TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

August 18, 1981

Prefatory Note

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

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

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

Staff Statements Appended to the Transcript

Mr. Cross, Manager for Foreign Operations
Mr. Sternlight, Manager for Domestic Operations
Mr. Zeisel, Associate Economist
Mr. Axilrod, Secretary and Staff Adviser

Meeting of the Federal Open Market Committee

August 18, 1981

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, August 18, 1981, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Boykin
Mr. Corrigan
Mr. Gramley
Mr. Keehn
Mr. Partee
Mr. Rice
Mr. Schultz
Mrs. Teeters
Mr. Wallich

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

Messrs. Morris and Roos, Presidents of the Federal Reserve Banks of Boston and St. Louis, respectively

Mr. Axilrod, Staff Director
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Mannion, Assistant General Counsel

Messrs. Burns, Ettin, Keir, Prell, Scheld, and Zeisel, Associate Economists

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

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

Mr. Coyne, Assistant to the Board of Governors
Messrs. Gemmill and Siegman, Associate Directors, Division of International Finance, Board of Governors

Mr. Lindsey, Assistant Director, Division of Research and Statistics, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Messrs. Czerwinski, Forrestal, McIntosh, and Smoot, First Vice Presidents, Federal Reserve Banks of Kansas City, Atlanta, Boston, and Philadelphia, respectively

Messrs. Balbach, T. Davis, Fousek, and Koch, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, New York, and Atlanta, respectively

Messrs. Bisignano, Broaddus, and Syron, Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, and Boston, respectively

Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis

Mr. Lang, Research Officer, Federal Reserve Bank of Philadelphia

Mr. Levin, Manager, Federal Reserve Bank of New York

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CHAIRMAN VOLCKER. We welcome Mr. Cross as a new participant.

MR. CROSS. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Comments or questions?

MR. WALLICH. Sam, in describing the concerted intervention of the Germans as "organized," do you have any information as to whether there was anything more than their urging others to do something? Were there rate ideas or quantity ideas put out?

MR. CROSS. Not that I'm aware of. As I understand it, and of course we don't really have a great deal of information about it, it was more in the nature of urging all the participants to act and to act promptly.

MR. WALLICH. Does it look as though they have started something, so to speak--a kind of [organized effort] that can be revived any time?

MR. CROSS. Well, it involved the EMS and the Swiss. In addition, the Germans did talk to the Japanese. I didn't mention the Japanese. The Japanese did undertake some intervention but it wasn't entirely clear whether they would have done so anyhow or whether it was part of the German's attempt to mobilize a general effort.

VICE CHAIRMAN SOLOMON. I think the fact that the Germans are claiming it was successful implies that they would like to use it as a precedent from time to time when it's necessary to have what they call a common dollar policy, particularly since we don't seem to intervene in what they consider a disorderly market.

MR. CROSS. If we [encountered] another one of these situations, it would be perfectly reasonable to expect them to do the same thing. Some of the Germans, as you know, have not been very keen on a coordinated dollar policy; they've changed their views on that subject. So it is significant in that respect.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Sam, you spoke of the possibility of a free fall. I don't know exactly what you mean by that, but suppose there's a 10 or 15 percent drop in the value of the dollar in the next month, say, which I guess might be a free fall--

MR. CROSS. That fits my definition.

MR. PARTEE. There has been a great deal of speculation in the dollar. Just making an analogy with domestic markets, when there is a great deal of speculation in one direction, naturally the end of it comes and when it does there is a stock adjustment. So, I would think you're quite right that there could be a 10 or 15 percent drop--

using my figure. But what harm would it do if there were a 10 or 15 percent drop in the dollar?

MR. CROSS. I was really thinking in terms of a sudden decline of a very major amount. For one thing, it does develop among the participants of the market [a recognition of] the fact that this kind of thing can happen. It would make the participants, I would think, quite chary about the extent to which they would get in there and make a market, if it's going to be subject to that kind of movement. Even pork bellies have a limit on how much the price can decline. It might in a sense undermine the strength of the market.

MR. PARTEE. The market mechanism itself could be harmed, you think?

MR. CROSS. I would think so, yes.

MR. SCHULTZ. If 10 or 15 percent is a free fall, would it also be considered a disorderly market?

VICE CHAIRMAN SOLOMON. Normally we would have thought that.

MR. SCHULTZ. We might have before.

VICE CHAIRMAN SOLOMON. In fact, normally we would consider a 2 percent drop in half an hour disorderly [unless] there's a special reason.

MR. PARTEE. Well, at an annual rate that's a very high rate of decline.

MR. WALLICH. Could we get a little more information on this disorderly market? Were you able to observe whether spreads widened drastically, whether the two-way market just disappeared and there were no bids at all?

MR. CROSS. Spreads widened and there was a kind of discontinuous market. It moved down to a point and then the next transaction would move down the next step, all in the space of a very few minutes. There have been newspaper articles on it. People in the market described it as "madness" and various other lurid words, but apparently it was, at least to participants in the market, something that did shake them up considerably.

CHAIRMAN VOLCKER. The market is very broad and efficient.

VICE CHAIRMAN SOLOMON. Most of the time.

MR. RICE. Did I hear you say that the Germans considered their operation a success?

MR. CROSS. Yes.

MR. RICE. Why did they consider it a success?

VICE CHAIRMAN SOLOMON. They did check the dollar from moving up.

MR. RICE. The dollar moved up afterwards.

VICE CHAIRMAN SOLOMON. No, it didn't move up after that. At that point it was close to 2.57 and it has been down mostly around the 2.50 to 2.52 range. And there were a couple drops down to around 2.47.

CHAIRMAN VOLCKER. But it did move up.

MR. CROSS. It moved up once after the German effort; it went up from about 2.52 to 2.54 and then I think it went up a little higher. But it's now 2.47, so it has declined substantially since they first made the effort, and they regard it as a very successful move.

VICE CHAIRMAN SOLOMON. Since they asked for the concerted intervention, they have to consider it a successful move in a certain sense. It was sufficiently successful, I suppose it could be argued, that one can get away with calling it that.

CHAIRMAN VOLCKER. It's very hard to argue that this foreign exchange market is operating very effectively at the moment. It has some analogies with the domestic market in terms of the uncertainties and the discontinuities and a lack of confidence.

MR. CROSS. Yes, it seems to have the same problem of not having anything it can really hold on to. There are no verities on which to operate.

CHAIRMAN VOLCKER. And no conviction in it.

MR. PARTEE. The last verity I can remember us discussing at length was the question of the viability of the dollar/mark rate when it was 2.00.

MR. CROSS. [Unintelligible.]

VICE CHAIRMAN SOLOMON. Actually, it was 1.70.

MR. PARTEE. Well, we thought it was very low when it was 1.70, but as it got back to 2.00 we thought that was about right. And as it got above 2.00, as I recall, we were doing quite a lot of intervening. So, maybe 2.00 is the right rate rather than 2.47.

VICE CHAIRMAN SOLOMON. We calculate that just the movement in July alone probably worsened our current account deficit next year by a further $8 billion. Everybody is looking at this. The Treasury and the New York Fed and the Board's staff are looking at a projection in the mid $30 billion area for the current account deficit for next year. That's very, very substantial. The largest one we've had was, I think, $18 billion; when I was over at the Treasury it was between $15 and $18 billion. And even though markets now are not paying a whole lot of attention to current account surpluses and deficits, when the fashion and the mood change and they go against the dollar, we're going to see a lot of stories about this enormous deficit and our export orders just going [up].

MR. PARTEE. That's why I asked the question, Tony. It seems to me that most analysts would say that the dollar is way too high. And it has been bid up there by speculation in these markets. Therefore, why not get the adjustment over with and have a free fall? Wouldn't it be better perhaps to get the rate down to a more credible level quickly rather than very gradually? That's why I raised the question.

VICE CHAIRMAN SOLOMON. Well, it would have been better. It can keep American industry more consistently export oriented if we don't have such enormous swings, but that requires leaning against the wind. And if we're not going to lean against the wind and we have [the dollar at] these high levels, when a decline comes, it may be better from a purely export competitive point of view if it comes in a month rather than over six months. On the other hand, [a sharp move] is very demoralizing to financial flows and financial markets and politically as well, because it doesn't look as if there's much cooperation left in the system. I think there are tradeoffs on that, Chuck. There are a lot of people who will feel that a rapidly plunging dollar shows mismanagement by the Administration, and to some degree by the Federal Reserve, and is an indication that things are not right in the United States. There is that view.

CHAIRMAN VOLCKER. Well, there's something we ought to do if we get that kind of fluctuation in either direction in my opinion, but we're not going to solve that this morning. Do you have a recommendation for us, Mr. Cross?

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

SPEAKER(?). So, the proposal is to give us enough room to accommodate the interest receipts for about the next six months?

CHAIRMAN VOLCKER. If you're close to the German mark limit, how close are you to the overall limit of $4-1/4 billion?

MR. SIEGMAN. Let me see. We have $3.4 billion in total holdings at current market value.

MR. CROSS. We're way below.

CHAIRMAN VOLCKER. I raise the question: Why do we have to increase that limit? I understand the German mark limit, but with that much leeway in the total, one doesn't follow the other, does it?

MR. CROSS. The figure of $4.25 billion is made up of $1 billion in yen, $2.75 billion in DM, and $500 million in other currencies. I assume it would be legal, I'm not sure, to modify the makeup of that in some way.

CHAIRMAN VOLCKER. If we don't increase the total, we're implicitly reducing the yen limit or the other currencies limit. Is that what you're saying?

MR. CROSS. Right.

VICE CHAIRMAN SOLOMON. I don't remember the details. Isn't there a distinction between the rigidity of the overall ceiling and

the informal ones? The informal limits are somewhat less legally [binding].

CHAIRMAN VOLCKER. As I understand it, all we're talking about are the informal limits and this doesn't require any vote. The formal limit is actually $8 billion.

MR. CROSS. That's correct.

CHAIRMAN VOLCKER. Which we're far from.

MR. AXILROD. The Commiteee had established [informal] limits for each of the currencies, so there is an implicit--

CHAIRMAN VOLCKER. If we kept the others the same, then the overall limit would follow [the increase for German marks]. I don't think it would make much difference. Unless we're going to sell some currencies, we have to increase the [informal] mark limit anyway.

MS. TEETERS. Do you [need] a formal vote on it?

CHAIRMAN VOLCKER. No, but I think we need an understanding.

MR. WALLICH. Did we ever make clear that this means at book value and not at market value?

MS. TEETERS. They're recorded at cost.

MR. WALLICH. At cost, yes. If we didn't [use cost], we wouldn't have to raise the D-mark limit, but we might at some time have to raise it without--

MR. CROSS. I assume this is not anything that gets announced; it's just an informal [understanding].

CHAIRMAN VOLCKER. I think that's right. All we have to do is confirm that there's an informal understanding that we'll increase these limits by $1/4 billion in order to allow for interest payments. If that's acceptable, we will assume that that is done. There aren't any transactions to be ratified because there weren't any transactions. I'm reminded that we forgot to approve the minutes of the last meeting at the beginning of this meeting. Could I have a motion to approve them?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. If there's no objection, we'll approve the minutes. We have approved informally that increase in the limits [on our foreign currency holdings]. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Comments or questions?

VICE CHAIRMAN SOLOMON. There is a significant point or observation--at least it seems to me significant--that even though it

was grudging, the fed funds rate did come down somewhat while at the same time the whole spectrum of [other] short-term interest rates went in the opposite direction. We don't seem to have as much direct influence over short-term rates as we did before. There was a movement of the fed funds rate. It's not clear what is causing this situation except I suppose some of the factors that Peter mentioned. Not all of them apply at this particular point. But I guess the heavy volume of Treasury borrowing is probably the biggest single factor.

MR. WALLICH. I'd be inclined to welcome that, wouldn't you? If the funds rate were more detached from other rates, the immediate impact of [a move] in the funds rate resulting from tighter monetary control wouldn't communicate itself so fast and so strongly to the rest of the market. It happens that in this case the rest of the market went in a very expensive direction for the Treasury, and that's not good. But I think there's no damage in looseness.

MS. TEETERS. But [now] they're really coming back together. I think other rates anticipated a drop [in the funds rate], which didn't occur. And now the federal funds rate and the other short-term rates are coming together again. The other rates were an aberration for a period of about four weeks.

VICE CHAIRMAN SOLOMON. But aren't the other short-term rates still on the high side?

MS. TEETERS. They're back to the relationship they normally have. The federal funds rate has come back and [other rates] have come up, so they're together again.

MR. MORRIS. Well, I'd like to put a [question] to Peter: If you're following a nonborrowed path that requires a substantial amount of borrowing at the window, and if the surcharge on the discount rate is 18 percent, why should you expect the federal funds rate to fall below 18 percent? It seems to me that it has to stay above.

MR. STERNLIGHT. Well, I think it depends on what that amount of borrowing is, President Morris. If borrowing were up toward that $2 billion level, as it was at the beginning of July, then I would think that 18 percent is very much a solid floor that would be hard to penetrate. As borrowing gets down more toward $1 or $1-1/4 billion, somewhere around that area, there's enough borrowing done by banks that don't encounter the surcharge that there could be penetration [below] the surcharge rate.

MR. AXILROD. Some econometric work we've done recently suggests that the basic rate in some sense is 3/4 of the surcharge and 1/4 of the basic rate, in terms of weight. So the basic rate, if we didn't have a surcharge, was more like, say, 17 [unintelligible] not 18 percent.

MR. GRAMLEY. Governor Wallich, I'm not sure at all that one ought to accept the view that a looser relationship between the fed funds rate and other rates of interest is desirable. If one could argue that what we're trying to do in the short run is make reserve demand and reserve supply come into balance and one can do that with the federal funds rate alone, then I would perceive the wisdom of your argument. But I doubt that that's the case, because very

fundamentally the demand for reserves depends on the demand for deposits. And the demand for deposits will depend on a whole spectrum of short-term interest rates other than just the federal funds rate. So, I'm a little concerned about our ability to get where we want to go, not just in the longer term but even in the shorter run, in regard to control of the monetary aggregates if the relationship gets too loose.

MR. WALLICH. Yes, I'm aware of that point. If there were no movement of other short-term rates in response to the funds rate, it would be more difficult to control the aggregates.

MR. PARTEE. Well, it was a very brief period and an awful lot was going on. I don't know that there has been any great change.

MR. STERNLIGHT. If I could comment just a little further on that: I think Governor Teeters put her finger on a very important part of the reason. By that late June/early July period the short market and the long market, too, to some degree, had gotten ahead of themselves, anticipating declines in the funds rate that didn't come about. To an important degree it was the disappointment in not seeing that develop that permitted this apparent anomaly of the funds rate giving some grudging ground but short rates moving up because the market had expected more of a decline in the funds rate.

