

Meeting of the Federal Open Market Committee

April 22, 1980

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, April 22, 1980, at 9:30 a.m.

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

Messrs. Baughman, Eastburn, Mayo, and Willes,  
Alternative Members of the Federal Open  
Market Committee

Messrs. Balles and Black, Presidents of the  
Federal Reserve Banks of San Francisco  
and Richmond, respectively

Mr. Altmann, Secretary  
Mr. Bernard, Assistant Secretary  
Mr. Petersen, General Counsel  
Mr. Oltman, Deputy General Counsel  
Mr. Mannion, Assistant General Counsel  
Mr. Axilrod, Economist

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

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

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

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

Messrs. Broaddus and Danforth, Vice Presidents,  
Federal Reserve Banks of Richmond and  
Minneapolis, respectively

Mr. Ozog, Manager, Securities Department,  
Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of  
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CHAIRMAN VOLCKER. Can we come to order, ladies and gentlemen? I am delighted to say that our Vice Chairman, Mr. Solomon, who was duly elected in absentia last time, is with us today. Welcome to your first meeting. I am sure you'll find out about the wonderful ways of the Open Market Committee very quickly. First, we have the minutes.

MR. GUFFEY. So moved.

CHAIRMAN VOLCKER. Without objection, we will approve the minutes. Mr. Pardee.

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

CHAIRMAN VOLCKER. Comments or questions?

MR. BLACK. Scott, how would you rate the relative importance of the declining rates and prospective declines in rates vis-a-vis the Iranian situation, so far as weakness in the dollar is concerned?

MR. PARDEE. Much more important are the interest rates. On the Iranian situation, when you talk to different people they'll give you different interpretations even on the same day. For the moment interest rates are the dominant factor in peoples' minds in the exchange markets.

MR. BLACK. But if we kept the aggregates under control successfully for the next several months, would interest rates and prospective interest rate movements mean as much as they do now?

MR. PARDEE. In a couple of months the exchange traders might be thinking about something else. The [focus of their] attention tends to shift from time to time. Currently, given that there is a feeling that we're in a period where interest rates are topping off and people are uncertain as to how far interest rates are likely to go down or whether they will stabilize, rates are the dominant factor. The exchange market people look a little at the aggregates. I was a bit surprised and rather pleased that the decline in the aggregates reported on Friday did not lead to a sharp sell-off of the dollar, given the sensitivity the market is showing toward monetary questions in the United States at this point. But they look mainly at interest rates and less at the aggregates.

MR. BLACK. Has that mix changed any? I know that has been true for a long time.

MR. PARDEE. It depends in some banks on whether they have monetarist economists that they have to listen to; but they work with interest rates. And I'm afraid, with this 1.4 [number released] this morning, that we're hearing again from the market that there has not been any improvement on inflation in terms of the CPI.

MR. WALLICH. Following up President Black's question: The market knows the projections are for falling interest rates. These forecasts are also derivable from Treasury bill futures and the like.

Do you think the exchange rate discounts these future declines in interest rates so that if they materialized there would be no further exchange rate effect?

MR. PARDEE. It's a question of [timing]. We surveyed corporate treasurers yesterday to find out what they were thinking at this moment. Several of them related practically the same view: They expect that sooner or later interest rates may decline in the United States--that it's necessary--as we move into a recession. But as I indicated in my report, if interest rates come down faster--before there is a demonstrable improvement on inflation and internationally on the trade [and] current account balances--then we're heading for trouble. So there is some expectation that interest rates may recede, and certainly plenty of hope that they will at some point, from this particular group of people. But the traders and corporate treasurers are telling us that it's a matter of timing in terms of when the interest rates come down and when these other things start improving.

CHAIRMAN VOLCKER. The consumer price index isn't going to come down for three months.

MS. TEETERS. What are the price indexes doing in other countries?

MR. PARDEE. They are beginning to level off, I'm afraid, certainly in Germany and Switzerland where they are running around 6 percent or 5 percent. Wholesale and producer price indexes are still very high in many of these countries. Japan is still reporting very high increases, but they are beginning to level off, too, as the oil shock gets filtered into their price mechanism. But the consumer price indexes are behaving better in some of these countries.

CHAIRMAN VOLCKER. What are German interest rates doing? Are they off their peak or not?

MR. PARDEE. Today they're off a little. The Euro-mark is about 9-1/4 percent and the three-month rate on interbank [loans] is down below 10 percent.

CHAIRMAN VOLCKER. What were they at the peak?

MR. PARDEE. Euro-marks as against Eurodollars were around 17 percent as against 9 percent. We're still at a differential of about 7 to 8 percentage points, depending on which measure we use.

VICE CHAIRMAN SOLOMON. That's close to the peak.

CHAIRMAN VOLCKER. It's not appreciably off the peak.

MR. PARDEE. Well, it was at about 10 percentage points before, close to 10-1/2.

CHAIRMAN VOLCKER. Any other questions?

MR. EASTBURN. A question, I guess to Ted Truman: In the summary of the Greenbook, the staff concluded with a paragraph about the outlook for the dollar, which as nearly as I can remember has said about the same thing for the last year or two, whereas the dollar has

had some ups and downs. I wonder if this is because that is the best you can do or [Laughter]--

MR. TRUMAN. Well, the dollar has had some ups and downs. However, for the last 18 months, or in fact since shortly after the November 1st program, the dollar on average has not moved. It has moved in a band of about 5 percentage points on average and our projections have been more or less within that same range. As far as your second question is concerned, about whether that's the best we can do, my feeling and the staff's feeling is that there are a number of conflicting forces at the moment. On the one hand, we have the prospect of interest rates coming down; that's something that the market looks at very closely, in part because that's the cost of money. That's a different phenomenon than the monetary aggregate targets, which are a function of what is going to happen to inflation and the economy over a longer term. I would differ with Scott in that I think the market believes and has appreciated the fact that our trade and current account positions are relatively good and will continue to be relatively good, partly because of what our domestic projection is, and that should tend to give some strength to the dollar. So, it's really those two conflicting forces that lead us in some sense to a projection that the dollar will remain in the range it has been for the last year or so. As far as the technical side of the projection is concerned, we did in fact raise it from 88.5 to 90, but that's a relatively small difference. It's in the same range where it has been for the last 18 months or more.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. We hear a good bit of publicity about domestic credit problems. The Chrysler story is in the paper this morning, and so forth. I hear no mention of international credit problems, and that seems to me to be an exposure that gets overlooked in the assessment. I don't know whether you have any feel for this or not.

MR. PARDEE. There are several people who might be able to answer that. In terms of the non-oil-[producing] less developed countries, there is a lot of discussion about that.

MR. WINN. That's the sort of thing I mean. It seems to me that's a problem that is ahead of us in spades.

MR. PARDEE. I think both the Board staff and our staff, as well as other staffs, are looking at this very carefully. We're moving into another period where the whole discussion of recycling is very important. Since the 1974-75 period scared so many people, perhaps we're in a little better shape coming into this one. People talk about Brazil and a few other countries that will have big problems, but of course the [unintelligible] decided not to talk to the IMF. I don't know, Ted; you might want to comment on that.

MR. TRUMAN. Well, as we said in the presentation to the Committee in February, it's not clear how the international credit problems will impact on the dollar per se or on the U.S. economy. There is a feedback between the policies that are adopted by other major oil importing countries in this framework [in terms of their effect] on the dollar and the international credit situation. So, if Japan and Germany and the United States, for example, decide that they

do not want to sustain the kinds of current account deficits that everybody seems to be projecting at least for this year and next year, then we could have problems. It's not clear how it would impact on the dollar, but the impact on banks and the financial system could be quite severe.

VICE CHAIRMAN SOLOMON. The difficulty of the non-oil-[producing] LDCs in borrowing sufficiently and the need to draw down reserves will probably lessen the pressures for diversification out of the dollar. On the other hand, the probable failure of the substitution account negotiations may increase diversification pressures by the OPEC countries. My own view is that right now the best estimate is probably that we'll be nip and tuck with the Germans on the external current account deficit. The picture is not as optimistic as it was when we thought a couple of months ago that our deficit would be significantly lower than the German and Japanese deficits. I agree completely with Scott that in the short run, meaning in the next month or two, there is likely to be pressure on the dollar if the decline in interest rates moves very precipitously. But I think the outlook in the longer run, a few months from now or later in the year, is sufficiently reasonable that we're unlikely to have any major dollar pressure of the kind that we saw in October 1978. But in the period immediately ahead of us, as these interest rates move very sharply--if they do--I think that will cause us problems.

CHAIRMAN VOLCKER. What is the capital conversion situation now? Have the Germans stopped that?

MR. PARDEE.

CHAIRMAN VOLCKER. But we're not getting any now.

MR. PARDEE. On the capital conversion? No, they haven't had many issues lately.

CHAIRMAN VOLCKER. If they had them, presumably we would get them. But they just haven't had any.

MR. PARDEE. Right.

MR. PARTEE. I wonder whether it wouldn't be desirable to have some downward pressure on the dollar, with the economy moving into what could prove to be a pretty sizable recession. Wouldn't it be nice to have a little better export market?

MR. PARDEE. There are considerable lags. You're talking about effects in 1981-1982, not now.

MR. PARTEE. Yes, I know. But we don't know how long the recession is going to last either.

VICE CHAIRMAN SOLOMON. On the other hand though, Chuck, until the inflation rate does begin to go down, the reasonably stable dollar is one of the few things we have going for us. It is considered an anti-inflationary influence to a modest degree, so I

think we would be well advised to try to make sure, as best we can, that any decline in the dollar is a reasonably gradual one.

MR. PARTEE. Well, I agree with that.

VICE CHAIRMAN SOLOMON. Not to resist a decline, but [to ensure] that it is a gradual one.

CHAIRMAN VOLCKER. The trouble with declines in the dollar is that they get a certain momentum of their own.

MR. PARTEE. And, of course, the thing that would bring the inflation rate down the quickest in the short run would be lower interest rates because the CPI is being affected so greatly [by] mortgage costs and other indirect costs of higher interest rates.

MR. WALLICH. These all strike me as rather unorthodox ways of coping with our problems: Depreciate the dollar, bring down interest rates, and fight inflation. Now, I don't think you really meant this seriously, but it sounded a little ominous because there are people who do believe that.

MR. WINN. One more question. The freezing of the Iranian assets [added] one aspect to the diversification desires of other nations. Did the suggestion in the latest of the President's proposals that we seize them--not only freeze them but seize them--to meet various expenditures, etc. have any further repercussions?

MR. PARDEE. Well, the whole package, as I indicated, is that as long as the United States is exposed, whatever we do to act unilaterally in Iran is seen as bad for the dollar. The indications out of the European ministries meeting today are that perhaps they will help us, and that is giving the dollar a little lift. But, as for individual items within the package we put together, it's hard to isolate what the effect on the dollar has been.

CHAIRMAN VOLCKER. We need a motion to ratify the transactions.

MR. WINN. So moved.

CHAIRMAN VOLCKER. Without objection. As for recommendations with respect to operations, we took an action last month regarding these forwards with the Bundesbank, which we would turn over to the Treasury. I would hope that we could still do that. I take it that the Bundesbank is taking the position that if we have any swaps outstanding, we have to use [the proceeds] first for that. I don't know if you can arrange to get the swap repaid before then, Mr. Pardee. If not, let's negotiate vigorously so that the Treasury gets [the funds].

MR. PARTEE. Gets to realize its losses!

CHAIRMAN VOLCKER. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. Peter, I'm very curious about what happened to the expected April bulge. As you know, the Committee was concerned that it not be allowed to happen. I'm not quite sure we were looking forward to a negative bulge. Do you have any insights into what was going on?

