is any alternative whatsoever to the confusing technicalities we--and even more the Chairman--have to explain on Capitol Hill and to the public next year. There is no pot at the end of the rainbow. Even to Nancy's suggestion, of which I am somewhat enamored, or the suggestion that we go back to reserves or that we average M-1A and M-1B, or come out with some new M I say forget it. In terms of our public stance and keeping our eyes on the ball within this group there is no simple answer. It's like putting a questionnaire around this table and asking "If you had only one thing to eat in the next six months, and could have plenty of it, what food would you choose?" Would it be peas or beef or milk or what? Everybody would say that's a ridiculous questionnaire. Everybody knows it is necessary to have some balance in one's diet and that one's excitement over a given type of food is relative to something else. We're trying to get the ideal M and there isn't any ideal M. So let's realize that and, as the British say, just muddle through on what we can do. That means a lot of technical confusion and a lot of

public relations confusion. I see no alternative to that. Any way we do it, it's going to affect at least our statistical credibility, which I think is a little different from our economic credibility. Let's keep those two things in mind.

I certainly would not go to the proposal in Bob Black's charts. That would not only give us great problems in 1981, but is a very dangerous precedent. If that precedent is one we like, let's make up all of our overshoots for 1975, 1976, 1977, and 1978 while we are at it, which to me would be a reductio ad absurdum. Let's face it, we have a confessional at the end of the year in this church and we are going to start a new year. Let's observe it that way. We have justified or will be justifying what happened in 1980. Let's go on with 1981 and not try to make it up. I must say that when push comes to shove, as they say, strategy I is okay with me. It maintains a public position which is quite acceptable; perhaps in some ways it's a cowardly "don't rock the boat" approach, but I still believe in it. The differences among the strategies in 1981 and their economic effects [are minor]; the differences are all within the margin of error in my book. So let's not take those differences too seriously as we try to aim for a simplistic approach as to what [the outcome] might be by 1983. I suppose I should stop there. But I also have a euphoric goal in that I'd like to see us get rid of the blankety-blank weekly figures; given the state of the world, I guess that's still an impossible goal.

CHAIRMAN VOLCKER. Mr. Baughman, you have the honor, given your status of attending your last meeting, of being the next to the last commentator. I have to reserve the right to comment last for myself.

MR. BAUGHMAN. It seems to me, Mr. Chairman, that it might be appropriate for a lame duck to quack last.

SPEAKER(?). No quacks, please!

MR. BAUGHMAN. Important things first: My answer to Bob Mayo's question is pecan pie.

MR. SCHULTZ. He had no trouble with that one!

MR. BAUGHMAN. As for the economy, it seems to me that the outlook is for no growth or worse for the United States. Further, as Nancy has already alluded to within that framework, the numbers on housing and autos just chill one's teeth. But I'm inclined to agree with that as the outlook. With respect to the Southwest, it looks as if things will continue to boom along and for two reasons primarily: the energy situation and the fact that the Southwest apparently will get a break compared with some other parts of the country from defense expenditures. We assume they will be increased or, even if they are not increased significantly, that the shift in their make-up will [be beneficial to our area].

As has been the case for the last several years, the forces of inflation in the economy seem stronger than the forces of expansion. Unless something different is done, we will continue to be compelled to trade off employment and production as we attempt to restrain inflation. And the results of that exercise will not be

particularly satisfying; in fact, the results may well be a continuing acceleration of inflation and a decline in the growth [of economic activity]. This suggests that the gradualism strategy or the slow persistent pressure hasn't been working, and I don't see any reason to expect that the situation will change. Therefore, if the incoming Administration is inclined to embrace something they call an emergency philosophy and propose some program of action under that caption--and to my surprise there is some noise of that around now--I think that is a development that should be encouraged and supported. And hopefully, under that kind of program, we would succeed in getting some restraint on the rate of growth in government spending and a fairly broad array of actions to begin to free up the economy and make it somewhat more flexible than it is. Only by making progress in that area are we likely to be able to get the benefits of monetary and fiscal policy that we'd like to have in the way of a favorable tradeoff among growth and employment and inflation.

A suggestion came up in our board of directors meeting last time around--and it came from the directors not from the staff--that a change in our targets on the order of a reduction of 1/2 percentage point would simply be shrugged off as inconsequential, particularly given the ranges of the targets. And they finally wound up adopting a resolution suggesting that I carry their view down here that the targets should be reduced on the order of 20 to 25 percent for 1981 compared to what they were for 1980. There was a good deal of discussion. It was initially suggested that we reduce them by 1-1/2 points; but after some discussion they settled on 20 to 25 percent as being a preferable characterization. As to the base for the [1981] targets, I would rather present the targets to the Congress and to the public using the 1980 base; in other words, I'd avoid appearing to accept the drift in the base even if that necessitated using larger numbers than if we did accept the base drift. It seems to me that base drift has become a pretty sensitive issue and one on which we are likely to lose if we take on its defense in the public arena.

With respect to wider ranges, I can appreciate the statistical evidence in support of the need for that but, again, a public proposal of wider ranges is likely to erode our credibility. So I think we would be better off not to widen the ranges even at some fairly high risk of not coming within them. It also seems to me that we are almost going to be forced to talk in terms of something more than the next year if we are going to look credible, particularly if we were to take the position of accepting base drift and having rather wide ranges and then saying we are going to cut our targets by 1/2 percentage point. That would be construed as raising rather than reducing the targets and probably would be construed as abandoning or weakening our resistance against inflation.

With respect to [which aggregates to] target, granting all the [uncertainties] involved, we probably would be best off to try to emphasize M2 because it has less danger built into it for 1981 than the alternatives. With respect to the strategies suggested, we pretty much have to go either with I or IV. And since we have talked enough about gradually moving toward non-inflationary monetary growth rates, strategy I is preferable to strategy IV in that respect. If we were to go to strategy IV, feeling that growth rates of that magnitude for 1981 were feasible, then I would think [we'd want] some downward progression there. But we need to bear in mind that unless we put

them out, nobody is going to know what our projections are for '82 and '83 and, therefore, we will be read and evaluated on what we put out for '81. Looking at [the scenarios described in the Bluebook], we'd look better giving them the whole picture than just the first timeframe. I admit I still hold the view that with all the uncertainties involved we can get more mileage out of announcing our plans and intentions over a longer timeframe than one year, even at the risk of necessitating revising it later on. Well, for what it's worth, those are the views of the lame duck.

CHAIRMAN VOLCKER. Well, the wisest decision we have made is not to arrive at [a conclusion on] these long-term targets and strategies today. I suspect we might be here for quite a length of time [if we tried]. Many of the problems have been well exposed, with quite different views toward them. I took a few notes as [the discussion] went along, so let me try to work my way through these notes and make some points that stand out to me.

First of all, I think Governor Partee's point is an interesting one that deserves reiteration: We are in completely new territory for the Federal Reserve or for economic policy. An implicit assumption that we are just avoiding excess demand is not the present policy. We have been put in a position or have taken the position--wisely or not, but I think probably wisely given the economic conditions--that we are going to do something about inflation maybe not regardless of the state of economic activity but certainly more than we did before in looking at it in the form of avoiding excess demand. It is a very important distinction. I also think his comment about the English experience is worth reiterating. If you want to know about the difficulties of monetarism, look there. They have a government with a 5-year lease on life, totally dedicated to the proposition of monetary restraint as the way to kill inflation and totally prepared verbally to take the budgetary measures that they thought appropriate to accompany that. They were almost unsuccessful on the budgetary restraint side, and on the monetary side missed a target not by 1/2 or 1 percent but by 100 percent from the midpoint of the target.

MR. PARTEE. Although M1 was very good.

CHAIRMAN VOLCKER. Well, I was just going to say that they put a lot of weight on one target, [almost] entire weight on one target. They have missed it by 100 percent. There's a lot of talk about their credibility and missing it by 100 percent, but is there anybody who really [doubts] that if they met that target the British economy would be in a much more serious recession than it is now? Was that wise or not? They might also have less inflation. I don't know. I'm not saying the experiment will be unsuccessful. We will find out about that. But I do know that to make what progress they have made on inflation--the British people I talk to are very discouraged, but from 3,000 miles away one can see some glimmerings of hope--they have a very serious internal economic situation. They are battling in an attempt to establish their credibility, and we'll see whether they can do it.

