

Meeting of the Federal Open Market Committee

May 20, 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, May 20, 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, and Mayo, Alternate 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
Mr. Holmes, Adviser for Market Operations

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

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

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

Mr. Coyne, Assistant to the Board of
Governors

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

Mr. Siegman, 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. Forrestal, Gainor, and McIntosh,
First Vice Presidents, Federal Reserve
Banks of Atlanta, Minneapolis, and
Boston, respectively

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

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

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

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CHAIRMAN VOLCKER. Let us proceed, ladies and gentlemen. We need to approve the minutes.

MR. SCHULTZ. So moved.

CHAIRMAN VOLCKER. Do we have a second?

MS. TEEETERS. Second.

CHAIRMAN VOLCKER. Without objection, the minutes are approved. Foreign currency operations.

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

CHAIRMAN VOLCKER. Are there any questions?

MR. WALLICH. Scott, I was struck by your emphasis on the good cooperation we have had. That certainly has been true in many instances. But wouldn't you say that the whole episode of the rise of the dollar several months back and the [subsequent] decline was an instance of different rate intentions and different preferences for up or down on the part of the two central banks and that, therefore, we always had operations in one market but not in the other? On the way up, the Bundesbank held the dollar down in their market and we did little in our own. On the way down, we held the dollar up in our market and the Bundesbank did little to keep it from going down. So, I draw the lesson from this experience that we ought to move toward somewhat more comprehensive coverage of the markets; each of the central banks should be potentially present in both markets at the [same] time. I think that could probably be worked out.

VICE CHAIRMAN SOLOMON. That doesn't solve the question of [how] we reach agreement between the two central banks.

MR. WALLICH. What we would do, Tony, is to agree that the central bank that wants the bigger intervention prevails. If we are willing to put money on the line to hold the dollar up, the Bundesbank [operates] in Europe. It has to be done for our account, but they would do it. We would have to agree on a method of communicating with them. And if the Bundesbank wants to have the bigger intervention, then they would prevail and we would do [the intervention] for them in New York if necessary, or they could do it directly.

VICE CHAIRMAN SOLOMON. But that means we would have a mechanistic formula whereby whichever side is more anxious to hold the currency up prevails. Even though there are departures from time to time between the Bundesbank's thinking and ours, if the dollar were too strong by their standards, during that period of time there would be some divergence between us, which would have to be combated with telephone calls and that sort of thing. But the more typical condition is one where the dollar is on the weaker side and, as we have seen in the last few weeks, we get relatively good cooperation from the Bundesbank. I have the feeling that would continue to work better than to switch to the kind of approach you are outlining, Henry. I also am reluctant to have the main burden for supporting the

dollar put on the United States more than it has been. We have been playing our role and doing our share in the last year or two. It's not benign neglect. But I think it is important that other key central banks also play a major role, and I am afraid that the implication of your suggestion is that the United States would end up being the sole supporter of the dollar. I would rather live with the difference of view between us and the Bundesbank during periods of strong dollar activity than start a whole chain of events moving whereby we end up being the sole supporter of the dollar.

MR. WALLICH. Well, I don't think that would be the result of what I suggest. But perhaps we should examine this--we can't debate it here--and see if we can make some progress with it.

MR. PARDEE. I have seriously considered putting in a double shift--that is, having people in the trading room at the Desk during the night hours when the European markets are open. We already monitor the Far Eastern markets, but there have been occasions when there was a slippage between the time operations ended in the Far East and the Bundesbank picked up its operations in Europe. But for us that's a major expenditure of personnel and other resources, and I'd rather do that only if I felt it would be worthwhile for our people to stay up during those hours.

MR. WALLICH. By worthwhile do you mean in terms of likely operations or in terms of a special emergency that might happen?

MR. PARDEE. [I'm talking about monitoring] operations and whatever feedback we might get from the European markets. We would be monitoring their intervention as well as what is going on in the market at the time.

MR. WALLICH. I don't know how much that would cost but it seems like a good idea to me because what [happens now], as we see, is that we sometimes wake up here and the dollar is down 1 percent and the Bundesbank has done nothing. And by that time it is too late to push the dollar back up.

VICE CHAIRMAN SOLOMON. We can explore that more. There are some disadvantages. It will become known that the Fed is staying awake and is willing to intervene in the Far East markets. The key point is that it will be known that the Fed is willing to intervene in the Far East markets and is doing 24-hour intervention. A 24-hour monitoring may make sense, but I don't think we want to accustom the Far Eastern markets [to our] playing too big a role; that view would tend to be encouraged if they begin to see more and more Fed intervention in those markets. On the other hand, whenever we have thought instability was likely, Scott or Gretchen have put people on to monitor [developments]. And we have where necessary, and a bit reluctantly, [unintelligible] role in Singapore as compared to New York and to some degree Europe.

MR. PARDEE. There is no one more reluctant than I am. A 24-hour day is unthinkable.

MS. TEETERS. I am a little surprised that you say there was equal intervention going up and coming down. I got the impression that there was massive intervention by the Germans and the Swiss when

the dollar was rising and that they haven't done anything on the way down--and we've done relatively little. Is that right or wrong?

MR. PARDEE. They've done more on the way down in recent weeks as a result of these mutual concerns. They're afraid that the dollar will start declining and [the monetary authorities will] have to intervene and undercut their monetary policy, and they want to maintain a certain policy restraint. And we have this other risk that we are running with a sharp decline in interest rates and that a sudden decline in the dollar will trigger a speculative crisis against the dollar.

MS. TEETERS. But the amount of intervention since we started out is nowhere near what it was on the way up.

MR. PARDEE. Yes, I agree with you. They sat very heavily on the dollar when it was rising, and ferociously so. And they didn't help very much at first when the dollar began to decline. But again, in more recent weeks with this convergence of interests, they have been very helpful. We haven't had to intervene much, partly because of this atmosphere we are in. And I still feel that the environment we've had since October 6 has been conducive to effectiveness of intervention because exchange traders are nervous; they are concerned that if they take a short position in dollars, interest rates might all of a sudden back up and it would become a very expensive speculative bet for them. So, since October 6 we have not yet had to do the type of massive intervention in support of the dollar that we had to do before, even with the environment we have had in the last month.

MR. AXILROD. Governor Teeters, it wasn't only the foreign central banks that were supporting their own currencies. We were intervening substantially to find the marks to cover the Treasury's intermediate-term debts. We may not even have done enough in that regard. So we, too, were trying to take advantage of the improving dollar availability to pick up the marks that would cover the Treasury's debts. We did it in substantial size.

MR. PARDEE. We didn't show up in the market until the dollar was around 190.

MR. WALLICH. That is another aspect of this two-party system. We had different reserve objectives. We would have liked to pick up some more D-marks. The Bundesbank was very unwilling to lose dollars because they were running a current account deficit [and were] worried. Nevertheless, the Bundesbank sold a great many dollars and we picked up as many marks as we would have liked. We could have arranged this the other way; had we done the D-mark support we would have gotten the marks and the Bundesbank would not have spent the dollars. So we did this to some extent by sharing the intervention proceeds, but not fully.

CHAIRMAN VOLCKER. Do we have a motion to ratify the foreign exchange transactions?

MR. WALLICH. So moved.

MR. PARTEE. Seconded.

CHAIRMAN VOLCKER. [Without] objection they are ratified. Do you have a recommendation, Mr. Pardee?

MR. PARDEE. Yes. The Swedish Riksbank has asked if the Federal Reserve would increase its swap line by \$200 million to \$500 million. You received last night two memoranda on the Swedish situation--one by me and one by Mr. Caprio of the Board's staff. As I indicated, the Swedish authorities expect a financing problem on the order of \$4 billion, which this year they plan to cover largely through official borrowings abroad. Of this, some \$2-1/4 billion has already been arranged and additional loans are in the early stages of discussion. In requesting an increase in the swap arrangement with the Federal Reserve, Governor Wohlin of the Riksbank expressed concern that the Riksbank needs more backstop in the form of short-term bridge financing than it currently has. The Riksbank uses an intervention approach based on a currency basket and finances its intervention out of the proceeds of the official borrowing. In light of the current economic and political uncertainties, the krona is vulnerable to a sudden burst of selling pressure, and the Riksbank may be obliged to [obtain] dollars in the market at a faster pace than they are raising them through financing. In their view, the increase in the Federal Reserve line would give them an added cushion in addition to their dollar reserves and their other short-term facilities. Governor Wohlin has stressed that the Riksbank has no immediate need to draw on the Federal Reserve, but he does not wish to rule out the possibility that they may come in for a drawing at some point.

Now, as you can see from the memo, the Swedes are passing through a difficult time. But under Governor Wohlin the Riksbank has acted to firm up short- and long-term interest rates and is pressing with some success for a reduction in the fiscal deficit. The Federal Reserve's agreement to increase the swap line could strengthen his hand in some of those negotiations at home. On the basis of these various considerations, I recommend that the Committee agree to the \$200 million increase. But given that we are living in a world in which we haven't had many changes in swap lines in recent years and haven't had much experience with drawings on those lines, I would like to introduce one wrinkle: That we make the increase for one year and that we review the whole matter at the end of the year when we consider the renewal of the whole [array of] swap lines and decide then whether we want to put it on a permanent basis or not. So, I would recommend a 1-year increase from \$300 million to \$500 million, with a review at the end of the year.

CHAIRMAN VOLCKER. What are your reactions?

VICE CHAIRMAN SOLOMON. I support the recommendation. I spoke with the Swedish Governor when he called me and he emphasized that they would only be drawing [on the line] as bridge financing for periods of up to about two months. And if we approve Scott's recommendation, I think we should tell them not only that the increase is only for one year but that each time they want to draw, they would have to check with us and tell us what actions they intend to take and give us a firm indication of the time period in which they intend to [repay the drawing], probably up to a maximum of about two months. I think there is a larger reason for going along with this, which is basically that Sweden dropped out of the snake; it is not a member of the EMS. And to some extent their request to increase their swap with

the United States tends to symbolize something we haven't seen in recent years, namely that the United States is the pivot and plays a critical role in the international monetary system. I think there is virtually no cost for us. And not only would we be cooperating with a G-10 country, but in a subtle way [the swap line increase] would tend to underline the fact that the United States has a critical role. I would recommend it.

CHAIRMAN VOLCKER. Are they making any arrangements with the Bundesbank or anybody else?

VICE CHAIRMAN SOLOMON. Well, I asked them that. They have

They do not have the ordinary kind of swap line with the Bundesbank. Scott, do you want to explain what that arrangement with the Bundesbank is?

MR. PARDEE. Well, I'm not fully clear myself [but] the Bundesbank does allow other central banks to accumulate marks up to a certain amount before they ask those banks to cash them. So, it is more of a facility on the reserve currency side. The Swedes are borrowing marks quite frequently and they might want to keep some of them for a while. That's the arrangement.

MR. SCHULTZ. Do we have any other arrangements on our swap lines with a takeout arrangement similar to what you are suggesting?

VICE CHAIRMAN SOLOMON. For most of them, each time a central bank wants to [draw on] a swap line we have some discussion as to what the conditions would be and what the period would be. Normally in the past, though, swap drawings have been made for six months or a year. This would be somewhat unusual. Our conditions would be tighter in that this is bridge financing and would probably not be for more than two months.

MR. WALLICH. I do think we should have that very firmly set down. It could be done in two ways: Either we set down all the conditions when we take action now to raise the line; or we do what we sometimes have done in the past, which is to treat an existing line as a framework for discussion, not as a commitment on our part to lend. For example, Mexico has a line--what is it, \$700 million? Italy has \$3 billion and England has \$3 billion. We take this as a framework for discussion of both the terms and the amounts. I don't know what lends itself better in this case. They many want to draw very soon and it might make more sense to lay down all the conditions at the start. But we shouldn't let it slide and then find that they are about to draw without our having had the chance to make clear what the frame of reference is, as Tony specified. I very much agree with him that we need a firm takeout; they have to say that they will go to the Euromarket [even] if conditions in that market are not very propitious when the drawing matures.

MR. RICE. What are the risks of not applying conditions to the swap line? Everybody seems to be in agreement. I don't know what--. Isn't Sweden a good credit risk?

VICE CHAIRMAN SOLOMON. Yes, Sweden is a good credit risk. I think the only risk, if you want to use that word, is that it becomes

awkward later on with other countries if we do apply conditions and they ask why we didn't apply them to Sweden. Our posture always has been, even if the country is a good risk, that we want to be in a position of applying reasonable conditions. Now, in the case of some countries--

CHAIRMAN VOLCKER. So long as they don't apply them to us.

VICE CHAIRMAN SOLOMON. It's an asymmetrical relationship. We don't exactly play the IMF role, but it is true that in the case of some countries that are less creditworthy--take Mexico--we would want to know what their stabilization program was and what the policies intended to get them out of trouble were going to look like before we would let them make a [large] drawing on the swap. In the case of Sweden, we can't say that this should be bridge financing [until they could get funds from] the IMF because they have only, I think, \$4 billion in external debt; it's not a country that one would push to the Fund. We have to give them some direction. But there is some danger, if we don't have some sense of the conditions, that we will have more difficulty with other countries in applying conditions when they are really needed. I think that's the reason for having some understandings, rather than the risk of not being repaid.

MR. PARTEE. They take the exchange risk, is that right?

VICE CHAIRMAN SOLOMON. Yes.

MR. PARTEE. And the interest rate is the U.S. bill rate? And you are proposing 60 days?

MR. PARDEE. Roughly.

MR. PARTEE. Ninety days is so conventional. I don't much like saying 60 days. It sounds as if we have some particular problem with Sweden. I would think a 90-day maturity--

CHAIRMAN VOLCKER. I was a little concerned on reading those memoranda that Sweden isn't in very good shape.