MR. STERNLIGHT. Well, the aggregates have proved once again their lack of short-run predictability. We thought we had a sure thing going with April because [the money supply in] April has bulged every year for the past 4 or 5 years it seems.

MR. BALLEES. You can't believe in anything anymore, can you?

MR. STERNLIGHT. I'm not sure that I can pinpoint any special factor. I don't know if Steve wants to add anything. In New York our faces are even redder than those of the Board staff because we were anticipating an even greater bulge.

MR. AXILROD. Well, the growth rate [of M1] in April of 1976 was 6.6 percent; in 1977, 9.2 percent; in 1978, 12.6 percent; and in 1979, 14.7 percent. My memory is that there is genuine weakness in the unadjusted deposits. If one compared year over year and applied the seasonal factor of 1976--that is abstracting from all the adjustments we've made--the increase would be something like the 6.6 percent recorded in 1976. I assume there is some possibility that we've over-adjusted because in the process there is a certain amount of coincidence of random factors. It's a conflict of terms, but something like that may have happened. And we may see [some rebound] in May and June. I'll have some comments on that in my own briefing. But other than that, we have no special explanation; there are no special factors that we could think of, unless income really is being destroyed at a very rapid rate here. But we don't have any substantial evidence of that yet.

MR. BALLEES. I heard Chuck mutter under his breath that it might have something to do with the weakness in the economy.

MR. PARTEE. Do we know what happened in April 1975?

MR. AXILROD. Yes, [M1 growth in] April 1975 was -3 percent. In fact, one has to go back to 1970, 1971, and 1972 to have high Aprils again. They were between 7 and 8 percent in those three successive years.

MR. PARTEE. I see.

CHAIRMAN VOLCKER. In April 1975 we were just coming out of recession.

MR. PARTEE. Well, in terms of money demand--

MR. AXILROD. I might say, Governor Partee, that the -3 percent of April 1975 was followed by a May of 13 percent and a June of 16 percent.

MR. SCHULTZ. So much for that!

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Well, I was going to raise a question as to whether the seasonal adjustment might not have been a factor. But I would also like to ask Peter whether he could comment on his confidence or lack thereof in the projected rather strong money growth for May and June shown in the report which I believe was put out in New York.

MR. STERNLIGHT. Well, I don't really want to claim any paternity for the money projections that are made in New York! I look at all those projections with great skepticism. In projecting a fairly strong May and June, basically I think our people felt that they did not see a reason at this point to change the quarterly growth patterns, which they tend to feel a little more confident in than the month-to-month gyrations. And to have the quarterly growth come in as they had seen it before, having had a weak March and April, one is driven to project a rebound in May and June.

MR. BAUGHMAN. But they use, do they not, something approximating the Greenbook outlook for the general economy?

MR. STERNLIGHT. They would be basing it on their own [forecast], but that is not a very different outlook in this case.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I can think of one small technical factor that might have affected [money growth]: The delay in mailing out the [tax] refunds might have made the money hit balances a couple of days later, but probably no more than that. If we figured it correctly, that would account for maybe \$800 million or something like that but the estimates for the week of the 16th were revised down to about \$4-1/2 billion. However, one thing we wondered about was whether or not the high interest rates and the greater availability of money substitutes such as the money market mutual funds may have led people not to build up their balances in anticipation of the tax date quite as [early] as they have in the past. How to measure that, I don't know. But we also were wondering about this great weakness, and that's all we could come up with as a possible explanation for it.

MR. AXILROD. The delay does have an effect. Our estimate is slightly higher than yours through the week of the 16th. We have some slightly counterbalancing upward effect in the week of the 23rd; we assume it will be washed out by the 30th and probably have a trivial effect on the month on average. But we are assuming that M1 for the week of the 23rd, the week we're in, rises by something like \$3-1/2 billion from the week of the 16th, in part because of this delay. Of course, if that doesn't develop, the negative for April will be much bigger.

MR. SCHULTZ. What about people paying off debts?

MR. AXILROD. Well, they can pay off debts out of almost any asset. They may be paying them off out of cash or they may be letting other assets run down. I just have no way of knowing until we get the quarterly flow of funds.

MS. TEETERS. But, Steve, didn't you say yesterday that there is no evidence that people are moving into other types of money?

MR. AXILROD. Yes, so far. I'll have some of that in my own briefing. But that's right; thus far we don't have evidence of money moving into higher order Ms. We don't have data yet for Treasury bills or complete data on debt.

MR. BLACK. I gather that there wasn't anything more than the availability of more data that led to these downward revisions.

MR. AXILROD. In the money supply?

MR. BLACK. Yes, for the week of the 16th.

MR. AXILROD. No, we don't have anything more than we normally have as the weeks go by.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Mr. Chairman, before we feel that our inability to forecast monthly behavior of the aggregates reflects some sort of weakness in what we're doing, I think we should keep in mind the fact that even the most ardent monetarists have never believed it is possible to control money or to avoid fluctuations on a month-to-month basis. If we see an undershoot or an overshoot in the short term, even though it might seem desirable to lean against that deviation through the operations of the Desk, I really don't think we should. Nor should we feel that because the aggregates are unpredictable on a month-to-month basis it in any way detracts from the wisdom of how we are conducting our business.

CHAIRMAN VOLCKER. If there are no other comments, we have to ratify the transactions.

SPEAKER(?). So moved.

CHAIRMAN VOLCKER. Without objection, they are ratified. Let's turn to the staff report on the economic situation.

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

CHAIRMAN VOLCKER. Since we've identified with such accuracy past financial relationships, I think we ought to have our economist discuss prospective financial relationships.

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

CHAIRMAN VOLCKER. We can have some general comments about the economic situation and policy implications and we'll return to a more precise discussion after an initial go-around. Mr. Winn.

MR. WINN. I had a question I wanted to raise, which may be more on the technical side than the general side, Paul. Do you want to hold that?

CHAIRMAN VOLCKER. I think it's fair to ask questions at this time, too.

MR. WINN. Okay. Steve, you have made an income analysis for money demand in the period ahead. If one looks back at many previous

credit crunches, one sees that after the economy turns down, we get a bulge in credit demand. The margins start to narrow; sales are off and inventories are up and there is continued price pressure for more carry. So, first, there's the seasonal adjustment [problem] that makes me quite nervous about May and June. Now, this may or may not happen, but there is also the possibility, it seems to me--with interest rates turning a bit and attitudes changing a little--of a rather substantial increase in borrowing in the May-June period as well.

MR. AXILROD. We actually have projected a rather sharp drop in borrowing in the second quarter, largely because we assume a very substantial liquidation of liquid assets built up by corporations.

MR. WINN. But that runs out eventually.

MR. AXILROD. That's right. So the sharp drop levels off, but with borrowings at a lower level. And, of course, we have some weakening in the consumer demand area. So, we don't have any substantial build-up in borrowing demand ahead of us. Over the long run, of course, we could probably foresee some business desire to restructure balance sheets, but that's a shifting of the borrowing patterns. We simply don't see any bulge, really, in credit demands.

MR. WINN. But if you talk to some of these businessmen, they don't have [unintelligible] they can hold out without having to come back in. They are out now. Rates have scared them off and they are using up what they have.

MR. AXILROD. That's right. There is pressure; they're not generating internal funds to any substantial degree. It's true that we have them running down their liquid assets. There is some built-in pressure generated against expanding their spending to a great degree. We don't have a vast expansion in spending; and to the degree that pressure is on them, it might constrain their spending actually at current rates.

MR. PARTEE. Don't you think, Willis, that they followed a different inventory policy this time?

MR. WINN. They kept inventories pretty tight; but if sales drop off, they still are faced with having to carry [inventories].

MR. PARTEE. They seemed to cut production very fast, too. I don't know.

MR. WINN. The adjustment is not quite as easy as we like to think of it sometimes.

CHAIRMAN VOLCKER. Let me say in connection with all of these confusing money figures and related numbers, that we took some actions in March that were unusual, to say the least, on consumer credit, on the voluntary program, on the money market funds, and all the rest. And we had interest rates at levels nobody ever saw before. I suspect this has led to some uncertainty and adjustments of a magnitude we can't quantify very well. We may have had a lot of "money" held in the form of Treasury bills for instance; we just don't know. It's not in our M2 and M3 figures. I suspect there may be something to what

Fred said--and we will not find out until later--in that a lot of people may be scared about consumer credit, and they may now be taking some money out of the bank and repaying their charge cards or something else. It's just a very uncertain period, too uncertain to reach conclusive judgments about anything. Unfortunately, we only find out about these things later when we get more numbers and get some more perspective as to whether we are getting a rebound or not. We just don't know at this stage. Mr. Roos.

MR. ROOS. I'd like to pursue, if I may, the reasoning that Steve expressed. It's my understanding that back in October we adopted a policy of letting interest rates flow freely. Indeed, interest rates did move up rather dramatically and we did not act to impede that upward movement; we let them move. Now, Steve, if I understood you correctly, you expressed concern that if we permitted interest rates to decline dramatically, there could be adverse reactions from markets and other sources in terms of inflationary expectations--that they may misread that in spite of the fact that the Chairman has repeated frequently the possibility that interest rates might decline and that it would not be a signal of any easing of our determination to deal with inflation. I have two questions. One question is: Isn't it illogical to let rates move one way and then get "antsy," if I may use a bad phrase, when they move the other way? Secondly--and I might pose this question to the Chairman--if we permit interest rates to drop, can't we in our published records, or through comments by the Chairman and others, explain that this is in no way any retreat from our primary concern with inflation? In other words, one of the things that I think causes the concern that you expressed is that in the past we have acted with a degree of mystery and secrecy and let the markets draw their own conclusions. Can't we comfort them and explain the rationale behind what we are doing?

MR. AXILROD. In answer to the first question, President Roos, I was trying to bring before the Committee the various concerns that the market would see and also the economic analysis. I was not expressing my own judgment, particularly, on one or the other aspects of this. The only thing I can say is that, empirically, in recent periods when interest rates have gone down, we have had a great hue and cry in the market that may or may not have been rational. It has probably had effects on the thinking of those who spend and those who invest; and it has brought forth the view that perhaps inflation isn't going to be conquered. That just seems to be a market event and I wanted to bring it before the Committee. On your second question, since it was addressed to the Chairman--

CHAIRMAN VOLCKER. You don't want to express any judgment about the persuasive powers of the Chairman, Mr. Axilrod? [Laughter] They are limited I would say.

MR. ROOS. Are they limited, Paul, by the tradition of our taking an action and letting people decide what caused us to do what we did or are they limited for other reasons? I think your persuasive potential--and it isn't salary-setting time, so I'm not polishing the apple--is enormous. [Laughter] But I think the Fed has traditionally not used that potential in past years because we thought we should just take actions and let the people out there decide why we did.

CHAIRMAN VOLCKER. The only answer I could give you is that we would get a mixed reaction. Some people will believe it. People of monetarist persuasion will believe it more than others. Some people don't believe the underlying theory, so they have no reason to believe it. And there will be people in between. But I don't know whether there will be more or less [confusion]. There was certainly a lot of confusion in late November, December, and early January for a variety of reasons. People saw the reserve figures going up, which was one confusing aspect. The money supply figures weren't going up, particularly, but the reserve figures were; and interest rates were going down. We get all different constellations of events. But I think you are misled if you think that pure persuasion is going to convince people. It may have an impact, but we are going to get mixed reactions.

MR. SCHULTZ. I would just remind you of how he charmed Gail Cincotta.

VICE CHAIRMAN SOLOMON(?). The ability to persuade is asymmetrical also.