In that connection, we obviously have a credibility problem--by "we" I mean the United States--as to whether [our policies] are going to deal with inflation. The Federal Reserve is only part of

that larger problem. But when we talk about credibility, I think far, far too much emphasis is put on these monetary targets. When I listen to people talk about credibility and their discouragement about inflation--and they are plenty discouraged--what I hear about the last year, specifically on Federal Reserve policy when you get away from the money market analysts, is: "You brought us to the brink in the winter and we got a little worried. We have been through that kind of experience before and in two months it all evaporated and nothing happened." They weren't looking at the money supply decline and saying all the pressures are off the money markets and it's full speed ahead. But there are a lot of other examples where Federal Reserve policy repeated [a pattern], as they see it, over a 20-year period, not just this year. They thought some results might be seen over the year and after two months the markets were easy again and they said: "We shouldn't have worried."

What else did we hear cited? Chrysler. A big company gets in difficulty and the government steps in, just as it did a few years ago when New York City got in difficulty. What happened this spring--I, at least, was part of it and I won't implicate any of you--is that we had a calamity in one commodity market. People got darned worried about it. The Hunts arranged a bail-out in the end. We acquiesced in permitting them to do it. Why did we acquiesce? Because we were worried about the second biggest brokerage house in the United States, and the biggest brokerage house in the country was not all that far behind. And at least one of the biggest banks in the United States was in potential jeopardy. Money eased anyway; maybe it wouldn't have happened. We came close. But the message that people came away with in their minds is not that we came close, but that when we come close somebody steps in to avoid it.

I have a wonderful example in the commodity markets in the last few weeks. Commodity prices had been going up pretty fast since about July or August. People got a little worried in the first half of December and prices went down for two weeks. The level went down all the way to where it was in October. There was a tremendous loss in the last two months [after the] inflationary gains, and there was almost a panic in the market. Those people weren't cheering for tight money at that point. They were worried about saving their own skins. Now again that has been avoided. I don't know what message is carried away from that, and I'm not sure it's over. Maybe I'm getting discouraged in one limited sense, but I will say in that connection that when we take on this inflation fighting job--taken on by ourselves or taken on in a broader context--we should not look around for much of a constituency. If we, in effect, go to the brink or let some of these things happen that we have not allowed to happen during the entire postwar period, people are not expecting that and they are not going to be very happy if and when it happens. And I'm not at all sure that we can change inflationary expectations without it happening. That, I think, is the nature of our problem. I wish Mrs. Thatcher well, but I don't think she has all that much of a constituency in the United Kingdom now. She does have a parliamentary majority for the time being.

So far as the business outlook is concerned, while I share the view currently that on any kind of analysis one would think we're going to have a downturn of some sort in the economy, I would be a little cautious about too much confidence in just what that is going

to be. The economic forecasting ability of the assembled economic wisdom of the United States in the short run has not been notable. And I don't know what the increase in GNP will turn out to be in the fourth quarter of this year; we are projecting between 4 and 5 percent. If we get a good December, it could be higher than that and entirely out of the range of what any economic forecaster was thinking of three months ago. And it will explain a lot about why the money supply has been rising so fast. As I say, I share the view that sometime along here we are going to have a decline in economic activity. I also think that the experience of the last year, as a number of people here have mentioned, suggests that there is an enormous latent expansionary force in the economy stemming partly from inflationary expectations, as soon as people think they have the money to finance it. So, I don't know how far it would go if we really got some easing of the money markets.

On the other hand, the opposite danger is sitting there. The danger is that if people's confidence that they're going to get bailed out of any serious situation were ever seriously challenged, the sense of panic in this economy could be enormous. We have one big company that is sitting on the brink right now, and I'll bet you that 90 percent or more of the people in the country think the government will not let it go down. They think in not letting it go down we are [reaffirming their] basic inflationary expectations and expectations that the government doesn't allow that kind of thing to happen. They also read into it that there's not much danger of real problems arising, so why should they change their behavior patterns.

I was out in Chicago yesterday and I heard two comments at breakfast that are typical of this. One banker commented on a conversation he had with a savings and loan executive the night before. The conversation apparently went banker to savings and loan executive: "Aren't you a little worried about the state of your industry?" They probably should be worried. "And how are you behaving?" The answer from the savings and loan executive: "I'm behaving perfectly normally, the way I always do, trying to expand my assets because the government is going to come in and bail out the savings and loan industry." The other conversation, instigated by me, was with a banker: "What do you fellows think you're doing? You're expanding your assets like crazy in the middle of interest rates rising; you're eroding your capital positions; you're getting more extended on liquidity; and you have every lending officer out there on the road." His answer: "I sure do. If we get in trouble, the government will protect us." These are attitudes that go a little beyond whether we made or missed our monetary targets. In effect, one way of putting it is that they think if there's a clash between the monetary target and a real problem in the economy, we are going to give way, whether we are inside the target or outside the target. And they don't translate those targets into their own behavior very readily even if they're fairly sophisticated.

In terms of those targets, I feel a little cautious about how much relaxation of pressure we are going to see in the money supply even if we have a little downturn or softness in business activity after the turn of the year. That's because, first of all, I'm not sure that it isn't going to be relatively mild. We don't have the credit control program we had in force that contributed to the sharp downturn both in the economy and in the money supply last year. We're

process. We were talking about budgetary expenditures of \$613 billion six months ago. I think that was an honest effort. They have been affected by the recession in an important way. But the last I heard the present Administration is going to be projecting budgetary expenditures of \$660 billion or thereabouts. That is an increase of close to \$50 billion in six months. I myself think it would [border on] a miracle, quite literally, if budgetary expenditures in fiscal year 1981 were brought down to that \$635 billion level that is sometimes mentioned by the Administration. I suspect the way things are going, it will take heroic budgetary measures to hold it to the \$660 billion level, after an increase of \$50 billion in six months. Just to hold the level at which it is now projected may be an extraordinary achievement. I'm not sure about that and I'm not sure about what they are going to project. All I know is that there's an enormous amount of built-in momentum; and if we casually talk about the economy taking another downturn, it means more unemployment compensation. We have succeeded--we, the markets; I'll be careful of my language--in sending up interest costs beyond what I'm sure is already in the budget. Defense spending isn't going down; it's going up. And there isn't much time left to make savings elsewhere in the budget in fiscal 1981. So when you are looking for help in other directions, you may have to wait a little while. I wonder a little about declarations of economic emergency that raise expectations that something is going to happen. It's nice and visible [and there may be] results in a visible period of time. That's not my decision to make. Whether that will be done or not or how it will be couched if it is, I do not know. But it all has a bearing on the decision that we finally have to make about how we posture ourselves for 1981. I'm sure I have not succeeded in making it any easier, but we have a lot of things to think about over the next month or two. Whether or not we will want a meeting in January, I do not know. But I do know we have to make some decision between now and then.

Let me outline a possible course of action in principle to you in the interest of perhaps speeding a decision, or maybe we will delay it. I do this against a background of an increasing restiveness over the artificiality of our decision-making process in some respects in setting forth these monetary targets for a short period in a framework of very static language in the directive itself. There are great advantages in static language on the other hand, so [changing] that is not my principal purpose. But, what do we want to do in this particular period? We have a lot of pressure, in terms of interest rates, on the markets. How much real pressure we have on the markets I don't know. We hear a lot of complaints now. I think we are getting a lot of complaints before people are very much hurt, in fact. You may think people are hurting now; but if we really do have one of these crises to which I alluded earlier, you haven't seen anything yet.

We have all the questions of lags in the process, of overkill and underkill subsequently, and of what happens to interest rates in the future. We have a fair amount of evidence now that the money supply is leveling off after all this pressure. And we have all the technical uncertainty beginning about 10 days from now, in terms of what those figures are that we are going to be looking at. I really have no idea how fast that's going to go. I hear what Jerry says on the one side and I worry about that. On the other side, I've talked to some bankers who think it's not going to go all that fast

initially, just from the inherent sluggishness of people in making changes. So we may not see much effect in the figures in the short run. I just don't know, but we may begin seeing an effect within the time period we are now talking about. It's going to make it very difficult to judge those M1 figures. My thought in general is that we might say something [about the fact that] we are now at the meeting before the beginning of a quarter when, in accordance with our normal procedures, we would be setting a target for a quarter with a relationship to a longer-term target. We have talked about setting the target in quarterly terms against the background of the annual target but we don't [at this point] have a well-defined annual target, [though] we have these tentative ideas that we talked about earlier. It occurred to me that it might be sensible to say that against the background of the tentative ideas we have, we would in a general way be content with and look toward growth during the first quarter consistent with those tentative views. We could cite what those tentative views are and say that for the quarter we'd be delighted to be on that path.

