

Meeting of the Federal Open Market Committee

July 16-17, 1984

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, July 16, 1984, at 3:00 p.m., and continuing on Tuesday, July 17, 1984, at 9:30 a.m.

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

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

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

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

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

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Promisel, Senior Associate Director, Division of
International Finance, Board of Governors
Mr. Gemmill,^{1/} Staff Adviser, Division of International
Finance, Board of Governors
Messrs. Madigan ^{2/} and Rosine,^{2/} Economists, Division of
Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant,
Board of Governors

Messrs. T. Davis, Keran, Scheld, and Ms. Tschinkel,
Senior Vice Presidents, Federal Reserve Banks of
Kansas City, San Francisco, Chicago, and Atlanta,
respectively

Messrs. Broaddus, Burger, Fieleke, and Meek, Vice Presidents,
Federal Reserve Banks of Richmond, St. Louis, Boston,
and New York, respectively

Ms. Meulendyke, Manager, Securities Department, Federal
Reserve Bank of New York

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July 16--Afternoon Session

CHAIRMAN VOLCKER. I don't know whether you've had a chance to meet all these people yet, Ms. Seger. We can make our introductions afterwards, but we welcome you to the meeting.

We don't have a coffee break this afternoon, I guess.

MR. BERNARD. There is coffee out there.

CHAIRMAN VOLCKER. Don't tell them that! We will proceed. We need the minutes approved.

MR. MARTIN. So moved.

VICE CHAIRMAN SOLOMON. Second.

CHAIRMAN VOLCKER. Without objection, they are approved. We will turn to Mr. Kichline.

MESSRS. KICHLINE, ZEISEL, TRUMAN, and PRELL. [Statements--see Appendix.]

CHAIRMAN VOLCKER. I have a sense that the inflation forecasts from people sitting around this table are considerably pessimistic relative to what has happened recently.

Let me ask a question about this debt number. I don't know how you figure all this; I'm sure you don't have any very precise way of allowing for the mergers. Suppose you did this differently--or this may be what you did--and included the normal level of stock financing in the numbers, whatever it is. What would these ratios look like relative to [the normal] experience?

MR. PRELL. Ratios? Are you referring to the bottom panels?

CHAIRMAN VOLCKER. Well, I'm looking at the bottom panel but that doesn't give me the answer. Suppose this measure that we use were not net domestic credit or whatever we call it but net domestic fund raising.

MR. PRELL. That is, of course, what I plotted in the bottom left panel. That is both debt and equity. So that is the total funds raised or the total external financing.

CHAIRMAN VOLCKER. But would these lines go below zero? Shouldn't the red line have gone all the way to the bottom in some sense?

MR. KICHLINE. Are you looking at the first chart in Mike's presentation?

MR. PRELL. Are you referring to the nonfinancial corporations?

CHAIRMAN VOLCKER. It doesn't make any difference what chart I'm referring to.

MR. PARTEE. I think he has a point.

MR. PRELL. The way we got the adjustment, in essence, was to make an estimate on the basis of all that we know about the equity flows and all the merger activities. And we came up with a net equity absorption number. There was a net decline in equities of something like \$60 or \$65 billion in each of the first two quarters. We then would hypothesize that, in the conditions that prevailed, that would be the relevant number. We know that new equity issuance is something slightly positive--say, on the order of \$10 billion. So, the [gross retirement] is on the order of \$70 or \$75 billion.

CHAIRMAN VOLCKER. That's what you subtracted?

MR. PRELL. That's right--a number of that magnitude. It would be a shade over a percentage point of the total debt flow.

MR. BOEHNE. How do you read the chart at the bottom on nonfinancial corporations when you have equity in the negative?

MR. PRELL. Well, that shows that net equity liquidation is about \$60 to \$65 billion by our estimates. Then the borrowing is the total height of the red part.

CHAIRMAN VOLCKER. The borrowing must be the total amount of the red part.

MR. PRELL. That's right. This [chart] is defective. I'm sorry. The total funds raised is the height and the borrowing really should be the entire length of that bar. That is not properly plotted.

CHAIRMAN VOLCKER. Now, all I asked was: If you took both of those together and had some base--I don't know if you used it correctly--what would the percentage increase there be?

MR. PRELL. If you put them both together, it's 12 percent. The debt was--

CHAIRMAN VOLCKER. It's 12 percent if you just apply it to a base of 10.

MR. PRELL. If there had not been any mergers, the debt presumably would have grown by 12 percent. I guess the right answer to your question is that the number would not be far different from 13 percent to the extent that equities are not a gigantic sum of the total liabilities in the economy. They are a significant part but the debt is much larger, so that absent the mergers you would have a figure approaching 13 percent, I think. I stand open to corrections. I'm having a hard time--

MR. CORRIGAN. Not absent the mergers per se. It's absent the stock [unintelligible] regardless of whether they came from mergers or something else. Then the number would have been 13 percent.

MR. GRAMLEY. If you put the market value of equities into it, you can't do that. You have to figure out what base to put in there; the amount of the base that's included is the critical issue.

MR. PRELL. That's the problem. That's one of the reasons we have not created a total financial aggregate. It's an arbitrary assumption.

CHAIRMAN VOLCKER. But you also have a distortion when you do it this way if in fact there is a lot of retiring of equity.

MR. PRELL. Well, that's what we've had this year.

MR. BOEHNE. I have a question on the chart that has the wage increases, which is about in the middle of the package. I keep reading these figures in the Greenbook that show wage increases around 4 percent or a little under or a little above. Yet everywhere I go in my District, except for the really hard-pressed manufacturing areas, 6 percent is the most common number. There are very few under that and most are over that; yet the national figures keep showing these relatively low rates. My District could be different or there could be some wide discrepancies among industries. Do you have any sense of how firm these numbers are?

MR. ZEISEL. Well, it's hard in any absolute sense to evaluate them. They have shown a reasonable pattern. There is no question that they have been remarkably optimistic in measuring the rate of [increase] and they have been somewhat lower than the employment cost index, which is another measure of wages and other changes for a broader group including supervisors and white collar workers. Those data have been showing something closer to the 6 percent rate. It's conceivable that this has a somewhat downward bias because it includes just production workers. Essentially, other than that, I don't have any basis for questioning them except that they look awfully good.

MR. BOEHNE. Well, my personnel department keeps coming back with these surveys and my research staff keeps coming back with these numbers, and there's a gap.

MR. ZEISEL. Yes, something of a credibility gap.

MR. PARTEE. A difference in objectives.

MR. MARTIN. Let me raise a question about your comment with regard to long-term productivity growth. I'm going to give you the Kendrick argument--you know whom I'm referring to--and then you shoot it down. The demographics are favoring productivity with regard to the age brackets, the experience of the labor force--women in the labor force having been on the job a while--and deregulation. Labor and management have negotiated quite a few work rule changes. [Management can say]: Work on this machine, work on that line, work on this shift, work on that shift. There has been a good deal of investment in business equipment, including computers. The computers may be a negative, but at any rate a lot of money has been spent on them supposedly leading to some kind of [increased] output. There is less environmental investment these days; there is not quite so much worry about what the smokestack looks like but whether or not there is

somebody working underneath the smokestack. Management attitudes are a little different; there is a younger breed in some cases. We have people who have experienced many years of slow growth and a couple of recessions that were close together. Supposedly there is some change in that. There is foreign competition. I could go on and on. But we have a whole number of factors that point toward getting back to the more historic trend in productivity--2 percent or whatever that is--and yet we seem to be gearing on the 1 percent. This makes a difference in unit labor cost, etc., etc. Can you help me?

MR. ZEISEL. It's another one of those things that are very difficult to grab hold of. Kendrick, I think, would be one of the first to admit that in many areas we don't have any very hard [data] that address the issue of productivity growth. He has demographics and he has a couple of other things, but when you cumulate them they only make up a relatively small proportion of the forces that really determine productivity gains. As you point out, productivity in the early postwar years of the 1950s was in the 2-1/2 percent range and there has been a progressive deterioration through the postwar years. How do we evaluate what we have? Obviously, productivity has a tendency to swing very wildly during a cycle. With real GNP increases of 9 percent we're going to have a different productivity performance than when GNP growth is 4 percent. First-quarter productivity appears to be at about a 4 percent rate. We have a model--I say this with a certain temerity--which attempts to characterize the cyclical behavior of productivity consistent with the trend; and the numbers that we are getting at the moment still appear to be consistent with an underlying trend in productivity, when adjusted for cyclical performance, in the 1-1/4 percent range. There is certainly reason to argue that there is the prospect for an improved productivity trend. That sort of thing takes time, however. The introduction of new technology, for example, has a marginal [effect]. It doesn't overwhelmingly change the character of the production process overnight. The effect of the maturing of the labor force again is a slow accretion in productivity. We just don't see enough solid evidence yet to convince us that a significantly higher productivity trend than we have been able to measure is warranted. I think we will know a great deal more within a few quarters when, in a sense, we have a fully matured cycle to look at. Also, by the way, when we have some revised GNP numbers in a few days they may tell us a slightly different story about productivity.

MR. ROBERTS. Isn't it true that up to now in this expansion, notwithstanding cost reduction stories and so on, productivity has gained less than in the average expansion in the postwar period?

MR. ZEISEL. Yes--that is, to the extent that it's consistent with a very slow rate of productivity improvement. In previous expansions over the postwar years the underlying productivity trend was substantially higher and, therefore, the cyclical performance was overlaid with a higher--

MR. MARTIN. I would suggest to you that a part of that is a lag phenomenon. That is, the economy took on so many employees so quickly here that even if these other factors that I cited were working toward a 2 or 2-1/2 percent productivity increase, almost 7 million people were hired in this past 20 months or whatever and--

MR. ROBERTS. Do you mean that the percentage gain in the labor force has been higher in this cyclical expansion than in the past?

MR. MARTIN. Right. It has.

MR. GRAMLEY. That's the converse of the argument that productivity hasn't gone up so much; those two are mirror images of one another. It's hard to use the one to justify the argument that productivity is going up faster than it really is. The reason productivity didn't go up so fast explains why we had such a big increase in employment given the rise in GNP. The rise in GNP in the first 6 quarters has been a little above average but not much. So, if you had that much larger increase in employment, it is precisely because the rise in productivity has not been so great.