CHAIRMAN VOLCKER. That's probably right. People believe what they want to believe. If they saw the inflation rate coming down, they would be more persuaded. But we are in this unfortunate position where I suspect the consumer price index, anyway, is going to remain at or above--or maybe if we are really lucky a little below-- its current level for three months because of the extraneous question of the oil import fee and the way the interest rates get factored into that. We probably will have three months of that, which will carry us into July. Now, maybe if we are lucky, the producer price index will begin showing some declines; that depends partly I suppose on how they treat the oil import fee in the producer price index. I don't think [the impact] is negligible. We are far better off if we see the aggregates under clear control and a given interest rate movement than if we see the aggregates shooting up and interest rates going down; the latter would be the worst of all worlds. Governor Wallich.

MR. WALLICH. I'd like to follow up on what Larry said. I think it is perfectly possible to convince the market that we are sticking to a fixed money supply policy. That doesn't mean that we are not engaging in a very stimulative policy at a time of recession. That's exactly the nature of that policy. It's not really a policy; it's a procedure. And it's analogous to building strong automatic stabilizers into the fiscal system where without tax cuts the recession will produce a large deficit which, of course, is very stimulative. Here we have generated a procedure that is highly restraining when demand for money rises against a fixed supply because interest rates rise sharply; and it's highly stimulative on the way down. So we convince the market that we are on track with our aggregates. All that we are telling them is that we are going to have low and extremely stimulative interest rates. Their analysis will be quite correct. Now, if it's a question of proving that we are following our policy, I think we can be persuasive. But that doesn't mean the market will believe that we are not following a policy that has very stimulative effects. So, I think we need to look at the reality--namely, that we would be stimulating very severely if we let interest rates go down--rather than at the procedure. The procedure says we haven't changed our method of feeding money into the economy.

All that makes very relevant what Steve said: That we may have to modify our path. We may be able to do this within the limits of the [annual] ranges of 4 to 6-1/2 percent for M-1B and 3-1/2 to 6 percent for M-1A. I think we would not have to go outside those ranges, at least for the remaining two months of the first half of the year. It would be very alarming if we went to money growth rates for the second quarter that would make us maintain the 5 percent rate of growth from December to June because we would have to have two months of very high growth rates in order to overcome the weakness of March and April. This is an occasion where we ought to allow a little base drift: Let the past be the past and make sure that in May and June we do not have very large increases in the aggregates. Now, to the extent that the funds rate can contribute to controlling that, we should be concerned about the funds rate and not let it drop very low. Our techniques of supplying reserves, of course, can give us a better handle on the expansion of the money supply. And when we get to talking about specifics, I'd like to supply some more specific suggestions on how large an increase we ought to aim at.

CHAIRMAN VOLCKER. Our present target is not 5 percent. It's 4-1/2 percent or somewhat less.

MR. WALLICH. That comes out of the movement in the previous period, I think.

MR. AXILROD. For December to June the Committee last time voted on 4-1/2 percent or somewhat less.

MR. PARTEE. It's consistent with the numbers you gave, which are the average over the longer run. Henry mentioned M-1B also.

MR. ROOS. Do you accept the fact that if we keep money growing slowly, there is a direct effect on output? Isn't that part of the risk?

MR. WALLICH. No. I don't believe there is any direct effect from money to the economy. The economy in my opinion runs on interest rates. The effect from money goes to interest rates and from there it goes to the economy. And the prescription for a fixed rate of growth of the money supply, far from being a neutral and noninterventionist policy on the economy, is a policy of very extreme intervention. One might even call it fine-tuning. You want wide swings in the interest rates and that's what we get by having inelastic growth of the money supply. [Rates] are high in expansions, which restrains, and are very low in recessions, which stimulates. There may be very good reasons normally for stimulating strongly in a recession and then as demand for money builds up again to get interest rates rising early in the expansion. But in our present predicament, where we have to worry more about inflation than anything else, I don't think we can afford this remedy.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I agree with the staff's further downward revisions in the projections for the forthcoming period. And if I had to guess, I would say that they still haven't got them quite low enough, because I just don't see any area in the economy that seems to have significant strength. Housing is headed much lower, I

think. The consumer is grossly overextended. We are getting grass roots reports of growing personal and business bankruptcies. The Redbook, and particularly the addendum that the New York Bank sent in, suggests that inventories are not as closely in alignment with needs as we had thought earlier, and that was the main thing we were counting on to keep this recession relatively moderate. And I would guess that there is probably going to be greater-than-expected weakness abroad, so that this recession might well take on more of an international cast than I think most people are assuming at this moment. If I am right on this, then prices will probably come down somewhat more rapidly than the staff and most other people are assuming. I have a lot of sympathy for what Henry was saying, primarily because I think we have made errors in the past. By the same token, when it comes to policy, I think we would be well advised to stick to the targets that we adopted last time, which inclines me toward "B." The only thing that causes me problems is this estimate of a sharp decline in the aggregates in April. If that [occurs], in order to stay on this targeted path we have to have growth in May and June in the principal aggregates of over 9 percent, and I think that would scare the devil out of the market and lead people to conclude that we had abandoned our October 6th policy. So, if April does come in that weak, then I would want to hit the midpoints of the ranges sometime later--maybe in September or somewhere down the line rather than try to get [growth] back to the midpoints by June. What I'm really saying, I guess, is that we ought to stick to the reserve target. And I would like to see rates come down, if that's the natural fallout of this. That should help prevent April from being so low and would permit us, hopefully, to hit the midpoints by June.

CHAIRMAN VOLCKER. April is pretty well gone, I'm afraid.

MR. BLACK. Well, probably so.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I think we have the first big test of our new operating procedure ahead of us. It may be more severe than the staff has projected because we feel the second quarter is likely to be weaker than the staff forecast. If at this juncture we begin to revise our money growth targets, then in effect we are back to managing interest rates again. If we abandon, for all practical purposes, our money growth targets at the first occasion we find interest rates that are uncomfortable, then how is the market going to have any confidence that when we require uncomfortable interest rates on the up side we will not then also abandon our money growth targets? We would be right back to where we have been. Now, to stay on the course, particularly if the economy is weaker than the staff projects, is going to be uncomfortable. I think we're going to have to live through a period of weakness in the dollar because of the very short time horizon of the foreign exchange trigger. And we will get talk--no matter how persuasive our Chairman is--about the Federal Reserve letting loose too soon. But we've simply got to ride it through. Rather than viewing lower rates as stimulative, as Henry does, I would view them as a force for mitigating the severity of the recession, because there is no question that we are in for a very sharp decline. The issue is: Do we want a monetary policy that is going to make the recession, if anything, sharper, steeper and longer than the staff has forecast? So, it seems to me, it is fish or cut

bait on our new operating procedure in the second quarter--whether it is at this meeting or some other meeting.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. First, Mr. Chairman--and it's possibly a trivial question--on page I-24 in the Greenbook it's reported that one of the reasons for strength in exports of nonagricultural commodities is the high price of silver in [the form of] exported coins. Is that a significant business?

MR. TRUMAN. Yes, exports of coins were something over \$2 billion at an annual rate in January and February.

MR. BAUGHMAN. Aside from the silver price, was that about a normal volume?

MR. TRUMAN. Well, we don't have volume figures for it; and in fact, we never will. That is one of the problems in putting together the first-quarter GNP numbers. The price increase clearly is some of it, as well as other random factors in terms of when the exports actually take place. But the two together, and they will never be unscrambled in the statistics, gave us a big increase in the fourth quarter.

MR. BAUGHMAN. And this is a product in which I take it we compete in the world market?

MR. TRUMAN. It so happens that we had a lot of silver exports and that they were very high priced in that period, which results in a big increase in nonagricultural exports in that period. I don't think it goes beyond that. The price has since come down, so even if we have a normal level of exports, we are going to get lower nonagricultural exports.

MR. BAUGHMAN. But it is silver exports in formal coins rather than--

MR. TRUMAN. That's how it's recorded on the statistics; that's the only information I have.

MR. BAUGHMAN. With respect to the general economic forecast, I have no particular quarrel with it. It seems to me that the direction and the amount of the revisions from a month ago are quite appropriate in the circumstances. With respect to the remarks that have been made here that were oriented to policy, I think I agree with everything that has been said.

MR. MORRIS. That's not possible! [Laughter]

MR. BAUGHMAN. It seems to me that it is. When we adopted our current policy posture, we did it knowing that it was going to give us strong swings in interest rates as we undertook to determine whether or not stabilizing the rate of growth of the money stock imparts stability or instability to the real economy. So as I see it, we decided that we would find out whether all of the statistical analysis that has been made through the years has a firm basis. And it seems to me that we should stick with it until we do find out

whether stability or instability flows from stabilizing money stock growth. We've redefined money with the idea that we're bringing that back to the real world concept, so to back away right at this point in time would just preclude our achieving what it seems to me is at stake.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I agree that there's a sizable decline in activity now in process. It was inevitable, I think. But it's probably worse because of the policies we've followed over the last six months in defense of a principle. The principle was that in the absence of knowledge about how interest rates should move--because we have so little knowledge of the rate that people are willing to pay based on expected rates of return and on inflation--we would provide aggregate growth that we thought appropriate to a moderation of the inflationary course. When we get into a decline, it has always seemed to me extremely difficult to forecast how far it might go because there are dynamics involved. There have been shocks: Chrysler, a major bank that has been referred to, silver, and the possible failure of a brokerage firm. There are shocks of that kind that can affect attitudes and deepen, more than anyone anticipated, the reduction in spending that people are willing to undertake. And what we have are the automatic stabilizers to guard against this becoming cumulative and self-reinforcing in its downward movement. Now, the automatic stabilizer in the case of fiscal policy, of course, is the fact that we get budget swings. And the automatic stabilizer we've introduced in monetary policy is the fact that we'll get interest rate swings as we hold to particular ranges of growth that we're willing to see in the monetary aggregates. Not to let that automatic stabilizer work would risk a self-reinforcing cumulative decline in activity because we don't know what is happening, as we didn't on the up side, to people's willingness to pay rates of interest for the use of money. I think, Henry, that one ought to distinguish between the automatic stabilizer principle and the setting that we put it on, which is the longer-run presumption. We have a setting for M1 growth; I won't say M-1A or M-1B because I want to say it's approximately 5 percent. Now, if the underlying rate of inflation is 10 percent, which I think it is, or if it's 15 percent, which you think it is, that's a very, very tight setting on monetary growth because it means there isn't much of anything left for real growth. In fact, it would suggest that unless the inflation rate comes down significantly, there won't be any real growth in the economy. And that is very much analogous to a setting in the budgetary posture of, say, a full employment budget of \$100 billion. It's quite similar. It seems to me that we deliberately chose a tight setting and we ought to stay with a tight setting; but it also seems to that me we ought to let the automatic stabilizer work because not to do so would be very much like the actions of this group in the period from 1929 to 1933. We could get a reinforcing decline in activity that is propelled by monetary contraction. And we can't stand that kind of risk for our economy or for the world.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. I don't know that I can add much to the comments of my three colleagues to my right except to say that I'm essentially in agreement with them. It certainly took a great deal of courage for this Committee to let interest rates rise to these extraordinary