We have a certain advantage, hopefully, if we are right about what most people expect for the near term, that this ought to be obtainable during this period without any additional pressure on the market. Indeed, if I take any of the projections literally, they would be obtainable with substantially less pressure on the market. Now, that is combined with the concern--I don't know how widely shared--over the amount of pressure that is on the market now and the lagged effects that might have and all the rest. But it does seem to me conceptually that we might say we have a broad objective of being content with a result consistent with those tentative targets for next year. I would suggest that we also say that we would be quite content with a lower outcome than that, given that we have been overshooting [our target ranges] most recently. So, if we had a decline from what has been a recent overshooting, we would be quite content with that, assuming that occurred in an environment of declining interest rate pressures. In other words, I'm not saying we would push for any undershooting of this tentative target; but if it developed out of what has already been done and developed consistent with some easing of market pressures, that would be quite acceptable. Finally, on the other side of that dimension, if some undershoot did develop, presumably market pressures would go down and we would permit some reduction of market pressures but we would not aggressively try to get growth up to an annual target for the year. That's the other side of the same coin, given that what has been happening most recently has been an overshoot. And then I'd put in a federal funds constraint of the type we have been talking about tentatively, one that encompasses this feeling. I would think the range would have an upper end around where the funds rate has been most recently or thereabouts, say, 20 percent; and a bottom end of the range consistent with all of this seems to be something like 16 percent. Those numbers can be debated.

I have written a tentative directive to that effect. It tries to encompass that kind of thinking. I don't know whether the language is any good. I did it in about 3 minutes this morning and Steve tried to make it look a little better. I don't know whether it conveys the message or not, but I might distribute it so we will have something to look at and see whether it captures a consensus of the flavor [of our views] or whether it's comprehensible. Look at it in that view and, unless this is clearly understood and meets immediate

acclaim, I suggest we go to lunch. Maybe it's going to meet such immediate acclaim that we can finish before going to lunch. We have to pick up at some point the analysis of what the market has been doing recently and maybe we ought to get that from Mr. Sternlight before we discuss this any further. I don't know how long your report is, but maybe we ought to do that before lunch anyway. Why don't you proceed.

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

CHAIRMAN VOLCKER. Let me say one thing. This market has been affected yesterday and today by rumors about the money supply figures. One rumor involved whether the figures were affected by this change and/or reserve saving games a couple of months ago, which is the thing that worried me. But we haven't been able to identify it in any significant way and we are not making any revisions on that accord. [Another rumor is] that there may be a decline in the money supply figure this week. I'm very much disturbed that it sounds as if there has been some kind of leak. That is just poison in terms of our whole posture in these markets and our credibility as an institution, and I am very much disturbed by it. The fact is that we are not going to make changes but we were intending at least to point out that the reserve figures in November were affected by the changes in that reserve game. Perhaps it would have been unusual, but maybe we should have made an announcement [earlier] to market people, who have inquired, that that did have an impact on the reserve figures during November. That itself could have gotten confused with the money supply figures earlier. But as for the rumor suddenly appearing about a decline in the money supply this week, which hasn't been announced yet, I don't know where it came from. It may have come from no place, but on top of these other developments it looks like a coincidence that I would be happier not to see. I don't know what else I can say.

MR. PARTEE. The rumor was heard in the foreign exchange market that the decline would be on the order of \$10 to \$15 billion. It's a wild rumor; it's not necessarily something with any substance.

MR. BLACK. What is the magnitude of the decline the markets seem to be expecting?

CHAIRMAN VOLCKER. For the money supply this week? I don't know exactly, but I heard something this morning about a couple billion dollars. I don't remember whether it's quite that closely identified, but it is a decline of some significance.

MR. STERNLIGHT. If I could add one point on that: The rally of the last couple of days is based on a rumor about the money supply and also on reports from the incoming Reagan Administration to the effect of some [likelihood] of a national emergency program, which the markets seem to be interpreting, for whatever reason, rather bullishly for the bond markets.

CHAIRMAN VOLCKER. Can we have a motion to approve these transactions before we forget it?

SPEAKER(?). So moved.

CHAIRMAN VOLCKER. Without objection they are approved. And I would propose, unless the sentiment is the other way, that we have a quick lunch.

MR. MAYO. Can we try to have it fairly quickly because changing airline tickets late in the afternoon is going to be an awful problem today.

CHAIRMAN VOLCKER. So far as I am concerned, we can sit here if you prefer, but--

MR. GUFFEY. I'd just as soon go forward.

SPEAKER(?). We'll get finished quicker if we are hungry.

MR. MAYO. That was the Arthur Burns technique!

CHAIRMAN VOLCKER. I am perfectly happy to do that if that--

MR. MORRIS. Are we going to bring sandwiches in here today?

CHAIRMAN VOLCKER. Well, we were not going to. We should have, obviously.

MR. MAYO. Well, let's decide quickly.

MR. CORRIGAN. Let's keep going.

CHAIRMAN VOLCKER. Let's try to keep going and see what happens. Let's distribute [this draft]. I looked at it and the language is not perfect. I don't know whether people will even agree with the concept, but let me go over it and tell you what I am trying to convey because the language may not be adequate to convey what I am trying to communicate. The whole thing indicates some sense of uncertainty about what the figures will mean in the short run, but the first sentence is simply designed to say that we are tentatively proceeding for this first-quarter period in accordance with our [preliminary long-run] plans [announced] before. As I noted, I don't think that raises all the issues as to whether the long-term plan is really the one we want to follow for the year as a whole because of this expectation that the money supply may be a little softer in the near term. The second sentence identifies just what that is. There is a practical problem. These [figures] are cited as the midpoint of those long-term ranges and M2 is probably going to be higher than that. So there is a question of whether we want to leave that as the mechanical midpoints of the ranges. The next sentence says that we are not going to give a precise figure for M-1A and M-1B right now because we don't know what the NOW and ATS accounts are going to be. And it says that's the way we will try to conduct ourselves in terms of the specific job of setting forth the reserve path. Then an important sentence is the next one, which says that we want [our short-term targets] to be consistent [with our longer-term targets for] next year, but we are not going to be disturbed by a shortfall. That has perhaps some implication that we'd be just as happy if [monetary growth did] fall short of these figures. The reservation is that we are not going to [push] for a shortfall by tightening the money market further, but rather that if the shortfall arises in an atmosphere of some relaxation of money market pressures it would be

accepted. It's an acceptance rather than a seeking through aggressive tightening action. The last sentence is more or less standard, but the numbers are important. I would like a phrase in there indicating "over a period of time" or something like that so it doesn't sound as if these ranges are applied rigidly on a day-to-day basis. That has always been the understanding. So, that is the sense of it; other people may have quite different ideas. I'd avoid the term "weekly average;" it sounds rather rigid and we have been over--

MR. MAYO. I think it's a good statement, Paul, except for the next-to-last sentence where it tips our hand that we are expecting some shortfall.

CHAIRMAN VOLCKER. Well, the wording of that sentence is difficult. This is a little different than the way I had it written, but that proved incomprehensible to Mr. Axilrod. I think my way had a little less sense that we were expecting [a shortfall]. It was mainly that [a shortfall would be acceptable] if it proved consistent or something like that, though I recognize that's obscure. Just how that's written is a point of difficulty, I think.

MR. MAYO. I'm sure we need that sentence.

MR. BALLE. I don't think it tips our hand. It just says if it happens, it happens and we won't resist it.

MR. ROOS. I think the last sentence, with the expression of a narrower fed funds range, could be terribly disturbing to some who might view it as a signal that indeed we are moving toward greater emphasis even in the short run on targeting on interest rates. If we narrow the range and set the upper limit at 20 percent--and we are over that now--with a lower limit of 16 percent, I think, that will wave a red flag to those who are suspicious of a possible tendency to move back to our old procedures.