MR. ROBERTS. Despite all the talk of cost reductions?

MR. GRAMLEY. I think the fact was that the recession phenomenon was one in which we had a better productivity performance than one could have anticipated, but there just wasn't any follow through, if the GNP statistics are right. Now, we may get a revision to the GNP statistics. But unless we get a marked upward revision, one has to hope for the future in productivity rather than pointing to something that's a fact now.

MR. MORRIS. The one piece of evidence we have that might lend some support to Pres's position--which I share, incidentally--is that we're seeing this enormous capital goods boom occur at a time when the cost of capital is extremely high. We discussed this
who is the head of a capital goods producing company had this answer: that we have been storing up technology in this country for the past ten years or so that hasn't been applied, and now when companies have the money to invest they find the productivity of the new technology is so high that they can afford it--that it makes sense to go ahead--even though the cost of capital is so high. But the fact is that if our corporations are making rational decisions, they are expecting extraordinarily high productivity from the capital in which they are investing.

VICE CHAIRMAN SOLOMON. How much does your inflation projection come down if we don't get the 15 percent dollar decline?

MR. TRUMAN. It would be about 1 percentage point off the four quarters of 1985. It would make very little difference for 1984 at this point but about 1 percentage point for 1985.

MR. PARTEE. If the dollar is held steady?

MR. TRUMAN. If we held it steady.

CHAIRMAN VOLCKER. You have it coming down pretty quickly.

MR. TRUMAN. Well, in '85 we have 15 percent [unintelligible] the first year.

MR. BLACK. Ted, is this off the deflator you are talking about?

MR. TRUMAN. It's not the deflator [where the decline would be] a little less because of the offsetting effect [of rising import prices]. This would be the CPE [deflator] or the consumer price index.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. That was the question I was going to ask, Mr. Chairman, but let me follow up on it. You are projecting a 15 percent decline in the value of the dollar. Are you expecting that to occur slowly over the next 18 months or are you expecting it to happen in mid-1985? What's your feel for that? Are we going to get a soft landing of the dollar?

MR. TRUMAN. We're projecting it to happen slowly but it's likely to happen by fits and starts. If you look at the chart on the dollar's rise, you see that it proceeded by fits and starts; so if and when it should ever start to decline, we might well see something like that trend line but find some jagged moves going down as we have had some jagged moves going up. In fact, we started one just after the last chart show.

MR. FORRESTAL. Could I just ask another question about the deficit? Your projection is for a deficit of \$189 billion in 1985. Does that factor in any deficit reduction measures by the Congress?

MR. KICHLINE. Not beyond the Deficit Reduction Act, which is on the President's desk and is estimated to be about \$15 billion of actions for 1985. It is expected that he will sign that and we assume that an additional \$10 billion will come out of further actions in the Congress, particularly in the area of the accommodation between the Administration and the Congress on defense expenditures. But our projection doesn't go beyond this \$25 billion area that most folks currently are talking about. If we had something major occurring in 1985, that is not captured.

MR. MARTIN. If the indexing stays in the statute, how does that affect things?

MR. KICHLINE. The personal income tax rates? That was not touched by this Deficit Reduction Act and is scheduled to take effect January 1, 1985. We estimate that to be worth about \$5 billion. Assuming that our price forecast of about a 4 percent rise is right, that would translate into a revenue loss for 1985 of about \$5 billion.

MR. MORRIS. But don't those numbers get very much bigger as you go out a few years?

MR. KICHLINE. That's correct. They grow over time.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. I have another question on the exchange value of the dollar. Some analysts believe that this recent action to eliminate the 30 percent withholding on foreign-owned U.S. securities

is cause for a renewed surge of funding for the United States to take advantage of. Is that likely to change your forecast of a 15 percent decline?

MR. TRUMAN. There may be some [effect], but I would not expect it to be substantial basically because most people could get into dollar-denominated assets on a tax-free basis already and there didn't have to be a withholding tax move in order to change that. My assumption would be that most major portfolios in the world already were into essentially tax-exempt dollar-denominated assets, so we would not get a move from nondollar- to dollar-denominated assets because of a change in the tax. There might be some marginal effect. Some people are pointing to Japanese pension funds as one area where the fact that there was withholding tax [was a factor] and they may have a preference for safer U.S. market-oriented instruments. Therefore, there might be a slight change in the portfolio between yen and dollars. But in general I think it would be unlikely.

CHAIRMAN VOLCKER. We learn from experience--and I have great sympathy--that nothing changes that 15 percent decline.

MR. TRUMAN. We'll fool you next time!

MR. PARTEE. Well, I was going to ask how come 15 percent? Last time you told us that it needed to drop 45 percent.

MR. TRUMAN. First installment!

CHAIRMAN VOLCKER. No, they have always said 15 percent.

MR. TRUMAN. [Unintelligible.]

CHAIRMAN VOLCKER. Do we have any other comments?

MS. SEGER. May I ask another productivity question? I haven't seen your model but I've been very interested in the productivity issue and I too have seen a lot of people with fundamentally different ideas about what is happening to productivity. Did your model forecast the size of the improvement of productivity last year?

MR. KICHLINE. Yes. Let me talk a little about this. I have been asking similar questions and probably have been living with these "models" more than Jerry. Essentially what we're talking about is, starting in 1980 and going forward, trying to explain or decompose actual productivity growth into a cyclical component and its long-term trend component. In the preceding period of the '70s, about 0.6 percent is the estimated trend growth of productivity. Now, a 1.1 percent--or with the revised data I think it's 1-1/4 percent--increase in trend productivity growth is very close [to the experience] quarter by quarter from 1980 through the second quarter of 1984. So, in a sense, that explains it; it does very well with that trend and a few other variables in decomposing the two components. So what we have to be looking for is [something] saying that this can't explain the total productivity growth, and we haven't really found that yet. I might say that the last four quarters changed a tenth from 1.1 to 1.2 percent, so it may well be that future observations will suggest that we're far off. But we're somewhat hesitant at the

moment because in fact we've done very well for the last three years. If a change is coming, it's really in the future. It's not in our reading of the past. There are other folks--productivity experts on the outside--who in looking at the past would argue the same. But there are many issues that suggest productivity trends may be in the process of change; that has not yet shown through and we would be the first to admit that.

MR. MARTIN. If you took some other period prior to the first oil shock--I don't know what period, but suppose you took 1965 through 1974 or something like that--what kind of independent variables would you get and what kind of model would that produce?

MR. KICHLINE. Well, you'd get the same sort of analysis, which comes up with trend productivity growth at 2-1/2 to 3 percent, depending upon the time period you pick. You mentioned the 3 percent number in the future. That really was [true], for example, for the period of the '50s and the first half of the '60s. Later on, and after the oil shock in particular, is when we found the dismal productivity growth. So, if we return to that--.

VICE CHAIRMAN SOLOMON. Well, we didn't have the drop in the dollar in our model and yet we come out with an inflation projection the same as the staff's. I guess that's at the low end, though.

MR. PARTEE. With no drop in the dollar?

VICE CHAIRMAN SOLOMON. With no drop in the dollar we came out about the same as the staff in our inflation [projection].

MR. GRAMLEY. One of the determining factors will be whether or not we get 2-3/4 percent real GNP growth fourth quarter to fourth quarter for 1985 or, let us say, 1/2 or 3/4 percentage point more. We're getting down into the range on the unemployment rate where that much additional growth, quite possibly, could trigger quite different responses in labor market conditions and wage rates than the staff has anticipated. Similarly, an additional half percentage point real GNP growth would result in maybe 1-1/2 to 2 percentage points [more] in manufacturing output and that gets the capacity utilization rate into a range in which we begin to have problems. So, while the staff's forecast might not be unbelievable in terms of internal consistency, a somewhat stronger economy can produce quite different results.

CHAIRMAN VOLCKER. What weight do you put in these remarkably low wage trends from the fact that the index that goes into wages is also remarkably low so far? I think for the past year or so the consumer price index W or whatever it's called [unintelligible] is fully 1 percent lower than the one that everybody looks at. And [the difference is] more than that this year.

MR. KICHLINE. Well, that's important. We do that exercise. I don't have the disaggregation in our [material here]. But it's very clear that the feedback effects from low rates of inflation and low COLAS do track into lower rates of wage increase. We do have that number, and maybe while I mumble here Jerry can find it.

CHAIRMAN VOLCKER. That index is going to reverse on us now, isn't it?

MR. KICHLINE. Well, that's correct--in our forecast.

MR. PARTEE. If mortgage rates rise.

MR. KICHLINE. That's right.

CHAIRMAN VOLCKER. It was going down while mortgage rates were rising because of this mix problem, I take it.

MR. KICHLINE. We don't have the COLA separately. I apologize. But that is important and, in any event, it does reverse.

MS. HORN. Mr. Chairman, on the subject of differences in forecasts, in Cleveland we have forecast a very strong underlying economy--stronger than the staff's--through the third quarter of '85 because of the assumptions. We make essentially no assumption about exchange rate changes; we have a five percent [decline]. But we made an assumption about fiscal policy that there would be a second down payment, if you will, enacted in the fourth quarter of this year or the first quarter of next year. And that would bite in the fourth quarter of '85. So then our pattern is a strong economy, not a slowing one--surprising us. We have a strong economy in 1985, growing at about a 4 percent real rate until the fourth quarter. That gives us an inflation projection very close to the staff's projection, but it does have the significant risk that the exchange rate correction, when it occurs, could bring about even more inflation. And we haven't really dealt effectively with the wage rate issue in our set of assumptions, and we consider that the other major risk besides the exchange rate.