levels that we've seen, and I think that was the right thing to do. I'm beginning to see encouraging signs, at least, that we've broken the back of inflationary expectations. I think we should be equally courageous on the other side, while sticking to our monetary targets. If that implies that interest rates are going to decline, that doesn't bother me one bit. As far as the foreign exchange value of the dollar is concerned, I've never believed--and I don't think it's the view of this Committee--that some given level of the dollar is an objective in and of itself. Obviously, we want to prevent disorderly changes from one level to another. But as far as interest rates coming down being an implication of sticking to our present monetary targets, that certainly wouldn't bother me in the short run because of the extraordinarily high levels from which they'd be declining. Our credibility would be badly undermined, as others here have said, if we abandoned the monetary growth targets and went back to some implicit view of a proper level of interest rates. I think we can and should persuade the market that what we're doing is a steady state course here; and if one implication of that is declining interest rates, so much the better. That will teach them that we can operate on both sides of this market. Personally I wouldn't be very much concerned about the implications of declining rates in the near future if we stick to these present targets.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. The new operating procedures seem to me a bit more effective when we're seeking to restrain credit on the up side than when we're trying to encourage the extension of credit on the down side. As a result, I've been pleased with what we've been able to do on the up side, but I am concerned about where interest rates will go as we move into a recession. Like Ernie, I agree with much of what has been said here this morning; it seems to me it's all relative. If we move into the May-June period when things are very weak, having come from a period when we've successfully--hopefully--killed off inflationary expectations and people are wondering what is going to happen and they see interest rates drop not to the 13 percent level implied by alternative B but maybe to 10 percent, then we may lose all that we've gained over the last 60 days by going to a 20 percent prime rate or a 19 percent federal funds rate. Thus, I think this Committee does have a responsibility to moderate [the movement of interest rates] on the down side. It's not that rates can't go to 13 percent or maybe to 10 percent, but they shouldn't do it in a 30-day period or perhaps even in a 60-day period. I would be concerned if we just turn those rates loose even with a down side of, say, 13 percent. If we're looking at a very weak economy and indecision by those who take down credit or hold money, then it is perhaps true that within a couple of weeks we'll find that 13 percent is not the right level; so via a [conference] call it will go on lower. I would hate to see that take place. If the staff is correct that to achieve [the money growth of] alternative B we're talking about increasing nonborrowed reserves at a 20 percent annual rate through those two months, I think that's far too fast and would add confusion to the market rather than stability. And I think right now we need stability.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Well, Mr. Chairman, most of my points have been made. I would stick with the targets. I would not see any objection, however, to our interpretation of "about" 4-1/2 percent being 4-1/2 percent or a little less rather than 4-1/2 percent or a little more. Okay, so that's fine-tuning, but I think we can lean in that way for one reason or another. Having said that, I would only add one other point: I think the main advantage of the credit restraint program that we have embarked upon, with great pain, is that it perhaps has added the public awareness frosting to the cake, if I may put it that way. The average consumer--I think for the first time really--has made an association, even just from reading the front page of his daily paper, that somehow credit restraint does have something to do with inflation. I've heard even from builders, believe it or not, that they can wade through this and that the whole idea that the banks are now clamping down a little on consumer credit and so forth is great in that it is going to help a great deal on inflation. All right, maybe that is overly magnified. But I think we have the public's attention in a way that our October decision failed to get public attention. It was still a market-oriented attention that had some limited significance outside of the financial community but [the average consumer] really didn't understand it. They understand it when the First National Bank of Chicago puts in the paper that they're going to charge \$20 for a Visa card. They understand it when they find that on their Sears bill they have to pay 10 percent rather than 8 percent of the outstanding balance. These things come home. I think the main advantage of the credit restraint program has been in public education; and that in itself can have a tremendous effect on inflationary expectations, giving us a few months. In the meantime, during the difficult period that Paul referred to, for the next two or three months, we just have to grit our teeth and bear it. If interest rates go down, that's fine; but I would tend to lean a little toward the lower end of our aggregate range--if not clear to the [lower] margin, a little below the midpoint.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. Just a couple of comments: On the theological issue, I come out with a view that we did make a decision back in October and that it was a very fundamental decision and we ought to adhere to it on the down side as well as the up side. In my scale of preferences, I'm going to worry more about a very sharp undershoot of the aggregates in the foreseeable months than about too sharp a decline in interest rates. And on a more technical scale, if we're going to have a decline in rates, I'd prefer to see it begin and proceed rather smoothly than to try to hold rates up and then all of a sudden have a very sharp drop, say, in the second half of the year. So, if it's going to happen, we ought to let it start to happen.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. I have no reason to disagree with the revised projections of the staff. It seems to me pretty clear that as a result of recent developments the recession is going to be more severe, that the recovery is going to be weaker, and that we'll be in a period of recession for a longer time than originally expected. I agree with much of what Governor Partee has said and what Frank Morris has said. I have very little to add to that. It seems to me that the basic risks are that if we revise our targets downward, we risk making

the recession worse and that if we stick to our current targets, we risk some misunderstanding of our policy and the inflationary psychology in the market might worsen. I would be clearly inclined to take that latter risk. I find it hard to imagine that whatever inflationary psychology might develop as a result of a temporary expansion in the rate of growth in money would last for a long time in the face of a nominal GNP growth that is roughly twice the rate of growth of the money supply. In other words, if we allow money to grow at 4-1/2 percent against a nominal GNP growth of twice that amount, I find it difficult to believe that inflationary psychology can continue for very long against those facts. Therefore, I am inclined to stick with our current targets. And I would see the period that we're in-- where we demonstrate that we are sticking with our course and are maintaining our goal of restricting money supply growth--as an opportunity to educate the public on our operating procedure and what it means as well as on our determination to stick to our goals for growth in the money supply.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I don't have much to add to what has been said. I would like to remind you that it took us two months to raise the federal funds rate by 5 full percentage points. And if you're uncomfortable about the period ahead, I'm very uncomfortable about the period we've been through. We choked the horse. Now, do you want to completely strangle him or do you want to be able to ride him a little further down the line? I find these interest rates outrageously high. And March housing starts are real housing starts; they're not a seasonally adjusted number in the middle of the winter sort of thing. If we get low housing starts in April and May, we aren't going to have any housing this year. And we're obviously not going to have very many automobiles built.

We went into this with the idea that we would do it as an automatic stabilizer and that if [rates] went up, they went up. They went a lot higher than I ever anticipated. And I think they've done a lot more damage than most of us know at this point. We should stick to our policy and, if anything, make some allowance for [rates] to go down a bit further. It's time that we come off [these high rates]. We've always had the reputation in the past of staying [with a policy stance] too long; this policy was designed to get us to the point where the market was signaling what the interest rates were going to do. It seems to me the market is signaling rather strongly that the peak is past; we should take that signal and let the market rates go down. I'd like to support Bob Mayo's comments about the March [credit control] program. He's the only one who mentioned it this morning. The six of us here [on the Board of Governors] have been fighting all these questions and answers and appeals and everything else; I think we've had a tremendous amount of impact both psychologically and on banks as to what the growth rates are going to be. Those standards are in place regardless of what happens to interest rates in the market. And finally, on the international scene, interest rates are going to have to come down in this country over the next 18 months. Whatever happens out there is going to happen. If we drop them suddenly, we're going to get a market reaction; if we drop them up, we're going to get a market reaction; if we keep them up, we're going to get a market reaction. I view the international [situation] as one we're going to have to live with; we will have to

take whatever comes out of it rather than try to gear our domestic policy at this point to controlling the international value of the dollar.

CHAIRMAN VOLCKER. No one else has volunteered but there are a few people [who have not commented], like Mr. Willes.

MR. WILLES. I promised my wife I'd be quiet today. But as long as you've given me the opportunity, I'll just make a few brief comments. We had Yoshiho Suzuki from the Bank of Japan in our Bank the other day and asked him to give a speech to some local people. It was very interesting to hear him in that speech analyze the Japanese experience where they have wholesale prices, because of oil imports, going up by about 24 percent and the consumer price index going up by about 7 percent. They in the Bank of Japan ascribe that to their willingness to hold firmly to fairly stable rates of monetary growth. We found that a pleasant message, as you can imagine, in Minneapolis.

MR. PARTEE. Are profits being squeezed? Is that how that works?

MR. WILLES. To some extent, profits have gone down. Also they have found reductions in energy utilization being forced by the policy and so on. There has also been a cut in real incomes because wages have not adjusted. They haven't allowed wages to [rise with inflation].

MR. TRUMAN. And 5 percent productivity [growth].

MR. WILLES. And 5 percent productivity [growth]. That doesn't hurt. It's a question of what leads what; and that's a whole other discussion, which I won't take time for. The only other thing I'd say, Mr. Chairman, is that I've listened to this discussion today with great interest and was particularly interested in the way Chuck posed the issue. As we look over the history of what the Committee has done, what the economic profession has done, and what the economy has done, it seems to me that we ought to have very modest objectives because it's not at all clear that we understand in a very detailed way how this complex system of our works and how we can intervene in such a way as to make it work substantially better. Therefore, it's a question of trying to minimize perceived risk. And it seems to us, given our current state of understanding, that the best thing we can do is to lay out for all the world to see a fairly simple policy procedure, a rule that we're going to follow. I think it's very hard to lay out such a rule in terms of interest rates because interest rates are subject to too many variables. But we can lay out such a rule in terms of the growth in the aggregates. It's not going to get us to heaven; it's going to have some undesirable consequences from time to time. But on average monetary policy is probably less disruptive if it is more predictable than otherwise. As a consequence, it seems to us that the decision we made last fall was a wise one and we ought to stick to it. And we ought to be rigorously consistent about that because at least over time, as the markets come to understand that we are going to be rigorously consistent, we will reduce substantially not only the risk associated with our own policies but the over-reactions that the market sometimes makes to their perception of our policy. So, as others have said, if interest rates are going to go down, I think this is one time when we just

ought to let them go down because we've got to make sure that we establish the credibility in the basic policy thrust that we've been following.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. Well, I certainly would agree that it is important that we continue with a course that strengthens our credibility. I believe we have made the right moves in going to a different kind of procedure. I think it's important that we hold to that 3-1/2 to 6 percent [M1] figure for the year. But while I want interest rates to go down--I think it's important that they go down--I really am concerned about the speed with which they go down. We have to keep in mind that this is where the action is right now. The country is looking to the Federal Reserve. Like it or not, we are in the eye of the storm. And people look at interest rates. We've done a lot of things. If there's anything to be said for the whole credit control program--and in my view there's damn little--it's the shock effect. And it has had a shock effect. It was important. [Changing] inflationary expectations was crucial. Why did the actions we took on October 6th not work better? Because people thought [our actions] were just going to be overridden by other things that were happening. So we see interest rates at these awful levels. But people are looking at those interest rates; and if they see them come down too rapidly, they're going to say the Fed has given up [on inflation]. And we're all they have to look to at this point in time. Let's not panic and do something that will tend to negate the strides we've made. We're getting there and we're getting the job done. A fed funds rate of 15 to 16 percent wouldn't bother me much, but I must say that if it starts getting down around 13 percent or below, under these circumstances, I would get really nervous.

As you know, we haven't been that good with our forecasts or projections. It does look as if this economy is weakening very rapidly and going off a cliff. But I would remind you that it looked pretty weak in October. It looked as if we had done the job then. Now, [the evidence] is stronger this time, and I feel pretty well convinced; but I don't see the necessity for letting interest rates just absolutely also fall off the cliff. I think the implications of that are very important. We can do something here which says we will stay within the target ranges, but let's not panic on these interest rates. I'd let them come down slowly. I hope we can hold these fed funds rates; I think they're important. I like our new operating procedure but interest rates, whether we like it or not, are a perception that other people have. And I hope we don't get in too much of a hurry and blow this.

CHAIRMAN VOLCKER. I guess we've left you the unusual privilege of going last, Mr. Solomon.