CHAIRMAN VOLCKER. Well, you obviously raise an important point. It's a substantive point as to whether we do want to avoid further increases in interest rates and also a presentational point that even if we do, do we want to say it this way. I don't know which you have in mind. As I said, I would put in a softening kind of phrase such as "are inconsistent with fluctuations in the federal funds rate in a general range of 16 to 20 percent"--if that's what it is--"taken over a period of time" or something like that to avoid any implication that we're going to sit on it on a day-by-day basis, whether it's above or below. But I don't know whether that helps you very much.

MR. ROOS. I just don't think the range should be narrowed. I would disagree on the wisdom of narrowing it. From a presentational point of view, I think narrowing it to 4 percentage points from the broader range that we've come to live with over the past year would be viewed by some as a reversion to the old [procedures].

MR. AXILROD. Mr. Chairman, as a point of information, the Committee at its last meeting established a range of 13 to 17 percent. It was subsequently widened in a special meeting to 13 to 18 percent.

CHAIRMAN VOLCKER. So we have a recent precedent, in fact from the last meeting, of 13 to 17 percent. This is a substantive issue where the Committee has to express its view. I was trying to reflect here what I thought were views on both sides: The view that we didn't want to put any more pressure on the market and the view on the other side that we didn't want the rate to get down too far. So, that's what I ended up with.

MR. MORRIS. I have a problem with this, Paul, because I think we have been in a corn-hog type cycle in monetary policy. It has produced the volatility of rates in monetary growth that we have seen and that we're all disturbed about. Now, some of it is inevitable from the fact that we are trying to impose a strict monetary guideline on an economy with a very high inflation rate. So, I don't think we can eliminate these cycles, but I think we can dampen them. But to dampen them we need to act before we get clear evidence that the economy is accelerating or decelerating. It seems to me the problems of 1980 were: 1) that we clung to a very tight policy too long; and 2) that we waited this summer and fall until it was very clear that the economy was accelerating before we started moving very vigorously against it. It seems to me we are in a situation now where we're beginning to get some evidence that the economy is about to nose over [into recession]. It's showing up in the money supply, in a jump in initial claims and unemployment compensation, and in projected cut-backs in auto production. We know housing is going down now, even though it hasn't shown up yet in starts. If we want to get out of this severe corn-hog cycle, we've got to act on the basis of what the data tell us right now. I would buy this if the fed funds range were 14 to 18 percent. In other words, I think we have to move now on rates. If we don't, we will be back in the corn-hog cycle we were in during 1980, it seems to me.

CHAIRMAN VOLCKER. I was wondering where you were going to come out because your initial comments about the corn-hog cycle seemed to me consistent with the way I view most of this. But you're just saying--

MR. MORRIS. No, because this will mean that the Manager will stay with a 20 percent funds rate until we have had a very long period of weak monetary growth.

CHAIRMAN VOLCKER. Well, I don't read it quite that way. It says the Manager will stay on some reserve path, which is probably-- it's a matter of judgment--now very close to being inconsistent with the present funds rate. I think the funds rate is being held up a little by psychological [considerations] right now, perhaps by banks feeling that they don't have such easy access to the discount window after some months.

MR. MORRIS. But we're telling the Manager that shortfalls from the ranges are acceptable. I don't know how long it would take Peter to move on this, but it could well be a month or two if we have the--

MR. SCHULTZ. What would you want the Manager to do? You want him to get that funds rate down to 18 percent now?

MR. MORRIS. Down to 18 percent, yes.

MR. SCHULTZ. Now?

MR. MORRIS. If we want to avoid another cycle like the one we had in 1980, I think we have to.

MR. SCHULTZ. My heavens, I think the effects of that would be terribly dangerous and disruptive.

MR. MORRIS. I think the market is anticipating--

MR. SCHULTZ. We're going to publish a drop [in the money supply this week] and next week we'll publish what looks like an equally big increase. If we get that rate down to 18 percent now and publish that increase next week, God only knows what is going to--

MR. MORRIS. No, I disagree. The action in the marketplace [suggests that] the market is anticipating that we are going to do something like this because they apparently think it's sensible.

CHAIRMAN VOLCKER. Well, I'd go slowly. I don't know what they're thinking. There are a lot of misleading rumors in the market at the moment.

MR. GRAMLEY. Mr. Chairman, what is it that is going to tell the Manager that he is supposed to keep the funds rate closer to the upper end of this 16 to 20 percent range or the lower end? I have problems similar to the ones that Frank has on the corn-hog cycle. And if I can be assured as to what is going to lead the Manager to lean toward the lower end--. But this language is so general that I have no idea what it is that's going to prompt a movement of the funds rate toward the lower end.

CHAIRMAN VOLCKER. Well, first of all, I don't conceive of this language as saying he should be guided by the federal funds rate in the short run. We're going to sit here and establish some money supply and reserve paths as we did before. A larger element of judgment will be involved, if we really think we can't interpret these M-1A and M-1B figures very well. But Mr. Axilrod will struggle as best he can to see whether we're coming in at or below the numbers cited [in the draft sentence] above, just the way he does now. And if those numbers are coming in lower, then presumably the borrowing total will be lowered and the money market [will react].

MR. WINN. Are these numbers internally consistent?

CHAIRMAN VOLCKER. Well, as I said, that M2 number may not be. There's a presentational problem. If we put in a higher M2 number in the short run, which is consistent with the projection for whatever that's worth, it also raises a question to the reader of this a month from now--the way it's constructed--about what we're doing with the annual ranges. So I don't know what to do with that number; it's a bit of a problem.

MR. BALLE. Mr. Chairman, because of the expectational effects, when will these minutes be published? Will they come out a month from now irrespective of whether we have a meeting [in January] or what?

CHAIRMAN VOLCKER. Have we ever faced that problem before?

MR. MAYO. Wouldn't they come out on February 6th?

MR. ALTMANN. February 6th would be the day, as of now, if we have our regularly scheduled meeting. If we call a meeting in between, it's not a regularly scheduled one, and I suppose we can hold this until February 6th.

MR. MAYO. That's all right.

CHAIRMAN VOLCKER. But if we hold to that schedule, I suppose the expectational effect won't mean much because we will be coming out very shortly and explaining our targets for the year.

MR. BALLE. That's an important consideration.

MR. ALTMANN. I have reason to believe that we couldn't have [the policy record] prepared in three weeks.

MR. MORRIS. Could we ask the Manager, Mr. Chairman, how he would interpret this directive? Maybe that would help Lyle and Larry.

MR. GRAMLEY. Well, let me ask my question more concretely. You're going to make up a reserve path which is consistent with this language. Will this reserve path be basically the numbers that appear under alternative B on page 11? I presume it would be. If that's the case, my question is: Why is it that we are considering changing the federal funds range from 13 to 19 percent to 16 to 20 percent?

MR. AXILROD. I think the easiest way to see it is on page 12, Governor Gramley. Just throw away that December 2-1/2 percent rate of growth; we now estimate it at 1-1/4 percent. Look at the panel that has December '80 to March '81 under alternative B for M-1A; that's constructed right on the midpoint of the tentative range, which is 4-1/4 percent. As of now we think NOW accounts will subtract 5.6 percentage points over the quarter, so the M-1A number in parenthesis would be -1.4 percent. For M-1B under alternative B, it would be 4.7 percent--that's the 4-3/4 percent--and we think NOW accounts would add 2-3/4 points. We would try to monitor this as these data come in to see if we're anywhere near right on that. And we'd construct the path on that -1-1/4 percent, which is something like -2 percent for January and -1.9 percent for February. That's the path we would construct the reserves on, which is what we'd guess now; and then we'd adjust it as the data come in.

CHAIRMAN VOLCKER. It's not a coincidence that this is the same as alternative B because alternative B assumed a path that is the same as our tentative annual ranges, which is what this is saying. What it adds up to is that we are not disturbed about a shortfall from the specified--

MR. GRAMLEY. Well, I would be quite disturbed about a shortfall, if the shortfall were not coming from a shift in the amount of funds going out of demand deposits into ATS but a slowdown in the economy and if the funds rate were staying up at 20 percent. Given the degree of uncertainty about what may be happening, I don't know how this Committee can make a decision without giving the Manager a

lot more instructions about what he's to do with the federal funds rate. When the numbers we're looking for--

CHAIRMAN VOLCKER. This does not say a shortfall will be accepted at a 20 percent funds rate. It says a shortfall will be accepted if money market pressures are easing. It says that quite explicitly.