MR. SCHULTZ. I asked for an analysis of 1974 not too long ago and just got it this morning. In looking at it, it indicates that in periods of volatility such as that the relationship among the various interest rates changes considerably and very rapidly. So, I think Governor Partee's point is accurate. It really hasn't happened for very long and it's the kind of thing we probably should expect, particularly at these very high rates with all the volatility going on. I'm not sure one can read that much into it.

MR. PARTEE. Peter, you mentioned that the premium for agency issues, particularly those of FNMA and the Home Loan Banks, has been going up. Has it gone notably higher in the last six weeks or so?

MR. STERNLIGHT. Most of the widening had already occurred by six weeks ago, but there was some further widening, maybe another 1/4 percentage point or so.

MR. PARTEE. There has been some further widening?

MR. STERNLIGHT. We just had a long FNMA issue that sold about 140 to 150 basis points above the [comparable] Treasury issue. I think six weeks earlier their premium might have been more in the area of a little over 100 basis points. A more normal [spread], going back six or nine months ago, might have been more in the area of 1/4 to 1/2 percentage point.

MR. PARTEE. So it's very much more than it has been traditionally.

MR. STERNLIGHT. Yes.

MR. PARTEE. And it also has gone up some [more recently].

MS. TEETERS. Would you explain why you're counting the thrift extended borrowing as nonborrowed reserves?

VICE CHAIRMAN SOLOMON. I think we are.

MS. TEETERS. Yes, but why?

MR. STERNLIGHT. Well, it is borrowing that's not really subject to the pressure on discount window usage that is associated with adjustment borrowing. And it's a source of reserves to the banking system just as though it came out of float or from an addition to Fed holdings of securities.

MS. TEETERS. So, if we get a large volume of extended borrowing, you'll take that into account as you mark out your nonborrowed reserve path.

MR. STERNLIGHT. Yes.

MR. BLACK. This is just the way you treated First Pennsylvania.

MR. STERNLIGHT. That is right, yes.

MR. BALLES. Peter, one question I'm curious about: As we look around the country--certainly in our District and I believe nationwide--there's virtually no bank paying the surcharge, as you know. What I can't quite figure out is why the federal funds rate can get much above 18 percent. As it goes to 19, 20 percent, it's rather curious, isn't it, that a few more banks wouldn't step in and incur the surcharge?

MR. STERNLIGHT. Well, I think there's an attitude among banks that there's something rather shameful about having to pay the surcharge. It's like being caught with your hands in the cookie jar or something. So, it's true that there hasn't been very much. There was one week or two when there was a fair amount of such surcharge borrowing. But banks making an effort to avoid that is what tends to keep the funds rate around the surcharge level. And when they are trying hard to avoid it, as banks seem to have been doing yesterday, for example, they're willing to pay 19 and 20 percent just to stay away.

MR. BALLES. The money desk managers get brownie points for not incurring the surcharge, but they're not given demerits for paying a point or two above the surcharge. That's a rather curious world.

MR. STERNLIGHT. Yes, it is.

MR. CORRIGAN. I think that's why Frank Morris is right, though, when he suggests that even at fairly moderate levels of borrowing the surcharge rate becomes a de facto floor in terms of the federal funds rate. The other thing that I think is going on here, and I at least don't fully understand it, is the way that these banks continue to manage their reserve positions. If you look at the daily federal funds rate over the past three months, we get almost a perfect 10-day cycle. It just repeats itself as if it's drawn with a machine. Obviously, that has something to do with the way they're playing the

game in terms of either letting their deficiency build up or avoiding the window or something. But the pattern is just incredible.

MS. TEETERS. 10 working days, Jerry?

MR. CORRIGAN. These are business days, yes.

MS. TEETERS. So it's a two-week cycle.

MR. CORRIGAN. That's a perfect two-week cycle.

MR. GRAMLEY. How long has it been going on?

MR. CORRIGAN. I just took it back to May.

MR. BLACK. Is it two weeks or ten days?

MR. CORRIGAN. Well, the way I have it plotted is ten business days.

MR. BLACK. Ten business days.

MR. CORRIGAN. But it's a two-week cycle.

CHAIRMAN VOLCKER. What we appear to get, for whatever reason, is a low federal funds rate, and banks underborrow one week and then get trapped at the end of the week and that sets up a higher rate. So they say "Oops, the funds rate is higher," so they overborrow for a while.

MR. GRAMLEY. Even the corn-hog cycle is supposed to be damped!

CHAIRMAN VOLCKER. [Unintelligible] the explosive corn-hog cycle. But this one is neither damped nor otherwise on the chart.

MR. WALLICH. Peter, without implying anything untoward in the future, what is the part of your portfolio that is reasonably saleable without great loss or without market disturbance?

MR. STERNLIGHT. Out of a total portfolio of about $130 billion, $49 billion is in Treasury bills, most of them short-term bills. Another sizable amount--I don't have the number at hand--would be short-term coupon issues due within a year. But I would think we'd look mostly to the bill area if there were a need, for example, to allow for a substantial amount of extended credit borrowing by thrifts.

MR. WALLICH. That seems to imply [unintelligible] that is something on the order of 1/2 of the portfolio.

CHAIRMAN VOLCKER. The coupons that are under one year, as I remember, amount to about $12 billion or something like that, right?

MR. AXILROD. Something like that.

MR. STERNLIGHT. That sounds about right.

MR. WALLICH. Well, that would get us about there.

CHAIRMAN VOLCKER. Coupons are not too easy to get rid of.

MR. PARTEE. The Federal Reserve does not have the authority to borrow, is that right?

VICE CHAIRMAN SOLOMON. Borrow from whom?

MR. PARTEE. From the public. Issue its notes in the market.

CHAIRMAN VOLCKER. No, but we can do--

MR. AXILROD. We only sell with an agreement to buy back.

CHAIRMAN VOLCKER. We can do reverse RPs with the other--

MR. BLACK. We'd have to call them something other than Federal Reserve notes!

MR. PARTEE. Well, I didn't mean that.

MR. BLACK. Commercial paper.

CHAIRMAN VOLCKER. Any other comment or questions?

MR. FORRESTAL. Mr. Chairman, just as a point of interest: Have we established a rate on the thrift borrowing?

CHAIRMAN VOLCKER. No, we have not; we'll discuss that at lunch. We have to ratify the transactions.

MS. TEETERS. So moved.

SPEAKER(?). Seconded.

CHAIRMAN VOLCKER. Without objection, that is ratified.

SPEAKER(?). It should be.

CHAIRMAN VOLCKER. Mr. Zeisel.

MR. ZEISEL. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Maybe you can go ahead, Mr. Axilrod, and then we'll discuss the two reports together.

MR. AXILROD. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Comments? Mr. Roos.

MR. ROOS. Steve, in setting both M-1B and M2 targets, which apparently currently increases [our exposure to] certain incompatible situations, aren't we putting ourselves in an almost impossible position? Let me phrase it differently. Listening to you, I thought you made a strong case that even though M-1B has some imperfections,

its imperfections are not overwhelming and that even if we wanted to control M2, certain parts of M2 are beyond our control. What would happen if we just abandoned M2 and told the world why we were abandoning it and concentrated on M-1B, even though it has some problems?

MR. AXILROD. Well, I'm afraid we're not in a position to come to that conclusion, President Roos, in my view in any event, because we know that M-1B is not really measuring transactions balances--and that's what we're seeking--and we know that M2 is measuring a lot more. We don't have an institutional structure that would enable us to sharply distinguish transactions accounts from other accounts. In that environment, I'm afraid there's probably little choice but to continue to make judgments about each of the aggregates as we view them and as time goes on--in my view, still paying somewhat more attention to M-1B, after making proper allowance for how one thinks the public is economizing [its holdings of transactions accounts], but not ignoring the others because we know there are shifts occurring between transactions accounts out of M-1B into nontransactions accounts in M2.

MR. ROOS. Hasn't the NOW account phenomenon pretty well washed itself out?

MR. AXILROD. Yes, but what I had much more in mind were money market funds and overnight RPs; all those sorts of things do have a transactions account element. One can run a zero balance demand deposit through these other items. One might even run it through things other than what we're measuring. That's one of the problems. It's very difficult, of course, to distinguish the investment element of those very short-term [instruments] from the transactions element, but they have both.

MR. SCHULTZ. I would tend to argue the other way, Larry, that if we were to target very precisely on just one aggregate, it would put us even more in a box. The object of trying to target on any aggregate is that it's a proxy for GNP. But the problem is clearly that those relationships are not very tight any more; they are getting looser and looser. It seems to me that the events that are taking place argue for looking at a broader range of aggregates and for having wider target ranges for the aggregates that we look at. Now, that may give us some difficulty in terms of the precision of monetary control on a day-to-day or week-to-week basis, but it seems to me that we'd get into a bigger box if we tried to target on any single aggregate and tried to be very precise about it because these relationships are changing. We could easily get into a situation such as the British got themselves into by targeting on sterling M3; suddenly they were just way outside of the target ranges and they had very serious problems. I, for one, would argue for looking at more aggregates with broader ranges than for looking at a single aggregate or a very narrow range.

MR. ROOS. I was under the impression, Fred, that the research studies that have been done indicate that there is a closer relationship between M-1B and real output than there is between--

MR. SCHULTZ. That's right. But that relationship seems to be getting looser all the time.

MR. ROOS. What bothers me--and I may see it totally incorrectly--is that a couple of our targets seem somewhat incompatible, just as years ago our interest rate targets were frequently incompatible with the aggregates targets. One can't steer with two compasses if those compasses aren't reconcilable.

MR. WALLICH. But then one would really have to--

CHAIRMAN VOLCKER. Still, [would we] be better off with one bad compass? Governor Partee.

MR. PARTEE. I don't want to interrupt this ideological discussion because I don't want to participate in it except to say that the work I have seen doesn't indicate that much additional information is gained as we move from M1, or in this case M-1B, to M2. So, I'm inclined to be sympathetic with Larry's point of view. The Committee has had very good political reasons for not wanting to be tied to one aggregate, and that's another element that would have to be discussed if we were to go just to M-1B. But I am concerned about M2, and particularly the Committee's decision last time to make it a constraint, because I think there is very substantial exposure here to missing by a fairly large margin even what the staff now says the M2 prospects may be. It's true that we didn't get the wild card [certificate], although we may. I don't know how long it will be until there's another court test of that. We did get the small saver certificate, and the early information is that it's selling quite well. Now, not every dollar of that money has come from other bank deposits. It just can't be so. It's a good instrument--a 2-1/2-year term yielding a high rate of return--and will tend, without any economic meaning, to raise M2 somewhat. But much more important now is the all saver certificate, which will be sold for three full months [at the end] of this year, October, November, and December. We had some off-the-wall staff estimates that I saw that assumed sales of a hundred billion dollars of those certificates. I would think most of those would be sold early in the period because of the tax exemption feature; one would want to have the full tax exemption period. So we're exposed to the possibility of one [M2] element going up like gangbusters in the fourth quarter. True, quite a bit of it will come from passbook savings, quite a bit will come from MMCs, and some may come from money market funds. But, again, I would argue that not all of it will. And that will be another factor tending to raise the nontransactions component of M2 in the remainder of this year. My concern last time, and even more so this time, is that if we have a constraint of that kind, we may find that it is running the ball game because it's going up at 13, 14, 15 percent in the latter part of the year, yet it doesn't really mean anything in terms of the economy. We used to cite both aggregates and give more or less equal weight to both aggregates, and I think that was the better position for the Committee to be in. That's sort of a policy comment, and I'm sorry about that, but I was responding directly to the content of Steve's talk.

MR. BLACK. Well, as a practical matter, does the Humphrey-Hawkins legislation really give us the right to abandon one of them completely?

MR. PARTEE. I think we could abandon it and explain it.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I'd like to ask a question of either Steve or Jerry, or both, relating to what interest rates are implied by the forecast not just for the next few months but on into 1982. How do they relate to the interest rates assumed a month ago, particularly if we're looking at a situation in which our projections of real interest rates are continuing to get higher and higher and higher?

MR. ZEISEL. Well, we have the expert here, Mike Prell. Our interest rate assumptions are for relatively little change from the current rates but Mike can elaborate on that.

MR. PRELL. Well, there isn't really much more to be said than that. We have essentially the same interest rate assumptions in our forecast as we did the last time. In essence, for the current year we had some offsetting developments of greater weakness in the second quarter than we thought, which lowered GNP for the year in our forecast, and a lower money stock for this year in light of the Committee's decision to shoot for the lower end of the M-1B range. And those effects were largely offsetting. We do have on the long-term side some small decline but nothing very meaningful in terms of real interest rates.

MR. AXILROD. I should add, Governor Gramley, that this again assumes that the Committee wouldn't be rigid in relation to M2. But if the Committee made M2 the predominant target, let's say, we're not certain that we could hit even the low end of the M-1B range. And under that assumption, I think interest rates would be higher in the short run and nominal GNP lower in the long run.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think Lyle is getting at the heart of the issue. If we should get some change in inflationary expectations and lower rates, we could see a much lower rate of growth in M2 than we're projecting, although I'm a little fearful that what Chuck suggested might really happen. But it is dependent upon an interest rate assumption that probably will not hold. If we convince the public [unintelligible] that we're really serious, I think some of those rates will come down.

MR. PARTEE. Why would lower market rates bring a reduction in M2 growth when it has so many interest-sensitive components?

MR. BLACK. Well, if the rates were lower, I don't think people would be quite as anxious to go into [M2 deposits]. They would just as soon--

MR. PARTEE. They would spend instead of save?

MR. BLACK. Yes, or they'd hold money. There wouldn't be as much incentive to--

MR. PARTEE. I see. There'd be more M1 relative to M2.

MR. BLACK. That's what I was thinking.

CHAIRMAN VOLCKER. Mr. Smoot.

MR. SMOOT. Steve, a question: In the directive language, can you define a little more precisely for me what "around the upper limit" of the M2 range means? Is 11-1/2 percent M2 growth, for example, consistent--

MR. AXILROD. That's a policy decision on M2.

CHAIRMAN VOLCKER. I think that's getting a little premature. We'll worry about that when we get to the directive.

MR. SMOOT. Well, let me raise a second question if I could. From the standpoint of looking at the federal funds rate, what do you think the likelihood is under these alternatives of seeing the lower ends of these interest rate ranges--15, 16 percent?