VICE CHAIRMAN SOLOMON. Well, that's the privilege of a new boy. I want to second very strongly what Fred Schultz said. I think we ought to stick with the "B" targets and accept the March-to-June targets that fall out. I'm perfectly willing to see a decline in interest rates, but I really would urge you not to permit too precipitous a decline. I would like to suggest, in view of the fact that the staff is projecting a 16 to 17 percent funds rate as compatible with the alternative B targets, that we ought to have a

phone consultation if it looks as if the funds rate is moving down very precipitously and significantly penetrating the 16 percent range. The reason I say that is because, like Fred, I feel that people judge our credibility--at least all the people I speak with in New York--not simply by a mechanistic adherence to the aggregates. They also judge our resolve and our credibility, particularly given the fact that they have had considerable skepticism about it in the past, by interest rate movements as well. And I believe in your October 6th statement, Paul, you did say that this was not a mechanistic formula and that judgment would be used. Interest rates should go down. They will go down. It's not going to do any damage to the economy if the decline is somewhat more gradual. So, I would hope that we would have a phone consultation if it looks as if they're going to go significantly below the 16 percent level that the staff is presently projecting as consistent with those "B" targets.

CHAIRMAN VOLCKER. Well, why don't we have a break and come back to this and be more operational in our comments after the break?

[Coffee break]

CHAIRMAN VOLCKER. Let me distill a bit what I think I'm hearing and what I'm thinking. The big change we've had--though we've had a lot of changes since the last meeting--is that we certainly have some evidence of an economic decline that we didn't have before. I for one still think it's a little premature to make very conclusive judgments about what kind of a recession we're going to have. I'd say also that it takes a little while to meet the definition of a recession. We've been fooled before. I do think that in all probability we are going to have a recession. What makes it a little riskier than before, and I thought it was risky before, is partly that special credit restraint program. I think it did send a message to the consumer and others psychologically and we may get a more sudden reversal in consumer spending than in some sense we'd like. Consumer spending was very high relatively, as you know; and if there's an attempt even just to make it normal relative to income, that would involve a big change in economic activity, which would then reflect back on the other sectors of the economy we've been reasonably confident about--inventories, and plant and equipment, and all the rest. On the other hand, we've already had a substantial adjustment in housing and domestic car sales.

You know, the car business is interesting. The first-quarter selling rate was not bad at all, but a lot of it was imports. The domestic car companies just can't sell anything other than four-cylinder front wheel drives, and that's not likely to change in a hurry. But it's a little extraneous--not in its impact in economic activity but in its causation, although I'm sure it's complicated by the credit situation. All I'd say is that there is some uncertainty, particularly when one looks at the other side and the inflation side. Two months ago everybody was going for leather and wanting to buy in anticipation of inflation; I think that mood has changed.

But when attitudes fluctuate as rapidly as they have, it's a little premature to say attitudes couldn't relapse the other way. And looking at a longer-term perspective, there's no question in my mind that in a considerable part inflation is what got us into this dilemma. And it is recognized as a major problem. Indeed, all things

considered--the amount of pain going on in the housing sector, agriculture, small businesses, and elsewhere--we have a considerable amount of support for keeping the inflation [problem] out in the forefront among the public at large and more directly politically. We get a lot of criticism these days, and I don't want to underestimate that; but there's also quite a lot of understanding about what we've been up to and the importance of it. Certainly the Administration has taken a cautious view and has gotten out in front on the credit program itself in terms of the extraordinary credit measures, and apparently it is willing to live with that. All of this has given rise to an immense amount of confusion in the minds of the public, as nearly as I can read it, which may increase the risks of a substantial recession. But it's entirely premature to think that [people] have forgotten about inflation, particularly when they're going to be faced with these high price numbers for a number of months ahead. In that sense I don't think we're in a situation where there's any course of action that is risk-free or even in some sense a "winning" course of action because there's a lot to be lost by a resurgence in inflationary expectations and there's a lot to be lost by accelerating the recession; and I'm not sure that there's any real room between those two contingencies. It has been implicit in everybody's comments that we have to keep our eyes on both [inflation and recession] as best we can. All I'm saying is that I don't think there's any perfect answer or any right answer that goes between them.

So far as interest rates are concerned, we ought to remind ourselves, as a number of people here have, that they were extraordinarily high and that there is some psychological feeling about [letting] them go down. But they weren't all that low in January and February, and anything we're talking about in terms of a range of interest rates is still an increase over roughly a 6-week period. Markets are always going to be more suspicious of our intentions when rates are on the way down. But I don't want to lose all perspective; I suspect anything we come up with is not going to be, in a broader perspective, a very low level of interest rates. The international [situation] is hard to figure. Just in the past couple of weeks it has been perhaps typical that the dollar got very weak before interest rates really came down--or at least rates had only gone down a little--on the suspicion that they were coming down. And since they actually came down the dollar hasn't been strong but it hasn't been under enormous pressure either, presumably in part because [the decline] was anticipated by the earlier turn of events. I don't know quite what [markets] are anticipating now, but I'm sure in the end that that's going to be affected by a feeling of confidence about [our policy] more than a specific level of interest rates, within some limited range anyway. It may be that changes affect psychology more than amounts; I don't want to discount that as being a very tricky problem, but I don't think we know just how it's going to break precisely.

In terms of specifics, we started out talking to some degree in polarities here--whether we should keep to the targets or whether we shouldn't in some extreme. It is easy to conclude in the early part, not so much in the latter part, that the extremes are overstated. I'm not very happy just in a tactical sense--in terms of figuring out what to do next and the psychology and all the rest--that we had this decline last week in the money supply. But we have to remind ourselves that that was one week and that April is one month

and God knows what [the money supply] will do next week and next month. We just don't know. If we keep this in any kind of longer-term perspective, such as what has happened since October, the general judgment one would come to is that we're pretty much on target. If these money figures mean something over a period of time--and we've always said that they're relevant in a 6-month to 1-year perspective--if we go back a year, we're above our present targets but we're pretty clearly in a moderating phase. Even if we look at them in a quarterly perspective, the first quarter on a quarterly average basis was a little higher than our target but December-to-March was lower than our target. Just how one puts these numbers together makes some difference. I don't want to put too much importance [on one week], although I personally would have been happier if that last drop in April hadn't come about.

I don't think we can throw everything out of perspective [because of] one week or even one month. I would assume from what people have said, and I certainly agree myself, that we're going to keep with this general targeting procedure and keep with the general targets that we have. It's a question of how to implement them. We are very uncertain about the short-run projections, as uncertain as we have ever been, after just having gone through much of April where everybody was projecting a big bulge on the up side and instead we are getting a bulge on the down side. And we're not only uncertain about the projections. Unfortunately, we are probably more uncertain now than before--given the special credit programs, given the psychological confusion in the markets, and given the confusion more generally--about just what these fine new techniques we have that look all right in the 6-month perspective mean in a 2-month perspective. Just where to set the level of borrowings and the nonborrowed reserve path is not exactly a science at this point. And that is the real judgment I think we have to make.

So, it seems to me, in general terms, we are sticking with the targets. Alternative B is roughly what we have now. I say roughly; I guess it is precisely the targets we have now except that we added the proviso "or somewhat less" [at the March meeting]. As a first approximation, I would think something like that and maintaining the "or somewhat less" [proviso], particularly in the light of what I will say next, is appropriate. It comes down to a question of how to manage it. If we take literally what the Bluebook says--and I'm not sure how much money one should put on these precise relationships, as I implied before, but we don't have anything better at the moment--we're talking about a general judgment based on the work we have done of a level of borrowing, at the start anyway, of something like \$1-3/4 billion. That in Mr. Axilrod's judgment, around which I would surround considerable uncertainty, implies a federal funds rate of around 16 percent or maybe a little higher at the moment.

MR. PARTEE. Does that include First Pennsylvania?

MR. AXILROD. Yes, that included [an allowance of] about \$500 million, when we were [calculating] that--

CHAIRMAN VOLCKER. Actually it included about \$500 million of [borrowing by] First Pennsylvania, so one might say the equivalent is a little higher than that to allow for the fact that they are borrowing \$600 million at this point. But that's fine-tuning. It's

not all that far from where we are. There has been a lot of talk about interest rates. I suppose what people mean when they say interest rates is the federal funds rate. We've had quite a decline in market rates, particularly in the long-term rates relative to the normal fluctuation in long-term rates. They've gone back three-fourths or more of the [amount] they went up in January and February. Some long-term rates may be very close to where they were in January; the CD rates seem to have moved down faster than the federal funds rate. The Treasury bill rate is down to 12 percent, plus or minus, depending upon which [maturity] you look at. As Peter said earlier, that's down 3 percentage points or more from the peaks. So in terms of the interest rates people are looking at in the market, there's probably room here for a decline in the federal funds rate that wouldn't even be reflected much in these market rates because it has already been anticipated in some sense. I don't know whether that's fair or not. We just don't know how it will hit the markets psychologically because people may then anticipate the next move in the federal funds rate.

But I do recognize in making the judgment about where we set the borrowing level, consistent with our techniques and amid all the uncertainties, that there are some implications for interest rates. There is a little danger, particularly in the short run, because we don't know what all these recent money supply figures mean. Among the unfortunate things that could happen--and there are quite a few of them--if we propelled the funds rate to the extreme low end [of the "B" range], it could get low enough so that it affects the whole string of market rates. If we began getting in May and June increases [in the money supply] of 9, 10, 11 percent or generally in the high area, which is what the econometric relationships would say, in a month or two months from now we're going to be saying that we have to pull back in the other direction. And presumably at that point the recession would have moved somewhat further and I suspect we'd be in an extremely awkward position at that time of not being very eager to [tighten]. Perhaps I've leaned too far toward the risks, whether in the exchange market or more importantly--and I don't think they're unrelated--of in some sense having given up and [seeing] inflationary expectations rise again, having been [unintelligible] to a degree. And then, as I say, if the aggregates were really running high in a relatively short time period, having been through a rather futile experience in this difficult business, we will be sitting here facing exactly the opposite dilemma we are in today of saying to ourselves: How much do we really want to tighten--tighten in the sense of interest rates or borrowing--at this point?

What I am suggesting is that I'm not sure we have to make a change in the basic aggregates decision we made last time. Monetary growth is running short of that at the moment, which definitely implies some relaxation of money market pressures and the borrowing level. We've already gone some distance in that direction; we'd go somewhat more. We would expect to see the federal funds rate decline from its present level. I don't know what that means for market rates. I'd suspect, if anything, not much change to some further decline. If Steve is right, that means 16 percent plus or minus on the federal funds rate in the short run. I don't think we can be sure of that, but let's say he's right; I don't know what range to put around it. But with a 4 percentage point range we can feel our way ahead on that perspective. We meet again in four weeks according to

our present schedule; that's an unusually short period of time. By that time we will know whether we're getting some reaction or whether the straightforward projections of the money supply are being borne out. I do not mean that we would not in the normal course of events make some further judgment on the reserve path and the borrowing path if the money supply continued to be weak in the next four weeks. The option is clearly open--I don't know whether I want to pin it down precisely but we can do so if you want--to consult, if in my judgment the degree of decline in the federal funds rate seems to be troublesome in terms of interpretations of our policy, whether those interpretations were manifested domestically or internationally. We can always have a consultation, and I certainly would be prepared to do that. But I think we ought to recognize that the probability is that there will be some decline in the federal funds rate. Again, I don't know what that means for other interest rates, but the short-term outlook would definitely be for a decline in the federal funds rate as we see it today. Now, if we suddenly get a burst in the money supply figures, maybe that won't amount to much [of a decline]; but if we had a great drag in the money supply figures, we would [expect] some decline fairly immediately. I don't know what the funds rate is doing now Peter, but--

MR. STERNLIGHT. It's about 17 percent.