MR. CORRIGAN. In terms of the task of sitting down and doing one of these forecasts twice a year, as Mr. Kichline knows, it is never very easy. From my perspective right now it's harder than it has been because on the one hand we have an economy that on the surface--by most indicators, statistical and otherwise--looks absolutely terrific. But underneath that gloss we have some very serious problems that seem to me on balance to be getting worse rather than better, and that colors my thinking about a forecast. For example, as Jim indicated, the Federal budget deficit in a structural sense continues to deteriorate in a very significant way and with nothing in sight that I know of that is going to change that. And Jim's estimate of the structural budget deficit next year of \$172 billion is literally off the scale of experience. Similarly, and again notwithstanding the spectacular performance of the aggregate economy, high interest rates are clearly placing very serious strains on selected classes of domestic and international debtors. The banking system, to put it mildly, is fragile. The conditions are affecting all sizes of banks and thrifts which, as Jim indicated, are now right back on the edge, if not worse. As for external trade, the financial position of the United States, which is helpful in some respects for us and for others, now leaves us highly vulnerable to the sudden and sharp fall of the dollar. Whether that will materialize, of course, is another question. From my perspective, looking at the first six months of this year, it seems to me that what we have on our hands is a good old fashioned credit binge--almost irrespective of which set of numbers we look at. They all say the same thing; and some of them relative to GNP or relative to inflation or relative to something are outside the spectrum of experience. Against that

background, as I said, I find it very hard to make a forecast. For what it's worth the forecast that I've come up with is one that shows the real economy a little stronger, by 1/2 point or so, than the staff has. I have no real good reason for that other than my sense of the sheer momentum that the economy has right now, notwithstanding the high interest rates.

In the inflation area, which I really think is the swing variable for 1985, I also found it very tough [to make a forecast]. In July of last year and February of this year, I had an inflation forecast that was very much at the bottom of the range of Committee members' forecasts. And I had it that way for two fundamental reasons. One was that I thought the economy was going to be stronger and at that phase of the cycle a stronger economy implied stronger productivity in a context in which wage restraint was still very much in evidence. Clearly, in retrospect, inflation was better than even I had thought and I attribute that almost exclusively to the dollar. Looking at 1985, unlike 1984, I have an inflation forecast of almost 6 percent on a fourth-quarter-to-fourth-quarter basis, which is on the high side of the Committee members' forecasts. I ended up there with considerable reluctance. But fundamentally the reason I ended up there was that I did have in mind an acceleration, however modest, in compensation, very much like the staff's. Strangely enough I had in mind stronger productivity growth than the staff, at around 1-1/2 percent. But the difference in my case is that my forecast basically assumes that we will continue to have a positive spread, on the order of 1-1/2 to 2 percent, between the deflator and the rise in unit labor costs in the economy. I arrived at that for three reasons. First, it is certainly not without a precedent at this stage of the recovery. Second, we are moving into ranges of capacity utilization and unemployment that seem to me to imply at least some further pressures in those areas. Last, but certainly not least and perhaps most importantly, I continue to think that the point will come when the dollar will have to come off; and if it does come off, my view is that the potential effects of that on domestic inflation coming from the direct effect on imported prices and also the indirect effect on the kind of restraint that these imports are producing could be even greater than the 1 percent that Mr. Truman spoke of. I am, of course, mindful of the fact that not only wage statistics but commodity prices and other things right now could very well lead to a different view on inflation. But even in terms of commodity prices, I assume at the moment that an awful lot of that also is a direct and indirect reflection of the international situation. I am not yet ready to conclude that its effects will be permanent over the forecast cycle.

VICE CHAIRMAN SOLOMON. I think the one thing that throws off the historical relationship between labor costs and prices is the rather unique price constraint influence of imports. It is unique in this recovery to such a degree. I continue to run into businessmen who keep talking about the fact that even though volume has picked up they can't raise prices; they can't get the margin because of import competition. And unless you make an assumption that the exchange rates [are] going to come down significantly, it seems to me you come up with a fairly low projection of inflation.

MR. CORRIGAN. I would agree with that. As I said, there is no question in my own thinking that precisely those circumstances you have described are one of the reasons why I end up with a higher rate

of inflation. I think at some point in the cycle the dollar will come off and the effect of that on domestic prices will be greater than the average effect one picks up by looking at models. The reverse is clearly true, in a context in which the dollar were to stay even within, say, 5 or 10 percent of where it is now over the whole forecast period. To me that would easily translate into a percentage point, if not more, of better price performance.

MR. MARTIN. Not only are there firms that are reluctant to raise prices but some firms have raised prices and have had to back off.

CHAIRMAN VOLCKER. They are busy getting legislation enacted.

MR. TRUMAN. There are only two features, I think, to the dollar's role. Its rise has helped to hold down inflation, and even if it stops rising the rate of inflation has been suppressed because of the dollar's rise. Then if it should decline, as we believe it eventually will, we will pay back some of the dividends that we had collected. One of the problems--and it's been seen in other countries--is that you start assuming that the underlying rate of inflation is the rate of inflation that's associated with a continuously rising currency and then that leads to some distortion in and of itself in the way macro policy operates. Then once you get to the point--I'm thinking particularly of Germany--where you come down the other side of that mountain, that creates its own problems. Everybody has been amused at the constant 15 percent [dollar decline we have forecast]; it is obviously a somewhat notional figure--less precise than some of the other imprecise numbers in our forecast. But I think it is partly motivated by the view that eventually we will have not only a [cessation] of this benefit but a rolling back of some of it. And it's better, at least in terms of thinking about what the correct underlying rate of inflation might be and in trying to forecast the rate even though the short-run favorable developments on the inflation side might be continuing because of the dollar's value.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. It's hard to pinpoint the precise reason why our staff forecast is a bit higher than the Board staff's on the inflation rate for next year. But I think it probably has to do with our estimate that as we get into 1985 we will be approaching or at the point, both in terms of the capacity utilization rising and the unemployment rate declining, where in the past we typically have seen an acceleration of inflation.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I have a difficult question to ask. I don't know who to ask, but the staff is forecasting a \$115 billion current account deficit in 1985 and a decline in the exchange rate of the dollar against foreign currencies of 15 percent. My question is: What levels of interest rates are going to be required to attract that amount of foreign capital to the United States in a regime in which the foreign investor may be contemplating further devaluation of the dollar, and what will be the implications for the economy of that level of interest rates?

MR. AXILROD. Well, we have only a small rise in interest rates in the forecast.

MR. MORRIS. I know. That's what I don't understand.

MR. AXILROD. It would be a lot higher if you don't want the dollar to go down.

MR. TRUMAN. President Morris is saying that if the dollar goes down, somehow we need even higher interest rates in order to prevent it from going down faster.

MR. AXILROD. We think we have a mutually consistent set of relationships. It entails somewhat higher interest rates, the sharp drop in the dollar, and the projected rate of inflation. We would argue, I guess, that if you think the dollar isn't going to go down, you need a lot higher interest rates. I don't know quite how to answer the question otherwise. If you believe that people don't want to hold dollars to the extent that we implicitly are saying, you're forced to argue that you have to pay them a lot more to do it.

CHAIRMAN VOLCKER. I think at this time we don't have the answer to your questions.

MR. PARTEE. He said it was a difficult question.

MR. MORRIS. It seems to me that if there is something wrong with this forecast, it's in this area. Can we carry this off neatly without any significant change in interest rates?

MR. AXILROD. But these are high real interest rates still-- very high relative to the rest of the world.

MR. MORRIS. But we're also asking the rest of the world after investing \$100 billion in the United States this year to come up with another \$115 billion.

MR. TRUMAN. But the point is that in the last 12 months they have over-invested in the United States or in dollar-denominated assets or the dollar wouldn't have appreciated by 15 percent or so. It's no more illogical that the dollar would go down slightly in this interest rate forecast than that the dollar would go up with a doubling of the current account deficit.

MR. MORRIS. But the fact that that has happened means that at the end of this year foreign investors are going to be sitting with a big accumulation of dollars. And the question is whether we can finance this current account deficit without offering much greater inducements for them to hold more dollars.

CHAIRMAN VOLCKER. Excellent question.

VICE CHAIRMAN SOLOMON. But right now they are more than financing the current account deficit. That's why the dollar is rising, you see.

MR. MORRIS. Yes, I understand that.

VICE CHAIRMAN SOLOMON. And the financial markets in New York--I don't know whether they are right or not--are placing enormous emphasis on the abolition of a 30 percent withholding tax. And even though there are very strongly mixed views about it, the possibility that the Treasury might consider bearer bonds is a separate issue. There are a lot of people who feel that there are going to be some substantial flows from that; and we're still getting some intrabank assistance as well. The dollar is being pulled back from the Eurodollar market, which is helping to finance the current account deficit. My sense is that even though, obviously, it's almost a tautology in the long run--neither we nor the world can accept that large current account deficit to finance indefinitely--I wouldn't assume it is going to be in 1985 necessarily that we're going to see that kind of change.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I have very little confidence in economic forecasts--my own in particular--but forecast we must, so I guess I will have to bare my soul. Like most everybody else, we ended up pretty close to the staff's forecast for 1984. But when we got to 1985 we differed in the same direction that Jerry Corrigan did, only more so. We came out with a little higher real growth, but the main difference was on the inflation side. We were on the high end of that and we would stress the factors that he stressed, but also would point out that we still have not yet paid the piper for the rather rapid growth--or what I view as rather rapid growth--in the money supply in the past. And even after allowing for the possibility of a rightward shift in the demand for money, I still think we're going to see more inflation probably than the staff is projecting. This, obviously, is one argument that I don't want to win.

CHAIRMAN VOLCKER. We can all be encouraged to know that Milton Friedman has decided that with the downward shift in velocity of--I can't remember whether it's 8 percent or 11 percent--all bets are off in the future for inflationary implications of that rapid growth.

VICE CHAIRMAN SOLOMON. He has retracted that inflationary [unintelligible]?

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Our forecast with regard to the GNP this year and next year is perhaps a touch higher than the staff's, and our inflation [forecast] is broadly consistent--a bit higher. But amongst all the good news, and I really do think we have a very powerful economic expansion in place, I continue to be distressed by the unevenness of it all. The people I talk to, particularly those people who run large capital intensive heavy industry companies, are continuing to experience very, very difficult times; by no means have they in any way really caught up with the euphoria that seems to be present in other areas. I tried to look at this a bit. We took the industrial production index and assumed that 1979 was 100 and then looked at the April physical output numbers in various parts of that index. A lot of these are the industries that are central to the Midwest. For example, in the primary metal category, consumer durable steel was 75 percent for April of 1984 versus 100 for 1979; equipment

steel was 53 percent versus 100 for 1979; farm tractors were 35 percent; construction and equipment were 78 percent; the big tractors like the kind Caterpillar makes were 40 percent; railroad equipment, which I have commented on in the past, was 15 percent.