MR. AXILROD. Well, assuming that the economy doesn't just fall on its face, a very low likelihood.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. In a recent update of some of our staff work, we seem to get the results that M-1B is a better predictor of prices and that real M2 is a better predictor of real economic growth. It seems in a way that we have the best of all worlds: undershooting M-1B and overshooting M2. I'm trying to inject some optimism in here. But having said that, I'm really very suspicious of those results. Number one, I would associate myself with Chuck's comments in that I think we went a step too far last time in making M2 a constraint on M-1B, and I would like to revert to at least the equal weighting that we used to use. I'd also like to ask Steve if the time may be close at hand when we should be going back to the drawing board trying to put some flesh on the skeleton that you mentioned on the point that we really ought to be aiming at a transactions account. I couldn't agree with that more. In principle, that's clearly what we ought to do. Has enough time elapsed in your opinion, Steve, to be thinking about redefining the content of these aggregates, as awful as that proposal may sound?

MR. AXILROD. Without going into any detail, President Balles, I think developments in the institutional structure of the depository system in the country are such as to make that almost impossible at the moment. I don't want to sound pessimistic, but it's almost impossible because we don't have a way of separating out transactions accounts from other accounts. For example, if we forbade anything to be issued anywhere that was under 14 days in maturity, then we might begin to separate out transactions accounts from other accounts. If it was under 14 days, it would be a demand deposit and have a reserve requirement--to give an extreme example of how we could make a separation. But the way things are going now, it's very difficult to make the separation. We don't even have reserve requirements on money market funds transactions use; that would give us some automatic separation. But now if money starts flowing out of money market funds, I wouldn't be tempted to think that was demand deposits flowing out; I would be more tempted to think it was investment money going out. But I wouldn't know. So, we just don't have any basis for doing that.

MR. BALLES. Well, if the Chairman's suggestions on how to treat money market funds were adopted, would that at least help alleviate the problems of--?

MR. AXILROD. If they behave as it seems likely they would; that is, if they separate accounts that are primarily transactions and subject to reserve requirements from those that are primarily investment and are not, then we would have a basis for putting those separated accounts into M1, very clearly. That would be an institutional change that would help.

MR. BALLES. Mr. Chairman, is there any prospect of that getting adopted?

CHAIRMAN VOLCKER. No, I don't think so. Just to amplify and emphasize Mr. Axilrod's point, we got a proposal for establishing a money market fund which would be marketed by VISA but conducted by all the bank members of VISA, which is about--I don't know if I can remember--6,000 banks or more. They would all be able to run this money market fund, if they wanted to, on an in-and-out, automatic, daily basis. People could hold their demand deposit at zero or any other arbitrary figure; there would be no fluctuation in the demand account and all the ups and downs would go into the money market fund in half, or much more than half, of the banking system.

MR. BRADFIELD. Plus VISA would place the resulting investments back with the originating bank--

CHAIRMAN VOLCKER. No, I guess it would be in M3; it wouldn't even be in M2. It would go right from a transactions account into M3, as presently defined. I can cite you the example of my famous banker in Tennessee whom I happened to be sitting beside at a dinner some months ago--this is a $500 million bank--and he said: "Do you count repurchase agreements in transactions accounts?" I said: "No, but it's a narrow question." And he said they had only begun this two years ago in his bank but they have quite a few corporate accounts and those corporate accounts are swept every day at noon. If they have a balance over the suggested amount, the excess is put into an RP overnight. In two years the RPs were up to 30 percent of their demand deposits. This was some months ago; the figure is undoubtedly bigger now.

VICE CHAIRMAN SOLOMON. Even though it's very crude, suppose, based on a sample survey, we were to make an estimate periodically of the percentage of money market funds that really represents transactions balances. And we'd do it for all these other new instruments. Even though it obviously would be only a rough estimate, adding that by either folding it into M-1B or putting it out as a separate line--

CHAIRMAN VOLCKER. We made an estimate of this sort for money market funds, not on a short-term basis, but looking at the whole first half of the year. We made some arbitrary assumptions--well, not entirely arbitrary, but based upon whatever evidence there was from surveys, etcetera--as to how much of that could be said to be used straightforwardly as transactions accounts, meaning that checks were written on them. And the velocity assumptions were such as to make them, say, comparable to a NOW account. Then we tried to make some

calculation of how much that affected M-1B and we got 0.9. I forget whether that is an annual rate or the actual--

MR. AXILROD. An annual rate for the first half of the year.

CHAIRMAN VOLCKER. But that made no allowance at all for the degree to which the holding of a money market fund enabled people to economize on a transactions account merely by the fact that they held the money fund and had that reserve available for instantaneous transfer. So, undoubtedly, it's an underestimate in terms of its substitution effect for transactions balances. That was an arbitrary thing which gave us a general order of magnitude perhaps. But we never get at that second kind of influence. What is a transactions balance? I don't know; one can't define it that clearly. But this direct substitution effect is even harder to get at than the direct transfer effect, so to speak. So what do we know? It was enough so that it brought M-1B roughly to the lower end of the target in the first half; that just allowed for the increase in money market funds from December through June or the 6-month period in the first half of the year. I don't know whether it's quarterly or monthly at this point. We can make estimates of that sort, but what confidence do we have in them and what does it tell us in the end? We have a figure that's increasingly an artificial construct to start with, even when we just take the numbers; and then we begin making these adjustments. The adjustment for NOW account transfers is becoming increasingly problematical. I think it was appropriate during the initial stage of big transfers; it gave us a much better feel for what was going on. But after six months these transfers have diminished substantially, and I don't know what it means anymore to make this adjustment because I'm sure we're now getting transfers out of NOW accounts into money market funds or something as well as transfers in.

MR. BALLES. On that score, Paul, even in the most extreme case--if all our sample surveys were off and it turned out that in practice 100 percent of NOW accounts were coming from demand deposits --the actual M-1B is almost smack in the middle of our range for the shift adjusted M-1B.

MR. PARTEE. For the shift adjusted M-1B?.

MR. BALLES. Yes.

MR. BLACK. That's what our small bankers think is happening. At every one of our board meetings the two small bankers say people are fooling themselves if they think it's coming partly out of savings; it's all out of demand. Of course, that's based on their own experience and nothing else.

MR. BALLES. My point is that even if that were true, we're not in bad shape.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I just wanted to point out that as I look at the shifts and the money issues, the things that we can control directly are either interest rates or reserves. And we really ought to turn back to looking more directly at reserves and seeing how they stand out for all these new instruments that are developing and not

try to get back to actual transactions accounts. That would take a lot of research and a lot of education on our part to find out just what we would want to do in terms of reserves. We're targeting now, hopefully, on M-1B. Because we don't control M2 directly, it doesn't seem to me wise to [target M2]. If we get to control M2, we only do it through M-1B, so to make that our major target simply submerges the decision on M-1B rather than doing it directly. The other thing I wanted to point out to you is--

VICE CHAIRMAN SOLOMON. Are you saying we should target total reserves?

MS. TEETERS. I think I'm moving slowly in that direction, frankly, simply because I don't know how to cope with all these other things. That is the one thing that we do have some [control]--

CHAIRMAN VOLCKER. Well, with all respect--I don't want to prolong this discussion--I don't understand the point analytically because the reserves are simply a reflection of currency and M-1B.

MS. TEETERS. I realize that. On the other hand, it also gets us out of having to judge between what we're going to target on. But, with all due respect, may I point out that in February the [long-run] targets for M-1B and M2 were not consistent and they've become even more inconsistent. Relative to the midpoint of M-1B, [the Committee] put the M2 midpoint too low. It's not at all surprising that one is at the bottom and one is at the top. It's just that they are more at the bottom and more at the top than we anticipated they were going to be.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I think there is some way of looking at M-1B and trying to find out how much it is misleading us. The adjustments one can make by adding the money market mutual funds in some degree and overnight RPs and Eurodollars are pretty arbitrary, but they give us some guide. But more than that, if we assume that velocity is moving at a reasonable rate with respect to what M-1B really is effectively--that is, after adjustments--by holding velocity on a constant trend, allowing for interest rate changes, then we would find out what M-1B would be if there weren't these shifts; and the rest I think logically should be ascribed to a demand shift. Steve has described that something like this may well be going on. It seems very characteristic that when M2 is very high and M1 very low, there obviously is something happening to one of the two; normally they move closely together. Something could be distorting both, but it does not seem implausible that it's M-1B that is being distorted by a rapid velocity change, a reduction in demand due to the substitution of other assets, and that, therefore, we have to treat M-1B very cautiously.

Another check of the same question is to look at interest rates. If interest rates were behaving in a totally outlandish way, one would assume that they were being pulled away by the aggregates. But that doesn't seem to be happening; they're very high, but not all that out of line with projections. So, whatever is distorted about the aggregates is probably a distortion of the aggregates and not a real effect, if I may put it that way. Now, the rates we have

evidently are too high for some sectors of the economy and are not very restraining on others. That is what leads me to think that they're not outlandish and may be regarded as about normal for this level of inflation. Lyle makes the point that at falling rates of inflation these same nominal rates are becoming heavier in real terms; and that's certainly true if inflation is coming down. Against that I would look at the expectations seemingly embodied in rising bond yields; the buyers and also the sellers of those bonds don't seem to have much confidence that inflation is coming down, so they're prepared to tie themselves to what seem to be very high real rates, possibly on the expectation of rising inflation. Thank you.

CHAIRMAN VOLCKER. We've had no comments on the business situation, which I would suggest we have to look at a bit in order to resolve these imponderables about which direction we want to go.

MR. WINN. Mr. Chairman, we have been sitting around waiting for a recession to happen now for a good many years, and I couldn't help but notice driving down yesterday that Lordstown, which is one of the large GM operations, had probably the fullest parking lot I've seen in the last five or six years in terms of employees' cars.

MR. PARTEE. The employees having the new ones?

MR. WINN. That's right. This may just be a temporary build-up, which could be shut off quickly when the cars don't sell, but I was interested in the obvious employment there. Secondly, I am surprised in talking with my business friends how few of them appreciate that the corporate tax benefits are effective in 1981, not 1982. They were effective on January 1, 1981 and we may have some realizations on that score that give rise to some activity in the fall. On the other hand, when the realization hits of the size of the deficit inherent in the present tax and spending programs, we may get some reactions the other way based upon the amount of budget cuts that still have to be made, if they are going to be anywhere close to it.

CHAIRMAN VOLCKER. We had no comment on the budgetary deficit in the presentation, as I recall. You might say a word about that, Mr. Zeisel.

MR. ZEISEL. The budgetary deficit is not one of all joy. The Administration has moved to adjust upward its estimate of the fiscal '82 budget [deficit] to about $60 billion from what had earlier been $40 plus billion. Our estimate is a deficit of about $88 billion for that period. The major differences are the assumptions, or shall we say conclusions, regarding the state of the economy and its implications for spending and receipts, and we have some higher assumptions for interest rates as well. On an NIA basis, as we move to the second half of '82 calendar year, we really begin to see the effect of the second stage of the tax cut--that is, the 10 percent phase that comes in on July 1 of '82. And we have a deficit that runs about $150 billion on an NIA basis for the second half of '82. That's a very substantial shift in those terms and in high employment terms as well.

MR. CORRIGAN. You have total borrowings, including the agencies, next year at what: $108 billion or something like that?

MR. ZEISEL. $106 billion.

MR. GRAMLEY. It's $106 billion. That's fiscal year?

MR. ZEISEL. That's fiscal year.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Mr. Chairman, you invited some comments about the economy and I just asked a question earlier. I would like to say a few things about where the economy is going. Basically, the staff has the right handle on the immediate future. I'm not so sure about the longer-term future, but then I really don't see how the kinds of real interest rates we're projecting can be tolerated for that long a period of time. But quite clearly, there is not a recession under way. We have an economy that is quite flat, with a lot of mixed signals coming in from different sectors and a lot of geographical diversity. I see evidence of substantial improvement on the inflation front, a good deal more than I had expected over the course of this past year. I don't think we can say anymore that we don't have any signs of improvement in the underlying rate. We are seeing significant signs of wage moderation. I'm going to reserve judgment until I see the employment cost index for the second quarter before I decide how much, but there is quite clearly improvement under way. And I think expectations about inflation are changing; I just don't think one can look at what has been happening or talk to the business community and say that they aren't changing. I don't get the same impression from talking to businessmen now that I did six months ago. And when you put those--

CHAIRMAN VOLCKER. You talk to different businessmen than I do.

MR. GRAMLEY. Well, that may be. I put this evidence together and I don't come to the conclusion that Governor Wallich does: That because bond rates got high, we shouldn't worry too much about that because that means expectations of inflation are still strong. If expectations of inflation are improving and our operations are keeping short-term rates at historic peaks, then one has to expect that long-term rates will stay there too, until such time as short-term interest rates begin to come down. So I think we ought to be looking more carefully now at what is happening to interest rates than perhaps we have needed to up to this point because the behavior of the money aggregates is becoming increasingly difficult to interpret. And when we have difficulty interpreting the aggregates, I think it's incumbent upon us to see what signals interest rates suggest about the impact of monetary policy on the economy.

MR. SCHULTZ. How do we do anything about interest rates when credit demands are the way they are? What did you estimate that the Treasury has to [raise] in the fourth quarter, counting sponsored agencies--$41 billion? These credit demands are very disturbing. I don't know how in the world we make--

MR. GRAMLEY. I bet our staff's estimates of total credit flows for the last half of this year as a proportion of GNP are nowhere near the peaks that we have seen in past years. Isn't that right? These numbers look big because we have a huge deficit in the

federal budget. And one of the major reasons, though not the only reason, we have a huge deficit in the federal budget is because the economy has been very sluggish and revenue growth has been slow. I can recall the same sort of argumentation going on in the first part of 1975 when people said it was impossible to bring interest rates down because the federal deficit was so big. The federal deficit is not the only factor that affects the interest rate. It's one of them. But a major reason why interest rates are high is because we have had a monetary policy that has been very, very tight in the context of an economy that has been relatively strong. But it's an economy that is showing a lot more signs of weakness, an economy that is looking--

MR. SCHULTZ. That's the point, though: Unless the economy slows or the deficit comes down, how do we get the credit demands down? I don't see how there is much--

MR. GRAMLEY. Well, you work on the supply side; that's the answer.

MR. PARTEE. The funds raised by nonfinancial sectors in the third quarter are estimated at 12 percent of GNP. That was 15-1/2 percent in the fourth quarter of last year and it was 18 percent in 1979; it's really quite a low number.

MR. WALLICH. It doesn't seem to correlate very well with interest rates.

MR. SCHULTZ. But, Governor Gramley, would you not agree then that if the Fed were to be seen as pumping out reserves at a rapid rate, it would have a severe expectational impact and would, in fact, put upward pressure on interest rates?

MR. GRAMLEY. I don't agree with that. What I believe has happened in the past that has led people to that thought is that when we've had very, very large increases in the stock of money, it has primarily come from the demand side. And the markets have reckoned with the fact that they know we are going to lean hard against that and, therefore, that interest rates will begin to move up.