MR. PARTEE. Oh, no, it isn't. They just had a long strike, you know.

CHAIRMAN VOLCKER. It raises the question in my mind why they aren't borrowing in Europe, and whether we are to some degree conceivably--

MR. PARDEE. They are borrowing.

CHAIRMAN VOLCKER. Officially?

MR. PARDEE. Yes, they are making official borrowings in the Euromarkets.

CHAIRMAN VOLCKER. No, the Eurodollar. I mean from European official sources.

MR. TRUMAN. Are you asking why they want to raise the short-term swap lines?

CHAIRMAN VOLCKER. Yes.

VICE CHAIRMAN SOLOMON. Well, remember, there is political importance to their not being in the European Monetary System. The Germans were furious when [Sweden] dropped out of the snake. That [furor] has died down and there's reasonable cooperation, but I think they would look to the supplier of the currency in which they keep their reserves since they are not members of the EMS. Now, we could always make it a condition, but I would advise against it, that they ask for a similar swap line with the Bundesbank.

CHAIRMAN VOLCKER. Why are they having trouble with the BIS?

MR. PARDEE(?). Because that's the seat of the European Monetary System and the members of the Board there are--

CHAIRMAN VOLCKER. Sweden is a member of the BIS, isn't it?

VICE CHAIRMAN SOLOMON. Yes, and it has a swap line with the BIS.

MR. PARDEE. They have a swap line they just--

VICE CHAIRMAN SOLOMON. They have drawn on it, with BIS agreement, but they have not gotten agreement from the BIS to increase the swap line.

CHAIRMAN VOLCKER. How big is their swap line?

MR. PARDEE. It's million. On the point of when we impose conditions, I would rather wait and see what the circumstances are when they come in for a drawing. We can then review it with the [Foreign Currency] Subcommittee and put on the conditions that are more or less specific to the circumstances at the time. That is why I think this review procedure and a 1-year limit on [the increase in the swap line] gives us a little more control. They are not in good shape, but this all relates to 1980. We don't know what 1981 will bring. But I think our side will be better able to monitor it if we do it this way.

CHAIRMAN VOLCKER. If we do this, we have to announce it right away--meaning within three or four days--right?

MR. ALTMANN. Yes. It should be included in the Selected List of Actions that would be available for inspection [this coming Friday]. We don't need to make a public announcement as such. It would also be in the Policy Record, and any conditions attached to the increase in the line would presumably appear in the Policy Record, which might be somewhat counterproductive from their point of view. May I just add simply that the Procedural Instructions with Respect to Foreign Currency Operations require that there be advance approval by the Subcommittee of any drawing up to a certain amount and by the full Committee beyond that amount. So [approval of a drawing] is not automatic under our procedures.

CHAIRMAN VOLCKER. What are they going to say when this is announced?

MR. PARDEE(?). As little as possible. We were discussing having it come out on a Friday afternoon. It's coming very shortly after this strike, and they did not want the market to think that they were acting in response to the adverse publicity of the strike.

CHAIRMAN VOLCKER. Well, we are going to have to say something, it seems to me.

MR. PARDEE. Well, we can say that the Federal Reserve and the Riksbank agreed on an increase in the swap line from \$300 million to \$500 million. Full stop, unless we want to add that this shows a cooperation between the two central banks--or some language like that which we have worked up in the past.

CHAIRMAN VOLCKER. It's no problem for us, but it is a bit of a problem for them.

VICE CHAIRMAN SOLOMON. They are aware that we would have to publish this increase within a very short period of time and also that we would have to publish any operations under the swap line with the usual lag of one month.

MR. BLACK. It will be a little longer this time because we don't have a June meeting, won't it?

SPEAKER(?). This comes out earlier [than the Policy Record].

CHAIRMAN VOLCKER. This coming Friday.

MR. WALLICH. Well, it seems to me that in terms of conditions we shouldn't discriminate between the Swedes and others. I think 90 days is reasonable and renewal for another 90 days is reasonable. I'm mainly concerned about a takeout because even though Sweden may be a good risk--it certainly still has a very high rating in the Euromarkets in terms of the spread at which it can borrow--they may for that reason decide to let it go. So [the drawing may extend] to 6 months, to 9 months, and to a year. That is where we want to be sure that they can't overrun. And it can be done very simply by agreeing that they will go to the market to pay it off.

CHAIRMAN VOLCKER. Well, this doesn't strike me as perfection in terms of a precedent, but at the same time I see no strong reason to turn it down. I do think we need an understanding now that they are going to pay it off. I don't have any problems between 60 days and 90 days or whatever and we can even exclude a renewal. But I think they ought to be told that this is a temporary increase; we are just talking about a 1-year increase at the moment. We can have a further discussion when they draw, but I think it has to be against the background of a clear understanding now.

MR. PARTEE. I thought it was 90 days.

CHAIRMAN VOLCKER. It's 90 days for the drawing.

VICE CHAIRMAN SOLOMON. The increase in the line from \$300 million to \$500 million would only be for one year. As for an actual drawing, they would advise us ahead of time that they would be drawing on it and there would be a 3-month limit to the bridge financing.

MR. PARTEE. I think that's reasonable.

CHAIRMAN VOLCKER. Well, with that understanding, are there any objections? It just looks to me as if Sweden may be in trouble before the end of the year on this.

MS. TEETERS. How dependent are they on foreign oil?

VICE CHAIRMAN SOLOMON. They are terribly dependent. They have the highest per capita consumption of gasoline--imported gasoline --in the world. We happen to have some domestic [production]. Also, this recent wage settlement of 11 percent does not improve their competitive position, although it doesn't worsen it. If you look at the weighted basket of currencies against which they keep their exchange rate, the wage increases in those countries on a weighted basis also work out to [an average of] around 11 percent. There's a major rethinking going on in Sweden; I think they are at a pivotal time. About 65 percent of their GDP goes through the public sector and there is an increasing reaction against that. There is a feeling that they've got to come up with a tough energy policy and that they have to shrink public sector expenditures. A whole new debate is beginning.

CHAIRMAN VOLCKER. But the current account deficit is \$750 per Swede.

VICE CHAIRMAN SOLOMON. Yes. They have probably the highest standard of living in the world and they owe only \$4 billion. The current account deficit, they believe, will be between \$3-1/2 to \$4 billion; I noticed that the Board's staff thinks it will be closer to \$5 billion. They do not have any creditworthiness problem. But unless they change their policy, I think they will be in trouble in two to three years.

CHAIRMAN VOLCKER. Do I hear any objections? [Hearing none], that is approved and we can go to Mr. Sternlight.

MR. PARDEE. I'm sorry, I have some other comments. I'd just note that there will be some first renewals of swap drawings in the days subsequent to the next FOMC meeting. Normally, in our renewal cycle we report on these at this time. [Each] is just a first renewal, so no action by the Committee is needed. We have swap drawings of \$141 million worth of German marks and \$74 million worth of French francs that are up in July. I would hope that we would have paid them by that time, but for the record I am mentioning them now.

CHAIRMAN VOLCKER. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Questions?

MR. ROOS. Yes, Mr. Chairman. Peter, I'm a little confused about your April operations. You attempt to achieve our aggregate growth targets, as I understand it, through the establishment and achievement of certain reserve paths--either for total reserves or the base. Is that correct?

MR. STERNLIGHT. We are trying to achieve nonborrowed reserve levels that have been associated with the Committee's targets. I don't think we are able to achieve, on a month-to-month basis, the Committee's monetary growth targets.

MR. ROOS. Well, I noticed [in] the Bluebook that [the staff], as I assumed the Committee as a whole would be, again was trying to understand the reason for the rather substantial drop in the rate of money growth during [April]. Now, during that month actual reserve growth was 2.7 percent for total reserves and 1.9 percent for the monetary base.

MR. STERNLIGHT. Right.

MR. ROOS. Let me ask you this: Do you have specific figures in terms of the monetary base, for example, that you try to achieve as a guide for your operations?

MR. STERNLIGHT. No, not in terms of the monetary base. But we do have specific figures for nonborrowed reserves that we are trying to achieve--in this case for both the 4-week interval and week by week. We have an objective that can be modified from one week to the next because of technical factors. On one occasion we added some to the nonborrowed [path] because we were so far below on total reserves going through this period.

MR. ROOS. These figures--the 2.7 percent, say, on total reserves and the nonborrowed part of that--I assume are significantly lower than the path that you sought. Is that a fair statement?

MR. STERNLIGHT. Total reserves are certainly lower. The nonborrowed figure, as I mentioned, is coming out about on track.

MR. ROOS. Let me just ask this, pursuing this line of questioning: Isn't it possible for you to achieve or at least to get closer to your path objectives than these two figures? It's mechanically possible to do, is it not?

MR. STERNLIGHT. Well, as I say, on nonborrowed we are coming out about on track for this period. For the total reserves, I think one can get a different view depending on what intervals one takes. I tend to think of this as the four-week block of time between Committee meetings. And total reserves are coming out well below the path, by some \$850 million, on our estimate.

MR. ROOS. What adjustments can you make, or do you make, if you see that we are coming out below the desired path, to supply reserves so they come out to a higher level? I thought you almost automatically try to adjust for that situation.

MR. STERNLIGHT. Well, part of the whole procedure that we are on now involves an almost automatic adjustment, because if total reserves are coming in weak and money supply is coming in weak, aiming for nonborrowed reserves means that there is going to be less demand for borrowing. I described how the borrowing had fallen off and with that [interest] rates had dropped off quite sharply.

MR. ROOS. When you observe that, Peter, can't you take compensating actions to inject reserves?

MR. STERNLIGHT. In part what happens is that it is an almost automatic response because as we aim for the path of nonborrowed reserves it calls for less borrowings, and conditions ease. And over time--not within a month's time but over some longer time--this is supposed to generate greater monetary growth.

MR. ROOS. Couldn't you achieve a base path objective if you wanted to?

MR. STERNLIGHT. I'm not sure we could achieve it; I think we could come closer than we did if there were no federal funds rate constraint.

MR. ROOS. In other words, within the family, to be candid, is it the federal funds constraint that really causes us to miss these paths occasionally?

CHAIRMAN VOLCKER. Not entirely. Over a period of time that may be true. But we are running into precisely that problem now, and that's what the debate will be this morning, I presume. But the Desk provided nonborrowed reserves more or less on path. It could have speeded that up, and we would have run into our federal funds constraint, and we will run into it now. That doesn't mean that the [level of] reserves would have come up to the path right away.

MR. PARTEE. It's somewhat like a freight train, you know. There's the engine and the caboose. And what happened is that we've now jerked forward and the borrowings have gone down.

CHAIRMAN VOLCKER. We went right through all the borrowings, so we are face to face with--

MR. ROOS. If you have an engine where both ends of that train are going in opposite directions, you have a very strange situation.

MR. PARTEE. I think there is a certain amount of looseness in the relationship, and the looseness that has been used up this month--

MR. STERNLIGHT. We did run into the funds rate constraint during the period, and the Committee acted on it.

CHAIRMAN VOLCKER. We are now in the rarified atmosphere--one we haven't operated in before--where we have no borrowings.

VICE CHAIRMAN SOLOMON. Let me ask a question. Aside from any constraint that may arise in the lower end of the fed funds rate range, isn't it the directive of the Committee to the Manager to achieve the target on nonborrowed reserves, given the Committee's borrowing assumption? If the actual borrowing level comes in lower than the assumed borrowing level, is he supposed to take additional compensatory action to go higher than the target on nonborrowed reserves in order to compensate? I didn't assume--

CHAIRMAN VOLCKER. It's possible.

VICE CHAIRMAN SOLOMON. It's possible, but there's no clear--

CHAIRMAN VOLCKER. Well, it's a matter of judgment in between meetings; Mr. Axilrod sits there and scratches his head and Mr. Sternlight does and occasionally I do.

MR. ROOS. Mr. Chairman, isn't this the dilemma that plagued us over the pre-October period, though, where we had incompatibility between our fed funds objective and other objectives?

CHAIRMAN VOLCKER. We would have run short on total reserves, and certainly the monetary base in any [case], even this time. But we don't escape, I suspect, all the dilemmas of the real world by whatever we said in October. And we are there right now.

MR. ROOS. A lot of people in the real world--and I'm sorry to [belabor this] but I know we have them in the real world where I live--are hoping desperately that when this incompatibility occurs we will do what we said we were going to do: Keep our eye on the reserve growth targets and let interest rates fluctuate. That really is the fundamental issue that we face, and I think our credibility--

CHAIRMAN VOLCKER. [Interest rates] had a lot of flux in the last month.

MR. WALLICH. This is attributing to the money supply a significance that I see hardly any economists attributing to it. The money supply is a means of getting [desired] interest rates. People who want a stable rate of money growth want wide fluctuations in interest rates. So we can always decide how much interest rate fluctuation we want to have and go from there without subordinating our decisions to the money supply. [If] we say that we don't want interest rates to move outside a certain range, then it seems to me that we've made the judgement that interest rates are to prevail up to a certain point.

MR. PARTEE. Well, we've announced our targets to the Congress not in terms of interest rates but in terms of aggregates. We've never mentioned interest rates in our targets to Congress.

MR. WALLICH. But if the money supply is a means of controlling interest rates, it is a better means than for us to set [interest rates] arbitrarily low, as we have in the past.

CHAIRMAN VOLCKER. In the interest of facilitating the discussion, I think these issues will arise in a more practical way a little later.

MR. RICE. Mr. Chairman, may I ask Peter a question? Is there any reason to expect a further back-up in short-term interest rates?