SPEAKER(?). Fifteen?

MR. KEEHN. It was 15, but that's not quite fair because 1979 was, for some tax reasons, a uniquely high year. But as you go down these individual categories in the industrial production index, many of these big, heavy [machinery] companies are still operating at very, very low rates. Universally, the people I talk with say that the value of the dollar is of extreme concern. And we think that will be key to our forecast for next year. Caterpillar, for example, is a classic example of a company that just has been decimated, both domestically and in the export markets. Therefore, I look at the numbers and statistically they all seem to make great sense and I can find no overall reason to disagree. But I have this nagging feeling as I look around at many of these big companies that, with the continuation of the trends with regard to interest rates and the value of the dollar or both, something could come a little unglued here as we look to the forecast--not so much this year, but next year. It's this unevenness that I find in the industrial component that has me particularly worried.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I think we're at a stage in the business cycle in which the uncertainties of forecasting are a heck of a lot greater than they have been. If you look at a recovery in prospect, the first four to six quarters do differ from one cycle to the next but not all that much. But what happens after you get up to where we are now is much harder to foresee. It's certainly very logical to anticipate some slowdown in the pace of the economic expansion but whether we slow down to something like a 3 percent rate, let us say, or a 4 percent rate, makes a hell of a lot of difference to the rate of resource utilization when it is up this high and, therefore, to price behavior. The other big factor on the price side now that makes price forecasting very, very uncertain is the issue that Frank was pointing out about the accumulation of dollars abroad and what that means for interest rates. When we have dollars accumulating abroad on the scale that has been occurring, the willingness of foreigners to continue accumulation on anything like the scale that the staff is forecasting depends on what happens to prices here and what happens to their expectations of prices. If we get the beginnings of some upswing in wages and prices in the United States, it will then induce the kind of drop in the value of the dollar that Chuck is talking about, which in turn will reinforce this price cycle. And that's why it seems to me the outlook for prices is very, very uncertain.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. In times like this when nobody knows what really is going to happen--more so than most other times--what we say about the economy tells more about the people [talking] than it does about the economy. Some people are just pessimists by nature and basically say: "Well, things are good but that means they have to get bad." And I think that's in most of us; it's our central banking blood. Others

are optimists and believe things are good and they are going to continue. I think the truth probably is somewhere in between. That's not very profound, but I suppose things won't turn out as bad as we think nor as good as we think. My own hunch is that we may end up with less inflation than one might expect in this kind of business cycle, largely because of the dollar. I just hear everywhere about how much a constraint it is on prices. We've been hearing that the dollar is going to come down, down, down and maybe it will at some point. Like Tony, I think it will come down but further out there on the horizon; and I think this is going to have a positive effect on inflation. On the growth side, we have talked mostly about what is happening in the real sector, but the financial side of the economy really is in pretty fragile condition. Just what those linkages are and how they spill over to the real side are hard to define, largely because so much of it is psychological. But it does seem to me that over an 18-month time horizon the fragility on the financial side is bound to have some downward impact on the economy. So, my hunch is that we probably will end up with both less inflation and less growth in 1985 than one might normally expect.

MR. FORRESTAL. Mr. Chairman, I think there is an awful lot of uncertainty as we try to make a forecast at this particular time. Generally speaking, we agree with most of the staff forecast with the exception of the inflation and unemployment numbers. I do think that the staff's inflation numbers are low. We look more for a 6 percent inflation number, fourth quarter '85 over fourth quarter '84, based pretty much on reasons that have already been alluded to by other members--namely, the depreciation of the dollar and so on. But I also think it is very unrealistic to think that the wage concessions and wage moderation that we fortunately have had so far are going to continue. Nobody knows, of course, what is going to happen with the automobile negotiations but I'm fearful that they could turn out to be difficult. And there are other wage pressures that I think are going to develop in the economy.

The other thing that I haven't heard mentioned, which we factored into our projection, is the monetary growth through about mid-1984. So, I think the factors of expansionary policy, wage pressures, depreciation of the dollar, and capacity constraints--which we certainly see in our District, incidentally--augur for a somewhat higher inflation rate than the staff projects. Also, as the unemployment rate goes through 7 percent, those wage pressures are going to increase as well. I also think unemployment is going to be a bit higher than the staff suggests, but otherwise I think their projection is pretty accurate.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I'm no more confident in my own forecast than others are [in theirs]. In terms of real growth, we're about where the Board staff is; we have a little higher nominal GNP and are higher on the deflator. When we are as uncertain as we are, maybe we can learn something from history just from the standpoint of where we are in the cycle. We are going into the third year of recovery; inflationary pressures tend to increase at that point. Looking at it today, it feels considerably different. But we've said that, [thus far] at least, this recovery is pretty well tracking a normal recovery. So, it makes one wonder if it really is going to be that

different as we go forward. I have some real concerns about the exchange value of the dollar. If the drop-off does materialize, that will likely bring inflation pressures back on the domestic side. Given capacity utilization and the other things that we normally look at, it just seems to me that pressures are going to start building as we get into 1985. Therefore, I'm not as optimistic on inflation as the staff.

CHAIRMAN VOLCKER. By a considerable margin. Governor Wallich.

MR. WALLICH. My numbers are on the high side of the forecasts, but not extraordinarily so. I ask myself: If these numbers come out approximately like this, what happens at the end of 1985? Do we then level off forever at a moderate rate of inflation and at a moderate rate of unemployment? Do we go on up toward higher rates of inflation? Do we encounter on the way--either before or after the end of 1985--a downturn? The answers, obviously, are unknowable. But if the numbers turn out pretty good through '85, as they are projected here, the chance is that it means we will be into a rather long and continued period of expansion that will carry us to a very low rate of unemployment and considerably higher rates of inflation. That seems to me the likely outcome of the present numbers being true. At most, the staff projections would get us to a growth rate below 3 percent, which would suggest that we are tapering off toward an even lower rate of expansion than potential that theoretically could be sustainable for a very long time. It's contrary to history. The economy either expands or contracts over time. And I'm concerned that the makings of a stronger and longer expansion are likely to leave us eventually out on a limb with high rates of inflation. Well, I guess I've expressed no more than my usual prejudice on the subject.

VICE CHAIRMAN SOLOMON. Would you be reassured if we all thought there would be a recession in '86?

MR. WALLICH. I would certainly be reassured, but I would prefer then to try to modulate that rather than run into it helter skelter.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Well, Mr. Chairman, we have discussed whether or not this expansion is typical of cycles, if we eliminate a couple of them. It seems to me that this expansion is significantly more vigorous than the typical cycle. That's certainly true of employment, as we have already touched upon. That always raises the question of whether we try to do too much in too short a period of time--in 20 months or whatever it has been. Is this expansion too fast in the sense of being inflationary? It seems to me that there already has been some slowing. We all have conceded the difficulties of forecasting and we know numbers are revised and revised and revised. But, just looking at the numbers, in terms of nominal GNP the range is 13.9 to 9.8 percent [unintelligible]. In the [remarks] of our twelve colleagues around the country, the comment that the rate of expansion is slowing is almost unanimously true of that group. Is a drop in nominal of 4.1 percentage points over some period of time enough? If we look at the calendar year 1985, using the staff forecast we get nominal GNP of 8.4 percent. Is that still too high a rate of growth?

I think in terms of those absolutes, it's difficult to make a case. Is business fixed investment coming on stream too fast? The first estimate of the rate of growth in the second quarter was almost 21 percent. But it is equipping; it is retrofitting; it is productivity oriented; and it's pretty short term. Only now are we beginning to build a plant as distinct from equipment, and so the payback in terms of output should be reasonably short term. As for capacity utilization, it's difficult to factor in all that retrofitting of plant into the bare number of the domestic capacity utilization and, unfortunately, no one has figured a really good way to figure the capacity utilization of all those thousands of firms around the Pacific Basin and in Europe and the developing countries that are selling to us. I don't know how to measure it; maybe no one knows how to measure that capacity utilization. Are we expanding too fast? We're not back to any reasonable trend line using various recent periods of time and using GNP growth. It seems to me that the case for arguing that we're expanding too fast is a weak one. I've tried to reflect that and probably have failed in my numbers, which are somewhat at variance with those of the staff.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I've been reflecting on Jerry's comment about financial fragility, which contrasts so sharply with the strong economy. And I suppose that the link is what Henry is talking about: the next recession. There are probably many roads to recession. But one that seems quite certain to me is to get into an environment in which interest rates have to increase substantially, because I think a substantial increase in interest rates, in fact, would turn the financial system on its ear--certainly the thrifts, probably the LDCs, and very possibly some of these people who have signed up for variable rate mortgages and that kind of thing. And, of course, the thing that bothers me is that if you look at past recoveries, we've always gotten into a period in which interest rates went up substantially toward the end of the recovery. So, I suppose the best and safest insurance that we could buy would be to try to insure that the economy does not grow so rapidly as to bring the inflationary consequences that will lead to substantially higher interest rates and bring the next recession. Now, the reason I haven't commented along those lines is that the staff forecast, I think, does that. That is, the staff forecast gives us a [slowing of] real growth in time to keep off some of these touch points that Lyle was talking about. It gives us a 3 percent rate of real GNP growth, roughly, in the four quarters of 1985. I have to admit that I forecast the same thing, but I'm darned if I know why I did because, taking it right up to where we are today, everything is stronger--and quite a lot stronger--than that. Maybe it's just a hope that the real growth will recede to a point where we can live with it over an extended period rather than a true forecast that all of us are expressing here. As I said, there is nothing in the consumption figures or certainly in business and plant and equipment spending or even in housing so far that would give one the strong assurance that the 3 percent rate of growth would be established by the latter part of this year. And I think we need to try to guard against the possibility that for the quarters ahead, as in the quarters past, we will find real results to be substantially greater than what had been forecast beforehand. That is very important because, otherwise, I do think the financial system is going to tumble.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. Well, I won't repeat the comments that others have made, many of which I would have stated. But I feel that the cyclical momentum of this expansion will probably carry us comfortably through 1985. I think growth is slowing now and that growth will continue as we approach capacity utilization as it always does. I think price pressures will increase from capacity utilization and probably from a leveling of the dollar rather than a decline and from the lagged effect of rapid monetary growth in the past. That leads me to the point that is critical: that we not provide excess money growth to fuel inflation in the future. I share Governor Wallich's view that we will have a critical problem at the end of 1985 if we do that. As to financial fragility, I'm aware of Continental's situation and the fact that the thrifts on an operating basis are breaking even or are slightly in the red. But to put that in perspective: We've been through a stiff recession. There is always a lagged effect of problem loans after one of those. If I'm not mistaken, the nonperforming assets in March were lower than they were at year-end. And we have some specialized problems, including the energy situation, which seems to be improving some. My own guess is that we could easily exaggerate this, including on the LDC front; it appears to me that major progress is being made. So, I'm not concerned that a moderate increase in interest rates, which would appear to be appropriate in terms of the direction of the economy, would in any way cause a major problem in the financial system.