MR. WALLICH. There is one factor in the level of interest rates that we seem to overlook sometimes. At the time we set these targets [for the aggregates], we looked at GNP projections. We first made these decisions in July of 1980. The projections were under [the actual outcome] for the first half of '81 by about $170 billion, of which $50 billion was due to a revision in the numbers. The other $120 billion or thereabouts was the result of a stronger economy in the fall of '80 and early '81. So, the economy is much bigger [than we projected]. And the money supply also has slipped because we used the base drift at the end of 1980 to start from a higher base than we could have anticipated when we set those targets. Nevertheless, the economy has moved well beyond the targets as we thought of them when we set the ranges in July 1980, so that has probably introduced some continuing interest rate pressure. I say that just as a comment on why the rates are so high.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I'll just make a couple of comments on inflation and the business situation. On inflation, I would align myself with Governor Gramley; if anything, I think we have been guilty perhaps of underselling even where we are, much less where we might be. In that regard, I would point to food and energy prices where there is a tendency to pass them off as transitory technical factors; but even in those areas monetary policy and high interest rates have had a bearing and have reinforced the underlying market forces that have been working. So, I do feel better on that score. Looking [ahead] on the inflation situation, I get the clear sense from both my own staff and from some of the people in the District that the food prices, while they will show some acceleration, may not show the kind of acceleration that the staff is suggesting over the balance of the year. Certainly, I can't find anybody who agrees with the latest Agricultural Department estimates of food prices over the balance of the year. So we may have a little more good fortune going our way in that respect than some are suggesting. There is another aspect of the staff's analysis of prices that I just can't reconcile, and that is the data that they are still finding on home prices. Nothing that I run into of an anecdotal nature supports anything like the 8-1/2 or 9 percent increases in home prices that your raw statistics are still pointing to. So there, too, things may be a little better.

A couple of other developments have come to my attention. I am beginning to see a lot of scrambling in state and local governments as they begin to assess the implications of this change in budget policy on their problems in the near term, both in terms of taxation and their own spending policies. I would also say that the high technology firms in the Minneapolis area report to me that there has been a very, very sharp increase in defense activity, even over the last month. None of that has yet gotten to the point of contract signing, but there is a tremendous increase in the amount of discussion and negotiation on what seem to them to be major commitments in the defense area. On this deficit question, I would just add that while we can all dance on the head of a pin here as to what it means and what percent it is and all the rest, to me it is a major overhang both in the markets and in the perceptions of business people and consumers in the public at large in terms of what is going to happen to the economy and interest rates over the next 6 to 12 months. Notwithstanding whether the economics and the theory of it are quite right, that clearly is the impression I get, no matter whom I talk to.

CHAIRMAN VOLCKER. Mr. Zeisel, we have gotten some retail trade figures recently and some inventory figures since the GNP figures came out. Do you have assumptions regarding that? When do the new GNP figures come out--next week?

MR. ZEISEL. Yes, it should be next week. Well, GNP comes out on the 19th, which is tomorrow. The retail sales figures came out with a 1.3 percent increase, but a very substantial amount of that gain was a rebound in car sales from the very low post-rebate level of activity. The sales rate in any realistic sense is still very weak. It is sufficiently weak to result in producers adjusting down their assembly rates significantly. Excluding automobiles and household repair kinds of expenditures, retail sales were about unchanged in current dollar terms between--

CHAIRMAN VOLCKER. The numbers were higher than what the BEA staff thought when they made the [first] GNP estimates. I'm just asking a technical question: Are they likely to revise the GNP number up or down or sideways?

MR. ZEISEL. It looks as if there is about a balance as far as the GNP figures are concerned. There were some upward revisions in retail sales, and some downward revisions in housing are likely; in general it appears as though it might well be a wash and end up close to what we have.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, as we look around our District and talk to directors and other business people about business activity, we see a very mixed picture. It's pretty clear that the economy in the Sixth District is softening, as I suppose it is in most other parts of the country, but it's not entirely clear that that is true throughout every sector of economic activity. For example, total employment and retail sales have been fairly buoyant in the very recent past. Nobody I have talked to expects any kind of major recession at all and, in fact, there is some feeling that business activity is going to pick up in the fourth quarter and certainly in the first and second quarters of next year. Part of this reflects a sense of optimism now on the part of business people and bankers as a result of the President's tax cut victories in Congress.

On the inflation front, we certainly have made a lot of progress and people do tend to recognize that progress, but I think inflationary psychology and expectations are still very much in the forefront of people's minds. And to a large extent they are taking a wait-and-see attitude toward what the Federal Reserve is going to do. On that score, just looking ahead a little to the policy decision, on the basis of my conversations with people, I think any interpretation by business people and the markets that we are easing either on M-1B or M2 is going to continue to fuel inflationary expectations. I think our credibility is very much on the line at this particular point.

One of the things that really troubles people in our area of the country, and I suppose other places too, is the plight of the thrift institutions. There is a good deal of concern, particularly on the part of bankers, that there is going to be a spillover effect if even smaller institutions get into trouble. The S&Ls themselves in the Sixth District are in a little better position, I believe, than those in other parts of the nation. But even so, it's a matter of time; they are looking down the barrel of the rifle, as they put it. So, that is a source of real concern in our area.

CHAIRMAN VOLCKER. We are approaching 11:30 a.m. I have about four people on the list at this point: Governor Partee, Governor Rice, Mr. Winn, and Mr. Balles. Do you have short statements or long statements?

MR. PARTEE. I don't have it written down. I don't know how long it will be.

CHAIRMAN VOLCKER. You're next on the list, so you ought to make up your mind right now.

MR. PARTEE. Well, I just wanted to agree with Lyle, in that I don't think there's evidence of a cumulative decline in business now setting in. It's very difficult to tell whether we are in a recession or not because we have had zero growth for ages, and we have it projected for ages to come. Of course, that is made up of stronger sectors and weaker sectors; if you happen to be in a weaker sector you surely think there's a recession. But the fact is that I don't see a cumulative decline taking place, barring a financial catastrophe of the kind Bob Forrestal mentioned. That is, assuming we can hold the financial system together, I don't think there's a major recession at hand. The big thing is this fiscal change, which I just want to emphasize again. There's a tremendous amount of fiscal stimulus in prospect; it starts right now and grows and grows and grows over time. And people will come to recognize that, as Willis says, and will take it into account in their spending plans. So, what we get is a difference in the fiscal/monetary policy mix, as we used to refer to it, which is quite a bit wider than anything I can recall. I think it means that the areas that are affected by monetary policy are going to be in a permanent depression and the areas that benefit by tax cuts--and they are a little harder to tell than just the specific spending things--will be supported by that. But I think the staff's view of about a zero rate of gain in real activity for some considerable while in the future is a pretty good basis for the Committee to operate on in deciding its policy.

CHAIRMAN VOLCKER. I think we better quit for a short coffee break.

[Coffee break]

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, most of what I'd planned to say has already been said, so I can be very brief. I agree with earlier comments that the staff's projection seems to be the most probable outcome. The only area where I could imagine some possible deviation is in the consumer spending projection. It seems to me possible that, based on expectational and improved confidence factors, there could be higher growth in consumer spending than is forecast. Despite the recent data on employment, retail sales, and industrial production, it appears that there is still considerable slack in the economy, even sluggishness. At the same time, as has already been pointed out, there is no evidence of any marked tendency toward deterioration or further weakening or of cumulative weakness. With the unemployment rate stable at the present time and perhaps even declining most recently and with inflation easing as it certainly appears to be, the economy would seem to be behaving pretty much as I think one would like. The trick seems to be how to keep it behaving this way. And in my judgment we wouldn't keep it behaving this way by further restraining growth in the aggregates, nor would we keep it behaving this way if we try to force interest rates down. Now, that doesn't mean that I would not like to see interest rates come down; I would. But I don't think they should come down as a result of changing our short-run or even longer-run monetary objectives. Rather, I would prefer to see them come down as a result of developments in the economy. I think the best chance of keeping things delicately balanced, as I believe it was described, is to stay with the monetary

objectives we've stated in the targets and try to maintain Federal Reserve credibility to the extent possible.

Obviously, at the present time we don't think we can keep both M1 and M2 within our target ranges. I would favor, at this time at least, giving at least equal weight to M-1B [and M2] and not having M2 as a constraint. If we tried to constrain the growth of M2, that would further restrict our monetary growth objectives and would of course run the risk of significantly higher interest rates--higher interest rates that we do not need at the present time. So, I would for the moment try to stick with the objectives that we adopted at the last meeting. I would not restrict them further. That has the effect of pushing M-1B closer to the lower bounds of the target range.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Just one comment, Mr. Chairman: I'm not sure I understand completely the economic implications of the redistribution of the retail sales figures, in which the upper end of the price range is the big factor in supporting sales and the lower end is having a real struggle. When you add on to that the implications of the tax bill, I think we're seeing a rather widespread shift in the distribution of income and I'm not sure I understand all the economic implications of that.

CHAIRMAN VOLCKER. Well, with that confession of ignorance--widely shared, I'm sure--we'll go to Mr. Balles.

MR. BALLES. You asked for some comments on business conditions. Just to give you a thumbnail sketch as far as the West Coast is concerned--Governor Gramley really put his finger on it a little while ago for the whole country--we have big geographical differences and big industry differences. I would underscore that by saying that the crosscurrents that exist on the West Coast are just about as strong as I have ever seen. Our lumber and forest products concerns are in very poor shape, obviously, and they are just screaming for some kind of relief. The auto industry, of course, is in very bad shape as it is around the rest of the country. In pretty good shape are companies that are active in defense work, energy companies, and commercial construction in some of our bigger cities. Electronics firms are going strong and the aerospace business is in stable condition right now, neither going uphill nor downhill. In California, agriculture, the biggest single industry--about a $14 billion industry--is under an extremely serious threat from the Mediterranean fruit fly. It has us all pretty darn concerned, with the recent action of Japan, for example, of putting an embargo on our exports of fruits and vegetables. California supplies about half of all the fruits and vegetables in the country. The rest of you might find prices going up a little if we don't get this problem under control. It's a very serious problem. I don't know if it's going to get licked or not.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. To add a very negative note, but certainly one you've heard with some consistency from the Middle West, our basic industries continue to be very, very hard hit and are really deteriorating further. I'll just comment on a few. On the automotive

side, which we've talked about at some length, I think any improvement that has occurred in auto sales really is a result of rebates. I'm told that the rebate structures that now exist and will be put in place in the near future cannot be afforded by the industry but they simply have to use them. On the capital goods side, machine tools are very, very soft; farm equipment is down again, of course; construction equipment is grim and I'm told that among some of the smaller companies in that industry bankruptcies are coming because enough has taken place that nothing can really turn them [around]. Railroad equipment [manufacturing] isn't just slow, it has all but stopped. It's an industry that is in really deep trouble. On the agricultural side, though production is up, which ought to bode well for prices, interest rates are having a negative impact on the cost of carry for that industry as well. Net, with regard to the Middle West, there's a growing fragility, if you will, in the system. At some point I think we are going to see some bankruptcies erupt across some of the industries that are the most troubled, and the fabric will be torn in such a way that it's very possible we will not get the kind of recovery that we need for good sustained growth. So, the word from the Middle West is really one of a very somber outlook.

MR. SCHULTZ. What's the story on International Harvester right now?

MR. KEEHN. If you're asking about the credit, they have not completed the renegotiation of credit. Some banks are giving them a very difficult time on it.

MR. RICE. If things are so bad in the Middle West, why haven't they fired more people?

MR. KEEHN. Well, employment is down.

MR. RICE. Is it down substantially?

MR. KEEHN. It's down 4 percent as compared to '79, and that would be substantially lower than the rest of the country.

CHAIRMAN VOLCKER. Do you see declining house prices in California, John?

MR. BALLES. Not absolute declines; we see a severe tapering off of the rate of increase.

MS. TEETERS. How about Chicago? Do you see house price declines in Chicago?

MR. KEEHN. I can give you an anecdote: I just bought a house and there has been no decline in the prices! Seriously, I think the rate of increase is clearly being tempered. Sales of houses, particularly in the middle price sector, are very, very slow and the prices are beginning to come down.

MS. TEETERS. What kind of financing is going on?

MR. KEEHN. 17 percent plus 3 points.

MR. BALLES. In California we had that court decision called Wellenkemp which precluded the enforcement of due-on-sale contracts. There is a lot of creative financing going on; it's the only thing that's keeping things alive at all--[that and] the assumption of old, low rate mortgages.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I've been a little puzzled by these various statistics showing more strength than I [anticipated]. It seems to me that both consumer and business pessimism is at a fairly high level right now. I know it was particularly marked at our directors meeting this last time; almost everybody there was pessimistic for some reason or other. And there was a very somber note in the Redbook this time. Also, the point that Si just made about bankruptcies is part of the tip of the iceberg; there may be some repercussions when some of these begin to appear, as they inevitably have to, with the small business situation and the high rates that people are paying. So, my guess is that the apparent strength in employment and sales in July may be temporary. We've had a pretty sharp deceleration in the aggregates, and real interest rates are pretty darn high, so I would expect the economy to weaken somewhat further in the third quarter. I think the staff's forecast of an essentially flat economy in the third quarter is about the best that we could expect and my guess is that it will be a little weaker than that. But looking at it out a little further, I think we might get a little more rebound than they are projecting, too, particularly if inflation continues to moderate. If this sluggishness in economic activity that I think might happen does materialize, there ought to be some downward pressure on interest rates and that ought to help. And if we can get any significant move toward deregulation, that's a further factor. So, I guess I'm pessimistic in the short run but maybe a little more optimistic in the long run than [the staff].

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. In the Eleventh District, we continue to enjoy a little stronger economy than other parts of the country. In terms of housing, houses are still selling down our way. Of course, we have people coming in all the time. I've not seen anything that would resemble a price decline. Commercial construction has been very strong, as you know. The interesting thing there is that for the first time I have heard a couple of fairly large developers say they are beginning to wonder if there might be a bit of overbuilding in Houston and Dallas, and I haven't heard that kind of comment at all in the last several years. Automobile sales are not all that strong but they're probably not as weak as in other parts of the country. On the agricultural side, I have been told, particularly in regard to the [feed]lots, that the cattle going in are going to come out at loss situations now. On the big ticket items you talked about on retail sales, that's the business is in; he calls me about once a month and he says nothing is slowing down. Their sales are really still going strong.

MR. SCHULTZ. What does say about commercial construction?

MR. BOYKIN. He is one of the ones who is thinking out loud that we may be into an overbuilt situation for a year or two. I don't think it's interfering with what he is doing. He's completing a

We have 7 buildings under construction in downtown Dallas that are 40 stories and above. Two more have been announced that are going to be 70 stories each plus about a thousand room hotel along with it. Plaza of the Americas, which you're familiar with, has just announced that they're going to start a new office tower next month.