MR. GRAMLEY. It could back off from 20 to 19-1/2 percent.

MR. PARTEE. It's a little tough, I know, Paul. It says a "modest reduction." A modest reduction could very well be 16 percent on the funds rate. It seems to me that it has to be a little more straightforward than you have it.

CHAIRMAN VOLCKER. I think this is a lot more straightforward than I would suggest in the ordinary directive. It is a little more operational in that sense. But if you want to give the Manager instructions that the federal funds rate should be 19 percent next week and 18 percent the following week and 16 percent the following week, that's a quite different kind of instruction. It's not the way we have been operating.

MR. FORD. Compared to the fed funds ranges in the three alternatives the staff developed, this is narrower than any of them. Why narrow it? I'd be inclined to give more leeway rather than less.

CHAIRMAN VOLCKER. That's the question you have to decide. This is simply designed to reflect the feeling--which I share to a substantial degree--that we wouldn't like to see the funds rate go up a lot more in view of this hog-corn cycle. But I'm also reflecting the feeling that a lot of people wouldn't like to see it plunge too precipitously if things get a little weak for a while. I don't know how to express that in the directive other than here, if it is the feeling that we want it in the directive. We can presentationally say one thing in the directive and have an understanding that it's a little different than that in practice. That's another way of doing it, but I--

MR. FORD. Yes, but we're setting this presumably for three months, right?

CHAIRMAN VOLCKER. No, it's until the next meeting.

MR. FORD. Oh, just the one month.

CHAIRMAN VOLCKER. Well, it's subject to review at the next meeting.

SPEAKER(?). That's in February.

MR. MORRIS. That's a month and a half we are talking about.

CHAIRMAN VOLCKER. Well, if we don't have a January meeting it would be until--

MR. ALTMANN. February 3rd.

CHAIRMAN VOLCKER. February 3rd.

MR. FORD. Yes, but still we're talking about a target that goes for at least a quarter or so.

CHAIRMAN VOLCKER. The target tentatively goes for a quarter, but the operational--

MR. FORD. I'd hate to think that within the next quarter we'd be upset to see the fed funds rate come down to something close to what any of these--

CHAIRMAN VOLCKER. Oh no, I think the federal funds range quite clearly only applies until the next meeting.

MR. FORD. The lower part of the range I mean.

CHAIRMAN VOLCKER. The history of these federal funds ranges, I will repeat, is that without exception every time we have hit the limits, they have been changed. Every time.

MR. FORD. So make it a little wider as these alternatives suggest and--

CHAIRMAN VOLCKER. Well, that depends upon whether the Committee wants to take another look at them. That's what we have to tell the Desk.

MR. PARTEE. I could accept 15 to 20 percent.

MR. MAYO. I'd say 15 to 21 percent; we are there now.

MR. PARTEE. No, 21 percent is too high for me.

MR. MORRIS. Me, too.

MR. CORRIGAN. Steve, this is an unfair question, I suppose, but what is your view as to the level of borrowings that might be compatible with this, say, over the next four weeks?

MR. AXILROD. Well, for lack of anything else, President Corrigan, I would tend to start out about where we are. And where we have been is that last week the average was around \$1.5 billion and yesterday it was \$1.7 billion. So, somewhere around \$1.5 or \$1.6 billion strikes me as a reasonable place to start, lacking any other indications.

MR. CORRIGAN. If there's anything to this view that once we get below \$1-1/2 billion or whatever the thought is about the frictional level of borrowings, the implication then might be that the funds rate could indeed come down fairly fast.

MR. AXILROD. Well, on that there is a divergence of opinion on the staff. My view, which has proved wrong this week, is that a level of \$1-1/2 billion of borrowing is probably consistent over time with a lower level of the funds rate than we have had. Once we get through this period--

MR. CORRIGAN. Well, that's not inconsistent with what I'm saying.

MR. AXILROD. But that isn't certain. And I'm not sure Peter shares that view exactly.

MR. STERNLIGHT. I think it could well be [the case] in time. Right now I would tend to associate \$1-1/2 billion of borrowing with something more like the 20 percent upper end of this funds range.

MR. CORRIGAN. Why, Peter?

MR. STERNLIGHT. Just because that has been the recent behavior of banks. There seems to have been a considerable--whether it's regional differences--

MR. CORRIGAN. Yes, but isn't that very recent experience a combination of some banks getting a little discipline at the window plus this expectational effect that may well be built into the funds rate right now?

MR. STERNLIGHT. It could well be. And I share Steve's view that in time we ought to associate \$1-1/2 billion of borrowing with something a little lower in the funds rate, 17 or 18 percent maybe. But I'm not sure how long this psychologically higher funds rate may last. I'm not sure we are about to depart from it quite yet.

MR. CORRIGAN. I can live with a 16 to 20 percent range, but the real question then becomes under what conditions you would feel compelled to adjust the nonborrowed path if things worked in the direction that we are talking about now and the edge came off the funds rate for whatever reasons--borrowing got at or below this frictional level--even in the framework of six weeks. The real question is: What would be the attitude toward adjusting that path?

MR. ROOS. I think this spotlights a very serious weakness in our present process whereby this Committee very carefully chooses aggregate growth targets and fed funds ranges and then the staff with some verbal guidance but no official guidance from this Committee makes the borrowing assumptions. Sometimes the borrowing assumptions are not consistent with the [monetary aggregates and fed funds] decisions we have made. Now, this may be something we ought to discuss when we talk about our future operating procedures, but I sense an awful lot of emphasis being placed on the definition of certain borrowing assumptions and shifts in those assumptions, which have an impact on the fed funds rate and on growth in the aggregates. I don't think the Federal Open Market Committee necessarily makes a policy judgment in connection with these borrowing assumptions. I know we talk about them.

CHAIRMAN VOLCKER. Well, I tried to bring that to your attention recently. And that's precisely [the reason for] my restiveness about sitting there and putting down some money supply figure that we have no control over in the short run. It's not a very satisfactory policy decision. The question comes to: What do we do about it? And I think the question that this conversation is posing right now--and there may be differences of views and one way of putting it is that it's related to the borrowing decision--is this:

Are you willing to see the federal funds rate stay around or move higher than 20 percent on the one end and are you willing to see it stay around or go lower than 16 percent on the other end? We have to get some consensus on that point, and people's views may differ.

MR. WALLICH. Mr. Chairman, it seems to me that the directive has to take account of two contingencies. One is that the economy may continue strong; the other is that it may weaken. If it continues strong then it needs restraint, and that means a higher funds rate--higher than it is now. If it weakens, it doesn't need much of an increase in the money supply because interest rates will go down anyhow. Our main concern will be to slow that decline. So I would go for a higher range on the funds rate than we have here, maybe 17 to 22 percent. And I'd go for a low rate of increase in the money supply. I think that meets both contingencies--if the economy weakens or if it remains strong.

MR. PARTEE. In your first case, Henry, if the economy remains strong, the money supply will be above these numbers that are mentioned. And, therefore, it will immediately bring to the fore a telephone conference meeting to raise the funds rate. So you needn't put the limit up to 22 percent. You can just depend on that occurring if the economy is strong.

MR. WALLICH. Well, we didn't follow a practice like that this last time. I'd rather have the number there so that we understand what we mean.

MR. MORRIS. Mr. Chairman, could I ask the Manager to define his understanding of this clause "some shortfall from the target ranges would be acceptable in the near term" as consistent with a modest reduction in pressures on money markets?

CHAIRMAN VOLCKER. Governor Partee has given you what is probably a more elegant expression of that thought.

MR. MORRIS. But Peter is going to be running [the operations].

CHAIRMAN VOLCKER. Well, Peter hasn't seen this language before, so let me give him the exact language: "Some shortfall from the target ranges would be acceptable in the near term if that should develop in the context of reduced pressures on money markets."

MR. MAYO. That's simpler and more straightforward.

MS. TEETERS. But no shortfall would be permitted in the target range in the federal funds rate?