CHAIRMAN VOLCKER. --with the high level of borrowings earlier this week and some softness in the money market today and presumably even more tomorrow, it will already have pointed in that direction because the level of borrowings currently is too high. It's very simple in a technical sense, I suppose, [for the funds rate] to persist at a lower level next week. That's what one would expect the market to do under these conditions. I think that's a fairly clear outlook for the very immediate future. It probably will be in the 16 to 17 percent area by the end of next week anyway, maybe throughout the week, just on this kind of decision which is basically an alternative B decision. I think that's where I would leave it.

One could argue either side of this. You could say that you don't quite believe Mr. Sternlight--and I would agree that there's a lot of uncertainty--and that the business scene is so uncertain you would push for more money [growth] and take a much lower federal funds rate in the process. I suggested why I think that may be imprudent in the very short run. You can take the opposite view and say it's too much risk, so let's not have the federal funds rate decline at all. I think that would probably be a mistake in this period, too. I'd play it in between, which happens to come out [to alternative B].

MR. PARTEE. Paul, are you specifying a funds rate target? Is that what we're going to be doing?

CHAIRMAN VOLCKER. No, I'm just telling you where I think the funds rate is likely to be with [an alternative B] borrowing target.

MR. PARTEE. I see. I don't think there's any problem if Steve is right and we get around 7 percent money growth in May and June. But what if we got zero money growth in May and June?

CHAIRMAN VOLCKER. We won't know that in the short run, so I'm really talking about what we will do in the next two or three

weeks. We're going to meet again in four weeks. We will know more, obviously, two or three weeks from now, and we may want a consultation. I'm just setting the dial at the moment and telling you what I think the result will be. I say it with some temerity or some uncertainty because we don't know all that much about these relationships in the short run. But that is my best guess. The dispersion around the guess is rather wide. I myself suspect that the risk, if that's the right way to put it, would be that the funds rate would come out a little lower rather than a little higher than what Steve has suggested. All I'm suggesting is that we adopt this course and rely upon him for giving us the best single point estimate in a very uncertain situation.

MR. AXILROD. I might add, Mr. Chairman, that we set that \$1-3/4 billion [borrowing level of alternative B] before the banks this week suddenly decided to borrow more. So I would go on to say that there's a lot of uncertainty in this borrowing/funds rate/discount rate relationship here. But our best judgment at the time we set this was that \$1-3/4 billion of borrowing would be roughly consistent with this whole pattern.

CHAIRMAN VOLCKER. I'm saying basically that something like "B" looks right--or, more specifically, what we adopted last time, which is now "B" in terms of the December-to-June period as a whole, or 4-1/2 percent growth just looking at M-1A. We said about the same thing for the others. Technically we said "or somewhat less" for M-1B and M-1A. And we said what for M2?

MR. ALTMANN. [About] 7-3/4 percent.

CHAIRMAN VOLCKER. So this alternative does have a lower figure for M2 than we had last time, reflecting the decline in M2. I think what has happened in M2, certainly in part, is that we just shut off the money market funds; and I'm sure there was some substitution between money market funds and Treasury bills, which are not in M2. So I'm not certain that involves a real or substantive economic difference. It just reflects what we count in M2 and what we don't count in M2. If we look at M-1A and M-1B, alternative B with the proviso "or somewhat less" is precisely what we decided last time. The difference, of course, is that growth has to be much faster than that in the last two months to come up into that range, which is why the level of borrowing is being reduced from \$2-3/4 billion or whatever we had last time to \$1-3/4 billion.

MR. EASTBURN. Another approach would be to say "somewhat more or less."

MR. PARTEE. Or "around."

CHAIRMAN VOLCKER. That depends. It gives a little feeling of how cautious we want to be about moving down the borrowing level I will say instead of the interest rate level. If we say "or somewhat less," there's a little more room for being a bit more cautious in moving down the borrowing level.

MR. PARTEE. That's what we said last time.

CHAIRMAN VOLCKER. In any event, consistent with "B," we'd have to move it down. There's no question about that.

VICE CHAIRMAN SOLOMON. Wouldn't it be a little better to set a borrowing level of about \$1-1/2 billion plus emergency lending and any special contingencies since, as I understand it, included in that \$1-3/4 billion is that uncertain situation and we don't know what else may arise?

MR. PARTEE. We could do that, except it should be \$1-1/4 billion, I think.

CHAIRMAN VOLCKER. I think what we're really saying is roughly \$1-1/4 billion plus whatever that emergency borrowing or seasonal borrowing or whatever happens to be.

VICE CHAIRMAN SOLOMON. As we did the projections we thought \$1-1/2 billion would be more consistent with the projections. But we defer to Steve, if he feels that his 16 to 17 percent assumption and staying on alternative B is more consistent with \$1-1/4 billion.

CHAIRMAN VOLCKER. In that connection, Steve, remind me: What has borrowing been ex this special borrowing situation?

MR. AXILROD. In the first three weeks of April, ex the special borrowing, it has been running around \$1.8 to \$2 billion. It was about \$1.8 billion in the week of the 16th. This week, though, it has moved up to around \$2 billion. That, of course, is with the funds rate running 18-1/2 to 19-1/2 percent. So our thought was that with the funds rate running in the 16 to 17 percent range, the borrowing level would drop from what it has been running.

CHAIRMAN VOLCKER. Another thing is that if we had the regular discount rate at 16 percent, I think we'd be pretty sure the federal funds rate would not rapidly go much below 16 percent. Whether our surcharge exerts any drag at all on the funds rate as it goes down to 16 percent isn't clear. But there's very little borrowing at that rate except for the special situation. My own guess is that it would exert a very minor drag rather than a really strong drag.

MR. PARTEE. We're also below [path] on total reserves, aren't we, Steve? That would be another reason for adjusting the borrowing down.

MR. AXILROD. Yes. I should be clear, Mr. Chairman, that the borrowing level in alternative B was on the assumption that rates would come down. And the borrowing level in alternative C--

CHAIRMAN VOLCKER. By rates you're talking about the federal funds rate basically?

MR. AXILROD. Yes, the funds rate. Alternative C was more like the borrowing that we had [earlier]. And even that was shaded a little lower because we thought the funds rate would be more like 18 percent, which is a shade below what it had been. So we did put in something that carries with it an easing in the funds rate.

CHAIRMAN VOLCKER. Yes. I realize that, but you said your guess is around 16 to 17 percent or somewhat lower. I guess that means 16 percent.

MR. AXILROD. I'd say it means 15 to 17 percent.

CHAIRMAN VOLCKER. But it also implies in the normal course of our operations that if the money supply in the next week or two continued weak, assuming for the moment that Steve is right, [the funds rate] would be lower. [Money growth] would have to be quite a lot stronger probably [for the funds rate] to be much higher. But I have no particular feeling about the federal funds rate range we have [in alternative B]. It might be logical to reduce the upper end since--

MR. PARTEE. It would be rather nice symbolically to move the upper limit down to 19 percent.

CHAIRMAN VOLCKER. Or 18 percent.

MR. PARTEE. Well, that gets a little tight. I like 19.

CHAIRMAN VOLCKER. I personally wouldn't like to see it go up to 20 percent again. I'm not at all sure I'd want to see it go up to 19 percent.

MR. PARTEE. After all, we could get a spurt in the money supply. The fact that we've had two minus months increases the odds that we're going to have plus months. That's the only rule that I have and--

MR. BALLE. Unfortunately, it hasn't worked that way over extended periods in the past, for example in the summer of 1979 and a good part of '76 and '77. We have a long history of sustained overshoots and undershoots, and that's what I think we have to guard against now.

CHAIRMAN VOLCKER. We're talking a little out of perspective. In perspective, with this unexpected drop [in M1] last week from a level that was already running a bit low, we start from a lower base; but it's still one week's figure and heaven knows what the future will bring. We can't all be speaking. Mr. Winn.

MR. WINN. Paul, the seasonal adjustment for April makes me fairly nervous, so I'd like to get a bit of feeling for May before we pump in an inordinate amount of reserves in the next week. I think the danger of being whipsawed is very great. I haven't any concern about your suggestion.

MR. PARTEE. Of course, we don't pump reserves in unless we have a shortfall.

MR. WINN. No, I understand.

CHAIRMAN VOLCKER. Not beyond what I said. But if you're interpreting what I said as "pumping," it is "pumping" a bit.

MR. WINN. With the inflation problem being what it is and with the fact that everybody doesn't read our policies the same way, a flip in our policy on inflation at this time could be most unfortunate, given all the other things we've done to move in the other direction.

CHAIRMAN VOLCKER. Well, let's get some other comments.

MR. EASTBURN. I think your proposition makes a lot of sense. It's a good mini-max solution to the very uncertain conditions that we face. If you add the idea that we would consult (a) if the rates seemed to be coming down faster than we'd like to see them or (b) if the aggregates were coming in quite low, which in my view would be the greater [probability], I think what you suggested is probably the best we can do at the present time. Then we'll just [deal] with it day to day.

MR. PARTEE. I'm agreeable to it, too, Paul. It's a nice intermediate course, and it is only four weeks to the next meeting. We could get a reversal or it could get a lot worse. So I would suggest, as I think you did, that we take a point off the upper end of that [funds rate] range and live with "B" and expect the funds rate to come down some from where it has been, maybe to the area of 16 percent or a little below. It might have to go down further if we get great weakness in the aggregates; it wouldn't have to go that far if we get a good rebound.

MR. GUFFEY. Thank you, Mr. Chairman. I feel some discomfort in what I'm about to say in the sense that it may be taken that I don't have great faith in our new procedures. But maybe it's because of uncertainty. I'd feel somewhat more comfortable if we were to move toward "C," [which has 4 percent growth for M-1A]. [Our directive] now has 4-1/2 percent or somewhat less. I'd also point out that the "C" [growth rates] are well within the ranges that we set for the year as a whole, the 3-1/2 to 6 percent for M-1A, for example. So it wouldn't do great violence but would recognize that we have gotten a bit less [money growth thus far] in the first half of the year. And as a result, I'd feel more comfortable with it. I take some comfort also from your statement that if the funds rate gets to the 16 percent level, whether we adopt "B" or "C"--and I don't think it makes much difference which one we choose in the short run--there will be a consultation. And the point of that consultation would be to discuss whether or not interest rates should continue to drop very quickly. I have a considerable concern that we should not in the next two weeks, or even before the next meeting, be at a 13 percent rate, for example, which is the bottom of the funds range [under "B"]. Thus, I would prefer to move to "C," with the understanding that the consultation would indeed take place at about 16 percent and we could discuss whether or not the rate should go below that in such a short period of time.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I would subscribe to "B," Mr. Chairman. I think your analysis is totally consistent with the facts of life. I don't want to belabor the 20 or 19 percent upper limit on the funds range other than to say that any change in it, to the person who concentrates on minuscule parts of what we're doing, might imply that

we still have an inordinate concern about the fed funds rate. But I don't feel strongly about that. "B" basically makes good sense to me.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I'm afraid I don't like any of the three [Bluebook alternatives]. I'd like something a little stronger. It doesn't mean that we'd have to get outside of our range. We can live within the 4 to 6-1/2 percent annual range on M-1B, which [is the aggregate] I like to think in terms of. We would have to have a lower growth rate for the March-to-June period and, therefore, for May and June. We'd have to go a little below [the growth rate in] alternative C for M-1B for the second half of our half-year period, to something like 3-1/2 percent perhaps. Bear in mind, if you will, that this does mean a substantial increase in liquidity in the second half of the year because nominal GNP, according to our forecast, is going to grow at 5 percent and M2 on the path in alternative B is going to grow at a higher rate than that. So we're going to accumulate liquidity on the way down. I don't know how fast we're going to come out of the recession.

MR. PARTEE. Isn't M-1B growth just about that, 5 percent?