MR. BLACK. Well, action in going from is probably significant.

MR. BOYKIN. Yes, but then there's another 60-story building being built in Greenway Plaza by a competitor.

MR. BLACK. They're thinking in terms of 60 stories and not 75; that is what I was--

MR. BOYKIN. Well, the height is limited by FFA regulations because they are in the flight path. The two 70-story buildings in Dallas are across the street, so they are going to squeeze by.

MS. TEETERS. Have you any idea what your in-migration is?

MR. BOYKIN. No, Governor, I don't. I'm trying to recall the figure for the new cars hitting the streets of Dallas every day.

MR. BLACK. How many strange new accents do you hear in Dallas?

MR. BOYKIN. Well, there are very few people I can talk to anymore who can understand me!

MR. BLACK. That's a good indicator, I think!

MR. MORRIS. Before this gets out of perspective, I should point out that if you look at the Boston Globe's business page today you'll see that most of the states in New England have a lower unemployment rate than Texas.

MR. BOYKIN. We had an aberration for one month in that the statistics showed 6-1/2 percent [unemployment]. We corrected that very, very quickly.

MR. MORRIS. Since we export a large part of our manufactured products, our people are very concerned about the big jump in the value of the dollar, which is hitting new orders very hard. And they'd love to see that free fall that Sam talked about.

VICE CHAIRMAN SOLOMON. So would our hotel owners in New York City. Tourism has dropped by about 25 percent; hotel occupancy is way down.

CHAIRMAN VOLCKER. Are you in the Eleventh District, Mr. Czerwinski?

MR. CZERWINSKI. No sir, the Tenth.

CHAIRMAN VOLCKER. I was going to speak to the Tenth District, just having been there.

MR. CZERWINSKI. I'll let you have that privilege, sir.

CHAIRMAN VOLCKER. Having observed Denver, if they are not becoming overbuilt, something is the matter because they certainly are building. I don't know what is going to happen when they complete it all. There are lots of beautiful people in Aspen who seem to have a lot of money to spend and I'm sure that's characteristic of the country.

MR. PARTEE. Do you suppose things are ever bad in Aspen?

CHAIRMAN VOLCKER. I don't know. They'd be a little worse if [unintelligible]. If you want to make a real estate investment, you can go to Aspen and get on the muddy side of the mountain and buy a half acre lot for $200,000!

Well, I think we'd better get to our policy decision. It isn't any great secret that we're in a difficult period here; we shouldn't have expected otherwise, I guess. The industry differences that have been alluded to seem to continue. I don't know what to make out of the latest figures, but the economy surely doesn't seem to be falling apart, despite the Midwest and some other gloomy reports that there are enormous pressure on some sectors of the economy. Some concern has been expressed here about a tearing of the financial fabric and bankruptcies and all the rest. I think those are very real and legitimate concerns. On the other hand, I guess one has to question whether we can get through this kind of period and deal with inflation without running into at least the threat, and maybe the actuality, of that. That is what we've been struggling with all along, and I suppose past history is that we were never willing to face up to this. We're facing up to it already, more than I think we have for many years, but we're going to remain in this extremely uneasy position for some time.

I wish there were some refuge in mechanics, of following one figure or another assiduously and feeling that this was going to solve our problems for us. I have no confidence that we can take such refuge in mechanics against the palpable knowledge that any one of those figures is potentially, and probably actually, distorted. We're in one of those periods for which we get paid--some of us better than others--for making a few judgments about what is going on. And I think those judgments do encompass what is going on in a most general view of the financial world and the business world when we get mixed signals from the more mechanical indicators of policy. We're obviously high on some and low on others. And I don't find any very convincing stories, looking at the past and putting together what we know of the distortions of those figures, that we can make much of a choice between relying on those that are high or those that are low.

When we look at the business picture, there is a lot of talk about recession. It's a political fact of life. We're going to get a lot of talk about recession every time the economy deviates below a zero growth pattern for a short period such as a quarter. Then people

say, "Is the next quarter going to be below zero?" and that makes a recession. We've been on an even trend, as a number of people have pointed out, for several years. If you're on an even trend, half the quarters, roughly, have to be below zero and presumably half above. I'm not sure it's a significant recession if you put together two quarters in a row below zero; I'm not even sure it's entitled to be called a recession if [the deviation below zero] is a very small number. In that context, the business picture isn't very bright, I guess we all agree. On the other hand, the latest data don't suggest, as many people have said and as I just said, that it's falling apart.

On the inflation side, I don't fully share--maybe out of natural caution--some of the optimism that has been expressed around the table. It's not that I'm unhappy to see the indications of lower prices. I think prices certainly have been affected, even on those things that tend to be called accidentals such as food and energy prices, by monetary policy. But it seems to me that we're at a stage where monetary policy has squeezed in an obvious way the things that can be squeezed and has helped affect the price numbers. What I'm not at all confident of yet--and I say not confident of yet to express my strongest optimism because I actually feel a little weaker than that--is whether lower price trends and lower price expectations have really been built into behavior. In a way that has to be built into behavior if the favorable price trends are going to continue when interest rates do come down and there's a sense of more monetary availability. I think what has happened so far is a reflection of the intense pressures on financial markets. If they were relaxed--if we waved our hand and relaxed them in the next two months--that favorable price impact on commodity markets, on food, to the extent it has been influenced, oil with a little greater lag, and that kind of thing, would dissipate very rapidly and we'd be back where we started. [Although] we see some glimmerings on the wage side, I think that could be reversed pretty quickly, too, if there were a sense of no restraint on the economy at this point. We have to play the game long enough so that we have a degree of confidence in the price outlook that begins to be inbred in behavior, including wage negotiations; I don't believe we're there yet. But there is a better chance than we have had in a long, long time, I think, that we can get there in the fullness of time. How much time it will take is another matter.

As for policy: I don't know how you measure it but in terms of the aggregates, the reserve aggregates in particular, the fact is that, taking into account the very latest money numbers, we've gotten easier again. I think there is some appreciation in the market that we've gotten easier. That will be reinforced by the announcement that comes out at the end of the week as to what our objectives were last time and people see whatever it was--9 percent growth in M1?

MR. AXILROD. 7 percent.

CHAIRMAN VOLCKER. Growth of 7 percent, which is much bigger than what it has been running. I don't know whether that will attract much attention or not. While we've been getting easier in that quantitative sense, interest rates haven't reflected it. I take it they're up again today. I guess there's a lesson in that: That we literally don't know how to affect interest rates these days. We don't know all the things at least in the market that are affecting interest rates. We don't know how that interacts with our policy to

get any very reliable change in interest rates, assuming we want that. There certainly is an enormous desire on the part of the country to have lower interest rates at this point. That pressure is building and it's going to build further. I'm sure the Congressmen are getting an earful as they go around the country during their recess--unless they're all at Aspen, and I didn't see any there. And that background is going to become more difficult.

Looking at this problem, which is reflected I suppose in the projections of the staff, right or wrong--and not many people have said they can make a better forecast this month, in contrast to last month when everybody seemed to be more optimistic and saw interest rates down--it seems to me that this is not a period we're going to be out of in a hurry, if you take that as a benchmark. The staff is projecting that with policies of anything like what we have the current interest rate structure is going to continue indefinitely without killing the economy in any sense; [in the forecast] the economy stumbles along anyway at a level course, gradually building up if we go out enough quarters. It's not a very happy picture for us to be in, looking ahead. Given that we are in the early stages, if I can put it that way, of any success in the anti-inflationary effort--given that kind of outlook and given the demonstrated apparent resilience of the economy in the face of very high interest rates despite the distortions in the economy and the very different impacts on different sectors--it seems to me that there is still a considerable danger, and maybe an overriding danger, of underkill rather than overkill. [I think that's true] whether one looks at it in short-term economic terms or in terms of the longer-range problem we foresee over the next year, 18 months, or two years, with the fiscal stimulus that's coming along and has been remarked upon here, the big government deficits, and the demonstrated resilience of the economy. It would be lovely to steer those interest rates down if we knew how to steer them, which I don't think we do. But if we did, what are the risks that in a few months we will [witness] another rebound in the economy and Henry Kaufman's [unintelligible] scenario will come true? Then we will be in an even more difficult period, losing time at the very least in the fundamental fight on inflation; and we will [face] a more awkward market and I suppose a [worse] political situation not very many months down the road, with higher interest rates, more concern about financial institutions, bankruptcies, the outlook for the economy, and all the rest.

When I add this together [I come out] with a posture that is not overriding but is convenient at the least, and makes some sense at the best. We are in a mid-quarter meeting; we set some objectives after some careful consideration at the beginning of the quarter and I'd say that unless there's a pretty strong reason for changing, let's stay where we are in terms of the directive. Where we are in terms of the directive is not bad. If these recent M1 figures hold up--while they look big in the short run and that has some unfortunate repercussions and shows the other side of our dilemma--it brings us at the moment anyway about on track in terms of the M1 figures that we set forth in the directive last month, taking July and August together. The M2 figure was slightly lower in July than was consistent with the directive. It didn't bring any pressure on us to tighten up. There is a fear and a concern, which is understandable, that the M2 figure will bulge at least in August because of some figures we have for the first week or so in August. And with M1 going

up more rapidly, that also tends to support M2. So there is some danger, if danger is the right word, of overshooting in the narrower sense on M2 in August anyway. Part of that, but a fairly small part depending upon how big the overshoot is, can simply be looked at as making up for a slightly low figure in July. So, while we are more uncomfortable on M2, the discomfiture is not yet at least at an acute stage. And I have some question as to whether fine-tuning at a mid-quarter meeting--to do too much tinkering on the basis of short-term expectations about M2--is worth it.

In terms of the expectational and imagery question, we have to maintain the policy course. We have not yet had whatever public impact there will be, if any, of the apparent raising of the M1 target, depending upon how one interprets it. It obviously hasn't been raised in the broader sense of the target for the year; indeed, it has been lowered by one interpretation. Regardless of that, I don't know how people will interpret both a higher rate of increase in the directive and a higher rate of increase that seems to be in store for August nor what that's going to do to expectations. But I wouldn't want to press our luck, if indeed we have luck on that score, of not being interpreted as having overtly eased policy by taking another step now that for two months in a row would seem to push in an expansionary direction, when nothing much has happened during this month to suggest that that's appropriate other than that people are sick and tired of high interest rates, which I well understand. But the business news, in fact, in this past month has been better than anything that was expected when we last met. I think almost every business figure has been better than one would have anticipated at that time. So, I would suggest to you that the most prudent course of action at this particular meeting is just to write a directive which continues the wording we had the last time and in effect says the Committee continues to seek what we sought a meeting ago, which is equivalent roughly to alternative A, the more liberal alternative given in the Bluebook.

MS. TEETERS. Are you going to leave the M2 part in it?

CHAIRMAN VOLCKER. [Yes.] At this stage I have not discussed questions of tactics and interpretation in a fine way, regarding just what we would do if one of these figures goes off. We've already had some discussion at this meeting, which the record will make clear, that we are aware that M2 may be distorted by these all saver certificates and the other kind of saver certificates. The difference between the all saver certificate and the small saver certificate is "SM" and I think this whole thing is somewhat of a sadomasochistic operation, so maybe that's appropriate.

VICE CHAIRMAN SOLOMON. If we hit the 14 percent increase for M2 for August that the Board and New York staff are projecting, that takes growth up for the year to 9-1/2 percent? Or is it higher?

MR. AXILROD. I don't have in mind a QIV-to-August growth rate, but it would be somewhat above 9 percent. I don't have the exact number.

CHAIRMAN VOLCKER. It might be worth getting that number when we get to tactics, because my sense is that it wouldn't carry us way above these targets and we could talk about generally being around the

upper end of the range. But how far it carries us would come to the question of tactics and how September looks and all the rest. The current projection--and I put as little stock in these projections as anybody--shows a much slower growth in September after this bulge in August. If that [were to materialize], the bulge in August wouldn't look all that enormous.

VICE CHAIRMAN SOLOMON. Well, whenever there is some strong growth, I'm told it means that weaker growth will always be projected in the subsequent period as a smoothing of the path. I don't think it means anything at all, but--

CHAIRMAN VOLCKER. It depends, I suppose, how much this early August growth is affected by these small saver certificates. I don't know whether [the staff] projection for August is right. They had a big jump in these small saver certificates; whether that's a one-week phenomenon or whether it will continue--

VICE CHAIRMAN SOLOMON. Anyway, what you are saying I gather is this: That if we got this kind of growth in August and we are running, say, 9-1/2 or 9-3/4 percent on M2, you wouldn't see any need to call for a consultation and a change in the signals. But if M2 started exceeding what--10 percent--you would? What is your thinking here?

MR. GRAMLEY. Alternative A has 10-1/2 percent for M2.

MR. AXILROD. That's the growth from June to September.

VICE CHAIRMAN SOLOMON. I'm talking about the long-term target, fourth quarter '81 over fourth quarter '80.

MR. GRAMLEY. But we wouldn't know whether what was happening in August is going to make that much difference in the Q4-over-Q4 increase.

MR. AXILROD. Governor Gramley, we are calculating that if August came out as we are projecting, while it would look strong relative to the path the Committee adopted last time, relative to the longer-run target the growth from, say, Q4 to August--the answer we were working on--would be something like 9.2 percent. It's a tad above 9 percent just because of the longer--

MR. GRAMLEY. But we would presumably be looking at an M-1B that is equally below the lower end of its bound. Your projection for August is what--$424 or $424.5 billion or something like that for shift adjusted M-1B?

MR. AXILROD. Yes, $424 billion.

MR. GRAMLEY. That's still $4.5 billion below the lower end.

MR. AXILROD. Oh yes, it's below the lower end for that.

MR. GRAMLEY. If M2 crept up above or up to the upper band from Q4 to August, I wouldn't think one would be unduly excited about that.

MR. PARTEE. The problem is interpreting that directive. It has an absolute proviso on M2.

VICE CHAIRMAN SOLOMON. Well, that's what I was trying to get from Paul. At what point does he feel that the caveat bites? Is it at 9-1/2, 9-3/4, or 10 percent? It may not be triggered at all. He may not have to face up to it.

CHAIRMAN VOLCKER. Well, I can't give you a precise answer. You have to tell me what is happening in M1 at the same time and what is happening otherwise. It obviously makes us more restrictive than we would otherwise be. It would have some influence if M2 were moving well above its range. If it's moving slightly above--I don't know what the exact--

VICE CHAIRMAN SOLOMON. It says "provided that growth in M2 remains around the upper limit." We should have said, I think, "remains substantially around the upper limit," but I don't think we can change it now.