MR. STERNLIGHT. Not from what I see here, particularly. If monetary growth should speed up, certainly it would be possible.

CHAIRMAN VOLCKER. It depends upon why it speeds up. Short-term interest rates are down this morning. That's the long-term trend through 10 o'clock this morning!

MR. RICE. There was a time when we used to think an increase in the money supply would cause interest rates to fall.

CHAIRMAN VOLCKER. It depends. If the economy gets stronger and credit demands increase and the money supply rises, interest rates would rise. If we're pushing up the money supply, then presumably they would fall.

MR. RICE. But, if the economy remains weak, with an increase in the money supply one would expect them to fall.

CHAIRMAN VOLCKER. They might, yes.

MR. GUFFEY. All of this discussion does point up the importance of the discount rate, however. That's because we could have moderated the fall in the funds rate, the [final] standard, if borrowings had been above zero. That is something we are going to face in the period ahead, and thus the Board [should] give considerable [thought to] what to do with the discount rate. So long as borrowings remain at zero, we have nothing to operate against but the funds rate--the fall of the funds rate itself--if we try to achieve these targets.

MR. PARTEE. That's all we have anyway.

CHAIRMAN VOLCKER. We have to ratify the domestic transactions. Without objection, they are ratified. Mr. Kichline.

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

CHAIRMAN VOLCKER. I wonder whether we shouldn't pause for a little discussion of the economic situation. [I hope] it doesn't go on too long because there are particular technical issues on the financial side that will need some discussion.

VICE CHAIRMAN SOLOMON. If you assume that we have a mortgage rate of around 12 to 13 percent for the rest of the year, do you have any projections as to what the level of housing starts would be later in the year?

MR. KICHLINE. Yes, we have housing starts rising to a little over 1 million units by the end of this year and continuing on up to about 1-1/2 million units next year. Our forecast for the remaining months of the current quarter is for a bit further decline on average. But starts would average 900,000 for the current quarter and then begin drifting up next quarter so that they are at an annual rate of over a million by the time we hit the end of the year. That's essentially what we have built into our forecast currently. I might note that for mortgage rates to get to that level they would have to decline further in conventional markets. They are not there yet.

MS. TEEETERS. May I ask: In your projection of personal income did you anticipate the number that came out yesterday, which was essentially zero?

MR. KICHLINE. Yes. In fact that was largely based upon the labor market developments in April, which we had available. Wages and salaries declined at about a \$7-1/2 billion annual rate. And that's one of the principal ingredients giving us for the second quarter a virtually unchanged saving rate even though consumption spending is declining very rapidly. So, we think we've roughly captured that.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I wonder if you would talk a little about your projections on the saving rate, Jim. What bothers me is that you have such a small rise in the saving rate over the next year when one considers that it has been abnormally low and that we seem to see every evidence that people are trying to pay down debt and improve their financial position. And, of course, if that saving rate were to come in significantly higher than you have projected, it would imply a considerably weaker economy.

MR. KICHLINE. That's quite correct in terms of the forecast that we have, in which the saving rate really never gets to 5 percent and then drifts lower. That is at least a percentage point below what one might have expected on the basis of experience prior to the last two or three years. There are a number of factors involved. Essentially, one is that we believe individuals will attempt to retain their standard of living. And when one looks at the composition of price changes, relative price changes have been extremely large for necessities such as food, energy, and housing. So, our view is that one of the elements driving the saving rate down recently has been the surge in the relative prices of necessities; and individuals have been willing to let the savings side slip as an attempt to maintain their standard of living. We expect that to persist. We also tend to believe that the saving rate may have been adjusted lower as a result of the inflationary experience [and will remain low] through this forecast horizon, even though the rate of inflation is declining. It's still very high by historical standards, and there clearly has been a change toward spending as opposed to saving. And I think it will be hard to get consumers around to the view that they want to save substantially larger portions of their income once they have adjusted in this fashion. Admittedly, it is a very difficult part of the forecast. It often comes out as a residual. To go about this, we use the saving rate as a check and then begin asking questions about it and whether we believe it's appropriate. If consumers' attitudes change quite differently and in the aggregate they feel squeezed in terms of their financial positions, as they ought to, then the saving rate might tend to be higher. And if it were, of course, other things unchanged, activity would be weaker.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. I tend to be at least as pessimistic as the projections. There's one other factor that could enter in and I wonder if you have explored it, Jim. And that is the [potential] catastrophic aspects of this, with large numbers of bankruptcies both in the nonfinancial and financial side--in municipal finances and so on if they accumulate.

MR. KICHLINE. That's one of the major risks in a forecast like this because [the downturn] is deep enough and it also started

with many sectors being in what we would perceive at least to be a vulnerable position. [So], even though one is looking for that kind of evidence, those developments tend to be unpredictable and could pose serious downside risks for the forecast. We have been looking very carefully, for example, at the corporate sector, and the aggregate numbers there do not provide any comfort at all. There has been a great increase in downgradings of corporations and cutbacks in capital expenditure plans, some of which seem to be stemming from the financial side. You mentioned also the government sector, and we are clearly getting a squeeze there with real expenditures declining; but with the Administration's effort to curtail the rate of growth in federal expenditures, a good chunk of that [spending] falls on the state and local sector. So there are sufficient concerns in the nonfinancial sectors as well as the financial sectors to be aware that something may go wrong, and that could very easily set off expectations in an adverse [direction]. That is one of the risks that would argue for the possibility of seeing even lower numbers. They may not materialize, but we are at the point where there are [enough] warning signs to be cautious.

MR. SCHULTZ. Individual bankruptcies are already up very substantially, but there is a real question as to whether that's related to the new bankruptcy law--how much effect one can assign to that.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. What about the \$20 billion budget deficit that you have for fiscal '81? Do I understand that that would be even larger if the import fee were cut out?

MR. KICHLIN. Yes, that includes \$10 billion, roughly, in receipts. So if nothing else changed, the deficit would be in the neighborhood of \$30 billion.

MR. MAYO. So from your standpoint this is a swing from a \$16 billion or so surplus projected by the Administration?

MR. KICHLIN. Well, some of the developments in Congress have lowered that, though, so the numbers coming out of the Senate side were a small surplus. But the numbers are all on the plus side. I might note that we have not assumed passage of the withholding on interest and dividends and that's worth something like \$3-1/2 billion. We've assumed that some of the expenditure cuts won't materialize, given the much weaker economic forecast that we have. That's worth \$4 or \$5 billion more in direct expenditures than we have assumed. And the remainder is accounted for principally by weaker receipts, higher unemployment insurance compensation, higher interest rates, and that sort of thing. So, we've [made some assumptions] on the expenditure and tax sides, but the bulk of it is the different view of the economic outlook.

MR. MAYO. I think's it's a very reasonable assumption, but it is a very important ingredient in the Greenbook presentation.

CHAIRMAN VOLCKER. Any other comments or questions? We will turn to Mr. Axilrod.

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

CHAIRMAN VOLCKER. I [am tempted] to suggest that you might get into the more technical problems. But maybe we will defer that and get whatever reactions we have at the moment to as far as you have gone. Governor Partee.

MR. PARTEE. Well, on this question of strategy for dealing with a shortfall, I just don't know; I have a feeling of discomfort about it. I suppose what it amounts to is that having suffered an unprecedented decline we ought to be prepared for an unprecedented increase to make it up, should it occur. Therefore, if we had a sudden surge, restoring us closer to the trendline, that would be all right; that should be permitted without any difficulty. If we don't have that, the question is: How hard should we push to get [money growth] turned around? As a matter of procedure, I feel it's incorrect in May to use the whole rest of the year to try to get back within the range because we may well continue to have adversity in reaching the numbers desired. And if we do, the shortfall will get worse and worse and harder and harder to adjust to. So, without speaking to the policy issue, I just think that procedurally it is better to have a fairly moderate period in which we plan to recoup our losses rather than a long period. Therefore, [aiming to get] back to path by September strikes me as much sounder than [getting] back to path by December, which is the alternative given.

As long as I have the floor, I might just go on. I think there is a fair possibility that something big--really big--is going on out there in the economy and that in fact we may not get a rebound in money supply or credit demand for some while. If that is so, the decline in final demand that is occurring will destroy income; and the destruction of income will result in a further weakening in final demand. And if that's the situation, that is a classic depression situation developing in the economy. The worst possible thing that could happen would be to continue to see credit and money contract because that would perpetuate and deepen the decline and really get us to the point that Dave was raising. Nobody ever projects what would happen if we had a wave of bankruptcies because there is no way to project it. We so seldom have a wave of bankruptcies that we just can't see how bad things might be if that occurred. The last real big wave was in the 1930s. And, of course, it created grave effects on expectations and attitudes and the willingness to spend and so forth. So, if there is something big going on, it's terribly important that we stop the decline in money and credit. If there isn't something very big going on, we will get a turnaround without doing an awful lot, in which case it won't turn out to be such a big problem. So it seems to me that the risks are all on the one side, and we ought to structure our operations and our policy to recognize those risks.

MR. SCHULTZ. May I ask a question of Steve? Steve, what you have done is [to present] two alternatives here, both of which are geared to reaching the midpoint of the range. Now, Governor Partee feels that structurally it is better to do it by September. But doesn't it leave us a lot of flexibility if we attempt at this point to target the midpoint of the range by December? It gives us the flexibility, if we have a substantial shortfall, to look at the lower end of the range as an alternative if money growth is not very rapid over that period.

MR. PARTEE. That's precisely why I suggested September, because in fact we might continue to have a shortfall relative to our expectations, in which case having targeted on December we will have no more room. I think we will be lucky if we are within the ranges at all this year. But it's just a question of how quickly we try to get back [within them].

CHAIRMAN VOLCKER. It makes a big difference which M one looks at. It may be true of M1; M2 and M3 don't look so bad.

MR. SCHULTZ. And maybe L is even; as Steve points out, those T-bills may be pretty high.

MR. PARTEE. The analytic significance of L escapes me.

CHAIRMAN VOLCKER. It's pretty good when you have a decline in M2 and M3 simply because people bought Treasury bills.

MR. PARTEE. It always happens; in every credit crunch it has happened.

CHAIRMAN VOLCKER. That's why the analytic significance is high. Governor Wallich.

MR. WALLICH. I'd like to make the opposite case, and in fact express some concern about getting back on track even in December. There is at least a good chance that we have had a demand shift and that we would just be pouring in money when [instead] we should have taken account of the diminished demand for money. Nobody can say how likely that is at this time. There are some indications--and I think it has a rather fair probability--so I'd give it weight. Certainly the situation seems to be rather similar to what we had from the fall of '78 through the winter of '79. There was an unexplained shortfall, though not as drastically concentrated in one month; I think we had close to four or five months of negative M1 growth. Then, in the spring and summer the aggregates took off. For a while we said that was just compensating for the shortfall of the previous six months. Suddenly, in August-September we realized what was happening: That the aggregates were running away, that it was not a compensatory movement, and that we were going into an accelerated inflation. And we took the strong measures of October of last year; even that wasn't enough and we had to do it again. So I think the pattern of having a shortfall and then trying to catch up--or allowing the aggregates themselves to catch up--has existed in the past. And it seems that it can be very dangerous.

Furthermore, under alternative B, M-1A would be growing at 9.5 percent and under alternative A it would be growing at 7.6 percent. Even if these very high rates of money growth didn't lead to an inflationary situation, which is not likely given that we probably are going into a substantial recession, it nevertheless would be an uncomfortable situation to be moving at those rates of speed and then suddenly either in October or January have to turn off the faucet and get back on track [to a path that] would be more consistent with moderate growth. In other words, at that time, when the recession would probably be at its deepest, we would be confronted with turning off the faucet and raising interest rates if we were to move as fast as these alternatives imply. I would not like to be confronted with

that calamity. We can handle all of this, I think, within our existing target ranges, if we aim at the lower edge. I have a rough sense that we should aim [for growth in M-1A] by December at 1-1/4 percentage points lower than the midpoint. We would be saving ourselves about 2 percent growth or a little more. And taking down the aggregates by that much, [as I've] proposed here, would not get us to very rapid rates of expansion. We would not incur the danger of overshooting and would not run the risk of having to confront a sudden change of pace that would raise interest rates.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. Well, I would like to shift the argument back to what Chuck started with. We really are dealing with probabilities here, and that's what makes it so very difficult. There is a possibility that we have had a fundamental shift in the demand for money. There is a possibility that we are in for something bigger, perhaps bigger even than the staff has projected. It's very tempting to say: Let's avoid that kind of decision and just deal with the immediate problem and face this issue later. I don't think we can [wait] because there's too much at risk. So we have to cast our lot on [one side or the other]. And I cast my lot on the side that says the probability is that we will have a persistent shortfall in money growth. My reason for this is historical experience. A shortfall has tended to happen when we have had recessions and probably will happen even more in a recession of serious magnitude, which is the kind I believe we are going to have. I think we should anticipate that and get back to the [money growth] path as soon as we can; that to me would require us to try to shoot for [a return to path by] September rather than wait until December. I think Chuck is absolutely right that if the other [scenario] turns out to be the case and we find ourselves with rather large increases in the money stock, we can pull back from that. But I believe the risk is more on the other side, and I would prefer to move more rapidly to get back to path.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I recognize the possibilities that Governor Wallich has outlined, and he outlined them very well. But I feel that if we don't [do something to] be on target before long, we may get almost impossible pressures against us to ease later on [by more than is desirable], at about the time the economy is recovering. And that's the time when we usually make our mistakes. So I come out about where Governor Partee and Mr. Eastburn did, and I would align myself very closely with the remarks they made. I have some specific [recommendations to make] later on regarding the federal funds rate ranges, the level and width of the ranges, and also the wording of the operational paragraph.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, one major problem I have with the funds range of alternative A is that if we were to vote for a 10 percent floor, after having given the Manager a 10-1/2 percent floor in our last telephone conference, I don't think we could honestly or with a straight face say that we are trying to control bank reserves. Quite clearly, de facto, we would be moving back to controlling interest rates. Now, if we are faced with a foreign exchange crisis,

then we ought to be honest and say that we are going to keep the federal funds rate where it is for the next month, hoping that the fundamentals of our balance of payments will improve and that, therefore, we are temporarily abandoning our policy to control the rate of growth of bank reserves. As far as I can see, alternative A is out for that reason unless we are willing to admit that we are going back to controlling interest rates, as we have done before, though the results of that [operating procedure] were not terribly satisfactory. So I would like alternative B, but I would like a funds rate range of 8-1/2 to 12-1/2 percent.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Mr. Chairman, before we try to make a decision on "B" or something else, I'd like to ask a question of the staff. Do you, Steve, or any of your colleagues, have a judgment as to the extent to which the special credit restraint program of March 14-- otherwise known in some sections of the country as "Jaws II"--might be a very inhibiting factor in getting back to path? We have scared off a lot of bankers around the country [by] having them appear before Vice Chairman Schultz with their boards of directors and submit daily reports and all sorts of other things. Unless we "unscare" them pretty quickly, I'm concerned that, while it's always hard to push on the string, in this case it will be impossible. I've given you my view. I was really asking for yours.