MR. WALLICH. Well, [you are] talking of "B." But now look at M2, which is after all what guides bank credit mostly. If that has a reduction of velocity, I see considerable accumulation of liquidity. In any event, after all that has happened, I think we'll be sitting here a year or a year and a half from now and I will then be asking that we stick by our targets. And some members of the group will say: What? You're trying to cut off this expansion at 8 percent unemployment? I fear the logic of the argument is going to cut both ways at that time. That's why I'm willing to budge now on my side, but I hope you'll support my side next time around. As far as the funds rate is concerned, I don't care if we cap it at 19 percent if the aggregates turn out to be as fast as [estimated] and we follow the alternative B target. If that [monetary growth] were reached, we would probably find [the funds rate] moving back to the top of its range and we would have to have a consultation. I very much think we ought to put a floor on the funds rate [that would trigger] a consultation at 16 percent at the minimum.

CHAIRMAN VOLCKER. Who else wants to say something?

MS. TEETERS. Henry has a one-way ladder. Have you noticed? It keeps ratcheting up as we go.

MR. SCHULTZ. "B" sounds fine; I'm not a bit uncomfortable with funds in the 15 to 17 percent range and I think having a consultation point makes a lot of sense. Maybe I just don't know quite enough about how the projections are put together to have great belief in them, but on the track record they have been [unintelligible].

CHAIRMAN VOLCKER. It's one of those things you're better off not looking into too closely!

MR. SCHULTZ. I'd really just like to sneak up on this animal a little in case he springs at me. So, rather than borrowing at

\$1-1/4 billion plus the emergency or the special lending, I'd like to start at \$1-1/2 billion and if things look a little weak, then we can move back down in line with the sort of technique we're talking about here. It seems to me that we have time and, as you say, this last week may have been quite an aberration. We may get a big change in these numbers. If we started at \$1-1/2 billion and the aggregates continued to come in weak, it would be easy enough to move borrowing down to \$1-1/4 billion.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I don't have any problem with "B." And I think it would be desirable to move the top [of the funds rate range] down to 19 percent. It's not clear to me what the consultation point is. Is it 16 or 15 percent?

MS. TEETERS. Or is it the money supply going negative? We have a consultation any time we get a big number but we don't seem to have very many consultations when we get little numbers.

MR. MORRIS. Well, we won't have a consultation, presumably, if the money supply is coming in weak.

MS. TEETERS. I know.

MR. WALLICH. When the funds rate drops as a result, we will have a consultation.

CHAIRMAN VOLCKER. The implication, in terms of a consultation, is that we would have a combination of two things. We can make a formal decision on it if you want to, but we would have a combination of a weak money supply and a sharply declining funds rate. If the money supply were not coming in very low, we wouldn't face the interest rate constraint so to speak. So the consultation would basically be about the money supply coming in low or the interest rate coming in low, whichever way you want to look at it, because presumably it would be the same [phenomenon].

MR. SCHULTZ. I'm not uncomfortable with consultation at 15 percent. I wouldn't mind seeing it get down in that range, but it would make me feel--to use Larry Roos' term--a bit antsy below 15 percent.

MR. ROOS. But Fred, if I may, Mr. Chairman, the factors that would essentially cause interest rates to decline would be a softening of economic activity and a softening in the demand for credit of a substantial scope. If that were to happen--if the economy were in a seriously weakened condition and credit demand fell off--and, let's say, we consulted, our only option it seems to me would be to pull money out of the economy with great force. And boy, that would certainly put the final kibosh--if I may use another Missouri expression--on the recession. Is that correct? I don't know what part of the world that expression came from. But that would really drive a very serious nail into the recessionary situation and would be procyclical and accelerate a recession.

CHAIRMAN VOLCKER. I think you're probably overstating the possible significance of what would be happening in a 2- or 3-week

period. I think what you say is true if one looked at it in a long enough perspective. But we're dealing with uncertain seasonal adjustment factors, uncertain week-to-week numbers, and an extremely uncertain relationship between borrowings and the money supply in a 2- or 3-week time period. That is all we're talking about.

VICE CHAIRMAN SOLOMON. I'm not as experienced as the rest of the people at this table, but it doesn't seem to me that we need a formal decision in this regard. We ought to give the Chairman an indication, as he himself suggested I guess, that when the funds rate gets down to the 16 percent range, more or less, he would initiate a consultation. I don't think that requires any kind of formal instruction. And at that point it really is a question of making a judgment on what is happening not only in terms of the fed funds rate and the interest rate picture but on the aggregates and the rate at which reserves should be fed to the System. I think it's just a prudent measure to take, and I hope we would all be able to combine on asking you to pursue that.

MR. WALLICH. I think we ought to look at other interest rates, too, because the funds rate has become a very poor indicator of the rest of the spectrum of rates. If bill rates, for instance, were to fall more rapidly than the funds rate, that would be a further signal to the market.

CHAIRMAN VOLCKER. I don't know who has not talked yet. I don't think you have, Emmett.

MR. RICE. Well, I'm prepared to go along with what you suggest. Alternative B seems right, and I would be willing to see one point knocked off the top end of the federal funds range to 19 percent.

CHAIRMAN VOLCKER. Who else has comments? I seem to have a number of Committee members who haven't--

MS. TEETERS. I can support alternative B and taking off the one percentage point [on the funds rate range]. I think we're more likely to run into a problem of not being able to maintain the growth rates of the money supply, [which may mean we would] need a consultation. I also think that the spread between the federal funds rate and other market interest rates may be a function of the surcharge. I think the banks are doing everything they can to keep out of the window and not pay the surcharge and, consequently, there's greater demand and greater pressure on the funds rate and on other rates. So that gap may just have developed out of our own actions rather than anything drastically different in the market. So I would support "B" and a 13 to 19 percent funds rate range. I don't know about the borrowings. I think we're almost going to have to play that by ear. We may just have to end up with a range on the borrowings [and see] how they come in.

CHAIRMAN VOLCKER. Well, let me fine-tune this a bit further, if I can, after listening to people here. What I would continue to propose is the same language in the directive that we had last time, which in some sense is "B" minus. It's this language of "B" [M1 growth] or somewhat less, which has some significance. I don't feel strongly about the federal funds rate, but there seem to be more

people who would like to knock it down to 19 percent, I guess, Murray. In thinking about the borrowing again and listening to these comments, I would modify what I said to this extent: I'd suggest that we start out with \$1-1/2 billion with the intention, if in the next week or so the money supply were developing more or less as projected, of it probably being at \$1-1/4 billion in the second week or the third week from now. I'm just being slightly more cautious; if the money supply were kicking up above what we're now projecting, we'd probably stay at the \$1-1/2 billion for a while.

MR. GUFFEY. Is that exclusive of the big bank borrowings?

CHAIRMAN VOLCKER. Yes, these figures all exclude the big bank borrowings. So that's a slight modification toward a little more caution than has been suggested.

MR. AXILROD. I interpret that, Mr. Chairman, for constructing the path--it's only four weeks here--as putting in \$1-1/2 billion for the first two weeks and \$1-1/4 billion for the last two weeks. What would actually develop--

CHAIRMAN VOLCKER. I guess so, but the last two weeks would be affected by what happens. We might move a little more rapidly toward the \$1-1/4 billion if money came in low; or if it came in high, we would--

MR. AXILROD. I think that would happen if the data we get tomorrow or next week--

CHAIRMAN VOLCKER. If the money supply were right on the present projections, we'd presumably get down to \$1-1/4 billion.

MR. AXILROD. Two weeks from now.

CHAIRMAN VOLCKER. Two weeks from now, yes.

MS. TEETERS. We don't have the borrowing in the directive, do we?

MR. ALTMANN. No.

MR. MORRIS. Well, Mr. Chairman, I think one thing we should have learned in the last few months is that we are unable to forecast the volume of borrowing.

CHAIRMAN VOLCKER. Well, we have to have some flexibility here. But it's useful to discuss this just to get some sense of which way the caution should be exercised in the short run. What we're saying, I think, is that we want to see some increase in the money supply, first of all, to meet these targets. We are willing to see some short-run decline in the federal funds rate to achieve that, and that is reflected in the lower borrowing figure. But there's also a healthy feeling of caution about not moving so fast that we have to reverse ourselves. So that caution is expressed in going down tentatively over a period of time on the borrowing number. That's in substance the way I would interpret [this directive]. That leaves Henry with some concern. Does that help you infinitesimally?

MR. WALLICH. It helps me infinitesimally.

VICE CHAIRMAN SOLOMON. May I ask a question? If the fed funds rate goes below 16 percent, will that make the 3 percent surcharge on the discount rate sustainable? Would there would be a large amount of pressure to take that off as not being appropriate? I don't know enough about this--

MR. PARTEE. I don't know, either, but it certainly would tend to bring the borrowing down pretty fast if we had a 16 percent--

MS. TEETERS. There's not much borrowing at that rate.

CHAIRMAN VOLCKER. There's very little borrowing at that rate now.

MR. PARTEE. Except at one bank.

CHAIRMAN VOLCKER. That's a separate decision. Obviously, it would raise the question at the very least. How much pressure it will bring I suppose is a judgment as to whether we want to give that kind of overt signal at that particular point in time. There's no doubt that the question will arise. I'm not sure it would arise very forcibly at 16 percent, but if the funds rate began to go below 16 percent, then the question would arise.

MR. EASTBURN. The only question that remains in my mind is whether or not we want to say "or somewhat less." It would be helpful to me if Peter would give me some interpretation of how it would affect his actions any differently if "somewhat less" were in or not.

MR. STERNLIGHT. That really has more to do with the construction of the paths than specific Desk action. Having the "or less" gives me a little sense or tone of being a bit more accommodative of lower growth. Steve might want to comment on that.

MR. AXILROD. Operationally, I think there are two things, President Eastburn. If we construct the path on 4-1/2 percent, which is the exact point, then the "or less" would mean to me that if total reserves were falling short a little, we would not make a big upward adjustment in nonborrowed reserves to offset that. That would be the immediate operational [effect]. We'd just let the normal drop in borrowings occur and work its way through. The other thing that could be done, but which the Committee hasn't followed, of course, would be to set the initial path not at 4-1/2 percent but 4-1/4 percent. But assuming the path is set at 4-1/2 percent, it would mean to me that when total reserves are falling somewhat short we wouldn't rush in to raise nonborrowed reserves to offset that.

CHAIRMAN VOLCKER. Well, I think we've accepted this kind of operation where the path is set consistent with the 4-1/2 percent but we have a slightly higher borrowing figure at the beginning than the one in the center of Steve's frequency distribution. I happen to think that frequency distribution is a rather flat bell instead of a--

MR. AXILROD. Yes, but with some limits to it.

CHAIRMAN VOLCKER. Well, are we ready to vote?

MR. GUFFEY. Does this imply consultation at 16 percent?

CHAIRMAN VOLCKER. I think I have the message on consultation. Don't hold me to an exact number. If the federal funds rate drops to 16 percent on one day, on Wednesday afternoon or even on another day, don't stay right close to the telephone. If there's a problem in that area, I'll let you know. I have a sense that if the money supply is running low and interest rates seem to be going down below that level, people want a checkpoint. And I understand that.

MR. PARTEE. Well, I agree very much with Tony. I think we have to be careful not to make this too formal because if it is formal, it ought to be in the directive.

CHAIRMAN VOLCKER. I understand [the thinking] about the 16 percent. But the real sense of what we're saying, consistent with these directions, is that if the money supply persists in coming in low, that is what is going to make the interest rate go down. So we could state it as--

MR. PARTEE. Consultation if we have low money supply.

CHAIRMAN VOLCKER. Consultation if the money supply doesn't seem to be coming up. Are you ready to vote?