MR. MORRIS. [The Bluebook] is projecting 11-1/2 percent for the next two months under alternative A. The proviso was in terms of the upper limit for the year as a whole, basically. There was a chance that it would have an influence last month. I don't think it did have an influence last month because M2 came in fairly low. If it appears to be coming in high and persisting, it has an influence. That's the purpose of the proviso.

MS. TEETERS. And then what would you do--call a conference?

CHAIRMAN VOLCKER. I don't think I'd necessarily call a conference. It's in the directive.

MR. BLACK. And if we are wrong about rates--

MR. PARTEE. That's the trouble. I think it's an automatic instruction to the Manager. You could intervene and say we better have a conference. But it is an instruction. The Manager is to provide nonborrowed reserves below the path he otherwise would if M2 is at the point where the proviso takes hold.

MS. TEETERS. But it also depends on what is causing M2 to be high.

MR. PARTEE. Not in the directive.

MS. TEETERS. That's why I think it would be better to talk about why M2 is high rather than to automatically--

CHAIRMAN VOLCKER. Well, as I say, I think that requires some interpretation, which we would reflect in the discussion at the least. But there's nothing that's going to affect M2 that we didn't know about last month when we put this [proviso] in the directive.

MR. GRAMLEY. Except that last month we were looking at a situation in which we thought that nominal interest rates were going to end up somewhat lower than they were at the time of the FOMC meeting. In fact, they've ended up somewhat higher with the exception

of the funds rate. That's something, it seems to me, that we ought to take into account in thinking about where we want to be. I agree with your general prescription of what we ought to be aiming for. I don't think we know enough about the trends in the economy to make any significant change from what we wanted a month ago. But what we wanted a month ago was not higher nominal interest rates. And that colors my thinking. It seems to me that we ought to do something like Tony is suggesting and put in a "significantly" above the upper limit for M2 to give us a little flexibility there, particularly in light of these developments regarding the small savers and all savers certificates, which are going to have effects on M2 that are awfully hard to predict.

MR. ROOS. Paul, I would agree totally with your analysis of policy. One thing bothers me, though. It seems to me that what we do and how the world generally perceives what we do may be two totally different things. With the sensitivity of the markets and with the enormous importance of what we want to achieve and how we are trying to [affect] people's expectations, is it conceivable that the directive, which is a pretty formal, cold, delayed statement of what we do, could be supplemented with a more foreceful explanation of what we are doing? Do these times call for something like that rather than relying to the extent we do on the directive? In the early segment of your remarks a little while ago, you said, for example, that the policy record that is going to come out at the end of this week might be interpreted as some easing in policy. Now, it seems to me that if we stick by our annual target, which we are doing, that nobody who knows or who receives an explanation of what we're doing could imply that the Fed has all of a sudden eased in the sense of abandoning its anti-inflationary policy of restraint. Is it possible under these circumstances, where everybody hangs on every little hint or signal of what we are trying to do, to say occasionally in a white paper form the sort of thing you just told us, which in effect says: "Look the Fed hasn't eased up." Would that be in order? Are we so tied to the tradition of a central bank sending signals in a rather obscure way through directives that that's the best we can do in communicating?

MR. SCHULTZ. The Chairman is going on the MacNeil Lehrer program tomorrow night. There are some of us around here who hope very strongly that he would be willing to go not only on MacNeil Lehrer tomorrow night but that there will be a couple of other opportunities for him to speak over the next month or two. Those of us who feel that expectations are absolutely critical are trying to push him to do a couple more public appearances.

CHAIRMAN VOLCKER. I have a little more modest view of my capabilities.

VICE CHAIRMAN SOLOMON. I would hope you wouldn't tell them that we increased nonborrowed reserves at the annual rate of 23 percent!

CHAIRMAN VOLCKER. I think this is the problem Larry: There's nothing we can tell people that is going to convince them because everybody will have different interpretations. I can assert that [we haven't eased] but somebody can come back with a different viewpoint and say that's a lot of baloney. I think it's right in our terms; I'm not saying it's wrong. But somebody will say that he looks

at reserves and at nonborrowed reserves--and that's what they do most immediately--and those measures have gone up at an annual rate of 20 percent for two months. Or someone will say: "I look at the reserve base and the Fed had that under control for a while, but now at the end of August for two months in a row growth in the base has been 9 to 10 percent. So, he's blowing a lot of smoke because those are the indicators I look at and they've eased [because] total reserves are going up by whatever." There's nothing we can say to convince a person who looks at those indicators that we haven't eased. This is the state of the confusion we have in the markets, even though in my terms it's a misinterpretation. There it is. And they are not going to change their minds because we issue a white paper or anything else.

VICE CHAIRMAN SOLOMON. The sustainable monetary policy should have only half the country against you instead of everybody.

MR. ROOS. I hope that the gentleman sitting at your left, Governor Schultz, will convince you to get on; I think you undersell the impact of your ability.

CHAIRMAN VOLCKER. I'm not saying I'm not going to get on. All I am saying is that I don't think that's going to solve in any complete sense the kind of problem that you suggest. We are stuck with it in this peculiar period, when so many people operate on different theories and they are all uncertain. There is no action to be taken that everybody is going to interpret the same way.

MR. BLACK. Mr. Chairman, I agree with that substantially. But the directive will be released on Friday and I would like us to authorize you to explain that 7 percent when you go on MacNeil Lehrer --to point out that the 7 percent on the face of it looks higher, but it would only take us to the low point of the range.

MR. PARTEE. It doesn't get us to the low point of the range.

CHAIRMAN VOLCKER. Well, it does, but by the end of the year.

MR. BLACK. But it did from last month. Now we've got to have 8-1/2 percent.

CHAIRMAN VOLCKER. It is consistent with getting to the low point by the end of the year.

MR. PARTEE. By the end of the year.

MR. BLACK. By the end of the year. That's all I meant.

MR. PARTEE. Let me remind you that the directive has a bracketed phrase, which says "resulting in a quarterly average of less than 2 percent" or something like that. So, it's already there.

MR. BLACK. That's right. But the 7 percent is what they are going to look at, Chuck. And if the Chairman can say the 7 percent is not a ridiculous number--and in fact I would have preferred it to be higher than that myself and I'm usually quite tight--

MR. GRAMLEY. The markets surely are going to remember the decision to aim toward the lower end of the range for '81 and to

revise down the figure and establish a target for '82 which was still lower. It occurred at the same meeting.

CHAIRMAN VOLCKER. You know, the really sophisticated people won't have this interpretation. But I would suggest that there is nothing much we can do. I am very sensitive to the fact that last July I pronounced in all splendor that M1 was low, we weren't uncomfortable about it being low, and we weren't going to force it up. And I think that's true; we did not in those terms "force it up." But the market remembers that we had a couple of months of big increases and a lot of momentum and we ended up slightly overshooting the target. A lot of people will go look at that; I hope it's not the predominant view, but I just can't project it.

MS. TEETERS. But don't forget rates dropped very sharply before that happened. Rates haven't dropped this year.

CHAIRMAN VOLCKER. Rates did not drop. They dropped before. At the time I made that statement they were at the bottom, as it turned out, and we had the great overshoot while rates were rising very rapidly.

MS. TEETERS. From a relatively low base.

CHAIRMAN VOLCKER. I'm not saying that it's going to repeat itself. All I am saying is that there are a lot of skeptics in the market who are going to say that it's going to repeat itself.

MR. WALLICH. Well, I think there's some reason for thinking that because if the growth acquires any momentum, it will take more effort to break that momentum. If we now have 8 percent growth, let's say, for a month or two in order to get that down, interest rates will have to go up. So, I think we have a choice possibly of being a little tighter now or being a little less tight later on.

VICE CHAIRMAN SOLOMON. I don't think this makes a lot of difference, frankly, on what we talked about--the most you could assume is that those of us who are more sensitive to interest rates might like to see them a point or a point and a half lower--because one can't have an impression that the Federal Reserve is sharply easing monetary policy. I don't think the real crunch is coming now. The real crunch is going to be next year when, basically, I think we are going to be blown out of the water. Unless we can show an inflation rate decline to 5 percent, when the Administration is disappointed in all of its projections and we have a stagnant economy and the supply-siders are beginning to turn against us and everybody else is turning against us, it's quite clear that people will not understand why we are still continuing with such a high level of interest rates. And it's going to be very hard to explain unless we can show an inflation rate of 5 to 6 percent and say "Yes, we have a stagnant economy but look at what we achieved, and we achieved it in the face of huge budgetary deficits." Aside from that kind of defense, I don't think we will be able to sustain this kind of monetary policy next year. I don't think we are at the crunch yet, and I think it's a very minor decision whether we do--. If we really want to get interest rates down a point to a point and a half, we have to put in an initial borrowing assumption of about $1.2 billion or maybe even a fraction lower. If we put it at $1.4 billion, then I

think we will have to add--and we probably wouldn't want to add--a 1 percent cut in the discount surcharge in order to get it down there. But then we would be giving a policy signal. We wouldn't appear to be following the market. So, I don't have any problem in a certain sense with Paul's taking such a hard line as he is, but I just don't think this [policy stance] is going to be sustainable well into next year if we continue running such a stable, stagnant economy with certain sectors getting into a crisis situation.

CHAIRMAN VOLCKER. If you're worried about next year, and there's a certain legitimacy in that, surely your best defense is not to be easy prematurely this year. There will be some tradeoff between lower interest rates now and lower interest rates then. I don't consider my line a particularly hard one. It seems to me it's on the upper crust of the choices given us. But whatever that interpretation is, my general point is: What has happened between last month and now, except better employment figures, better retail sales figures, and less concern about an immediate deterioration in the economy that induces us to change the directive in a way that will be interpreted as an easier mode?

MR. PARTEE. A one percentage point increase in interest rates.

MR. RICE. Higher interest rates.

VICE CHAIRMAN SOLOMON. I think the difference is this. This is the same point that Lyle has made, that Emmett has made, and that Chuck has made, I think. We assumed last month when we set these targets that short-term interest rates would ease--very, very slightly, but somewhat. Instead, short-term interest rates are higher even though the fed funds rate has erratically come down. But even that is not down now; it has been running over 20 percent in the last couple of days, although the average is about 18-1/4 percent. So, basically, we miscalculated the interest rate effect of the targets we set last time. Now, I don't think we can set a target [that differs from] 7 percent, but we could--if we wanted to see some slight easing of interest rates--set an initial borrowing of about $1.2 billion.

CHAIRMAN VOLCKER. You are assuming that the object of policy somehow is to try to manipulate the short-term interest rate.

VICE CHAIRMAN SOLOMON. I keep one eye on it.

MR. PARTEE. It's a traditional New York view; I agree with it.

CHAIRMAN VOLCKER. I don't object to keeping one eye on it, but it's a pretty old bird.

MR. GRAMLEY. My concern is not so much that we adopt something by way of a directive that will assure a drop in interest rates. What I would like to see adopted is a directive that makes sure that we don't have a rocketing upward of interest rates just because M2 is above the upper end of the range. If your concern is that you don't want to change the wording of the directive now because of the signals that may send, that I can understand. If we can just have an understanding among ourselves that we will tighten if M2 is

significantly above its range--if that's in our minds--then, fine. I would be very reluctant to see a marked further increase in interest rates just because we have one month of big money supply numbers. This is a projection. You've said that many, many times yourself. As yet we only have one week's data for August; we have some partial data for the second week. We don't really know what is going to happen. We may have a sudden reversal. And I just don't think we ought to jump to hasty conclusions about the need for tightening just because an M2 number happens to go above the upper end of the range.

CHAIRMAN VOLCKER. I don't think anybody is jumping to hasty conclusions, from anything I know now.

MS. TEETERS. The wording has been changed to that effect.

CHAIRMAN VOLCKER. I know. We're operating on a directive that now produces borrowings of $1.4 billion and produces an increase in reserves in August of what, Mr. Axilrod?

MR. AXILROD. That's a projection, but total reserves in August could grow at around 10 percent and nonborrowed reserves could grow at around 18 percent or something like that.

CHAIRMAN VOLCKER. I don't see anything now that suggests we should change that technical path that we are now on, which implies at the moment $1.4 billion of borrowing.

MR. SCHULTZ. It's not quite $1.4 billion, is it, Steve? What is the target, $1.37 billion? I understand that's pretty close.

MR. AXILROD. That's this week, and for the three-week average we have about $1.285 billion or so.

VICE CHAIRMAN SOLOMON. That's 1-1/2 basis points!

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I think you are right: We ought to keep the same directive for the reasons you suggested. On this issue of M-1B and M2 and their divergent behavior, I think there's nothing in economic theory that suggests to us which one of these we ought to be pursuing. Therefore, not having a theory, we are thrown back on common sense and I am beginning to think common sense suggests that we shouldn't be trying to control either one of those. But that's a subject for the future, it seems to me. If we are going to be governed by common sense, we ought to start looking at the state of the economy and the state of real interest rates. And it's clear that the economy is flattening and that real interest rates, if we knew how to measure them, are at the highest level since the 1920s.

CHAIRMAN VOLCKER. That's not true.

MR. MORRIS. That's not true?

CHAIRMAN VOLCKER. [No,] having made a little study of it recently--

MR. MORRIS. When were they higher?

CHAIRMAN VOLCKER. First of all, heaven knows what real interest rates are. After taxes, they're half what they appear to be. And if you cut them in half, they're not even up to the inflation rate. Now that [assessment] is legitimate for some people and it's not legitimate for other people. But it's a very mixed up picture.

MR. PARTEE. After taxes they are more than they were a month ago because the tax bill reduced the tax rate.

CHAIRMAN VOLCKER. That is fair. I think this tax reduction will have some impact on this. Somebody put together for me the existing studies on real interest rates. And the one that was most impressive--it went back to 1791 and covered just the United States because the picture is very erratic if you look abroad--shows no consistency of real interest rates at all. And I thought the concluding comment from this study was rather interesting. It said, in effect: "If there is a law of economics that the real interest rate must be maintained at a positive 2 or 3 percent or something like that, it is a law that Moses must have brought down from Mt. Sinai about 1950 and retreated back up on Mt. Sinai a few years ago" because there is no evidence for it at all before 1950. The rate goes all over the place. Forgetting about the tax issues--and that makes a big difference because we never had these kinds of income taxes earlier in history--there are quite a few periods, which look short on a long-term chart but were periods of a year or two, of high interest rates that were [at current levels or higher]. What is unusual about this period, and quite unusual, is that those periods of high real interest rates in the past typically accompanied a period of declining prices. We had enormously high real interest rates from 1929 to 1933 and in similar periods of recession. You can't find, I think, without examining these charts more carefully, any time when real interest rates, forgetting about taxes, were so high during a period of inflation. Typically, the opposite happened: Real interest rates became negative during inflationary periods as was true in the '70s up until fairly recently. It's all consistent with an explanation of what we've had, maybe for the first time in history during peacetime, which is an expectation of a continuing peacetime inflation. That was never built into expectations before. Before when we've had inflation--including in the postwar period--people thought that prices would subside, so real interest rates went negative during inflationary periods, as they began to do in the '70s. But we've had a heck of a difference in the interest rate structure since '79, in those terms, which one can interpret as the American people giving up on the idea that we were ever going to return to price stability. I don't think we get a lot of wisdom from looking at real interest rates, even though I don't object to the theory that there ought to be some tendency to go toward a low real positive rate.