MR. AXILROD. I have a judgment; perhaps Jim also has one. I would say that it probably did have some effect on bankers' attitudes, or at least it seems so from the data. But perhaps even more importantly, it seems to have had some effect on consumers' attitudes. Spending has been very weak and I think that weakness is associated with a reluctance to use credit. There have been reports all over the papers and it [is evident] even in one's personal experience that people have some reluctance to use credit. Going along with that there has been some shift, apparently, to using cash and a shift to paying off debt and reducing spending. Whether the end of these programs would change those attitudes is an open question, of course, because once a person finally decides something is right, for whatever reason, I simply don't know whether the ending of a program is going to change his mind substantially. That's particularly so if we're in the middle of a recession when the program ends and people have some doubts about future income prospects. But those are subjective judgments and we have precious little evidence other than to note that the sharp declines in bank credit and consumer debt are very coincidentally related to the imposition of the program. That suggests a change in attitudes, and I think it's the attitudes of both the lenders and the borrowers.

MR. SCHULTZ. May I comment on that from an anecdotal point of view on the basis of talking to bankers and others all over the country who are involved in credit extensions? I think Nancy [Teeters] would corroborate what I say. Well, I don't know that for sure but I think so. It's clear that [the credit restraint program] was a real shock to the consumer. If the credit controls are removed, the people I talk to do not believe there will be a resurgence of the same attitudes the consumer had before. They believe this effect is not reversible. So I think it's important to get them off because they are having a serious effect on the economy at this point. I just

worry about how we are going to get them off if we're going to have an easy money policy, too. It could be pretty difficult to do both at the same time, and I would hope that we would keep that in mind as we are talking here.

MS. TEETERS. Of course, Fred, if we take credit controls off and it has no impact--if people don't go back to spending--then we can do both simultaneously.

MR. MORRIS. [We would say] we're taking them off because our prior tight money policy was successful.

MR. RICE. We'd say that we're not really using it. We'd try to ease our target growth.

MR. PARTEE. Certainly we'd say monetary growth is lower than ever--

MS. TEETERS. Let me comment further on what Fred was saying. The reports I've been getting are that credit sales have just plummeted. And it shows up on the profit reports of Penneys and Sears that came out this morning. Another aspect that people seem to be worried about is that purchases of household durables were so strong in the second half of last year that [that sector] is not going to rebound. Everybody has a new refrigerator. The other aspect of this is that consumer debt is unbelievably high; and with a very low saving rate the chances of a rebound in consumer spending such as we've had in previous recessions are much lower this time. I think that is already built into the staff's forecast.

MR. BALLES. If I can end my comment, Mr. Chairman: I suspect the March 14th programs--this is just an intuitive feeling on my part--have done the job that we hoped they would do, and that was essentially to break the back of inflationary psychology. Therefore, I think those programs have outlived their usefulness and they will simply get in our way if we try to restore monetary growth, whether to the lower end of the range or the middle of the range by September or December. I hope some very serious consideration will be given to how quickly [the economy] can unwind from those programs. My instincts are to go along with the alternative B target and to get that restoration done more quickly than by the end of the year. That's about the way I would come out. But I fear that the credit restraint programs, unless visibly relaxed--I know you alluded to that possibility in public--are simply going to be one more inhibiting factor getting in our way.

CHAIRMAN VOLCKER. I have a great vacuum of volunteer speakers here.

MR. WINN. Mr. Chairman, I think this is a time when we need to go back and restudy some of our history on these things. The problems of our undershoots and overshoots are a little sobering it seems to me. It's a problem, really, of the gaps that occur in this process. It's not just [a question of] when we get back on target, because the gaps are never corrected. I think our [undershoot] problem is something to be concerned about. I share some of Henry's concern as to what we do [later], but it seems to me that we have an even more important problem as to what we do now. Consequently, I'm

in favor of making an effort to get back on path by September. But I doubt that even the funds range specified in alternative B is going to do that. I think we have to have a wider funds range if we're going to be serious about our efforts, and I'd be inclined to consider a 7 to 14 percent range--not knowing what is happening on that score--as a basis of approaching our target by September rather than December. One reason is because the gap between now and December is going to be a painful thing for you to have to testify about in January or February because I think [the members of the Congressional Committees] are loaded for bear. Others have studied the misses we have had in the past, and it seems to me that we ought to learn a little from history in our approach to the current problem.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. First, on the credit restraint program: I, too, think it should be dismantled, but in parts. The time is already ripe for getting rid of the consumer part. I don't see any particular damage in taking it off piece by piece if only because, based on some of our traditional observances, the bank credit hangs on after activity starts down. But also as a counterbalance, I feel we should keep at least the special deposit on the money market mutual funds for perhaps a little longer than some others have suggested simply because of the public perception. If we take the special deposit off, people might feel the Fed is out of its mind to do that if we really believed in limiting their growth in the first [place]. We know the reasoning, tying it to what the mutual funds invest in, but I think the public perception would give us a black eye. And phasing out the equity [requirement] on the bank side too soon would give us a black eye. But I think a case can be made for dumping the consumer credit [part] pretty fast.

Moving on to our policy question, I lean the way Willis does. We should be getting back on target or we will have a credibility problem again. I don't think [our recent adoption of] a 10-1/2 percent lower limit has strained our credibility but [adopting] any lower limit higher than 8 percent would tend to strain the credibility of our decisionmaking today when it comes out because, for better or for worse, we have announced that we're going to concentrate mostly on [achieving] our targets for the aggregates. Sure, we can change those targets in July if we wish, but for the moment we haven't given any indication--and I think properly so--that we have any desire to change those targets. So I, too, would prefer "B" or almost a "B-" to get us back [on path] by September--we can always have a consultation in between [meetings]--and I'd pick figures of 8 to 14 percent [for the federal funds range]. I consider the 10-1/2 percent [lower limit], which could become a sore point, something like a temporary intervention point, if I may draw the analogy from our foreign exchange side. I would like to consider it that rather than as a real constraint that might upset our credibility on what we said in October and again in March.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, I don't feel that I can dispel any of the uncertainty that has been cited here today. It is a very uncertain situation. On the credit restraint program, I think it would be desirable to announce that it seems to have achieved its

objective for the time being at least and, consequently, all required reporting under it will be discontinued with, say, the May reports. But [I'd say] the program itself is being put in cold storage for reactivation if and when it is needed. That latter part is simply on the assumption that it would be politically expedient to say that forthrightly [rather than imply] it at this point in time. But it does seem to me inappropriate to continue a fairly comprehensive reporting program in an environment where it's not doing anything useful for us. I think it will look rather foolish to the people who are reporting under the program and not--

MR. PARTEE. You'd [take] off the special deposits too--not just the reporting but also the special deposits?

MR. BAUGHMAN. Well, yes. But we're not getting any of those anyhow, are we?

MR. PARTEE. I don't know; we got some from the mutual funds.

MR. BAUGHMAN. On the monetary policy issue, it seems to me that the risks are on the side of a fairly extended period of [money growth] running well below target and that, therefore, we should move fairly quickly and fairly decisively to try to get back within our announced target ranges. So between alternatives A and B, that would lead me to favor "B" and it would lead me also to suggest that the bottom of the funds rate range should be reduced probably to 8 percent from 9 percent or, if not that far, I could go with Frank's 8-1/2 percent. That's all I have, Mr. Chairman.

CHAIRMAN VOLCKER. Mrs. Teeters.

MS. TEETERS. Well, all the news has been consistently bad. Every day brings in another indication of greater depth of the slump. And it seems to me that the risks are all on the down side at this point. If we look at the staff forecast, they have made the recession deeper but somewhat shorter. And the total recession isn't much greater [before] some upturn. Probably it will be both deep and long, the worst of all possible combinations. As a result, I think we should get back to our targets or we should be providing to the economy the sort of support that it needs at this particular point in time. So I would support alternative B, moving back by September, and a lower range on the funds rate. This does raise problems on the international side. If we move to where the interest rates are dropping to the 7-1/2 or 8 percent range, we may encounter some heavy drains [of funds to abroad] and heavy pressures on the dollar. I think we have to face up to the fact that if we move to accommodate our domestic policies, it will have some international implications. It seems to me that we should openly face the fact that we're probably going to have to intervene rather heavily to keep the dollar where we want it to be in terms of international exchange rates. So the directive today should not only focus on domestic monetary policy but on how we are going to cope with the pressures, as they develop, in the international market.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Mr. Chairman, I think it is important to understand fully the nature of the decision we made on October 6 and

the potential or lack of potential for accomplishing what we said we were going to accomplish. As I understood the meaning of what we said in October, it was that we were going to set fairly long-range targets for the growth of money. By law we have to do that. We have announced those targets to Congress and we've announced them publicly as targets for a span of one year. [We said] that in any targeting of monetary growth there are inevitably going to be some overshoots and some shortfalls. That is a part of the process. And if our objective is to achieve longer-range targets, when we have a significant shortfall such as we have [now] we will take steps to compensate for that shortfall by expanding the rate of money growth in order to bring us back into the target range. I've always seen it as similar to the process of steering a large ship. If the ship swings off course, you attempt gradually to bring it back onto course. And in my opinion, these overshoots and shortfalls are not totally beyond our control. If they were, then we would be making better use of our time to be back in our various Districts trying to administer the various programs of a local nature. We do have the ability at least to influence the growth of money in a very significant manner. I think not only is the credibility of our October 6 program at stake, but the very credibility of the Open Market Committee is at stake in terms of whether or not we perform what we've said we were going to accomplish.

I wish there were an alternative C that could get us back to the range even before September, but being a realist I guess alternative B is the best we can accomplish. But also being a realist, I would bet a Christmas turkey--although I'm not a betting man--that there's no way of accomplishing alternative B and getting us back within the range by September with the constraint of a 9 to 14 percent federal funds target. I see no reason why, after we've finally gotten into better habits than in the past by having a broader fed funds range, we're all of a sudden [talking about] narrowing it again. I think we should have a 5 to 15 percent fed funds range on alternative B, and I would certainly prefer alternative B to alternative A.

Let me just close by making one further observation: As our Chairman has said repeatedly, as have others among us, accepting a reduction in interest rates in times like this should not be construed as an easing of monetary policy. As for concern about the adverse effect that a further reduction in interest rates would have on the international exchange markets, the day that any of us says that publicly, [people will say]: "Look, the Fed is retreating to its old practice of concentrating on the stabilization of interest rates." If that is said or if that is perceived, I think we'll have a catastrophe in terms of the value of the dollar on international exchange markets that will far overshadow the effects of seeing interest rates continue to drop gradually, if that is a necessary adjunct to achieving the objectives that were stated in October. I feel very strongly that it's a critical time [for us to persist] in what we're doing. I've felt a great deal of pride in taking to the hustings with the message that we are serious in what we're doing and we're going to stick with it. If we vacillate now, Mr. Chairman, I think the game will be over.

CHAIRMAN VOLCKER. Mr. Schultz.

MR. SCHULTZ. I am amazed, and I must admit disturbed, at the fact that I haven't heard the word inflation mentioned around this

table this morning. My word, it was only two months ago that we were wild about the subject and terribly concerned about it. I admit that we're in an unusual period. Things have moved exceptionally fast. But I don't think we can seriously say that we're out of the woods on inflation. And it seems to me that at least we ought to continue to think about it a little. We do have evidence that things are getting somewhat better and are likely to get better in the future, but that certainly is not in the bag. And the perception out there is absolutely crucial. There aren't very many people around the country who understand our change from a federal funds operating target to a reserves operating target. But a lot of people understand that what the Fed does is crucial in the fight against inflation. And there are people who still do worry about inflation. If we move too rapidly, that could have some very serious attitudinal effects [on the] psychology of inflationary expectations and could subvert [any progress we've made in that area].