CHAIRMAN VOLCKER. Well, not without a meeting. It depends upon what we put in. I remind you that every time we've hit one of these [constraints], we have removed it, rightly or wrongly. But if I may say so, I don't think it's up to the Manager to interpret this now; it's up to us to tell him what the interpretation should be. We could discuss a little more whether [we agree with] Steve's view that the federal funds rate would probably come down if with \$1.5 billion in borrowing the money supply came in a little weak and the judgment was that it was running below this target. But my interpretation of

this is that the Desk would move a little more slowly in reducing the borrowing target under those conditions than if we didn't have this reservation that says if interest rates are declining. So there would be a reflection in declining interest rates, but that would be moderated in the rate of speed with which the borrowing level was reduced.

MR. WALLICH. I think in principle it's a good formulation because it says there has to be some compromise when we're not meeting the target on the aggregates and having a movement in interest rates.

MR. GRAMLEY. The problem, though, is the numbers that are going to be used to make up the reserve aggregates and what the reserve aggregates are going to look like. The M-1A number, depending on whether or not one takes into account the staff's estimate of NOW accounts in January, is from -2.1 to 4.0 percent. The number for M-1B is 4.6 to 7.5 percent. And I think this--

CHAIRMAN VOLCKER. Those problems clearly exist, but I'm not sure what your operational point is.

MR. GRAMLEY. But that's my whole point. My whole point is--

CHAIRMAN VOLCKER. Do you want to give the staff a guideline on the federal funds rate and say aim at a 19 percent federal funds rate this week?

MR. GRAMLEY. I would be prepared to do that, although I don't think the Committee would. But the essence of the arguments that were going around the table was that we have to give more weight to broader aggregates. And I think we have to start now. If we don't start now, we'll be working with this element of uncertainty--which is going to prevail all year long--until such time as we make our longer-run decision. And one way to deal with this operationally would be to say that particular emphasis will be given to M2 in light of the uncertainty in M-1A and M-1B.

CHAIRMAN VOLCKER. Well, I don't disagree with you [but] we ought to discuss what we are talking about for the annual range. If you want to say that this time, we've got to put in a higher number for M2, I suspect, if we give any weight at all to the staff forecast. It's on page 13, Lyle.

MR. PARTEE. I don't think we ought to face that today.

CHAIRMAN VOLCKER. Well, that's what I implicitly said: Let's not face that today.

MR. PARTEE. This says reserves along a path consistent with growth of 4-1/4 percent in M-1A and 4-3/4 percent in M-1B. I think that does allow some room for the kind of thing you are talking about; that is a bigger M-1B number because the M-1A number will be smaller. As far as reserves are concerned, it allows us some room. I just don't think we are prepared to decide what these numbers ought to be for the range of aggregates today. We've just had a long, long discussion of it and we are all over the lot.

CHAIRMAN VOLCKER. Just to be clear, if we accepted these kinds of numbers with a 20 percent [upper constraint on the funds

rate]--though Henry doesn't want that--I interpret this to mean that the borrowing number initially is going to be set, with all the uncertainties that exist, at something that is not thought to be inconsistent with a 20 percent federal funds rate or lower. It is not going to be set with the idea that the federal funds rate is going to go above 20 percent. In making the decision today, we are saying that we are broadly concerned about 20 percent. Obviously the operational people should reflect that decision in their target. Now, if we want to change that next week or whenever, we can do it. But talking about it right now, this week, that's what we're saying.

MR. GUFFEY. Mr. Chairman, maybe in view of the time and hunger, I would say I like what you have proposed. The only reservation I have about it is the 16 percent on the low side. I think we must maintain at least a 4 percent range but I would hate to see us get to 16 percent in the next two or three weeks or even by February 5th, or whatever the date of the next meeting is, without some consultation and a better view of what is happening in the economy. With money growth and what is evident now, I would really prefer a consultation, say, at 17 percent, which is consistent with what the staff is projecting under the B alternative in the short run.

CHAIRMAN VOLCKER. Well, I didn't put 16 percent in there with any thought that it would actually reach that, but who knows.

MR. GUFFEY. What I'm really suggesting is that we adopt this with Chuck Partee's amendment to the language in that one sentence. I think we should at least consider some consultation if the funds rate is above 20 percent and stays there for any long period of time or if it drops to 17 percent and looks as if it's going to pass through 17 percent to that 16 percent level.

MR. ROOS. I'm as hungry or hungrier than Roger; nevertheless, I would be able to support this only if we don't have a narrow specific numerical range. I would urge instead that we broaden that fed funds range. If the Chairman at any time feels uncomfortable and wants to set up an interim telephone conference, that's the chair's prerogative. But the tenor of this discussion has implied an awful lot of sentiment to get back on a federal funds rate constraint, and that just ruins my Christmas Eve.

MR. SCHULTZ. You're celebrating early, Larry!

MR. PARTEE. I should say on this word change, Larry, that I'd change the 16 to 15 percent if the Chairman agreed.

CHAIRMAN VOLCKER. Well, you had some other suggested word changes anyway. This language could use a little tuning up just in the sense of smooth reading. It has "consistent" in the first paragraph twice and Governor Partee suggests making the first one "associated." He puts in a sense of a longer path before the second consistent, so it reads: "In the short run the Committee seeks behavior of reserve aggregates associated with growth...over the first quarter along a path consistent with" those targets. I had begun changing it to start the sentence with "Abstracting from the effects of deposit shifts..." I was looking for whatever language we used in earlier directives when we actually cited the [numbers] here. That should be 1981, of course, in the next sentence. "Beginning in 1981

the discrepancy between growth in M-1A and M-1B is likely to widen to an extent that cannot [be determined]." That, I think, is an improvement in the language. And for the last sentence on the federal funds rate he put "averaging generally between 15 and 20 percent." Apart from the numbers, "averaging" sounds like averaging over the whole period. I think that goes a little too far, Chuck.

MR. PARTEE. It's a very difficult thing to deal with. A weekly average is what we have referred to in the past.

CHAIRMAN VOLCKER. That sounds somehow as if it has a little too much rigidity. Weekly average is all right with me, but I would say is consistent with a federal funds rate of whatever range we put in "taken over a period of time" or something like that. That conveys the notion that we are not talking about one or two days but about something that seems to be persisting.

MR. GUFFEY. Isn't this consistent with what we publish [now] --"generally in the range of" and then we cite the range--for the federal funds rate?

CHAIRMAN VOLCKER. Well, that language is somewhat different than what we've published before. It sounded a little more rigid before, and that's what I--

MR. SCHULTZ. Remains within a range of--

CHAIRMAN VOLCKER. It's in two sentences. It's stuck in as a proviso or understanding "provided that in the period before the next meeting the federal funds rate remains within a range...." That, just on the face of it, sounds as if it's a daily thing.

MR. ALTMANN. It says weekly average.

CHAIRMAN VOLCKER. Oh, it says weekly average. That's how we used weekly average. We can go back to the weekly average, but that always sounded a little peculiar to me, in terms of a weekly average coming in precisely above or below--

VICE CHAIRMAN SOLOMON. I'm willing to live with the substance of this--the 16 to 20 percent and accepting the shortfall. I am a little concerned that the first sentence, by setting up the first-quarter targets as consistent with a kind of annual target, may be read by the markets as indicating that we are probably going to go ahead with the same annual targets that we set tentatively. We we might correct that impression, which I think is a distinct danger, if we simply add to the end of the first sentence "consistent with the tentative annual targets set at its meeting of July 1980, which will be reviewed..."

CHAIRMAN VOLCKER. "Will be reviewed." I think that's fine.

MR. PARTEE. Yes, that helps a lot. Your point is very good.

MR. ROOS. That means we are locking ourselves in in view of the--

CHAIRMAN VOLCKER. If in fact we don't publish this until February, there isn't much locking in; but I think what you are saying is fine. I have no problem with it.

MR. ALTMANN. There's about a 3-week lag between when this will be published and your testimony.

VICE CHAIRMAN SOLOMON. You testify when--February 20th?

CHAIRMAN VOLCKER. Yes.

MR. MAYO. There are still two weeks.

MR. PARTEE. Yes, there is still some [lag]; this will be out in the market for--

CHAIRMAN VOLCKER. Well, the substantive issues--and they are substantive--revolve around the borrowing assumption and the implications of that for the federal funds rate. And that's what we can't duck. Before we get to that, I don't know what people think about these [monetary growth] numbers. Somebody may think these numbers are too high and we should in fact aim for a significantly lower level--not just accept a shortfall but express it as an objective. If we do that, it substantially increases the probability, or the possibility anyway, of having to force a higher federal funds rate.