MR. MORRIS. Well, if you look at nominal rates, I would have the same conclusion, because we have a flat economy and we have nominal interest rates at historic highs. It seems to me that alternative B would suggest a deliberate policy of needing still higher interest rates, which to me is a policy that is pretty hard to sustain at the present time. So, I think alternative A with the same directive, which you are proposing, is correct.

VICE CHAIRMAN SOLOMON. But can we talk about the initial borrowing assumption?

MR. AXILROD. Mr. Chairman, I would like to [correct my earlier comment]. Borrowing is not $1.370 billion; it is $1.409 billion this week.

MS. TEETERS. That's for this week?

MR. SCHULTZ. That changes the whole situation!

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I, too, am fairly comfortable with "A," but I may look at this a bit differently than [implied by] a lot of the comments that have been made so far. I do think that M-1B growth in a real sense is artificially low and that the equivalent of what it should be is probably growth at a rate of more than the 0.9 percentage point measured rate that we can attribute to the direct effect of money market shares. I also still think that in some sense interest rates are either artificially high or technically poised to come down, partly because of the view that I happen to take regarding what that surcharge rate is doing to behavior. So to me it is still conceivable that we could get some give, particularly in short-term interest rates, under either of the scenarios that are being talked about here, particularly if we could find a time slot within which that surcharge rate could be changed. But that's not easy to do.

CHAIRMAN VOLCKER. I thought everybody wanted a penalty discount rate.

MR. CORRIGAN. At the surcharge rate, which now could be lower.

CHAIRMAN VOLCKER. Not put it at a penalty?

MR. CORRIGAN. No.

VICE CHAIRMAN SOLOMON. What do you mean by "everybody"?

CHAIRMAN VOLCKER. That was a generalization.

MR. CORRIGAN. The other thing is that there is some upside danger here in terms of these money growth rates. We're looking at two months where we'll have pretty steep growth with a clear need later for such growth to come back down. That's where this tradeoff between interest rates and the problems we have now has to be viewed in the context of similar problems later on. So, while I think you are right in suggesting that we would be ill advised in the current circumstances to change the directive, I for one am sensitive to the potential for an overshoot now in terms of money growth and other things. And, as I suggested, I think we may at least in the short run be able to have the best of both worlds. If we can, I wouldn't mind that at all.

CHAIRMAN VOLCKER. What's the best of both worlds?

MR. CORRIGAN. The best of all worlds in the short run would be to get some give in short-term interest rates while having money growth rates that are perhaps not as steep as those associated with alternative A.

CHAIRMAN VOLCKER. Well, I don't know what is going to happen to M1. I don't think it's inconceivable, looking at the July pattern which is the most recent we have, that we could get a decline in the second half of August that would bring M1 below the growth pattern implied here and would be consistent, then, with some easing in the borrowing level. But I don't know whether that's going to happen.

MR. CORRIGAN. Neither do I.

MR. PARTEE. For M-1B we only have the first part of August. What is given for the whole quarter is--

CHAIRMAN VOLCKER. And we know that that has some funny money in it from this merger business, which should be out by the following week, I guess.

MS. TEETERS. But it might be into M2 by that time.

MR. WALLICH. When it does, they're [unintelligible].

MR. BLACK. To some extent.

MS. TEETERS. [Unintelligible.]

MR. CORRIGAN. Back to Europe.

CHAIRMAN VOLCKER. I don't know if there'd be much in M2; there'd be [some] in M3 at least. What would be in M2?

MS. TEETERS. They might park it temporarily in money market mutual funds.

CHAIRMAN VOLCKER. I don't think Dupont--

MR. AXILROD. But we can't identify the money that the stockholders got. We're identifying the money that Dupont and Seagrams were keeping for making payments. When that disappears, it ought to go into M3 or other type assets.

CHAIRMAN VOLCKER. Stockholders' money could go into M2.

MR. PARTEE. Yes, I thought that's what you were talking about. You're talking about the other side of the transaction.

CHAIRMAN VOLCKER. Well, I think that is another caveat on the M2 numbers, if we had some sense that this merger was affecting it. It's swelling up both sides of the balance sheet and I would suggest some caution on M2. I think all of these concerns ought to be reflected in the record somewhere.

MR. SCHULTZ. Well, there's a lull in the conversation, and it's a good time for me to comment. I continue to think that we must not lose sight of what we're trying to do long term. We just have to get inflation down this time. If we don't, I'm afraid that we will have an awful period ahead of us lasting a great many years. We're making some real progress. I get concerned, as Tony does, about getting blown out of the water next year. I get concerned about it maybe even from a little different point of view. I get concerned

that if this economy continues to hold up and doesn't break--and it's remarkably resilient--and if the Administration doesn't do something to stretch out defense expenditures or hold down spending in some way or find some way to cut the budget further, these interest rates are going to stay very high. Next year is an election year, and I think we could easily get blown out of the water because I think the Administration could well come under enough pressure at some point early next year either to go for credit controls or to cut and run on supporting a firm monetary policy. So, I think we have a tough, tough period to go through here.

What we're trying to do is to walk a rather fine line. It strikes me that we do have some restraint on the economy at this point in time. These interest rates do seem to be high enough to bite, but they don't seem to be high enough to bite as badly as everybody thinks they ought to. I continue to be amazed at how well small businesses are holding up, at how well they continue to be able to be viable entities. They're learning how to price; everybody is learning how to adapt. I would not like to see further restraint on the economy, but I certainly would be afraid to start letting up. I don't know about the rest of you, but I look at those retail sales and I hear my wife talk, and we haven't changed any consumer's ideas about [inflation]; they all still talk the same way. They say: "I better buy it now because it's going to cost more next year." We haven't changed many of those perceptions in the marketplace. All those market participants are still [behaving] the same way. They've been burned and burned; it took us 15 years to change their expectations and we aren't going to change them back very fast. It's going to be a slow process. So, it seems to me that we ought to continue to move on the course we're on. Things might clear up a little after Labor Day. Governor Gramley, as you say, things do tend to get a little clearer in the economy after that time. But they're murky enough right now that I think that we ought to continue with the course we're on.

CHAIRMAN VOLCKER. Let me just remind you of something that I think is true. I don't know what to do about it, but it isn't going to make life any more comfortable. If the expectations that Fred Schultz is talking about do change, it's going to have some impact on the economy. What is holding up house prices? The expectation that house prices are going to rise. What's holding up farm land prices? The expectation that farm land prices are going to rise. What's holding up retail sales? To some extent, I assume it is the assumption that prices are going to be higher next year. If we could snap our fingers and have that perfect world in which nobody expected prices to rise next year, I think the inevitable implication is that house prices would decline, farm land prices would decline, there'd be less construction activity in the short run, and retail sales might take a short-term nose dive. I don't know how to avoid that. That's assuming our policy was a great success in terms of inflation.

MR. PARTEE. That, of course, is a reason for trying to follow a middle course, Paul. I continue to be impressed by the potential for monetary growth to fall below our specified ranges. And I think that could be very harmful, particularly if in the course of this the economy begins to weaken.

CHAIRMAN VOLCKER. I'm not sure there is a middle course. That's my concern. I don't think there is. I don't see any way to fine-tune this situation.

MR. SCHULTZ. Scylla and Charybdis have overlapped.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I have no desire to raise interest rates at this time. I think they're high enough now.

CHAIRMAN VOLCKER. Certainly, we've achieved something!

MR. WALLICH. I'd like to qualify that [by adding] "but barely."

MR. BOYKIN. After tax.

MR. WALLICH. They're high enough, but barely, because the economy is bearing up very well under these interest rates. There is one sector that is very badly damaged and it is bearing up poorly. But the rest are curiously unaffected and on the whole the economy is standing up remarkably well. So, I can see no grounds for going down on interest rates. I can see the danger of a great boom as these tax cuts take hold later in '82, and I think we'd be a lot better off if before then the economy had been slow rather than beginning to move, because it will get enough or more than enough movement out of that tax stimulation. So, keeping [economic growth] at zero seems to me about right. One can't positively look for a reduction and feel good about it, but we certainly ought not [foster] any stimulation at this time. We just have to sit with the high interest rates, painful as that is.

Now, I am concerned about a repetition, on a small scale, of last year: namely, that we start below the lower end of the M-1B band and shoot through the band. It would be the third time that we've done that. It doesn't seem likely at this time, but it has happened twice before. And that makes me concerned about anything that looks like a rapid growth of M-1B, suspect as that variable is. I'm also concerned, if we imparted to it any degree of momentum, about how we would bring [that pickup] to a halt once growth has gotten more or less back on track. At that time we'd have to have higher interest rates. And that's something we had better avoid. So, I lean toward a low growth rate for M-1B, as described in alternative B. One could mitigate the interest rate consequences of that by being cautious about setting the borrowing requirement. In any case, I think the setting of the borrowing requirement is a much more powerful instrument than the change of the path by 1 percentage point up or down. That would get me to alternative B, possibly rephrased as it is in the second version of the directive [shown in the Bluebook] where the possibility of accelerating M-1B is allowed. I'm really not happy about the acceleration. I just don't want to put too much of a burden on M2 because of the doubts that are attached to it at this time.

VICE CHAIRMAN SOLOMON. I'd like to clarify something with Steve. My understanding of the wording of the M2 constraint in alternative II is that it's completely different than the meaning of the M2 constraint in alternative I. As I read alternative II, it says

"Provided that growth of M2 remains around the upper limit of, or moves within, its range for the year, growth of M-1B at an annual rate somewhat higher than the ___ percent specified above would be acceptable..." In other words, it permits an easier monetary policy on M-1B. It does not say, though, the way alternative I does, which tracks what we did last month, that it's a cap. Is that deliberate?

MR. AXILROD. Well, alternative II was written only to provide an alternative in case the Committee did not want to continue specifying the third-quarter growth rate it adopted at the last meeting for M-1B. That is, if the Committee wanted to adopt a lower rate, this is written so you could have a lower growth rate that is consistent with alternative A, what you adopted last time, but permits it to rise in case M2 happened to come in all right.

VICE CHAIRMAN SOLOMON. Right.

MR. AXILROD. It's just written to start off with a lower M-1B growth rate, should the Committee wish to do that.

VICE CHAIRMAN SOLOMON. I understand that.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I just want to say very briefly that I wouldn't have any trouble with maintaining the status quo policy. But, as you indicated earlier, I think we've already had some easing in terms of the increases in total reserves and the monetary base. As I look at alternative A, and even alternative B, I think they could be interpreted as being somewhat stimulative, particularly with respect to M2. The concern that I'd like to express is: Will the market interpret an action such as you've indicated as being stimulative with respect to M2 [since there is no provision for] bringing the growth of that aggregate down and thus question the will of the Fed to tackle that particular aggregate?

CHAIRMAN VOLCKER. We'll find out on Friday, I guess, when it is published.

MR. FORRESTAL. Well, the question is: Would that action excite the market to the extent that interest rates could go up?

CHAIRMAN VOLCKER. I don't know. In answer to that question, I don't feel so confident that it won't [excite the market] that I would want to take another action here that a month from now is going to be interpreted as further easing.

MR. FORRESTAL. What I was coming to is suggesting that perhaps at some point the Committee ought to look at an alternative that would be even more restrictive than alternative B with the purpose of bringing M2 growth down further into the range and not leave it above the range set by the Committee.

CHAIRMAN VOLCKER. Well, we have had a variety of opinions expressed. But I detect, with some prejudice, a willingness to live with last month's directive, though with some concern about how it's going to be implemented. I don't find entirely answerable those

questions because [they require] too many assumptions about what is going on. In the immediate sense, [an unchanged directive] doesn't imply anything but staying on the path that we're now on. That involves borrowings of around $1.4 billion, as I understand it, and in the first instance borrowings would be reduced if M-1B comes in weaker than now projected for the month. Presumably, they would tend to go higher if M-1B came in higher than projected for the month. But those judgments would be shaded by what is happening to M2, particularly. If after several weeks M2 appeared to have a lot of momentum and was continuing high into September, we would shade the decisions on the tighter side. And if the reverse happened, we would not.

MR. GRAMLEY. What is the projection for M-1B for August? Is it the same as in the Bluebook, 11 percent? Is that what we're talking about?

MR. AXILROD. Yes, alternative A is essentially the projection.

MR. GRAMLEY. It is a current projection as well as a target?

MR. AXILROD. Well, that's right. It works out, of course, that alternative A, August to September, is consistent with that 7 percent [for the quarter], so that September growth would have to come down.

MS. TEETERS. Does that mean in alternative I, in the wording that relates to M2 remaining around the upper limit of its range for year, that you're going to take out the words "or moves within"?

CHAIRMAN VOLCKER. Well, I would not, but we can do that. I wouldn't just because everybody reads these things with an electron microscope and will say: "Why did they do that?"

MR. BLACK. Mr. Chairman, I'm with you one hundred percent on this but I wonder if it wouldn't make some sense--this is the point I was trying to develop awhile ago--if we added a sentence in the draft directive right after that sentence at the top of page 12 in the Bluebook that said something like "In view of the shortfall in M-1B in July, this would imply growth in M-1B at an annual rate of 8-1/2 percent between July and September."

CHAIRMAN VOLCKER. Why do you want to say that?

MR. BLACK. Well, I think we ought to tell the public more about what we're doing. If they see 8-1/2 percent growth coming in, they're going to interpret that as easing unless they understand that's what it takes to get to the low point of the range by the end of the year. It's the same reason I suggested awhile ago that we ask you to say on the McNeil-Lehrer program that we adopted a 7 percent rate [for the third quarter] but people must not think that that is an easing of policy because all that would do, if it's achieved, is get us to the lower limits of the long-run range we indicated in the testimony in July.

MR. WALLICH. We seem to get very little credit for our earlier shortfalls. All the public sees is the rapid rise in that particular month.

MR. BLACK. I think that's partly because we have never said as clearly as we should what this implies month by month.

VICE CHAIRMAN SOLOMON. I respectfully disagree. I can't think of anything worse than starting to use numbers on public television aside from the year-over-year number. If we start talking about intermeeting numbers of 7-1/2 or 8-1/2 percent, or whatever it is, I just don't think people would understand that. I think it's much more convincing if we talk in somewhat more general nonquantitative terms.