The other side is that I think the economy is weakening very rapidly and will turn down very sharply, and I want interest rates to come down. But if they come down too fast, the result can be counterproductive. If we want mortgage rates to stop coming down [so rapidly] we have to let them back up a little. There is volatility. We gave up some things when we went to this reserves operating target and one of those things was some stability in interest rates. The volatility in interest rates does have an impact on people. They see interest rates jumping up and down and they say: "What is happening in the country?" Those interest rate risks get greater and lenders want to protect themselves against them so they don't bring interest rates down as rapidly. We need to think about the rapidity with which we're [lowering the funds rate]. I don't know if we [should] take these lower targets of alternative A; I do believe we need lower funds rates targets than we have in that alternative. But if we [implement them], are we really going to [reduce] the interest rates that have an impact on people any more rapidly than we would if we proceeded a little more slowly or had a little steadier approach? I think [a slower steadier approach] would avoid a lot of risks. So, I'd certainly like to argue for alternative A, but I do admit that the funds rate target would have to be widened some.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, we share the [view that there are substantial] uncertainties in the present situation but I must confess that we don't share the pessimism about the economy that I've heard around the table this morning. We certainly would not want to minimize the extent of the downturn that has occurred. On the other hand, we don't view the recession as overly severe at the present time, nor do we think it's going to be as severe as it was in, say, 1973 and 1974. We have some things operating in our favor it seems to me. For example, inventories are in much better shape than they were. The construction sector of the economy is not as important as it once was. There are other sectors that provide a cushion for us. We have a fairly prevalent underground economy, which seems to be functioning pretty well. There are also some built-in structural [elements] in the economy in our favor: We have the food stamp program, the trade assistance program, supplemental benefits, unemployment compensation, and so on. Moreover, at the present time interest rates are coming down, particularly on mortgages, which I

think is going to foster a rebound in that sector of the economy and also perhaps in the auto industry as we get lower rates there. So there are [developments] in the economy that are going to help us in the long run, and my concern is with the long run and not the short run. We have had a couple of months with very low monetary aggregate growth or a decline, but only a few months. And I don't think we ought to be bullied into acting too quickly because inflation certainly is still a problem.

Now, if the credit restraint program comes off, that's going to [provide] greater impetus to consumer expectations. And inflation is still going to be with us. I think we're going to get a rebound in the monetary aggregates in June and July. So for those reasons I hope that the Committee will not overreact to the declines that have occurred and that we will take a more gradual approach to bringing the targets back to their paths. Also, I don't interpret alternative A as a departure from our October 6 strategy. I think it does reflect the desire to get back to our [monetary growth] paths but over a more gradual period of time. So I feel that alternative A is the better approach. Whether the 10 to 14 percent federal funds target is the way to achieve that, I don't know. I think a number a little lower than 10 percent might be in order. But we do have the option of looking at that between meetings, as we have done in the past, and that might be a desirable way to go.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I favor alternative B for the reasons that have been given by a number of people. I'd like to assure Governor Schultz that I'm still very much worried about inflation and hope that we will bring it under control. But at this time I believe the risks of undershooting our targets are greater than the risks of overshooting. And I feel that if we adopt alternative A and find in September or October that we are far short of our targets, then we will be in a position--if we take our targets seriously and I certainly hope we do--of having to pump in reserves at a very rapid rate, thereby running the risk of giving the wrong impression again that we're panicking and that we are moving too rapidly toward monetary ease. For that reason, it makes much more sense to try to get back on target as early as possible. In this case, the earliest practical time is September and I would hope that we could do it [by then]. I'm also, at the same time, comfortable with the federal funds constraint of alternative B. I'm perfectly prepared to stay with a 9 percent lower limit for the time being. And if that constraint prevents our reaching our targets as we move toward September, then I would be prepared to lower that 9 percent at the right time.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. As a relative newcomer to this Open Market Committee, I've been struck by the very frequent reference to losing our credibility if we don't stick to the targets. It seems to me, first of all, that the target is a range and that it's perfectly appropriate to come in at any part of that range, if we can, rather than to zero in always on the midpoint. But the larger issue is that we seem to have a misunderstanding of what the Committee's October 6 decision was. I thought the Chairman said publicly that there would be somewhat more emphasis on targeting monetary aggregates and less on

the fed funds rate and that judgment would be used; there was not a mechanistic formula. If that is a correct understanding of what he said, and if he was reflecting the decision of the Committee at that time, then quite clearly some people in this Committee are not on line with the public articulation of [that decision].

CHAIRMAN VOLCKER. Just to be accurate the phrase used in the release was "more emphasis," not "somewhat more emphasis."

VICE CHAIRMAN SOLOMON. Okay, I stand corrected but I think my point is still a correct one. You did say that it was not a mechanistic formula and that judgment would be used. Now, in a world where there is so much uncertainty, I recognize that there is a good possibility that we will undershoot but there's also a good possibility that we will overshoot. I don't believe the Federal Reserve System is so different from any person or institution in the policymaking arena that they should ignore the importance [of the maxim] that in a world where there is great uncertainty the prudent thing to do is to move gradually.

Larry Roos said that our commitment was to gradual changes in the money supply, although his recommendation was to use the faster path to get [back on track] by September. It seems to me that we need to consider the public's perception of us as central bankers, with a world of great uncertainty on both sides. We need to maintain a certain public perception and level of confidence in what we are doing rather than make what others see as very major changes. We may think that we are being consistent. But as Fred Schultz said, the outside world does not [understand] what we are doing in terms of this very sharp volatility. For us to move to supplying nonborrowed reserves--particularly since there's an assumption of virtually no borrowing if alternative B is accepted--at roughly a 9 percent rate is completely inconsistent with any responsibilities we have toward the long-run objective on the money supply, which is our principal objective as central bankers. And, hopefully, there is a connection in terms of the rate of inflation. My understanding was that the Committee had as its long-run target a desire to edge down the money aggregate targets as occasion permitted in order to achieve a long-run reduction in the rate of inflation. I am concerned about our terms of reference in our discussions here where everybody's position is completely predictable, including mine. And I frankly don't know how we break out of this situation. But if there's no room for judgment--if it's going to be get back on path even [if reserves have to] increase at a rate of 9 percent over the next few months, then it means with an assumption of no borrowing that the Manager will be committed to achieving the nonborrowed reserve target. And he probably will achieve that. That would not necessarily result in the aggregates behaving exactly in line, in proportion, but they will certainly go in that direction. The second point I want to make is: How can we expect to maintain interest rates at lower than everybody's expectations regarding the lowest likely pace of inflation? There is nobody who assumes that the rate of inflation is going to be below 10 percent even by the end of the year.

MR. PARTEE. I think it will be.

VICE CHAIRMAN SOLOMON. Well, then I take it back. There is one person. Even Bill Miller said that he would hope to get it down

to 10 percent by the end of the year. And we're talking about maintaining short-term rates at lower than the rate of inflation. What is going to be the reaction of long rates, which have the biggest impact on the real economy, if there's no confidence in the Fed as the guardian of monetary prudence and a strong anti-inflationary effort? We're going to get a perverse reaction. When we raised short-term rates as part of the November 1st package, there was a greater confidence that the Fed was coming to grips with the problem of inflation, and long rates actually declined. If there is a widespread perception that we are running a short-term interest rate policy with rates significantly below the rate of inflation, I think we're going to have a perverse reaction in the long markets. And that will have a more damaging effect on the real economy. So, I would hope that the Committee would opt for a more gradual approach in this area of great uncertainty. Therefore, I would urge that we adopt alternative A or something lower than the midpoint area. And I would hope that we would not endorse a fed funds rate floor which is significantly below the rate of inflation, as some people here have suggested.

CHAIRMAN VOLCKER. Mr. Guffey, are you the last one here?

MR. GUFFEY. Well, it's fortunate, I think, because Tony Solomon just synthesized my feelings both for moving somewhat gradually and for building stability. I would also point out only as an addendum to what he said that if we [adopt] alternative A and shorten the horizon to September, if the estimates are right, by the end of September we would be above the lower bands of M-1A and M-1B, and that to me is an acceptable performance. I also feel rather strongly--and the argument has already been made--about people's perceptions if the federal funds rate is allowed to go much below the perceived rate of inflation for the remainder of the year. But it points up again what I believe to be the operating reality: If we have no borrowings whatever, the bottom of the funds range that we set today will be a constraint if at any time within the next week or two the staff finds that the projections are not quite as strong as those put forth in the Bluebook. So, we'd really almost be choosing a lower federal funds constraint wherever we set that. I would opt to set it not much below the 10 percent level. Thus, I would like to adopt alternative A--and maybe it will [get us] back to path by September--recognizing that if the staff is right we'll be within the range established for the year as a whole.

CHAIRMAN VOLCKER. Mr. Gainor, do you have two words you want to say?

MR. GAINOR. Mount St. Helens has covered the Ninth District with [inorganic] ash but it hasn't wiped us out yet, Mr. Chairman. We favor adherence, as closely as possible, to the money supply targets set by this Committee previously. We think they were reasonable targets in the long-range [plan to reduce] inflation, and we'd like to see them followed. We would favor alternative A as a means of getting there and we would widen the range for the funds rate. We would favor dissolution of the credit restraint program as early as it can reasonably be done.

CHAIRMAN VOLCKER. Okay, let's drink coffee quickly. I won't deprive you completely!

[Coffee break]

CHAIRMAN VOLCKER. Well, let me see if I can sort this out a bit. We've done a lot of talking about the risks in the situation, and they undoubtedly exist. The obvious risk is the presence of recession, and when that [occurs] one always has the feeling of being in a bottomless period. Indeed, there is a certain degree of risk that we are in a more bottomless period than we would expect or like to be in. We have the risks of the exchange market situation. I will only mention that; those risks are fairly obvious. I don't think we can deal with them. I don't have any confidence that we can deal with them through intervention anyway. I have nothing against intervention [in principle], but I have no confidence that we can sit here and escape responsibility or concern by saying that we can intervene because intervention is not going to take care of the situation fully if it really develops in an adverse way. I repeat: That is not a prejudice against intervention, particularly at the right point, which is probably about now--before [the situation] deteriorates, or earlier rather than later in an effort to maintain a feeling of stability [in the foreign exchange markets]. And we have the risk of inflation that Fred Schultz talked of eloquently. That's not a risk; it's here. It affects psychology. I think [the psychology] has improved somewhat, and it will affect how well we're going to do in coming out of this recession.

I think we ought to recognize that we're in a situation that has impossible aspects to it. There is nothing we can do here by fiddling around with either interest rates or the money supply, for instance, to reduce consumer indebtedness, which is very high. And that is undoubtedly affecting consumer behavior at the moment, apart from all the [credit control] programs that we have. And there is nothing we can do about the fact that the saving rate is very low and that there may be efforts to move it higher, and that's related to the indebtedness situation. I'm not even sure in some longer-range perspective that there's anything we should do about it because we've been complaining about the saving rate being too low. The car industry has problems of its own. They couldn't sell rear-wheel drive cars even when credit was available and people wanted to buy cars. All I'm saying is that we're not going to solve the world's problems by what we do here. It doesn't mean our judgments are not important, but we're living in a difficult period with problems on all sides of us. We have to evaluate how those various risks impinge upon each other. When I look at all these risks, what impresses me is that the greatest risk in the world is not whether we miss our targets or not. I don't want to miss our targets, but we have to put that in perspective of what is going on in the rest of the world. I don't think we can avoid some judgment about what we should do to minimize those risks. We can't escape them. But I don't consider it a full answer to say we set down a target some time ago and we've got to hit the midpoint of that target, as much as I would like to do that in general.

There has been a certain amount of discussion of the credit restraint program. I think that program probably is having some effect; it's very hard to [quantify]. I want to get out of it myself. I've spoken to that point publicly. It's a question of how to do it both substantively and, in terms of our general posture, gracefully. I would expect some movement on that very shortly. I would make one

other general point: I get comments sometimes from outsiders and from insiders that if we take some action--let's say we remove all of the credit restraint program tomorrow and we drive the interest rate down to 5 percent--and if we explain to the market that that's really a tight money policy, then all the psychological implications will be gone. I want to tell you that it just isn't possible. I'm not going to cure in a speech what we do in substance. There are concerns about the direction of policy and there's a lot of confusion. I'm not saying speeches aren't important or statements aren't important. But people who want to believe black aren't going to believe white when we make a speech. A sense that we're giving up will contribute to higher interest rates rather than lower interest rates in the long-term area. And what happens to the monetary aggregates may have something to do with that, too. I'll just give you a case in point. I did make a speech last week in which I said the money supply, I hoped, would go up. I had expected it to go up; I had in mind that we probably would be pushing it up if nothing else happened. And interest rates promptly went up.

MS. TEETERS. So did the money supply.

CHAIRMAN VOLCKER. Well, I knew the money supply was going to go up for a week when I made the speech. But I thought the reaction we were going to get from that increase in the money supply was going to be an increase in interest rates in the short run. That's partly why I said it. [I figured] we might as well get it in reaction to the speech instead of in reaction to the number. All I'm saying is that the market is going to react in its own way to some extent regardless of what we say, however important what we say is. Just don't be under any illusions that we can reverse attitudes by making a statement.

When we look at the more specific decisions we have to make, I would just make a couple of comments that I think perhaps were not adequately reflected in the earlier comments. Presumably these ranges that are set down and their accompanying federal funds rate ranges reflect our best professional judgment--I'm speaking in a corporate "we" now--as to what a consistent relationship is. I have expressed before my underlying skepticism about the accuracy of these kinds of projections. I have not lost my skepticism. All I say is that we don't have much to go on in this area and this presumably is the best judgment that Mr. Axilrod and his cohorts have made about what level of the federal funds rate is consistent with the targets that he's presented. Secondly,--

MR. PARTEE. Following up on April!