VICE CHAIRMAN SOLOMON. Let me note what my market contacts in New York say. I went out of my way to hear [the views of] a very wide group of people during the last two or three weeks. Even those who I might say are the strongest hawks in the tradition of the New York market sense are saying: "Don't tighten any further; keep the funds rate where it is." I don't see that our credibility requires us to do any further tightening. There may be periods of time in which the operations will work out so that the funds rate has to be somewhat over 20 percent, in the 20 to 21 percent range, but I gather it's possible that the rate will subside a little. The language "over time" is loose enough that if we have to spend a large part of one week at 20-1/4 or 20-1/2 percent, that's permissible.

CHAIRMAN VOLCKER. I think that is right. But consistent with this language and those numbers, which can be changed, we will set a borrowing total that we don't think is inconsistent with what we are saying here. Now, we don't know; so, something else could happen.

VICE CHAIRMAN SOLOMON. We don't know.

CHAIRMAN VOLCKER. But we are talking, I would say, about a \$1-1/2 billion borrowing level, or maybe a trifle lower, particularly if next week's money supply comes in low. That probably is consistent with a federal funds rate of 20 percent or less. It may take a few days for that to develop, but that is the implication. Now, if the next money supply figure or the next two money supply figures came in high, there may be some doubt. At some point we may run into an inconsistency, but that's--

MR. FORD. And we'll be calling each other up during the Christmas holidays. To me, Mr. Chairman, your proposal to soften the

language so as to signal the money market watcher that we're not watching every day for every little glitch of fed funds rate--the averaging idea or however you want to express it--is a good one. Between that and Governor Partee's idea of making the range 15 to 20 percent it may provide enough [flexibility] so that we won't have to be on the phone with each other all over the country.

CHAIRMAN VOLCKER. Well, let me take it up in order and see whether we have a consensus. The first thing is the numbers we mention. Forgetting about the special problem with M2 for the moment, is citing something like the midpoint of these tentative ranges too high, too low, or on the mark in terms of recognizing that presumably we will have a clause in here that says shortfalls will be accepted.

SPEAKER(?). Just right.

MR. BALLEES. Just right.

MR. MORRIS. Fine.

MR. WALLICH. It's too high to me.

MR. PARTEE. We need to have a show of hands or something.

CHAIRMAN VOLCKER. Right.

SPEAKER(?). These are the figures for the aggregate?

CHAIRMAN VOLCKER. Yes. I'll ask another question [later] about the M2 figure. I'm talking about citing a figure which as a point of departure is the midpoint of these tentative ranges and implies that that is an acceptable number but shortfalls will be accepted. We won't be happy about overshoots. How many members of the Committee find that a desirable way to go about it? That's not so many.

MR. ALTMANN. It's eight, not counting you.

CHAIRMAN VOLCKER. Well, let me just linger over what is partly a presentational problem on M2. The staff tells us this M2 figure is too low. Let me make Henry happy. It looks a little funny if we say "broadly consistent with the tentative ranges" and then cite a number that doesn't seem consistent. So, we have a bit of a substance versus presentation problem here.

MR. PARTEE. We either have to depart from that base or give up M2 and not state [a number for] it.

MR. ROOS. What about adding a sentence, if we do have a higher M2 figure, qualifying it or explaining why that is higher.

CHAIRMAN VOLCKER. We could do that. We could use the basic form of the sentence which says that these are the midpoints that we are aiming for but add a clause at the end of the sentence saying "although it is recognized that M2 for a time may run somewhat higher" or something like that.

MR. GUFFEY. It doesn't seem to me that this is something we need to deal with in this intermeeting period. Your testimony is going to come within 10 days [of the publication of this directive].

CHAIRMAN VOLCKER. Well, I think we can just barely get by with it this way, even recognizing in substance that it's only one of three numbers and so forth. But it is something of a problem.

MR. ALTMANN. That thought could be in the policy record without being in the directive.

CHAIRMAN VOLCKER. Yes.

MR. FORD. You would explain it in any event in your testimony, right?

MR. GRAMLEY. Can we instruct the Manager to read 10 percent where the 7 percent is?

CHAIRMAN VOLCKER. Well, Murray is pointing out, which I think is fair, that we can mention this point in the policy record. We can say that while it's generally consistent, we recognize that M2 for a time may run above [the midpoint]. That's one way to handle it.

VICE CHAIRMAN SOLOMON. I think that would be better. We don't really want to open up this discussion until we talk about it in the context of the longer run.

CHAIRMAN VOLCKER. That strikes me as a reasonable compromise, to make sure it's in the policy record but just as a general practice to use the midpoint of the ranges here.

MR. AXILROD. We would construct the path assuming something like 10 percent.

CHAIRMAN VOLCKER. Is [your estimate] that high?

MR. PARTEE. [M2] doesn't make much difference in the path.

MR. AXILROD. That's what we have as consistent under alternative B. We have 10 percent for the December-to-March period, which translates to roughly that for January and February. That may be wrong, but most of those [components] don't have reserves attached to them anymore, of course.

MR. PARTEE. Then your reserve path wouldn't change.

CHAIRMAN VOLCKER. I wonder whether it's really going to be that high. I was looking at this 8-3/4 percent figure you have; that's because you're projecting a low December, I take it. Well, okay. We're saying [the Manager] is not going to be too disturbed if it's 10 percent in the short run. I wonder if it will be that low in December; we are talking about the period until the next meeting and--

MR. MORRIS. That paragraph on page 5 really is critical.

CHAIRMAN VOLCKER. I'm not sure you are talking about 10 percent between now and the next meeting.

MR. AXILROD. No, that's right. But in constructing a path, January is what we would be putting in there. And I would tend to put in around 9 percent.

CHAIRMAN VOLCKER. What makes you think January is suddenly going to jump up if December is very low?

MR. AXILROD. Well, it may or may not; we have had this--

CHAIRMAN VOLCKER. I just have a gut feeling that if December is that low, there isn't a strong basis to think growth is suddenly going to jump up to 10 percent in January, even if you're right for the quarter.

MR. AXILROD. Well, the only operational question is what number to put in. It's not going to have any real effect on the operations.

MR. CORRIGAN. 8-3/4 percent.

MR. AXILROD. Whatever number we put in there, because we tend to ignore M2 in the very short run,--

MR. FORD. Why argue about it?

MR. BALLEES. Even for the long run, too.

CHAIRMAN VOLCKER. I guess what we are implicitly saying is that we are not going to get too disturbed about something in the 8 to 10 percent area, and that will be reflected in the policy record. Otherwise we have to use the exact number. I take it the shortfall idea is incorporated in here. Is that generally acceptable?

SEVERAL. Yes.

MR. MORRIS. With the revised language?

CHAIRMAN VOLCKER. Yes. Then we're down to the federal funds rate range; varying views have been expressed. I listened to both sides of this and I don't have a better suggestion for you than 16 to 20 percent, but let's look at it differently. Let me ask questions. What about the upper end of the range? How much consensus is there on 20 percent with language that says "over a period of time" or "weekly average," whichever you prefer? Understand that as before--we have had two recent examples--we have never let these things be binding, for better or for worse. I'm not saying that's right, but again I cite the historical experience. We have discussed this at frequent intervals recently and we can continue to discuss it if it becomes a problem. So with all those understandings, to how many is 20 percent acceptable? That does influence where the borrowing figure is put at the moment.

MR. GRAMLEY. Does that mean you are going to set the borrowing figure to achieve 20 percent or so?

MR. MAYO. No.

CHAIRMAN VOLCKER. We are thinking of the kind of borrowing figure that Steve is talking about as consistent with that.

SPEAKER(?). Initially.

CHAIRMAN VOLCKER. Initially, right now.

MR. PARTEE. But if the aggregates are weak, the borrowing figure will drift down from that and eventually the funds rate would come down.

SPEAKER(?). You are going to starve me to death if you keep [talking]!

MR. GRAMLEY. What was his borrowing number again?

CHAIRMAN VOLCKER. It was \$1-1/2 billion, I believe.

MR. PARTEE. Probably.

CHAIRMAN VOLCKER. It would go down if the incoming money supply figures are below the present estimates.