CHAIRMAN VOLCKER. Well, we've had a long and I guess useful discussion. If nobody else wants to say anything--.

MR. RICE. Since my forecast is rather way out, I'd like to say a word. Ed Boehne pointed out that a lot of the forecasts reflect individual personalities and whether one is a pessimist or an optimist. When things are going poorly, I'm an optimist and I expect things to get better; when they are going very well, I'm a pessimist and I expect them to get worse.

MR. PARTEE. You can make money on that!

MR. RICE. So, while my forecast was very close to the median for 1984, it's way out of line for 1985 and I'm going to revise it because I've been influenced by both the staff forecast and some of the comments I've heard. Basically, I forecast a growth recession starting in the latter part of 1985; I just thought somebody should reflect that possibility among our forecasts. Based on what I've heard and what I've looked at more recently, I don't really expect that to happen. But it seems to me to be a possibility--enough of a possibility to note. Having made my forecast before the latest figures on unemployment and employment and some of the more recent data reflecting more strength than I had assumed, I had real GNP falling off very substantially in the latter half of 1985. So, I came out on the low side for growth in 1985 and that's the basis for my way-out forecast. The reason is simply that real interest rates are rising very rapidly. The price forecast is very favorable but at the same time our forecast is for rising interest rates. And real interest rates now, and as projected, are going to be fairly close to where they were in the latter part of '81 and early '82, at which point the economy began to reflect this by turning down. I think it

is distinctly possible, though not probable, that in the latter half of next year we will see such a severe slowing in real output that we could think of it as a growth recession.

CHAIRMAN VOLCKER. I think we ought to go on to Mr. Axilrod's presentation before we quit today. But before we do that, I just want to say a few things myself. I want to ask, because it has been on a lot of people's minds in this city, about a theory going around that we are on the verge of deflation--a theory that is widely publicized by one group morning, noon, and night. It has been an expanding group in political terms. I haven't detected it, but I just want to confirm that that theory that we're close to some deflationary movement is not shared by anybody around this table.

VICE CHAIRMAN SOLOMON. That's price deflation?

CHAIRMAN VOLCKER. Well, it's price deflation as I read these things--price deflation followed by severe recession down the road.

MR. BOEHNE. The only place I've seen anything about deflation is in these articles I read in The Wall Street Journal. I haven't heard anybody in the business community anywhere worried about deflation or giving any evidence that it's a risk that much weight needs to be put on.

MR. CORRIGAN. Actually, the only way I can see something like that in the time frame we're talking about here is if we really had some kind of financial blowout--not that we haven't had some already. I don't know how to define that, but there is very little question in my mind that if something of that nature happens in the near term on top of everything else that already has happened, that could precipitate a pretty nasty situation.

VICE CHAIRMAN SOLOMON. But even in that situation, a drop in real output would come first and then the price deflation.

MR. CORRIGAN. That's even worse; you're right.

MR. PARTEE. Prices of some sensitive industrial commodities --for example, the price of gold--have been moving down. They are probably the source of much of this, but it's hard for me to see how that could become general.

CHAIRMAN VOLCKER. Well, let me make a couple of comments that have occurred to me in listening to all this. I could have left these for later, but what jumps out at me is how atypical this cycle is. Just on the face of it, we have had more rapid growth than at any time during the postwar period--which I guess makes it atypical--though we started from a low level, to be sure. Take those domestic demand figures, which didn't include inventories, that were presented to us a little while ago. If you compared the domestic demand with earlier cycles, I think you would see nothing like what has been going on in the past 20 months. And, in fact, it doesn't show much sign of a slowdown. If you look behind it, we obviously have a budget deficit, as was mentioned, that is out of line with all our experience. It is in fact rising in the third year of expansion and the full employment deficit, however calculated I guess, is rising rather sharply. Of course, the mirror image of that is the trade

deficit, and however one adds it up I cannot believe such a deficit is sustainable forever--however long forever is.

I would like to think that there is something else atypical--but it remains to be seen--and that is that prices are moving up exceptionally slowly, given the strength of demand at this point. I'm sure the dollar has something to do with that. But how much we have ingrained in the wage situation from a succession of recessions or other factors remains to be seen. I share the feeling that a number of people have expressed that the reliability of any economic forecast in the 18 months ahead under these conditions is exceedingly limited, to say the most for it. I don't doubt that there's a lot of momentum in the economy right now; I wasn't so sure a month or so ago, but it surely looks that way now. And I don't doubt that we're getting a continuing thrust on fiscal policy. I must say that I don't see much effect from the rise in interest rates we've had and I'm not sure we're going to get it when we're in the midst of one of these periods of considerable momentum. I was--I don't know the right word--bemused, I guess, by the analysis of the last Michigan survey that says the public thinks interest rates are low and one of the reasons they are buying is that they think rates are going to be a lot higher later. That doesn't sound as if marginal changes in interest rates are going to affect purchasing very much. Of course, consumer interest rates in fact aren't doing anything, except maybe very recently, and I doubt that there is much there to change the behavior very strikingly. At the same time, all these interest rates produce a lot of income on the other side of the balance sheet--on the income statement--that we haven't had in past expansions. We certainly need some slowdown in my judgment, given all that's going on. In fact, I think we're having a test of monetary policy in deregulated markets and it doesn't look very sensitive in terms of responses out in the economy. I have to say that I think a lot of the difficulty we are facing is due to no great news on the budgetary situation. The only promise I can see in that area is that the budgetary situation wasn't absolutely written in heaven or wherever it was written, maybe the opposite place, and it conceivably could be changed--not in the next three months but looking beyond the next three months. I'm almost inclined to say it better be changed or we have an almost insoluble problem. I won't berate the fact that we now have a financial system under pressure in every direction. I don't for a moment want to underestimate that problem, which I think is a considerable risk on all sides in terms of looking ahead. We'll talk more about that tomorrow when we get to the short-run policy. So, with that much comment from here, why don't you give us your wisdom about the long run, Mr. Axilrod?

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

CHAIRMAN VOLCKER. Well, thank you. I'm aware that it's 5:00 p.m. and somewhat warm. But maybe we at least ought to deal with any specific questions that people have or go on and say something about the ranges themselves. We can do so or wait until the morning.

MR. BOEHNE. I have one technical question on the history of the 4 to 8 percent range on M1. Wasn't it at one point 4 to 9 percent and then dropped to 4 to 8 percent? It seems to me that a year or two ago there was some special reason that it was dropped to 8 percent. Do you remember that?

MR. AXILROD. I don't remember. Maybe Norm has the history in front of him to see if it was. I don't remember that.

MR. BERNARD. Well, at the beginning of 1983, the range for M1 was 4 to 8 percent. And then it was raised to 5 to 9 percent, but with the base shifted to the second quarter; so it applied only for the second half of last year.

MR. BOEHNE. And that was because of the velocity.

MR. AXILROD. It was never 4 to 9 percent.

CHAIRMAN VOLCKER. We were way over the 4 to 8 percent range, I guess.

MR. BOEHNE. Well, that's right. And then it was dropped back to 4 to 8 percent.

MR. WALLICH. Could I just ask the role that the midpoint of these ranges plays? To me, the upper end is generally the important one. But I realize that if the staff works with the midpoint as something to base projections on, for instance, then it makes a difference whether one also pulls down the lower end or not. That's a technical item that I've never found the answer to.

MR. AXILROD. Well, in the earlier part of this year, the staff generally had been working with something around the midpoint for M1 because that was what was indicated at the February meeting. As M1 began being much stronger, we interpreted "around the midpoint" as being 6-1/2 percent instead of being specifically 6 percent. But we would assume that it's somewhere around that midpoint at the moment unless the Committee were to say that it was expecting growth to be around 8 percent, in which case we'd change our assumption.

MR. WALLICH. So, in that sense, 3-1/2 to 7-1/2 percent is the same as 4 to 7 percent?

MR. AXILROD. Yes, in terms of the midpoint. But whether it's going to have the same effect on the markets and the policy or actual operations followed by the Committee is yet another question. At 4 to 7 percent, if M1 is running at 6-1/2 to 7 percent, I can't say in advance whether the Committee is going to feel that more work is needed to restrain it than if the range were 3-1/2 to 7-1/2 percent. That is the issue, it seems to me.

VICE CHAIRMAN SOLOMON. It's going to try and get you, Henry; it's like Jello!

CHAIRMAN VOLCKER. It means what the Committee says. Are there any other technical questions?

MR. BALLEES. This is a technical observation, I guess, Mr. Chairman. If I remember your most recent testimony correctly, you at least--and perhaps the Committee--are on record as saying that M1 is still on probation. I would think that before this meeting is over we ought to get that question settled as to whether it is or isn't. In terms of public understanding at least, the record should show whether

we're still placing primary emphasis on M2 and M3 or whether, in fact, we're going to restore M1 to its prior position.

CHAIRMAN VOLCKER. We ought to put them all on probation!

MR. BOEHNE. Yes, put them all on probation.

MR. PARTEE. Certainly, M3 ought to be on probation.

VICE CHAIRMAN SOLOMON. Perhaps put credit on probation.