CHAIRMAN VOLCKER. Having made the best judgment, that's exactly right. I yield to nobody in my skepticism about these things. I am equally skeptical of anyone else's projections--maybe even more so, if that's possible. The point has been made by several people that the ranges are in fact ranges. Nobody has ever committed, at the extreme, to meeting the midpoint of a range. The thing that preoccupies me a little here--and I recognize that this is also the staff's best professional judgment--is that the M2 and M3 figures are not as bad, in the sense of a decline, as are the M1 figures. We've been putting an awful lot of weight on M1 because we get it weekly and it's a more immediate operating variable. But we used to do an awful lot of talking about how important M2 and M3 were; and a lot of people

thought they were more significant [than M1]. I suspect, if we are relaying suspicions, that if have growth in M1 of the magnitude indicated in the Bluebook for either of the [alternatives], that growth of M2 is going to be higher than growth of M1. But they're [projected to be] practically the same. I suspect, particularly if it does turn out that interest rates are lower, that there could be quite an inflow into savings forms that would produce a somewhat higher figure for M2 than for M1. And we don't have to do all that much better on M2 and M3 to be within our ranges. In fact, M3 is projected to be within its range in May.

MR. AXILROD. I should add, Mr. Chairman, that our long-run forecast, of course, is for interest rates not to be lower but actually to edge up.

CHAIRMAN VOLCKER. Yes. So, these may well be consistent under that kind of projection of interest rates. But if interest rates in fact turned out to be lower, which is the gut instinct of a number of people around the table and a gut instinct that I can understand, I think we're going to find that M2 and M3 are running better than shown in the projection. We could clearly end up in a situation where M2 and M3 are pretty much, let's say, around the midpoints of their ranges and M1 is running quite soft. I don't know how one reconciles that even if our targeting allows for [differing] weights and all we look at is the targets. We have to balance the desirability of meeting these targets against some sense of what the attitudes are toward what we're doing in the short run and over time. That has been amply discussed by various people already, and we have come out with somewhat conflicting views about what that means for policy.

I'm told that you have a revised first-quarter GNP figure, Mr. Kichline, which you might as well throw into the conversation.

MR. KICHLINE. The revisions came out this morning. The Commerce Department had previously indicated that real GNP rose 1.1 percent in the first quarter; they now indicate the rise was 0.6 percent. Final purchases are roughly the same at a 1-1/2 percent rate of increase. And now there is indicated to have been a small liquidation of inventories in contrast to a small accumulation. I would only note that the composition has changed a fair amount, but in general final purchases are where we thought and inventories are a bit lower.

CHAIRMAN VOLCKER. I'm not sure that that really changes anything. Maybe it's good that inventories are a little lower. I do think, in making a specific decision, that we have a technical problem in the sense that we are in unknown territory when we are dealing with the possibility at least that we're not going to have any borrowings, which is about where we are at the moment. In one sense, I suppose that could be an advantage. If we don't have any borrowing, we know that the nonborrowed reserves are going to be the reserves. And if we put out the reserves, presumably the money supply should follow-- overlooking a few multiplier difficulties and all the rest--in time. But it also creates the problem that we may have a vacuum in the market for the federal funds rate between wherever we are and zero. And the question arises as to whether we really want a vacuum between 10 percent and zero. Nobody [has proposed] going quite that far.

Well, Mr. Roos came pretty close; we could at least split the difference.

MR. PARTEE. I didn't specify [a fed funds range].

CHAIRMAN VOLCKER. More than one may not have specified.

MR. PARTEE. I think zero is a bit of a possibility, unless we constrain the funds rate.

CHAIRMAN VOLCKER. The point of this is that there is a good chance that at least in some weeks--for more than an isolated week as some of you [have suggested]--the lower end of the federal funds range will become a constraining influence on the speed with which nonborrowed reserves are provided. That depends in part, of course, on precisely where the path is set in the short run, and these tables on page 7 aren't very enlightening in that respect because the--

MR. MAYO. I suppose also we could cut the discount rate, Mr. Chairman.

CHAIRMAN VOLCKER. You know, I'm not even sure how relevant that becomes in these circumstances. We just don't know. I don't know whether or not \$1 billion of excess reserves and a 13 percent discount rate will give us a federal funds rate of 7 percent instead of zero. We really are in an area of unknown relationships at the moment. I would judge that nobody is going to be very concerned if M1 or any of the Ms increased quite rapidly in the short run. I'm thinking of the situation where we have a higher increase in the money supply than currently projected over the next few weeks and it might be incorporated in a path that ran through September or December, whatever point we picked. If we began in the short run to run above that path and we mechanically applied [our procedures], we would drive the federal funds rate up in the short run. As I interpret the discussion, [we would not want our decision] to lead to that kind of conclusion. That is, if we can pick up some money supply in the short run without raising interest rates, nobody is going to be very sad about that. I'm not sure that's going to happen, but if it does, I don't think people want [to see rates rising]. I don't know what that says about the top end of the funds range. But in that event I don't think people are contemplating that the federal funds rate would go up to 14 percent, the top of the range as set forth here, even though a very literal path approach might produce that result. Maybe I just ought to pause and see whether that's a common agreement.

MR. PARTEE. The question is: What do we do with that \$850 million shortfall in reserves? That's money in the bank, I might say. Do we first permit an \$850 million increase?

CHAIRMAN VOLCKER. Well, that's one way of putting it. In a sense, that would make up [for] April and nobody would be much disturbed about it. Putting it extremely, I would begin to get disturbed by an 18 percent increase in the money supply in one month.

MR. WALLICH. And the associated move in the funds rate. If we put in the \$850 million regardless--

CHAIRMAN VOLCKER. No, I'm not saying put it in regardless. I'm just saying if it happens to arise now. I don't think that's going to happen and perhaps we don't have to look at that extreme. But in essence what I'm saying is that we would permit some of that \$850 million to be made up without any concern.

MR. AXILROD. I would interpret that operationally, Mr. Chairman, as meaning that if it so happens that required reserves in the first two or three weeks of this forthcoming period come in significantly higher than these paths call for, that we should adjust the nonborrowed path up, given that [earlier] shortfall, in order to avert a rise in the funds rate immediately.

CHAIRMAN VOLCKER. A rise in the funds rate of real significance anyway. I'm talking about it going up to 13 or 14 percent or probably even 12 percent. That's a--

MR. ROOS. Mr. Chairman, are we as a Committee accepting the conclusion that we really see great dangers in freely rising and freely falling interest rates? When interest rates went way up, did that cause disorderly markets?

CHAIRMAN VOLCKER. Yes.

MR. ROOS. Did it really? Didn't the markets adjust to it? I hate to see the stock market go down or up. But why is that different than the interest rate markets?

CHAIRMAN VOLCKER. Well, I'm not sure I have to argue that point at great length. What I'm saying, approaching it from a different direction, is that we don't have to resist some recovery from the shortfall in the aggregates that we've already had.

MR. WALLICH. With all the concerns I have, I wouldn't want to see interest rates jump up now. I think people, at least people abroad, would think that we've really gone haywire.

CHAIRMAN VOLCKER. We'd have a different situation if we were within the target range or high in the range and the funds rate jumped up. That's not the situation I'm talking about. Then we might well say okay, interest rates have to rise. But we've had a big shortfall.

MR. ROOS. Do you feel in your contact with the public, Paul, that nobody out there knows that we are no longer trying to control or stabilize interest rates? Hasn't that message reached anyone overseas or here or anywhere?

CHAIRMAN VOLCKER. I think it has reached quite a few people. But we have a skeptical audience out there. Some people would say, if they saw the money supply going up and interest rates went up: "Oh, your policy has gotten easier." They will pick whatever variable they want to pick at the moment to attack us if they're skeptical to start with. I don't think we can completely win in this game. I suppose nobody attaches a very high probability to the contingency I just described, but we constantly are surprised. And I think Steve's conclusion from my general comment is probably what we would do mechanically. We would just in effect start from a higher base,

feeding out reserves within some limit--in a sense within the \$850 million that we're behind--should that happen.

Before we get to the precise numbers, this does imply that if we operate on a path--let's say "A" or "B" at this point--and we don't have any borrowings, our [instinct] is that if the actual Ms come in below whatever path is set, we may have some excess reserves and may be pushing down the funds rate. The question then becomes: How far do we want the funds rate pushed down? The differences between "A" and "B" are not all that great in terms of the short-term fluctuations we [typically] have, or could easily be exceeded by random fluctuations. The funds rate constraint may become much more important than which precise path is chosen in the short run. But we are biasing the chances of meeting the bottom end of the funds range. I myself would not want to bias it strongly toward constantly running into excess reserves of big amounts if we can avoid it at this point, so that we're constantly operating on a funds rate constraint. Given that we're not forsaken to meet the midpoint of a range--and certainly given a feeling that if the funds rate goes down, M2 and M3 probably will be stronger than projected and they are not all that far below the ranges now--I would not set the short-run M1 and M-1B targets as high as in "B."

MR. PARTEE. For the two months, for May-June?

CHAIRMAN VOLCKER. I'm just talking about May-June at this point. As everybody has indicated, the critical point is going to be that funds rate constraint. We have the opportunity for consulting on that as time passes but I want to get some general sense of what seems appropriate at the moment. We've been operating at 10-1/2 percent; that's being threatened now. Given a balance of all the risks and forces, I think we're talking clearly about something below the present constraint. I feel that 10 percent is rather close to the present constraint and that we can live with a constraint lower than that. Whether we want to go all the way to 9 percent is a question of how much we want to consult. I would be concerned at the moment about going below 9 percent. I'd feel a little more comfortable, at least for an interim period, if we could adopt a technique [similar to what] we used at the last meeting by putting in 9 percent or something like that with some understanding that if it went below the 9-1/2 to 10 percent area, let's say, we could have a telephone check to discuss whether, or at least how promptly, we wanted to go to 9 percent. Nine percent doesn't bother me particularly, and we have six weeks until the next meeting. That's a long period of time, and maybe we will want the funds rate to go below 9 percent before that next meeting. But as a judgment sitting here at the moment, recognizing that we're at 10-1/2 percent, I think 9 percent would be a pretty big move in the market's perception. It may not be too big in terms of the objectives for the aggregates that we want to reach over a period of time. That may be a reasonable answer: Putting in 9 percent now, recognizing that it can always be changed with some check in the form of a consultation when it's [somewhat] above 9 percent. Every time we've had these consultations we have withdrawn the funds rate constraint. I would think that is likely at these levels in the future, too, but it may be useful just to have the opportunity to check. We really haven't had any [occasion] since last October where we have let the federal funds constraint persist for any period of time. But that does not mean that there isn't a certain amount of comfort, I suspect

to all of us, in taking a look at it when it passes some point that is considered significant to some of us or to all of us.

VICE CHAIRMAN SOLOMON. I interpret what you're recommending to mean that we will take a look at it when it reaches 9-1/2 percent before a decision would be made to move down to 9 percent. Is that what you said?

CHAIRMAN VOLCKER. Yes. That is what I'm suggesting on the funds rate. On the aggregates target, you now have a projection for May and June of what specifically, Steve?

MR. AXILROD. Of essentially 4 percent for May and 10 percent for June--an average of 7 percent.

CHAIRMAN VOLCKER. That comes close, in one sense, to alternative A. That could be biased up a bit, but that's the actual projection now. It may be consistent to bias that up a little in terms of the federal funds constraint that we're talking about--to have a higher federal funds constraint for a slightly higher target through December.

MR. RICE. Mr. Chairman? Could I raise a question about the target range and the target itself? It's my understanding that while we set these targets in terms of ranges, we set our objective toward the midpoint of the range, the implication being that if it got above the midpoint we'd be a little nervous and if it got below the midpoint we'd be nervous. I sense now some fudging of this objective of trying to hit the midpoint of the range. I hear people say it's not the midpoint that's so important as long as we're within the range. That's not my understanding [of what we decided earlier].

CHAIRMAN VOLCKER. Well, I can only answer for myself. Everybody probably has his own opinion; that's how we get agreement on ranges. That midpoint is the central tendency of what we're looking for when we set the range. That doesn't say, now that it's five months later--and, of course, we'll look at these ranges again in July--how individual members of the Committee may feel in the light of what has happened in those five months. They could feel more comfortable being in the upper half or the lower half or whatever. There is no feeling, certainly in my mind, that there is something magic about keeping a precise midpoint as an absolute target throughout the year. Otherwise, we might as well just set a point target and not even look at it in the middle of the year.

MR. RICE. I'd say it's a matter of the point at which one begins to get nervous.

CHAIRMAN VOLCKER. I would say that, certainly, the month after we set the target almost any deviation would make one "a little nervous," in your terms. But I don't think that's inconsistent with someone saying six months or eight months later that in the light of everything that has happened over those months, he might be nervous about hitting the midpoint. He might prefer to be above it or he might prefer to be below it. I don't remember the exact circumstances but I do remember that in October we said we wanted to come within the range. At that point we had in mind the upper end of the range, but nine months had passed [since we set the target for 1979]. And I

don't think anybody, if they felt nervous at all, felt that being in the upper part of the range was too high, even though it was the upper part and not the midpoint of the range that had been set nine months earlier. I think that's natural.

MR. RICE. I was thinking about what we decided within the last two or three months.

MR. PARTEE. I think it's true that in the last two or three months we've consistently thought the midpoint of the range remained about appropriate. There is a question now, after the big shortfall in April--a much bigger shortfall in M1 than M2 or M3. I don't view it as a betrayal for somebody to say that under all the circumstances he'd now feel more comfortable with growth in the lower part of the range. Indeed, next month we get an opportunity to change the range entirely.

MR. WALLICH. This is the practice of most other central banks. They typically, though not always, state ranges; sometimes they aim at the upper end and sometimes they aim at the lower end. The Swiss do it differently, but the British, the Canadians, and [unintelligible] use a range.