MR. ROOS. I'd like to raise one question along this line. I'd invite the Committee's attention to page 18, which has language we have used in the past in the last paragraph. It says: "If it appears during the period before the next meeting that the constraint on the federal funds rate is inconsistent with the objective for the expansion of reserves,..." We are changing the words. In this draft the wording is: "If it appears likely that the monetary and related reserve paths are inconsistent with fluctuations in the fed funds rate,..." It seems to me that the latest wording places the fed funds rate as the anchor that will control aggregates behavior, and that's exactly the opposite, I think.

CHAIRMAN VOLCKER. I assure you that you've picked up a point to which no substance was attached by the author. He has probably written it that way without knowing it. But I take it you would prefer it to be written as: "If it appears likely during the period before the next meeting that fluctuations in the federal funds rate over the general range of 16 to 20 percent, taken over a period of time, are inconsistent with the monetary and related reserve paths, the Manager will...."

MR. ROOS. I'd feel much more comfortable.

CHAIRMAN VOLCKER. Okay. If you can detect a difference in that language, I--

VICE CHAIRMAN SOLOMON. Some Fed watchers might.

CHAIRMAN VOLCKER. Okay.

MR. ROOS. That's the only thing I've ever discovered on my own, Mr. Chairman!

CHAIRMAN VOLCKER. Let me assume the reversal of the language is made. Do we have we a consensus on 20 percent for the number to put in?

SPEAKER(?). It's a majority.

SPEAKER(?). It's 7.

SPEAKER(?). Can we do it again?

CHAIRMAN VOLCKER. We went through that one. Let me try the 16 percent on the bottom.

MR. SCHULTZ. You want hands raised on 16 percent?

CHAIRMAN VOLCKER. 1,2,3,4,5,6. Is there a greater number for any other number on the bottom, like 15 percent?

MR. GRAMLEY. I could vote for 15 percent just as easily.

CHAIRMAN VOLCKER. We're about tied, I guess. Is anybody for 15-1/2 percent?

MR. SCHULTZ. I can accept 15 but I prefer 16 because I'd like to see us talk about it if the rate gets down to 16 percent.

MR. PARTEE. Yes, we'll talk about it.

MR. SCHULTZ. We have never had a problem on the up side. I would see no particular problem on the down side but it would be worth talking about. There are a lot of things going on. And 16 percent seems to me [a big move]; we have talked about the volatility problem. I think we ought to do some talking at 16 percent.

VICE CHAIRMAN SOLOMON. Well, Paul, maybe those of us who prefer 16 percent would go along with 15 to 20 percent to get a larger consensus if there were an understanding that when it got down near 16 percent we would have a consultation.

MR. GUFFEY. I would go for consultation at 17 percent. Then I would join you.

MR. PARTEE. I do believe that the aggregates would have to be pretty weak for the funds rate to get down in the low end of the range we are talking about. And we would probably want to have a telephone conference call to talk about what is creating the weak aggregates in any event.

CHAIRMAN VOLCKER. I can obviously go either way, but it seems to me that 16 percent has some advantage. Well, it's not going to be published for a long time anyway, so maybe it doesn't make much difference. But there is some disadvantage in saying that the Committee in the middle of December, when everything was still on the high side, was rather anxiously looking for a great big decline in interest rates. I think there is some credibility problem in that direction, too. But--

MR. SCHULTZ. That's our lower end now.

VICE CHAIRMAN SOLOMON. Well, does it look as if we have widened the range? The last range the public has--

CHAIRMAN VOLCKER. The last range was apparently--

VICE CHAIRMAN SOLOMON. But when do we publish the 13 to 18 percent?

MR. ALTMANN. On this Monday we will publish the directive, which had a range of 13 to 17 percent, along with the subsequent actions which raised the upper end to 18 percent and then allowed in effect for it to be exceeded.

CHAIRMAN VOLCKER. The pattern is very clear if anybody-- people who are so suspicious of us all the time--ever looked at it. This range has never bound that hard.

MR. PARTEE. Yes, it certainly hasn't.

MS. TEETERS. It has bound at the bottom.

CHAIRMAN VOLCKER. Well, we stayed with it for a couple of weeks; it never [presented] a hard conflict. We thought we were going to--

MR. PARTEE. I agree with Nancy. I think we've had more difficulty getting it reduced than getting it raised.

MS. TEETERS. [Unintelligible] down than up.

MR. FORD. Mr. Chairman, on the point you just made about how it would be read if we made it 16 percent, am I not right that our current range, [which went into effect after we consulted] on the telephone, has a bottom of 13 percent?

MR. PARTEE. Yes.

MR. FORD. So if we raise the bottom by 300 basis points, we're going to be read as tightening now.

CHAIRMAN VOLCKER. But they know where the rate has been all this time; the funds rate is now up to 21 percent.

MR. FORD. But that is a big jump, going from a bottom of 13 percent to 16 percent, when we're really anticipating moving the other way.

CHAIRMAN VOLCKER. Well, I don't think this is a vital matter, myself.

VICE CHAIRMAN SOLOMON. I don't think we're going to be operating in the bottom part of the range and, therefore, I don't think we're stretching out the--

MR. ROOS. 15 to 20 percent.

CHAIRMAN VOLCKER. Well, let me try something. Everything remains the same, with some changes in language which I don't think

are substantive at all, apart from the ones we've discussed. Let me just ask: Is your preference to say "taken over a period of time" or "weekly average"?

MR. SCHULTZ. Taken over a period of time.

SPEAKER(?). That's okay.

CHAIRMAN VOLCKER. Let's assume the language says "taken over a period of time."

MR. PARTEE. [Maybe it should say] "days"--taken over a period of days.

MR. MAYO. No, no.

SPEAKER(?). It is a period of days.

MR. PARTEE. Over a period of time could mean a year.

SPEAKER(?). Right, the whole [intermeeting] period.

MR. SCHULTZ. Let's stay as loose as we can here.

MR. GRAMLEY. I like Chuck's "days." I'd like to be a bit more specific on what we mean. I'd hate to give instructions to the Manager that are so general that no one has the foggiest notion of what anybody means.

MR. PARTEE. We don't say how many days. It could be 30 days.

CHAIRMAN VOLCKER. We have three choices: a period of time, a period of days, or weekly average.

MR. ALTMANN. That's seven days in the weekly average.

MR. SCHULTZ. I'm for a period of time.

CHAIRMAN VOLCKER. Let's say "a period of time"--I will interpret that as a series of days--and change the 16 percent to 15 percent. We are reversing the language to conform with the way it was before.

MR. SCHULTZ. Are we going to talk when it gets to 16 percent?

CHAIRMAN VOLCKER. Unless somebody has a suggestion that he thinks will command [wider] support, I would propose that we vote.

MR. WINN. You're going to specify the borrowing at--

MR. PARTEE. A billion and a half dollars.

CHAIRMAN VOLCKER. I hear no appeals that we have another plan that is going to command wider support. I will, therefore, call for a vote.

MR. BALLEES. I'll mention that I'd go back to 25 years ago and add in tone and feel of the market and operate in bills only.

CHAIRMAN VOLCKER. Gee, we didn't have any inflation in those days.

SPEAKER(?). It was pretty good.

MR. GRAMLEY. Which way did the cause and effect run?

MR. PARTEE. I wish we knew.

MR. GUFFEY. May I ask what the vote is on?

CHAIRMAN VOLCKER. On the whole directive.

MR. GUFFEY. No, I mean the range of the federal funds.

CHAIRMAN VOLCKER. It's 15 to 20 percent.

MR. GUFFEY. With any idea of consultation at a higher level?

CHAIRMAN VOLCKER. I have observed the remarks about consultation.

MR. ALTMANN.

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

CHAIRMAN VOLCKER. Thank you. We can go eat.

MR. SCHULTZ. If Henry and Nancy dissent, you know you're in the right area!

MR. ALTMANN. Hold a minute. Let's see whether we have any objections to [publishing the 1975 Memoranda of Discussion].

CHAIRMAN VOLCKER. You received a memorandum about the minutes for 1975.

MS. TEETERS. I move that we accept the proposal.

CHAIRMAN VOLCKER. Do I have a second?

SPEAKER(?). Second.

MR. PARTEE. It's all right with me.

CHAIRMAN VOLCKER. [Approved] without objection

END OF MEETING