MR. PARTEE. [Unintelligible] false signal.

CHAIRMAN VOLCKER. Any other questions or clarifications or whatever? I wonder if we can just do one other thing: get a preliminary view just on the 1984 ranges. Maybe it will be easy; if not, we won't carry it through to a conclusion. Why don't we present it with a relatively simple option here, which is a largely cosmetic ingredient. It may be more cosmetic than substantive, but I'll find that out. Mr. Axilrod is not suggesting any change in M1 or M2. Is that going to meet with general approval?

SEVERAL. Yes.

CHAIRMAN VOLCKER. Then the analysis says--whether it's right or not is another issue--that for M3 and debt we in all likelihood are going to end up above the present ranges. Is that a good reason for raising them or should we keep them the same?

VICE CHAIRMAN SOLOMON. Keep them.

MR. BLACK. No, keep them and explain.

VICE CHAIRMAN SOLOMON. I agree we should keep them the same. It seems to me that the fact that they are running over is not a good reason for changing the ranges unless we're prepared to say that we're going to tighten policy or ease policy as a result of changing. In other words, it's got to imply a policy change that would be meaningful rather than a statistical adjustment just to come in within the range.

MR. WALLICH. It's a question of whether it's a forecast or a target. I think of it as a target.

MR. MARTIN. If it's a target, then that would argue for changing the range.

MR. BOEHNE. I think I would argue for raising it.

MR. WALLICH. If it's a forecast, I would say we made a bad forecast, but--

MR. RICE. Well, the target is the forecast.

MR. PARTEE. A target is the desired number.

MR. MORRIS. The problem with raising the upper limit for debt is that we would be saying implicitly that we think a 12 percent rate of growth for debt is acceptable.

MR. MARTIN. Given the acquisitions, mergers, and leveraged buyout situation, I would argue that it is acceptable.

MR. BOEHNE. So would I.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would leave the M1, M2, and M3 ranges the same, but I would argue for increasing the debt range at this time to 9 to 12 percent. It's not so much to make the argument for 1984, but I'd like to move on to 1983 and be able to reduce that in 1983 back to 8 to 11 percent.

MR. BLACK. You mean 1985.

MR. GUFFEY. Pardon me, I mean 1985. I'd like to increase it in the last half of 1984 to 9 to 12 percent with the anticipation of showing a reduction for 1985 back to an 8 to 11 percent range. It's more consistent. It is only a monitoring aggregate at the moment, and we have had very little experience in this Committee with using the debt aggregate. It seems quite logical to me that the Chairman can present the picture that with the merger situation there are uncertainties as to what the debt aggregate really means. Because we're still monitoring it, one could make the case for increasing it now and dropping it in 1985--carrying through the idea of continuing to move down on all of the aggregates for 1985.

MR. PARTEE. Roger, wouldn't we have to raise M3 too?

MR. GUFFEY. No, I think not.

MR. PARTEE. Because that's how they finance the credit numbers.

MR. GUFFEY. Yes, I understand that. But I would prefer, simply because we've had more experience with M3 and consistently have been over that targeted range in past years, to leave it as it is. Because if we raise both of them, it seems to suggest to me that we have indeed turned the reins loose a bit and I would not want to give that view.

VICE CHAIRMAN SOLOMON. It's funny, but I come to the opposite conclusion. It seems to me that if we raise the target for credit, we are implying to the markets that we're going to be somewhat easier in our policy than if we don't raise the target. It seems to me that there has to be a policy implication to making a midyear adjustment. You don't read it that way, I guess.

MR. GUFFEY. Tony, I would just rebut that by saying it's a monitoring range now that we've had very little experience with. We elevated M1 at the last meeting to a higher position, equal to M2 and M3. And we have not elevated the debt aggregate to that position. As a result, if we're still experimenting with it, let's experiment with it by raising it to be somewhat more consistent, with the thought of

dropping it in the '85 presentment that the Chairman will make at the same time he talks about '84.

MR. CORRIGAN. I'd go one step further even than Tony. I'd be troubled by raising that credit range, particularly on the grounds of raising it because of mergers and leveraged buyouts. It seems to me that that's tantamount to sanctioning a pattern of financial behavior that is going to get us in trouble sooner or later. If we're going to raise it, raise it. But I would not say that we're going to raise it because we have all these damned leveraged buyouts. That seems to me to be just bad policy.

MR. GUFFEY. It's simply a recognition of what has happened over the first 6 months.

MR. PARTEE. I agree with Jerry on this.

CHAIRMAN VOLCKER. Well, we may not want to debate this at this time of night. My own inclination is to keep them the same and say that we expect that we're going to come out above these ranges but we're not too happy about it and that's why we're not changing them.

MR. ROBERTS. We monitor it and see if it leads us to something we can do or control as against something we look at.

CHAIRMAN VOLCKER. We think they're higher than they should be for the long run.

MR. MORRIS. That says it's desirable in this year to have something that's running above the range, it seems to me.

VICE CHAIRMAN SOLOMON. Why?

CHAIRMAN VOLCKER. I don't know what it means if we raise it. If we raise it a little, we're probably saying we better darn well get within it. I don't know how people will interpret that.

MR. BOEHNE. A lot depends on the context and what we do for next year. It seems perfectly reasonable to me to say that we aren't going to tighten policy because of a lot of churning of funds relating to mergers. I would think we'd gain some credibility with that. It also would indicate that once these things are fixed they aren't fixed in cement and that we do adjust them to unfolding circumstances. If we then lowered the ranges for next year, that would minimize the risk of concerns that we're throwing away the discipline. To adjust would show more realism. Now, one can get at it the way you suggested, by saying: "Here they are, but we're going to go over them." It seems to me it's two ways to skin the same cat.

MR. PARTEE. Well, if I understand it, we're over them even without the leveraged buyouts, but not so much. And it seems to me that we might just say we are running over and to a considerable extent it is due to the leveraged buyouts and the mergers and so forth. We expect this damn fool nonsense to stop and, therefore, we haven't raised the ranges.

VICE CHAIRMAN SOLOMON. Particularly since Frank Morris has assured us that this is the one target that we did come in within the range up until the time we monitored--

MR. MORRIS. It still is. It's the only aggregate that predicted a 12 percent rate of growth in nominal GNP in the first half. Certainly, M1 didn't and M2 didn't.

MR. GRAMLEY. May I talk a bit about what I think this credit variable is supposed to be?

CHAIRMAN VOLCKER. Predicted or accompanied?

SPEAKER(?). Yes, what is this?

MR. MORRIS. In other words, if you were to have predicted a nominal GNP of 12 percent, you wouldn't be surprised to see a 13 percent rate of growth in total debt. That would be fairly in line with past experience.

MR. GRAMLEY. I would have thought the way we were supposed to use a variable like this--a monitoring variable that we're not targeting on--is as a variable that gives us some information about the adequacy of the monetary targets we set in the first place. M3 very much falls into that same category also. If we set ranges, say, of 4 to 8 percent for M1 and 6 to 9 for M2, and we think we're doing pretty well in those and get these gigantic increases in M3 and in credit, what we really ought to do is to lower our targets for M1 and M2. That's the logical thing to do. To go to the conclusion that what we should do is increase the target for the credit variable because we didn't anticipate it right is totally the wrong thing to do. If we're not gutsy enough to follow the logic to its conclusion, which is to pull the growth rates of M1 and M2 down--and I'm not going to suggest that we do that--at least let's hold to the targets for M3 and debt.

MR. BOEHNE. It's getting time for cocktails, I think!

MR. MORRIS. But it does tell us that the monetary policy in the first half of '84 has been much more expansionary than M1 or M2 would indicate.

MR. GRAMLEY. Yes, we provided a lot more credit than we should have.

MR. BOEHNE. Even though there are some distorting financial factors out there in merger actions?

MR. GRAMLEY. Well, but if you take out the 1 percent or so for mergers, we still end up well above the upper limit of the range for the first two quarters.

MR. MARTIN. But the 1 percent is a very feeble measure of the volume of leveraged buyouts, mergers, and acquisitions. It only measures the very biggest ones. And this phenomenon is happening throughout the industrial complex and the services [industry].

MR. PARTEE. That's not how I understand it.

CHAIRMAN VOLCKER. If I understand the way they measure it, that is not the way they get the number. They say they get the number by the amount the stock was reduced. [Unintelligible] statistic.

MR. MARTIN. It's not enough.

MR. PRELL. Well, we tried to calculate every merger and make allowance for those that we can't itemize. So we really do think it is our best guess of the total. It could be short; that's clear because there's so much that is below the surface.

CHAIRMAN VOLCKER. Well, I won't pursue it any further. Let's dispose of this first thing in the morning.

[Meeting recessed]

July 17--Morning Session

CHAIRMAN VOLCKER. I had a little research done overnight on a couple of factual points that arose yesterday. Let me just report the results of my research. Nonperforming loans of the big banks have been going up rather regularly--through March, anyway. They were 3.8 percent compared to 3.5 percent at the end of last year. From very incomplete reports that we have so far, my impression is that they have taken another jump in the second quarter. Mr. Boehne raised the question of impressions about wages--and I think we all have been surprised at the low level of the figures--and whether the figures are right. We went back and looked at wage settlements that have been reported so far this year and it's a rather interesting story. Let me read the list, which begins in January and goes more or less to date:

Commercial builders in New York City in January--a big settlement, no cola, but 6-3/4 percent;
 Teamsters/Motor Express--minus 15 percent;
 Oil refineries, the first big settlement of the year--1-1/2 percent, no cola;
 Highway contractors in Pennsylvania--0 to 2-1/4 percent;
 Container industries, 17,000 production workers at the four largest companies--0;
 Fieldcrest Mills clothing--5.5 percent, no cola;
 Honeywell office machines--0, no cola;
 Minneapolis hospitals --4 percent, no cola;
 United Airlines flight attendants--6 percent increase over three years and they get it right away;
 Dow Jones & Co.--not, I think, terribly affected by business conditions--7-1/2 percent, a big one;
 Los Angeles hospitals--5 percent;
 Western Coal Mines, United Mine Workers, 10,000 people--2 percent, no cola;
 Hawaii hotels--4 percent, no cola;
 Southern California Gas--6 percent, no cola;
 Frontier Airlines--minus 11 percent;
 New Jersey building contractors, unlike New York--3 percent, no cola;
 Northwest Airlines flight attendants--6 percent, lower for new hires;
 Public Service Elec. & Gas, New Jersey--5-1/4 percent, but with lower pay for new hires;
 McDonnell Douglas Aircraft, 9,600 workers--0;
 Chain Food Stores, New York & New Jersey--5 percent, lower pay for new hires;
 Pipeline contracts nationwide agreement in June, 45,000 workers--0;
 Houston Power Co., a utility--3 percent, no cola in the first year;
 Cargo and Tanker operators, National Maritime Union, 20,000 workers--0, no cola;
 Chicago area contractors, 45,000 workers--0 to 2 percent, no cola;
 Niagara Power Corp., 8000 utility workers--5-1/4 percent, no cola;
 United Airlines, mechanics and ground crews--4-1/2 percent, lower pay for new hires, no cola.