MR. BLACK. I think they will understand it a whale of a lot better than if we get 8-1/2 percent growth [over August and September] and we haven't put that in the proper perspective.

MR. PARTEE. Well, we may get 11 percent right here in August. What do we do with that? That will come out before the policy record is [made public].

MR. BLACK. Unless we've said something about what those numbers are ahead of time, I think we'll scare people to death.

VICE CHAIRMAN SOLOMON. But you're assuming that we're going to get it. Suppose Paul says it's 7 percent or 8-1/2 percent and then we get something completely different, lower or higher?

MR. BLACK. What I'm saying is that I don't want someone to think that in choosing 7 percent last month we made a move toward ease. I don't think we did.

MR. PARTEE. No, I think we tightened.

MR. BLACK. I think we tightened, too; I would rather it had been above 7 percent. But when the market sees 7 percent, unless we say why it is 7 percent, they are going to oversimplify things and look at that one number. I'm trying to say we should tell them how we look at those numbers so that they'll interpret them right.

MR. SCHULTZ. I hate to tell you, Mr. Black, but I really don't believe there are very many people out there who understand the difference between these kinds of numbers you're talking about. I would hope the Chairman would not speak in these specific terms but would give, in effect, a broad overview of what is going on.

CHAIRMAN VOLCKER. Well, I don't think we have to worry right now about what I'm going to say on McNeil-Lehrer tomorrow. We have to resolve this directive.

MR. BLACK. I agree they don't understand, Fred, but that's why I think we ought to be trying to explain it to them. And that's where we differ. I think this will help a sensible person understand it whereas [now] they misunderstand it in every possible way, as the Chairman indicated awhile ago.

CHAIRMAN VOLCKER. Well, let me make a slightly different suggestion. I think we can say something along the lines of what you're saying in the policy record someplace. I don't know that we have to put it in the directive just after it says that it implies 7

percent for the quarter as a whole. That sounds awfully fine-tuned to say it implies 8-1/2 percent for two months out of the quarter. We're probably not going to come anywhere near the figure anyway.

MR. BLACK. Paul, are you going to stick that number in the first part? No, I guess not; in this version we have 7 percent. Okay.

CHAIRMAN VOLCKER. The problem revolves around the M2 issue and I don't think I can fully resolve it. There should be some discussion in the policy record about the problems, of which we have several. What was the last one? Oh, this takeover thing. We have the takeover, the new institutional thing, and that was all in my statement. Well, the takeover was not, but my statement in July mentioned the other things. And we did not say it was going to make us terribly happy with a big overshoot in M2 only three weeks earlier.

MR. PARTEE. And then in the fourth quarter we have the tax exempt certificates, which could blow this aggregate out of the water.

MR. AXILROD. Well, there is evidence of somewhat more interest in the small savers certificates than had been expected.

MR. SCHULTZ. New technical differences.

CHAIRMAN VOLCKER. Well, I have no problem with reflecting in the policy record that these things may have unexpected results that we can't anticipate and that they would have to be taken into account in judging M2. I would prefer to keep it out of the directive just in the interest of continuity. But if we made any change in the directive, I'd make it in that next artificial sentence, which is put in there routinely, that says shifts in the NOW accounts will distort measured growth. We could say other things will distort measured growth in M1 or M2 and we will take account of those distortions. But I think we could say the same thing in the discussion within the body of the policy record text. That's what I would prefer, just in the interest of not complicating this further.

MR. GRAMLEY. It's okay with me. I think there's a broad agreement with this sort of formulation so long as we have some understanding that the mere fact that M2 is starting above the upper end doesn't lead to an unusual--

CHAIRMAN VOLCKER. I am not saying that because M2 is projected high at the moment for August we would do anything but remain on the path that we're now on.

MS. TEETERS. So it's not going to automatically trigger any reaction?

CHAIRMAN VOLCKER. Not right now.

MS. TEETERS. Not right now.

CHAIRMAN VOLCKER. No. Things will change and M1 will be higher or lower or M2 will be higher or lower; and we just have to look at it as time passes. I don't know what other answer I can give you. If the growth in M2 is high but that in M1 is low, it obviously

has a different implication than if they are both running high. If M1 is right on the bottom and M2 is beginning to run still higher than we project now and it begins to look [high] in September, then I think it does have some implications.

VICE CHAIRMAN SOLOMON. I think that's all we can expect.

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. I guess we're ready to vote. I would make one change in the directive. I would say "In the short run the Committee continues to seek..." just to emphasize that we're not changing anything.

MS. TEETERS. This implies initial borrowing of $1.4 billion?

CHAIRMAN VOLCKER. Or "In the short run, as decided at the last meeting, the Committee will seek..." I'd use one of those two.

MR. CORRIGAN. There's no thought here that we would be implicitly tolerant of short-run money growth of a little less than perhaps these 8-1/2 and 11-1/2 percent numbers.

CHAIRMAN VOLCKER. Well, I think it's consistent with what I just said. If we have a significant drop in the second half of August beyond what is anticipated now and the M2 figures are just what we anticipate now, that would have at least a modest effect of reducing the borrowings. If M2 were coming in high at the same time--by high I mean higher than now projected--we'd probably shade that judgment.

MR. CORRIGAN. I have some predisposition or a mild prejudice in the direction of money growth being a little slower, if it turns out that way, simply because I still think it's in our better long-run interest to have it work that way than the other way. But I am comfortable with the overall formulation.

CHAIRMAN VOLCKER. And consistent with not changing anything, we just repeat the current federal funds range of 15 to 21 percent. Am I right? We're somewhere in the middle of it.

MS. TEETERS. And add this language in the sentence that starts "It is recognized that shifts..."?

CHAIRMAN VOLCKER. No, I was not going to add that. I'd put that in the text, in the discussion about adopting the same [short-run objectives].

VICE CHAIRMAN SOLOMON. You mean in the policy record, not the directive.

MR. PARTEE. Well, we're getting awfully close to having a cooked directive. It doesn't really mean that [in] the directive. That's a bothersome fact, Paul.

CHAIRMAN VOLCKER. Well, I don't know that I--

MR. PARTEE. Well, if you read the directive it says one thing, but there's some side agreement that we'll do it a different way. I just think that's a very bad procedure.

CHAIRMAN VOLCKER. Well, that's your interpretation, not mine. The directive says "provided that M2 growth remains around the upper limit." The current projection, as I understand it, meets [the description] "around the upper limit."

MR. AXILROD. I ought to correct what I said: The calculations with the hand computer came to 9.4 percent for August.

MR. PARTEE. And what's the upper limit?

MS. TEETERS. 9 percent.

MR. AXILROD. But I don't know whether it's 9.3 or 9.4.

MR. PARTEE. It says "remains around or moves within." You want to leave that phrase in there. Now, I suggest that 9.4 percent is certainly right on the very border of violating, if it doesn't already violate, the directive.

CHAIRMAN VOLCKER. Oh, I think 9.4 percent is "around the upper limit." That 9.4 percent is for August?

MR. AXILROD. From Q4 1980 [to August].

CHAIRMAN VOLCKER. And in September on the current projection M2 growth would come down. I think that is around the upper limit. I don't disagree with that, but I don't think it's beyond it; that's all I'm saying.

MR. BLACK. We're leaving the "or moves within" in there, Mr. Chairman?

CHAIRMAN VOLCKER. I'd just leave it in on the basis that it may well move within, though I don't know, by the time we get to September. Why change it?

VICE CHAIRMAN SOLOMON. Yes, if we leave it out, a lot of the Fed watchers are going to think that that's a significant easing. And I don't know--

MR. CORRIGAN. Then they will think we've eased.

MS. TEETERS. But in reality, we're not going to follow this. That's Chuck's point, that it's a violation.

CHAIRMAN VOLCKER. Well, I don't think that's right. Obviously, it's a question of interpretation. But "around the upper limit" does not mean <u>the</u> upper limit.

VICE CHAIRMAN SOLOMON. Yes. I'm almost surprised, Chuck, that you say that. If we're talking about something like 9.3, 9.4 percent, isn't that around the upper limit?

MR. PARTEE. Well, I had the impression that one would read the whole phrase, "moves within or remains around the upper limit." And I think that gives less tolerance to being above the upper limit than it does being below.

CHAIRMAN VOLCKER. Oh, there's no question about that. I think it gives less tolerance for above than below.

MR. PARTEE. It's difficult. There has been over the years a tendency for the Committee to want to have things [in the decision] that we don't say in the directive. I think that needs to be resisted because the directive is our only record of what we've done. We don't have minutes of the meeting that go through all this discussion and--

CHAIRMAN VOLCKER. I proposed this on the basis that we're not changing anything from last time. We knew about the special [small] savers certificates and we knew about the all savers certificates. We didn't know maybe quite so much about the takeovers. What we didn't know was that we'd have a bulge in the beginning of August. But presumably that's what we were forewarning ourselves against.

MR. PARTEE. Just to clarify, we didn't know that the all savers certificates would become law.

VICE CHAIRMAN SOLOMON. [On] October 1st.

CHAIRMAN VOLCKER. I think that is true. We did not know. We were only 99-1/2 percent sure.

MR. PARTEE. I just wanted to repeat that position so that you can change it next time.

VICE CHAIRMAN SOLOMON. Well, when we hit the two-year anniversary of October 6th or 8th or whenever--

CHAIRMAN VOLCKER. Actually, the all savers certificate is probably reducing M2 at the moment because the savings banks are all offering RPs in the anticipation of the all savers certificates. Instead of putting money in a money market certificate people are using RPs, which are not in M2 and the money market certificate is.

MR. PARTEE. Well, I know the passbook savings at least are going up.

CHAIRMAN VOLCKER. So, we may be getting an artificially low M2 at the moment.

MR. BALLES. Mr. Chairman, I'd just like to raise an important technical question. In this material that was passed out called the general paragraphs, in the operational paragraph on page 3 line 57, I hope the language there is a mistake. It says "provided that growth of M2 remains at the upper limit."

MR. AXILROD. Yes, that was a mistake. That should say "about."

MR. BALLES. Okay, if it's still "about," then there's some leeway.

MR. AXILROD. That was a mistake. It's a transcription error. [The intended wording] should be exactly as it was in the Bluebook.

CHAIRMAN VOLCKER. "Around" is the right word.

MR. BALLES. Okay, otherwise we would be taking--

CHAIRMAN VOLCKER. I'm just wondering. This part is not the part where we can put in some sentences about the possible artificial factors affecting M2.

MR. BALLES. That might be a good idea.

VICE CHAIRMAN SOLOMON. Artificial factors affect M-1B too.

CHAIRMAN VOLCKER. Yes, but that's mentioned. I think it's alluded to, yes.

VICE CHAIRMAN SOLOMON. If we come in at the end of the year within the target range on M-1B, we may not want to stress the artificial factors that much.

MR. CORRIGAN. Then we can say we're really in the middle.

CHAIRMAN VOLCKER. That's right. I agree. I wouldn't suggest to you any more emphasis. This says "...the shortfall in M-1B growth in the first half of the year partly reflected a shift in public preferences"--that's good Federal Reserve language--"toward other highly liquid assets." It adds that growth in the broader aggregates has been running somewhat above the upper end of the ranges for 1981, but "in light of its desire to maintain moderate growth in money over the balance of the year the Committee expected that growth in M-1B for the year would be near the lower end of its range." Is there any reason why we can't insert a phrase there? We could add "at the same time, growth in the broader aggregates might be high in their ranges, an expectation reinforced by..." Or let's put in another sentence. "It was recognized that changes in the institutional setting might have an effect on M2 and M3 in the second half of the year" or some such language. Is this language sacred? Do we have to repeat exactly what we had the last time?

MS. TEETERS. Well, it was [sacred] two minutes ago.

MR. PARTEE. No, we're not talking about that part. We're talking about the longer run. It's page 2, around lines numbered 39 to 40. Is that where you are, Paul?

CHAIRMAN VOLCKER. Yes. Well, I'm on line 44. I just don't know if that's a more convenient place to insert it.

MR. BALLES. Paul, as an alternative to putting it at line 44--

CHAIRMAN VOLCKER. The trouble is that this says what we did last time, which doesn't--

MR. BALLES. I was going to suggest, Mr. Chairman, that if we want to add an extra sentence that would call attention to artificial distorting factors in M2, we might slip it into the sentence that now begins on line 58. "It was recognized that shifts in NOW accounts would continue to distort measured growth in M-1B and..."

CHAIRMAN VOLCKER. That's what I was suggesting before, but that gets into the operational part of the directive. It could be put there, but--

MR. BALLES. Just add a phrase there that M2 may be similarly distorted by recent developments in new savings instruments. Insert a phrase that we would then follow an operational reserve path to be developed in light of evaluations of those distortions.

CHAIRMAN VOLCKER. That is the place we can put it if we want to change the operational paragraph. If we don't put it there, I guess the best place to put it, if we put it in the directive at all, is in line 25. That discusses what happened in July. Growth in M2 accelerated; the level wasn't very high. The level of M2 was slightly below the upper end of the range. "It is recognized that during August and potentially in October the introduction of new certificates may..."

MR. AXILROD. Well, we once had a sentence in there which we took out because it included the early estimates for the week of August 12th. But we could easily say: "Available data for early August suggest acceleration in growth of M-1B and M2, in the case of M2 reflecting..." It depends on some of our preliminary estimates, but that would be a reasonable sentence to put in there.

CHAIRMAN VOLCKER. I think we can put it in there and then put in the body of the [policy record] discussion again our concern about this factor. Let's assume we will do that and let's vote.

MR. GRAMLEY. Mr. Chairman, I hate to do this, but I have one other small technical point on line 6, where it says the increase in retail sales reflected some recovery in sales of new cars. It's probably more used cars than new. I would suggest it say "some recovery in sales at automotive dealers," which is more likely to be the case.

CHAIRMAN VOLCKER. I think that will be accepted. Well, with all that, I would propose just sticking in the word "continues" on line 52: "In the short run the Committee continues to seek..." Are we ready to vote? Vote.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	Yes
President Keehn	Yes

Governor Partee Well, I have to vote against it again since I voted against it the last time and it is exactly the same as it was before.

MR. WALLICH. You could have changed your mind.

MR. PARTEE. No, I haven't changed my mind. I think more than I did the last time that it's the wrong thing to do.

MR. ALTMANN.

Governor Rice	Yes
Governor Schultz	Yes
Governor Teeters	Yes
Governor Wallich	Yes
President Black	Yes

Eleven to one, Mr. Chairman.

CHAIRMAN VOLCKER. Okay, thank you. We have some sandwiches out there. Do we have anything else? The next meeting is October 6th. There's nothing else on the agenda for this meeting.

END OF MEETING