MR. PARTEE. It's done partly so there is a chance of being within the range. If we have a point target, we're going to miss it.

MR. RICE. I understand that.

MR. PARTEE. But it's also true that we can say that it depends on circumstances where within the range we want to fall.

MR. RICE. It's a question.

CHAIRMAN VOLCKER. I'm saying that it's more than giving ourselves a safety margin. We may change our emphasis as the year passes. Let me try to be more specific, just for operating purposes. I'm proposing setting a short-term range that is probably more consistent with "A" than with "B" for the next six weeks, but with a caveat which is more consistent with "B" than with "A." That is, if things developed in a way that M1 began exceeding that short-term range, we would not resist it. We'd even go beyond the implied "B" in the short run without forcing a significant level of borrowing under those circumstances. It's an upwardly biased "A," so to speak.

VICE CHAIRMAN SOLOMON. Is that what you call being specific?

CHAIRMAN VOLCKER. Yes.

MR. ROOS. Mr. Chairman, doesn't the Desk have to know what we're shooting for in order to [operate]? Do they just sit there and see what happens out in the wild blue yonder and then try to do something cosmetically to make it appear we've achieved that? Don't we have to give the Desk certain specific instructions?

CHAIRMAN VOLCKER. Mr. Axilrod will now interpret the instructions.

MR. AXILROD. Well, if I understood the Chairman correctly-- and taking a number for purposes of an example--if the Committee said to focus on May-June at something like a 7 percent growth for M-1A but tolerate higher growth in view of the [April] shortfall, we would set a total reserve path consistent with that 7 percent and a nonborrowed path roughly equal to the total reserve path because borrowings are at minimal levels. If in the very short run deposits turned out to be stronger, we would raise the path because the Committee said it is willing to tolerate stronger deposit growth. We wouldn't try to keep to this original path set on 7 percent if higher growth, within the Committee's own tolerance ranges, suddenly began to develop. So, we would raise the reserve path in order to [accommodate] that. On the other hand, if the aggregates turned out to be significantly weaker, we would not lower the reserve path. We'd still shoot at the nonborrowed and total reserve paths but that might then call the bottom of the funds rate range into question fairly promptly, which would require Committee [consultation].

CHAIRMAN VOLCKER. We may have constraints that are inconsistent when we complete the story, and Mr. Axilrod has just completed it in effect. We're saying: Provide enough reserves, which we can do reasonably accurately now because we don't have any borrowings, to meet the base objective; we will tolerate an overshoot of that. When we get to the undershoot question, we're going to be constrained, potentially. If the actual level falls below that path, the question is whether we're going to be constrained by the [lower limit of the] federal funds range. On that I'm suggesting 9 percent with a check at 9-1/2 percent. And it may well be that either an overshoot or an undershoot is going to run into a constraint that the Committee will want to resolve. We do not have a set of specifications that permits the Manager to operate freely between the meetings without potentially running into an inconsistency. I expect we will be better equipped to resolve an inconsistency later rather than now, should one arise. And one could quite well arise.

MR. PARTEE. I think we're going to hit the funds rate constraint this week.

CHAIRMAN VOLCKER. Do you mean by this statement week?

MR. PARTEE. Yes, this coming week.

CHAIRMAN VOLCKER. Well, in the coming week we might.

MR. PARTEE. We'll be right down on 9 percent and we'll be below the target growth and will immediately face the problem. We just don't have any room, given the weakness in the economy.

CHAIRMAN VOLCKER. Well, you're making a guess about what is going to happen. That's not Mr. Axilrod's conclusion but you may be right. I won't say you're not right; it could well happen that way. If it does happen that first week, we have the constraint and presumably at the end of the week we will have to face it. If we operated a full week under the constraint, then we'd have to consider whether we wanted to operate another week under the constraint.

MS. TEETERS. Wouldn't it be wiser to make the funds rate range wider, but with the idea that if it hit certain points we would

consult before it goes down? Make it 8 to 14 percent so we'd have a full range of 6 percentage points. The presumption is that it's going to go lower, not higher.

CHAIRMAN VOLCKER. Well, again, that's your presumption. And it is the presumption of a lot of people around the table. It doesn't happen to be the presumption of the people who [constructed] the table [in the Bluebook]. I tend to agree that it might happen at least in a number of weeks, but I--

MR. PARTEE. Paul, it seems to me that the whole idea of moving toward aggregates was to create a situation where we wouldn't have to depend on presumptions. I'm not saying that Steve is wrong but the whole idea of having a wider range is to make it possible to flex as developments occur, without depending on a staff forecast.

CHAIRMAN VOLCKER. Yes, but we've just--

MR. PARTEE. I guess what you're saying is that you don't want to flex below 9 percent.

CHAIRMAN VOLCKER. That, I think, is the substantive issue.

MR. PARTEE. And I'm saying I do; so we're in fundamental disagreement.

MR. MORRIS. But you also don't want to flex above 12 percent do you, Paul?

CHAIRMAN VOLCKER. No.

MR. MORRIS. So why have a band higher than 12 percent if we wouldn't tend to implement it?

CHAIRMAN VOLCKER. It's a visual matter of which we want to put in. It's implicit in what I said earlier: Unless we have really explosive growth in the money supply, we're not going to resist it.

MR. BLACK. We have very little basis for knowing where the lower level ought to be, or the upper level really. The problem is likely to be on the lower end, but it could be on the upper end.

CHAIRMAN VOLCKER. It's going to be a while before it's the upper end if we adopt the bias that I suggested. It has to be several weeks anyway, I suspect. It would take a couple of weeks of \$5 billion increases.

MR. BLACK. That's probably right. I'd hate to see us narrow that, though, while we had an 8-1/2 percent--

CHAIRMAN VOLCKER. The substantive issue is how low one is prepared to see the funds rate go, or how high--though [not] many people think the latter is a real problem--in the particular circumstances.

MR. MORRIS. The advantage of your [proposed] checkpoint is that we will have a chance to observe how the foreign exchange markets

are responding and how the data are coming in. And we do have a long period between meetings.

MR. ROOS. Mr. Chairman, in that one week that might elapse prior to our consulting, couldn't a lot of potentially damaging work be done by the Desk? In other words, if they're bumping against the bottom end [of the funds range], couldn't they be pulling out reserves and couldn't that exacerbate the recession and make us look bad?

CHAIRMAN VOLCKER. It depends upon your view--whether you think we're going to look bad if the federal funds rate drops to 6 percent one week and goes up to 9 percent the next.

MR. PARTEE. Well, we have had a run of minus numbers on the aggregates. I'm inclined to agree with Larry. Adding another week to the extreme rate of decline will make us look much more like the Open Market Committee of 1930.

MR. WALLICH. I think Tony Solomon's point about not getting the interest rate below the rate of inflation is relevant, even though we are talking about the funds rate. Also, even though I realize all of us don't have a vote on this [Committee], I think you should be aware that the International Monetary Fund in its consultations with the U.S. [representatives] criticized us for the rapid declines in interest rates and also for going to rates that, as they said, are in all probability no longer positive in real terms. They said that would seem inappropriate. So that is a judgment of technically oriented people who believe that we should not go--

MR. PARTEE. Come on, you mean [unintelligible] said it.

MR. WALLICH. We are members of this institution, and they apply the same rules to everybody.

MR. PARTEE. I understand they also told us that we should certainly achieve our aggregates objectives. They're just like the Joint Economic Committee.

MR. WALLICH. We can't ignore completely what others say of us because there are two sides to every exchange rate--our side and the others. This was a judgment that these people made, just as it could be the judgment of other people abroad, [because there are] consequences for the dollar and consequences for inflation.

MR. SCHULTZ. Amazingly enough, I find myself somewhere in between Governor Partee and Governor Wallich.

SPEAKER(?). You could still be wrong!

MR. SCHULTZ. I really am in the morass. They're on the mountain tops and I'm down in the swamp. What is the big difference among us if we're going to consult at 9-1/2 or 9 percent? I don't understand what the big deal is on whether we set the lower constraint at 9-1/2 or 9 or 8 percent. If we're going to consult each time, why can't we change it to 9 or 8-1/2 percent?

MS. TEETERS. There's a six-week [intermeeting] period. And it seems to me of great value to keep that range fairly wide because

then the unanticipated things will be automatically caught by the market.

MR. SCHULTZ. If you use that argument, you're not accepting the consultation part. If you accept the consultation part, I don't know why it makes such a difference.

CHAIRMAN VOLCKER. I think I'm talking with historical accuracy when I say that since October it has not made any difference what the federal funds range was, in fact, except that it triggered consultation. Consultation has been triggered either by informal understanding or by the actual range put in the directive.

MR. ROOS. May we ask Mr. [Sternlight] whether that's true? I'm not questioning what--

CHAIRMAN VOLCKER. I'm not saying that it couldn't [make a difference] in the future, but historically it has not.

MR. STERNLIGHT. It seems to me that when we had a 20 percent top, we were a little eager at times to put some reserves in when we were getting very close to that top.

CHAIRMAN VOLCKER. I think at the 20 percent top it had some influence. No consultation was called at one point. [The directive] called for putting the funds rate up to 20 percent and we just left it there. That's the clearest case, at the top, when [a consultation] was not called.

MR. PARTEE. Well, [we stopped] at 10-1/2 percent. Over the last two weeks we were way short on reserves and we stopped [supplying additional reserves] on account of the 10-1/2 percent.

CHAIRMAN VOLCKER. We were [not] short of the path at that time, I don't think.

MR. AXILROD. Well, clearly, we would have had to call a consultation on Thursday or Friday if a meeting weren't scheduled for today. We had a consultation the week before and that range then became a limiting factor.

CHAIRMAN VOLCKER. I don't mean to suggest that these ranges never were a limiting factor for a few days. I'm saying that as soon as they became a limiting factor for a few days we had a consultation and we changed [the range], with the possible exception of that 20 percent situation. We would have had a consultation if the 20 percent rate had lasted for another few days, I think, but the rate turned [down] before--

MS. TEEETERS. Yes, but at 13 percent we raised it last time [from] 11 to 13 percent and went a couple of days with the 13 percent.

CHAIRMAN VOLCKER. As I say, we've gone a couple of days-- three or four days at times or maybe a whole week--where the range has had some influence. Eventually we've had a consultation and the range has been changed. I don't mean to suggest it hasn't had some influence in the short run. All I'm saying is that when it has had a constraining influence long enough to [trigger] a consultation, we

have changed it. It may well have an influence this time, but what we're talking about is an influence for a week and then having a consultation.

MR. AXILROD. Mr. Chairman, I don't know if this would be helpful to Governor Teeters, but perhaps she's worrying that if the bottom of the range were stipulated at 9 percent rather than 8 percent it might be an inhibiting factor in the speed with which we approach the bottom of the range. I don't think it would affect operations. That is, we wouldn't try to hold the rate at 9-1/2 percent because the bottom of the range was 9 as compared with 8 percent. We'd go ahead and provide reserves until we hit the bottom and we'd have a consultation. It wouldn't inhibit the process of getting there.

CHAIRMAN VOLCKER. I don't mean to suggest at all that these limits, if we ran into them, would not be effective for some days until we consult. I'm just saying that every time we've had a consultation we have in fact changed the range. The history is one of not sticking to these ranges between meetings.

MS. TEETERS. Well, I'm reacting to Frank's point that if we vote [for a lower limit] too close to the 10-1/2 percent, we would be going back too rigidly to setting interest rate targets. I think market conditions are such that the market is more or less going to override us at some point, so we might as well have the leeway to ride with the market even if we consult on every half point as the rate goes down on whether we want it to move down that next half point. I just think we would look better with a wider range.

MR. BLACK. The range is being narrowed from [6 points] to either 5 or 4 points, which is a whale of narrowing.

CHAIRMAN VOLCKER. You're talking pure cosmetics--what appears in the record of this meeting. We're not talking about pure cosmetics when we're talking about what the bottom of the range should be because that may become the effective rate and we're going to have a consultation to see whether we want to change it.

MR. PARTEE. Well, I'd rather have the cosmetics look right and have a wider range and have an understanding that there is a touch point that we wouldn't go through without a consultation, if Murray will let us do that short of recording it in the Policy Record.

SPEAKER(?). Somebody tells me this is being tape recorded.

MR. ALTMANN. We have in the past had some reference [in the Policy Record] to the notion of a consultation but I think if [the understanding] were so specific as to be a checkpoint, it probably ought to be in the Policy Record.

CHAIRMAN VOLCKER. We actually did specifically have that? Was it for the last meeting or the previous meeting?

MR. ALTMANN. We didn't have a figure in the last--

CHAIRMAN VOLCKER. I don't remember [if it was] this last meeting or the meeting before, but we were rather specific about it.

MR. ALTMANN. Yes.

SPEAKER(?). We did it differently.

MR. PARTEE. Let me retract the word checkpoint. Can we say there's a zone through which we would not wish to pass without considering together the implications of such a passage?

MR. SCHULTZ. Would you refer to this as the twilight zone?

MR. AXILROD. I think if the Committee indicates as it passes through that zone that it doesn't see a need to change the fundamental range, Mr. Altmann might not view it as a vote that needs to be reported.

MR. ALTMANN. That has been the practice. I think if it gets to be regular, it probably should be a vote.

CHAIRMAN VOLCKER. I guess that is the difference. When we did it the other time, we did not vote. We had a consultation without a vote, right?

MR. ALTMANN. It was April 29th, wasn't it?

MR. AXILROD. Yes, [when the funds rate was] at 16 percent the Committee met and, though it met, it decided [to retain the range in] the directive.