What is BNA? I don't know.

MR. KICHLINE. Bureau of National Affairs.

CHAIRMAN VOLCKER. A private outfit. I guess they update this and do some summary of wage agreements. For all industries the median first-year wage increase negotiated to date in 1984 is 2.8 percent, compared to 5 percent last year. From the report of the comparability survey of the government, average salaries among white collar workers increased between 3 and 6 percent over the year ending in March 1984, the lowest rate of increase in more than 10 years. That is the government's pay comparability survey. So, I think there is some comfort that what we see reported in average weekly earnings is not off the wall. We have some big agreements coming along and I only have the vaguest impression of them. The Post Office [workers] are in negotiation now and I understand there's some prospect of very little or no increase. As for mine workers, I don't know but I suspect they're far apart. There is another big one apart from the auto workers coming along. What am I forgetting about here, Jim?

MR. CORRIGAN. Coal miners.

CHAIRMAN VOLCKER. Coal miners I just mentioned.

MR. MARTIN. Construction union?

CHAIRMAN VOLCKER. The automobile one is coming, and we know that's a big, dangerous one. I thought there was one other. The postal workers are very big as are the mine workers and [those negotiations] going on right now.

VICE CHAIRMAN SOLOMON. You'd expect very little, if any, wage increase in the depressed industries. What explains the erratic pattern that in some nondepressed industries the increases are still extremely low, whereas in others--?

CHAIRMAN VOLCKER. Well, it's very clear that we're getting low settlements in some of the deregulated industries. There are two industries in particular: the airlines, which came up here again and again; and the construction workers, for which these aggregate figures show practically no increase in wages. The explanation I hear about that, despite very large increases in construction activity shown in these charts, is the threat of non-unionized workers.

MR. MARTIN. Not only the threat, but the utilization by developers of non-union workers.

VICE CHAIRMAN SOLOMON. Well, in New York, they got [6-3/4] percent.

MR. GUFFEY. Did I understand that most of these are one-year contracts?

CHAIRMAN VOLCKER. Well, no. I think a lot of them are two-year contracts and this gives the first year. There was a variety, but I think these numbers were for the first year.

VICE CHAIRMAN SOLOMON. There seems to be a qualitative difference in the psychology in the country in that for the second year of a recovery people are being much more careful about wage increases. One can either attribute that to the greater intensity of the recession than some earlier recessions or to some feeling that

they can't pass on these wages as easily in price increases. I don't know if there is any other explanation.

MR. MARTIN. Or the competition that you mentioned yesterday.

MR. RICE. Strike behavior has been very favorable.

CHAIRMAN VOLCKER. Let me raise another question while I think of it and we can return to it. These price estimates that everybody has given bother me a bit, partly because I'm not sure we should be in the public posture of saying our monetary policy is ineffective in keeping prices under control. It became very clear yesterday that you have a variety of assumptions about the dollar and I have no doubt that over a period of time--I don't know about next year--that can be a big influence, [particularly] if the dollar really fell out of bed. I wonder whether it would make some sense to have a standardized assumption on the dollar and do all these projections on the assumption that the dollar isn't going to be changed substantially, which would encompass a depreciation of 5 percent plus maybe, but not, I think, 15 to 20 percent. We could present the price forecast that way and say quite clearly in the material that these price forecasts are made on a standardized assumption that the dollar is not going to change very substantially and that if the dollar does decline substantially, everyone would be raising his inflation forecast appreciably. That would get us out of this business of evaluating different assumptions about the dollar, where I take it there is a good deal of uncertainty about the timing of any decline anyway, although there is a good deal of feeling that the dollar might decline, as I well understand.

VICE CHAIRMAN SOLOMON. But there is still a difference. We did that, as I mentioned, and we still came up--

CHAIRMAN VOLCKER. Well, we're still going to have some differences; having differences doesn't particularly bother me. I think a certain dispersion of the estimates may even be helpful. I understand the overall level if one is assuming declines in the dollar. But I think that is a separable and an unknown factor.

MR. WALLICH. It concerns me that this injects a degree of optimism, not to say euphoria, into the approach that could mislead anyone who forgets the assumption. One really then always has to make another 1/2 or 1 percent adjustment to one's inflation expectation in order to be reasonably realistic.

CHAIRMAN VOLCKER. If you assume the dollar is going down.

MR. WALLICH. Well, if it isn't, then one can say one deserves the dividend and bonus and perhaps one has missed a little bit of growth as a result of that.

CHAIRMAN VOLCKER. We missed by about 1 percent this year, it looks like.

MR. MARTIN. A million jobs. The coal miners. Nothing significant!

MR. PARTEE. [Unintelligible.]

MR. BLACK. Mr. Chairman, we had a little trouble with the [draft] wording of the continuation of the credit and policy stance, or whatever it was. I can't find it right now. But after we have voted on our long-run target ranges, I think this might bring us a little closer together.

CHAIRMAN VOLCKER. You all ought to have a chance to redo your forecast and I was planning that in the ordinary course of events. You may make any re-evaluation you want after the meeting and after any decisions we make. I'm raising the additional questions: Do we want to standardize the assumption on the dollar and, if we want to standardize that, how do we do it? I find it a little difficult to standardize it if [our report] says the Open Market Committee is unambiguously expecting a big decline in the dollar. I just don't think that--

MR. GRAMLEY. Another aspect we have to think about is that if we have a standardized, very small decline in the dollar, that is going to touch not only the price forecast but also the real growth forecast. And it begins to look perhaps a bit artificial.

CHAIRMAN VOLCKER. Well, I don't know how much it would affect people's growth forecasts during this particular time period. I guess nobody is assuming any budgetary action next year. I'm not sure that's a good assumption.

MS. HORN. We were.

MR. PARTEE. Not enough to affect my numbers.

CHAIRMAN VOLCKER. Well, I don't exclude the possibility. I don't see any way out of the box. I wouldn't bet a lot on it, but there is a chance of their going after the budget after the election. I would not like to presume that that's impossible.

MR. MARTIN. It may be politically very attractive to go after the budget after the election.

VICE CHAIRMAN SOLOMON. And come up with a mini-result.

MR. MARTIN. It's the going after it; it's the form, not the substance.

VICE CHAIRMAN SOLOMON. They'll go after it, no question.

CHAIRMAN VOLCKER. Well, I mean an official program.

VICE CHAIRMAN SOLOMON. The Treasury is considering various tax proposals.

CHAIRMAN VOLCKER. I don't think that is going to materialize in anything in 1985.

VICE CHAIRMAN SOLOMON. With that same assumption we came up with a 2.9 percent real growth forecast for '85. That's not too different from the staff's, with their 15 percent [dollar] decline. I don't know why we come out so closely to the staff on both inflation

and real growth when we don't have that dollar decline that they have. I haven't analyzed it. Dick [Davis], do you know the reason?

MR. DAVIS. We are essentially [unintelligible] net exports.

CHAIRMAN VOLCKER. Stronger somewhere else--

MR. PARTEE. That's consistent with--

CHAIRMAN VOLCKER. Well, we can substantially overdo our ability to make any of these forecasts.

MR. MARTIN. That would be the reason I would support your suggestion of a standardized assumption, whatever the percentage is.

CHAIRMAN VOLCKER. Let me return to that question later on.

MR. WALLICH. Let me mention something. This technique of no change in the exchange rates is one that the OECD has adopted [and followed] for many years as a result of a resolution. It is being questioned increasingly because it leads to conflicts with respect to projections made by the countries themselves, which contain all kinds of assumptions about their exchange rates. The same is true with respect to monetary policy. They are not allowed to make an assumption that their monetary policy--that is, budget policy--would be changed, whereas the countries that put in their projections have made whatever assumption they want to.

CHAIRMAN VOLCKER. I don't know how I would interpret that.

MR. WALLICH. Well, I think we are moving in the direction that the OECD now is considering abandoning.

MR. MARTIN. But why did the OECD take the position in the first place, Henry, unless there had been some good and compelling reasons to get them to square one?

MR. WALLICH. It made countries angry to have their policies preempted, so to speak, by suggestion of the OECD Secretariat. It looked like implicit policy advice. So to do it that way was the neutral and simple thing to do. I'm not sure what the IMF does.

MR. TRUMAN. They do the same thing, Henry. Of course, the Administration also does it, but for reasons on the political [side]. They do it for reasons of sensitivity--the same reason the Chairman cited, if I may put it that way.

VICE CHAIRMAN SOLOMON. Doesn't it get a little embarrassing, Paul, if you're asked by the [Congressional] Committee about the reasons for the wide spectrum [of views] among the members of the FOMC? If you said that some of them assumed a 15 percent [dollar] decline and some of them didn't assume that, is that going to look a little strange up there?

CHAIRMAN VOLCKER. Well, it doesn't make me too happy. I'm not sure I've thought this all through, but I think I would rather say that it's based upon an assumption that may or may not be right that the dollar is unchanged or that if it does change, as everybody thinks

[is likely], there is a substantial danger that one would have to add 1 percent or so to these figures.