MR. ALTMANN. This is 4-1/2 percent on M-1A, 5 percent on M-1B, with "or somewhat less" in the case of both, and a federal funds rate range of 13 to 19 percent. M2 is 6-3/4 percent; that's the alternative B specification for M2.

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

Ten for and one against.

CHAIRMAN VOLCKER. [To complete the agenda] I just have to remind you that there is a meeting set for Tuesday, May 20.

We have a little time, and I won't take all of it. But a memo was distributed to you and we thought we would have a discussion today, though not a prolonged one, of these different ideas of reserve --what do we call it, Mr. Axilrod? It's not reserve management; that has the wrong connotation. It's reserve computation, I guess.

SPEAKER(?). Various reserve proposals.

CHAIRMAN VOLCKER. The Board, of course, openly will have to decide that. That material has been sent out to all the Reserve Banks

and there is going to be a meeting of the Bank economists about it, isn't there, Steve?

MR. AXILROD. Yes, I believe--we'll talk to Mike [Keran]-- it's May 2. We, Mr. Lindsey, Mr. Simpson, and myself, will be meeting with the various Bank economists to discuss it in detail.

CHAIRMAN VOLCKER. Pending that discussion, any recommendations have been left out of that document. That is my understanding; I have not read it myself.

MR. AXILROD. That is right. We think we've covered the issues that the Committee members have raised. One is mildly irrelevant, as we're told it's illegal.

SPEAKER(?). Totally irrelevant?

CHAIRMAN VOLCKER. We've changed laws these days.

MR. AXILROD. Unless the Committee members would like to suggest other options, we hope to have this discussion with Mr. Keran's group and then be prepared to have a more pointed memorandum, with this as background, for the Committee at a later point.

CHAIRMAN VOLCKER. This is just your opportunity, if you had a chance to read it, to convey any violent feelings you might have had about something left out of this or any tentative conclusions.

MR. BLACK. Which one is illegal? Excuse me, Henry.

SPEAKER(?). That takes the fun out of it, if you--

MR. BLACK. Well, I always favor ones that are unpopular or illegal! I just thought I'd save some time.

MR. WALLICH. Paul, this is a very technical matter and it has many ramifications. Sometimes before when we've had a very technical matter, for instance on the directive, a subcommittee was appointed. I wondered whether this would lend itself to that kind of treatment. I guess by implication this examination by the Reserve Banks is a subcommittee in some sense. I don't want to carry this too far. And then I assume this is not before the Open Market Committee.

CHAIRMAN VOLCKER. No. The final decision is going to be a Board of Governors decision. That's right.

MR. AXILROD. But [we will present it at] a joint Board and President's meeting. We weren't assuming this to be part of an FOMC meeting since it's a matter to be decided ultimately by [the Board].

CHAIRMAN VOLCKER. Are we going to be able to have a discussion about it next month, in substance, do you think?

MR. AXILROD. Oh, yes; that's our idea.

CHAIRMAN VOLCKER. The schedule will be that first it will go through the Reserve Bank economists together with the Board economists.

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. Then the document is going to be modified to reflect the discussion and it will presumably have some recommendations, or differing recommendations, at that point.

MR. AXILROD. There are no recommendations in this document except implicitly.

CHAIRMAN VOLCKER. Right. So we will try to schedule a substantive discussion of this at the time of our meeting prior to the Board of Governors having to decide this.

MR. MORRIS. But it is important that we make a decision fairly soon, because if we are going to make a change, both Reserve Banks and commercial banks are going to have a lot of work to do.

CHAIRMAN VOLCKER. Yes. My problem with this in part is that whatever is nice conceptually, given all the other burdens put on the Reserve Banks--or all of us at this point--with the membership and the special program and the seasonal borrowing privilege and the operational problems, this may create [problems] for the banks on top of all the other things they're doing now at our request. We have a real hazard. I think we have to make a pretty persuasive argument, particularly if we're going to do it quickly on top of all these other things. I think one can draw the opposite implication: That if it's a marginally good idea and we want to do it but [our desire is] not overwhelming, we might want to wait a while just to let the banks get out from under some of these other special things we're imposing on them now.

MR. MORRIS. But if we were to do it, the logical date would be September 1 when we bring in all of these new institutions. If we are going to make a change, if we could make a decision next month, that would give us five months to prepare.

CHAIRMAN VOLCKER. I must say that is one view on the Board staff. We're going to have to get these techniques out now. They really are going to be tested. But it's going to be impossible to run on our current method after September 1st--with all the phase-in, phase-down, sideways movements, [vault cash] counting as reserves, and not counting as reserves--because we won't know what we're doing.

SPEAKER(?). Mr. Axilrod doesn't fully share that view, I presume.

MR. AXILROD. I don't think we're going to be any worse off than we are now.

CHAIRMAN VOLCKER. We'll be no worse off to we'll be in an impossible [position]. And some people think there's no difference between those two.

SPEAKER(?). Well, at least we'll have better data. I think that will be a big step forward.

CHAIRMAN VOLCKER. [Unintelligible] then the assumption is interesting enough. Again, this may be a minority view. But the

estimate of the nonmember banks is that the way we do it now will be better than if they were reporting daily for some indefinite period.

SPEAKER(?). I have to mention the credit unions.

MR. BAUGHMAN. Could I raise a question on a different subject if we're through with this one?

CHAIRMAN VOLCKER. Sure.

MR. BAUGHMAN. In view of the policy action taken today, based on the prospects for the economy and so forth, I'd raise a question as to what kind of posture we should be taking now that we're getting our first reports on our consultations with the big banks and big holding companies [regarding the voluntary credit restraint program and its] 6 to 9 percent [limit on overall credit growth]. Just by way of example, for all member banks in the Eleventh District thus far total loans have increased at a 12-1/2 percent annual rate. But in March they did not increase at all. Now, these first reports are going to give indications that [credit growth] will run well in excess of 9 percent, so we have geared up for some rather hard-nosed consultations calling for plans, projections, etc. It seems to me that we could rather easily get into a posture here that would look foolish, and that's not a very good posture to be in. So I raise a question as to whether you have any advice in that respect.

CHAIRMAN VOLCKER. I have a gut reaction, but let's see what Governor Schultz's gut reaction is first.

MR. SCHULTZ. That's pretty nice! My gut reaction is for now just to go ahead and get in their plans and talk to them. I'm not ready yet to give up too quickly on the first go-around. I'm perfectly willing to take the chance of looking a little foolish; I think we're going to look foolish no matter what we do. I don't think that's a situation we can get out of with credit controls, but I'd hate to give up too quickly on this thing. My feeling is to have a talk with them and then next month, if it looks as if things are easing off, then we can begin to ease off. We may eventually have to face the question of whether we want individual banks to cut back below 9 percent if it looks as if the total for the country is going to be at 6 percent.

CHAIRMAN VOLCKER. Well, it's a little early to judge that, I would think. And it's very hard to lay down any sense of rigidity about this. But as a matter of common sense, take your case. You have banks who probably are not unlike what we are finding in a lot of areas. You say [loans] are increasing at an annual rate of 12 or 12-1/2 percent for the first three months or a bit more than three months.

SPEAKER(?). That's an average. So presumably half of them are well above that.

CHAIRMAN VOLCKER. First of all, that's not a figure that's absolutely out of sight. And second, you say [that credit growth] is slowing down. It seems to me you should have a consultation with those banks, as Fred is suggesting. But you're not in a situation where you would jump up and down on the table or whatever and say they

have to be back within 9 percent by a certain date. You say: "Look, you were a little high or were quite high in the early part of the year; the most recent information we have shows it slowing down, and we presume it's going to continue to slow down. You have a program in place and all the rest and we'll look at you again next month and see if it has continued to slow." But you don't tell them to stop making loans at this point to get within 9 percent in the next 30 days or 60 days or 90 days.

MS. TEETERS. But it's a regional problem to some extent.

CHAIRMAN VOLCKER. Well, to the extent we have a regional problem--. I don't know if other people have a sense of this at this point. Well, here's a question: Suppose there is a 20 percent loan growth in a particular bank. Is that something we should stomp on?

MR. PARTEE. What is it? Is it non-priority loans? Is it take-over loans? That's another aspect of consultation.

SPEAKER(?). Well, it will be heavily loaded with oil and gas loans, almost inevitably.

SPEAKER(?). In the second respect.

SPEAKER(?). Real estate loans have been very strong also.

CHAIRMAN VOLCKER. But if you had a bank with 20 percent [loan growth] and it's not in a priority area, I think you have to be tougher on that bank than on a bank that's way below and consistent with the program. I don't think we can just say that the program [does not apply] for that banker when he comes in with a 20 percent figure. That's in the interest of fairness, I agree.

SPEAKER(?). I'd look foolish.

SPEAKER(?). If our economic projections are correct, then we ought to be phasing out this program in about two months anyway.

VICE CHAIRMAN SOLOMON(?). In New York only one commercial bank has come in over 9 percent.

CHAIRMAN VOLCKER. At an annual rate? That surprises me. Well, you have no problem.

VICE CHAIRMAN SOLOMON(?). We do have a bit of a problem with three bank holding companies. But we're looking into the data one more time.

CHAIRMAN VOLCKER. I'd say this isn't the time to stomp on them the way we would if the economy were running away.

MR. BAUGHMAN(?). Well, I've gotten what I asked for.

CHAIRMAN VOLCKER. Were there any other feelings on this, while we're on the subject? I was going to [bring this] up after lunch.

SPEAKER(?). I don't want this analogy to sound too strange, but I think credit controls are little like the Vietnam war. We need to decide earlier rather than later to declare that we've won and pull out. And it seems to me that we have a particularly difficult problem with some regional differences that in a way are discriminatory. As a consequence, the sooner the overall situation allows us to say "Okay, we've done it and we can now scrap it," the better off we will be because we are putting some institutions--through no fault of their own, really--through a harder vise than other institutions. And that's one of the undesirable effects.

CHAIRMAN VOLCKER. I think that's right to an extent, and nobody is going to be [happier than I] to get rid of [the program] when the time comes. It's just a question of when the time is [right] psychologically, which is difficult [to gauge]. But given the situation we're in now, as opposed to two months ago before we had the program, I'd say we can afford to be a little more understanding of a bank that has a legitimate regional growth problem. That was within the framework of the original program anyway; it was just a question of how it should be administered.

SPEAKER(?). Well, that's very helpful.

SPEAKER(?). It looks to me as if oil and gas loans ought to be priority items, too, if we can extend that priority list.

MS. TEETERS. Not publicly.

SPEAKER(?). Hang in there, Nancy.

CHAIRMAN VOLCKER. Of course the problem, I suspect, is that many oil and gas people are not getting the loans that they wanted. But the language that we use to one bank--

SPEAKER(?). I know.

CHAIRMAN VOLCKER. --has to be reasonably consistent with what we say to another bank. If a banker says "Gee, I talked to Bob Black and he told me I could draw all the oil I wanted in West Virginia" and then some other banker says "That's not the message I got from Willis Winn"--

SPEAKER(?). [Unintelligible] in Cleveland.

MR. PARTEE. Remember, if that's a loan to an oil company, that doesn't mean that it's a loan for the purpose of drilling an oil well. It might be for some entirely different purpose.

SPEAKER(?). Like borrowing silver!

SPEAKER(?). That wasn't the kind I was talking about though, Chuck.

CHAIRMAN VOLCKER. By and large I think you can be tough on the qualitative guidelines [unintelligible] gas drilling, but I don't think you should be giving them any sense that this is an open season on takeover loans or silver loans or something like that.

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SPEAKER(?). We'll regard this as a dance instruction. We'll tip-toe around it until it is demised.

CHAIRMAN VOLCKER. Any other comments on this program?

SPEAKER(?). Let's go to lunch!

END OF MEETING