CHAIRMAN VOLCKER. That's right, we didn't have a vote. I think that is the difference.

MR. PARTEE. And there was no vote on the 16 percent, as a matter of fact. It was just an understanding that at 15 or 16 percent, whatever it was--

MS. TEETERS. 16.

MR. ALTMANN. The point at which the consultation--

MR. WALLICH. Why don't you let individual members of the Committee call you when they think that Chuck's zone is being approached? And when more than half have called, you can call a consultation.

SPEAKER(?). What if he can't be reached, Henry?

MR. ALTMANN. The rules of procedure provide that three members can request that a meeting be called.

SPEAKER(?). Three members?

MR. SCHULTZ. He'll spend all his time on the phone!

MR. GUFFEY. Mr. Chairman, if I understand the way we have operated in the past, if we have a consultation and the rate is within the range established by the Committee, then no vote is taken at that consultation. Isn't that correct, Murray?

CHAIRMAN VOLCKER. I think that's what it amounts to.

MR. ALTMANN. There doesn't need to be a vote.

MR. GUFFEY. Well, I don't believe there ever has been one. There has only been a vote when we've lowered or raised the range from what the Committee set at the meeting. Therefore, I would be opposed to setting a range now with a lower limit below 9 percent. And I would also like the caveat the Chairman has put forth that there be consultation at 9-1/2 percent. At this point I feel fairly strongly that a federal funds rate below 9 percent would not be acceptable.

MR. ROOS. Mr. Chairman, I think it's more than the process. There is a very fundamental issue at this stage. The way this meeting is going and the way opinion is apparently evolving, we are getting right back to setting interest rate ranges and the stabilization of interest rates, and I could not go along with that. I think we're turning the corner, all for the worse, to right back where we were.

MR. GUFFEY. There is no compromise, either.

MR. ROOS. Right.

CHAIRMAN VOLCKER. We will unquestionably have a difference of opinion at that end of the table, anyway. But I think we've got to resolve it.

MR. BLACK. Mr. Chairman, there's another question we need to deal with, and that is whether we mention specific short-run numerical targets in the directive. If we narrow the ranges and don't mention any targets, it's going to be viewed as more than cosmetic when people find that out. I think they will conclude essentially what Larry has stated. I would urge us to put down whatever we agree to in the way of numerical targets rather than leave that blank and specify merely the federal funds range.

MR. PARTEE. We have been doing that, haven't we?

MR. BLACK. Yes we have.

MR. MORRIS. [I thought] 7 percent growth in M-1A was the target.

CHAIRMAN VOLCKER. Well, we have a [draft] directive that is written in more general language. I'm not sure I'm completely happy with it but I can't think of an alternative. Mr. Axilrod could not think of an alternative. If someone has a bright idea, we can--

MR. AXILROD. The alternative was to put down 7 percent, say, if that's what you voted for. It would be stated in the Policy Record very clearly that 7 percent was the target but that you would permit some overshoot. Our thought behind not putting specifically in the directive a number for growth over a two- or three-month period was that it would be better understood in the Policy Record where it would be surrounded by the analysis of the shortfall and all that. So we tried to phrase the directive to reflect what we thought the Committee might be trying to do in general, which was to [foster an increase] back into its range, and leave the specificity to the Policy Record.

We could put the specifics back in there, and they'd appear at the same time [as the directive was released as part of the Policy Record].

CHAIRMAN VOLCKER. The presumption was that the specifics that Steve had in mind would be in the Policy Record. The alternative was putting in at least 7 to 7-1/2 percent [in the directive] and some language saying that we'd tolerate some growth above that. Now, we're talking about the period before the next meeting only.

MR. AXILROD. Yes, that's the other thing that bothered me a little because [that would cover] only two months and that seemed like a very short period to focus on particular aggregates. It gives a sense of short-run control over the aggregates.

CHAIRMAN VOLCKER. I suppose we could say just what you have here: "In the short run, the Committee seeks expansion of reserve aggregates consistent with growth of M-1A...." Maybe we should leave out the "over a period of months." And then we can say that in the period before the next meeting, or over the two months, the aim will be to achieve growth of at least 7 to 7-1/2 percent with some tolerance for growth above that.

VICE CHAIRMAN SOLOMON. I think it's a bad precedent to start being that specific in the public record. I'm not arguing now for any particular policy. I'm just talking in terms of the long run.

MR. PARTEE. We're going to miss it, you know, one way or the other.

CHAIRMAN VOLCKER. We might miss it and, of course--

MR. PARTEE. We could say: "...seeks expansion over the next two months of M-1A, M-1B and M2 at rates high enough to promote achievement of the Committee's long-run objectives." It implies higher growth than the long-run targets without being at all specific about it.

MR. BLACK. We can say "growth over the first nine months of 1980" or something like that, essentially what we've done in the past.

VICE CHAIRMAN SOLOMON. I vote for keeping Steve's language. I think we'll get into less trouble later on.

MR. PARTEE. Well, it's really not at all specific.

CHAIRMAN VOLCKER. What was your language, Governor Partee?

MR. PARTEE. "Seeks growth in these aggregates over the next two months at rates high enough to promote achievement of the Committee's longer run objectives." Then we could [cite] the monetary growth over the first nine months of the year, or something like that.

CHAIRMAN VOLCKER. We'd have to put in some modifier about over what period of time, because otherwise it would sound as if in the next two months we are going to--

MR. AXILROD. Well, to seek growth over the next two months at a rate high enough to promote achievement of the Committee's long-run objectives implies the whole year. Or you could go to a nine-month [figure]. We were trying to avoid deciding at this point whether you were getting back in the range by September or December.

CHAIRMAN VOLCKER. Maybe it ought to be modified.

MR. PARTEE. I think we ought to be specific and say "promote its longer-run objectives for the year" or something like that.

MR. AXILROD. Yes, that's what we had in mind.

CHAIRMAN VOLCKER. Everybody has a gut feeling. My gut feeling is that we're going to find M2 and M3 coming up better than M1 in terms of the targets.

MS. TEETERS. Well, they did when the money supply was running so fast last summer. They've been within their targets all along.

CHAIRMAN VOLCKER. M3 has touched the upper end and the lower end, but has remained well within the [band] on average, which is more than M1 has done. Well, we have a substantive question to decide here. I take it that wording of the directive is reasonable?

MR. PARTEE. But we have to have point estimates for our growth targets for May-June in order to establish some reserve [objectives]. You never specified what you wanted those to be.

CHAIRMAN VOLCKER. Well, no I didn't.

MR. AXILROD. Those point estimates would appear in the Policy Record?

MR. PARTEE. No, for voting purposes.

CHAIRMAN VOLCKER. I'm saying 7 to 7-1/2 percent, I suppose, but with tolerance on the up side.

MR. PARTEE. What about M-1B?

CHAIRMAN VOLCKER. I'm just working off Steve's numbers. You had what--a little less than 8 percent for M-1B?

MR. AXILROD. Well, 7-1/2 to 8 percent [for M-1B] would be consistent with 7 to 7-1/2 percent for M-1A. And for M2 I would say 7-3/4 to 8-1/4 percent would be consistent.

MR. PARTEE. So you are going the alternative A route?

CHAIRMAN VOLCKER. This is broadly consistent with alternative A, with a willingness to overshoot.

MR. PARTEE. If fortune should smile on us.

CHAIRMAN VOLCKER. At this point I don't know what fortune is!

MS. TEETERS. What is the M2 consistent with that?

MR. AXILROD. Around 8 percent.

CHAIRMAN VOLCKER. We're talking about figures for the actual path. That's not quite the equivalent of the figures [mentioned here], which are for a longer period. We're just talking about now through the meeting date in July.

MR. PARTEE. Yes.

MS. TEETERS. Logic would have [unintelligible].

CHAIRMAN VOLCKER. In a completely symmetrical world, but I'm not playing in a symmetrical world right now.

VICE CHAIRMAN SOLOMON. Well, you have taken the fed funds range that is consistent with the staff's alternative B.

CHAIRMAN VOLCKER. With "B." That is correct.

VICE CHAIRMAN SOLOMON. In fact, if you want to make the switch, I think we could do it the other way.

MR. PARTEE. And you want to put in a 9 percent funds rate with consultation at 9-1/2 percent, did you say?

CHAIRMAN VOLCKER. Yes, [we'd consult] before we get there, figuring that that's more than a full [percentage point] drop in the federal funds rate. It may well come next week. I don't know for sure whether it will. It will depend on what our money supply figures show, so we don't know yet. And the significance of what rate we put in there is probably what Roger said--it [determines] when we need a formal vote of the Committee to lower the rate as opposed to a consultation. Well, let's just try it out.

MR. PARTEE. A show of hands?

CHAIRMAN VOLCKER. Yes, a show of hands on acceptability is what we're looking for at this point. Are the specifications clear? These do not appear in the directive, [except] the one for the federal funds range. On the others, we have the general language in the directive. We have a reserve target which we expect is almost certainly consistent with no borrowing, with tolerance on the up side because if some borrowing developed, we presumably would raise the path. So unless we have an extremely strong rebound in the money supply, we're talking about no significant borrowing during this period--only frictional levels of borrowing. Let me just try the 9 percent [lower limit for the] funds rate. I don't think the 14 percent [upper limit] is real, but let's maintain it for visual [purposes]. What is the range now? I don't even know.

MS. TEETERS. It's 10-1/2 to 19 percent.

CHAIRMAN VOLCKER. We still have 19?

SPEAKER(?). We lowered that.

MR. PARTEE. No we didn't; it was only [lowered from] 20 to 19 percent.

CHAIRMAN VOLCKER. Well, we're making this tremendous 5 percentage point drop in interest rates, Larry! It's an enormous tolerance, which we really--

MR. ROOS. In other words, we're narrowing the range significantly, Mr. Chairman.

SPEAKER(?). We're back to where we started out in October.

CHAIRMAN VOLCKER. How many find that acceptable? One, two, three, four, five. I thought it was you who proposed it, Emmett?

MR. RICE. No. The funds rate range is what I proposed, but not the money growth target.

CHAIRMAN VOLCKER. You want a higher path?

MR. RICE. Yes.

CHAIRMAN VOLCKER. The [problem] is that [a higher path] is inconsistent with this funds rate.

MR. RICE. I want alternative B both with respect to the aggregates and the funds range. I have accepted the funds range specified here as consistent with the [higher] growth ranges [of alternative B].

CHAIRMAN VOLCKER. We're not talking about this September/December question. We're talking about the rest of May, June, and the early part of July.

MR. RICE. I know, but that relates to whether we're going to get back [to the target range] in September or in December.

MR. PARTEE. You're taking it off of alternative A rather than alternative B.

MR. MORRIS. Also, an implication is that if the numbers come in higher, we are not going to push the funds rate up.

CHAIRMAN VOLCKER. That is correct. Well, who has an alternative?

MR. PARTEE. My alternative would be to raise the point [targets] for M-1A, M-1B, and M2 to make them essentially the midpoints between alternative A and alternative B for the 2-month period and to establish an 8 percent lower end on the funds rate rather than 9 percent. That would be my suggestion.

MS. TEETERS. Quick consultation, say, at 9-1/2 percent?

MR. PARTEE. We would be reviewing it. The Chairman could call for a telephone conference as we got down into the lower end of the funds range, yes. I wouldn't want to be too specific because Murray might make us put it in the Policy Record. But the Chairman

could have a call at 9-1/2 percent, as the rate was moving from 9-1/2 to 9 percent, with an 8 percent limit on the published range.

VICE CHAIRMAN SOLOMON. I don't think that represents a reasonable compromise. I am sympathetic with the Chairman's need to form some kind of consensus, given the difference in views. That tips it very heavily toward the view you expressed earlier, Chuck; it's not a reasonable compromise.

MR. PARTEE. Well, I'd compromise between alternative A and alternative B. I spoke in terms of alternative B. I would rather have a funds rate of 7 percent; I just specified a funds rate of 8 percent. I compromised compared with what I would otherwise have done. He asked if there were any suggestions and that was my suggestion.

MS. TEETERS. Another thing we can do to compromise further is to take your specifications of 7 to 7-1/2 percent and so on for the Ms and to make [the funds range] 8-1/2 to 14 percent.

MR. SCHULTZ. With consultation at 9-1/2.

MS. TEETERS. With consultation at 9-1/2.

MR. SCHULTZ. I could go that far.

VICE CHAIRMAN SOLOMON. Your proposal, Nancy, says what about the aggregate targets?

MS. TEETERS. The aggregate targets would be 7 to 7-1/2 percent for M1, 7-1/2 to 8--

CHAIRMAN VOLCKER. Everything is the same with an 8-1/2 percent [lower limit on the funds range] instead of 9.

MR. PARTEE. I couldn't accept that.

MR. SCHULTZ. I think that's good; I would go with that.

MR. ROOS. I can accept Chuck's, but I couldn't accept 8-1/2 percent. It looks like fine-tuning.

VICE CHAIRMAN SOLOMON. I'd go along with that in the interest of a consensus.

CHAIRMAN VOLCKER. Well, that's about as far as I can go. Let's try that one.

SPEAKER(?). Chuck's was 8 percent?

MR. PARTEE. We're voting on Paul's specifications [with a] drop in [the lower limit on] the funds rate to 8-1/2 percent?

CHAIRMAN VOLCKER. Should we put that one to a vote?

MR. GUFFEY. This is with consultation as we approach 9-1/2 percent?

CHAIRMAN VOLCKER. We'll see whether Mr. Axilrod's judgment here is correct.

MR. ALTMANN.

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

It's 9 for, 2 against.

CHAIRMAN VOLCKER. Okay.

END OF MEETING