MR. WALLICH. After all, what is the mental process by which we ourselves arrive at these numbers? I would say there is a fair chance that the dollar will decline. I don't know by how much and I don't know how great the probability is. I pushed my numbers a little in the direction that reflects this possibility. It's all a matter of probabilities and of having some ranges in mind, but I don't have a fixed assumption that the dollar will or will not depreciate.

CHAIRMAN VOLCKER. My main conclusion is that not too much weight should be put on these economic forecasts, but people look at them; they didn't look at them all that much in the past. I think the staff had an assumption of a big decline in the dollar a year ago; in fact, that may help explain why the inflation picture is better. It doesn't explain why the economy is doing a lot better than the staff projected a year ago.

MR. TRUMAN. I was just doing some calculations this morning, Mr. Chairman, which indicate that the dollar in June was only 8 percent above its peak.

CHAIRMAN VOLCKER. It's 8 percent above?

MR. TRUMAN. It's 8 percent above where it was in November of 1982, which in the way these things go I'm not sure is much of an appreciation anyhow. It happens that November '82 was the peak; it was the trough of the recession. Recently it hit another peak but the peaks have not been that far apart. It has been more level, I think, over the period despite [unintelligible], in part buoyed by the rise in interest rates.

CHAIRMAN VOLCKER. The way the dollar bounces up and down, I think a decrease of 10 percent may be insignificant!

VICE CHAIRMAN SOLOMON. One sees these things in hindsight. If we had waited 10 years, we wouldn't have had to float the dollar.

CHAIRMAN VOLCKER. Let me return to picking out these targets. On 1984, I'll make another attempt to see whether we can dispose of it relatively quickly. When I said no change yesterday, I thought I noted some oral acclamation. I may have been wrong about that because people began saying they disagreed. But let me just try something out to see whether we can [agree] without spending a lot of time on this. Suppose we keep them the same with a very clear caveat that we're keeping M3 and debt the same and expect to come in over the ranges for them but are not too happy about that. Is that the best way to present these? The alternative, obviously, is to increase the M3 and debt ranges. Among Committee members, is that the desirable course?

MR. WALLICH. I would like that.

CHAIRMAN VOLCKER. Apparently a couple of people think that's not the desirable course.

MR. MARTIN. Mr. Chairman, it is just a matter of emphasis. It would seem to me that in the presentation we shouldn't couple the importance of M3 and debt. We are learning something about what information the debt numbers will give us. My only footnote to that to join the raised hands would be that we differentiate between the two aggregates. M3 is more important.

CHAIRMAN VOLCKER. The debt range is awfully high. It seems to me inconsistent with any--. Mr. Prell gave me a figure after the meeting yesterday, but I don't know whether it made me feel better or not. If I understood it correctly, the trouble here is knowing what the base is. If you took net issuance of debt and equity this year and used as a base debt outstanding plus the market value of equity, which is a big question, the rate of growth would be about 9 percent.

MR. BOEHNE. Well, my preference would be to do the alternative, but I can accept the approach that you suggest.

CHAIRMAN VOLCKER. Is there anybody else who feels that way? My problem with the alternative--and I think we could do it either way--is that if we raise them we really have to say we're going to try to meet them. And then there's the question of how far to raise them. I think the worst of all worlds is raising them and then saying we're going to go over them anyway.

MR. MARTIN. And we are so uncertain about the merger/acquisition/LBO component of debt that I don't see how we could--

MR. BOEHNE. Well, I think that is a good argument. It may be best to say "Here they are" and then say "Hell, we don't know."

MR. BLACK. Leave out the interjection in the testimony!

CHAIRMAN VOLCKER. Let's tentatively assume that's what we're going to do then, and return to the '85 targets.

VICE CHAIRMAN SOLOMON. If you put a lot of emphasis on the mergers and the LBOs, you're going to be asked to send out a letter asking the bankers not to finance that activity.

MR. MARTIN. We already sent out a caution on the LBOs.

CHAIRMAN VOLCKER. It may not be the worst thing in the world to send one out. For 1985 the proposals here, which we don't have to limit ourselves to, range from no change to partial change to reducing them by roughly a half point. I will entertain any comments.

VICE CHAIRMAN SOLOMON. The whole thing boils down, of course, to the forecast on the velocity of circulation. I gather from this that Steve is projecting that in a year in which we don't have substantial price increases, the long-term average [growth rate of the] velocity of circulation for M1 is 2. Is that correct? And you are not talking about seeing relatively modest interest rate increases next year; you're talking about substantial--.

MR. AXILROD. In the projection we have very modest interest rate increases.

VICE CHAIRMAN SOLOMON. If he's really right that the long-term average [growth rate] is 2--and I don't have a view on that, I just assume that he's correct--then it seems to me that we probably should confine the M1 growth rate to 4 to 7 percent or else we might pump in too much money. On the other hand, my instinct is maybe to go down only a half point in this midyear preliminary proposal in order to preserve room in February of next year to go down all the way to 4 to 7 if that still looks [appropriate]. That's because it would be much harder to move up a half point if we go to 4 to 7 percent now; then it's going to look bad to retreat by that half point. So, even though I think there is an intellectual case at the moment for 4 to 7 percent, tactically I think we would be better off moving cautiously now and if the situation is still the same in February of next year, going all the way to 4 to 7 percent.

CHAIRMAN VOLCKER. Let me just observe, along the lines of your concerns about velocity, that something like 4 to 7 percent or whatever number you pick looks pretty good compared to the staff's nominal GNP forecast. Yesterday [we noted that] the staff's nominal GNP is below everybody else's except for one; quite a few of the nominal GNP forecasts are around 9 percent and some are as high as almost 11 percent, which raises the greater question of consistency.

MR. PARTEE. Well, the question is whether we want to have 11 percent.

MR. GRAMLEY. Not only that but if you had a stronger GNP forecast and more price inflation, then you probably would be talking about increases in nominal interest rates, in which case you're no longer confined to the projection of velocity that assumes that interest rates are unchanged.

MR. PARTEE. It seems to me that we ought to be thinking of nominal GNP of 8 percent as about right next year. And we ought to have money numbers more consistent with GNP around 8 percent.

VICE CHAIRMAN SOLOMON. Well, 8 to 8-1/2 percent.

MR. PARTEE. Yes. Let's say 3 percent real and 5 percent on prices or 3-1/2 percent real and 4-1/2 percent prices.

CHAIRMAN VOLCKER. Well, that's fine with me. I just hope the forecast--

MR. PARTEE. I hope we are right. That's an indicator of possible difficulty if the forecast is higher than that because it means higher rates and all that.

MR. MARTIN. It means we would adjust the ranges.

MR. PARTEE. Or let [interest] rates go up because we don't want that much GNP.

MR. MARTIN. Or don't want that much inflation.

VICE CHAIRMAN SOLOMON. But your point, Chuck, then also tends to work in the direction of concluding that a 4 to 7 percent range makes sense.

MR. PARTEE. I think I would agree with that. But I also agree with the other thing you said. I don't know if it's possible to preserve any freedom, but if we can preserve any freedom, we ought to try to do it for early next year.

MR. MARTIN. With velocity growth moving from 2-1/2 to 4-1/2 to a presumed 2 or [a little less than] 2, we better leave some degree of freedom, by going to 7-1/2 percent rather than 7 percent for a top.

MR. WALLICH. Well, historically, I think we have made these moves at midyear. That is, we have changed the ranges at midyear and then confirmed them in February. I could visualize the market watching us and saying "Well, they've decided not to continue [to move the ranges] downward." I think this could send a wrong message.

VICE CHAIRMAN SOLOMON. Well, no. We still would be moving them downward; I'm talking about at least 1/2 point.

MR. WALLICH. Oh, you do want to go down?

VICE CHAIRMAN SOLOMON. Oh, yes.

MR. PARTEE. Instead of saying alternative II at this point.

VICE CHAIRMAN SOLOMON. I would move down a half point now and then if the substantive case is still solid in February I'd move [down] another 1/2 point. After last year we made some significant revisions between the preliminary targets adopted in July and those adopted later, in February. It would be a little embarrassing, though, to move a full point now and then, if we felt we had to retreat, move up 1/2 point. That's why I'm suggesting this other sequence. You're shaking your head skeptically.

CHAIRMAN VOLCKER. Well, I'm just trying to imagine the circumstances. I don't think it's so hard moving [the ranges] up if the economy isn't doing well. It depends on all the circumstances. If inflation is doing well and we get no increase in velocity, we would say we're getting no increase in velocity and move up. That's a very favorable circumstance.

VICE CHAIRMAN SOLOMON. Suppose inflation isn't doing well but you can't be as tight in your monetary policy for international reasons or whatever. Then that's not so good.

MR. GRAMLEY. Then you leave the targets where they are and [let growth] run over them.

CHAIRMAN VOLCKER. I think that's the alternative--running over a little.

MR. GRAMLEY. I think we mainly have to ask ourselves what sort of message we want to convey now with the targets for 1985. In this connection, we ought to be thinking about what we're going to do with the others before we decide what we're going to do with M1. My guess would be that one would have a pretty hard time arguing for a reduction in the target ranges for any of the other aggregates. M3 and credit probably are going to end up way over the upper end of the range [this year]. If we can get back down into the range for 1985,

we will be doing well. For M2, there's a case [to be made] that its current behavior will persist, but the current behavior is really very, very odd relative to historical trends. Normally speaking, we don't expect to see much velocity increase for M2 over time. So, I would argue that we'd be better off now to play it safe and leave the ranges for M2, M3 and domestic nonfinancial debt where they are. Then that would argue, if we want to do something that conveys a message, for dropping off a percentage point from the top of the M1 range and being ready to go back up if the circumstances strongly recommend that in February.

MR. MARTIN. I think the limitations on that kind of policy would be the emphasis we would then be putting on M1. If we single that aggregate out and reduce that one, that's the signal to watch M1 for a signal of our policy.

MR. GRAMLEY. We could color that by noting that we've been looking at a range for M1 that was 1 percentage point wider than those for the other aggregates and now that the velocity of M1 is beginning to behave along a more normal cyclical pattern we changed the width of the range to 3 percentage points.

MR. MARTIN. Is it beginning to behave or are we assuming that it may behave in a more normal cyclical pattern?

MR. PARTEE. It's been all right for a couple of quarters.

MR. MARTIN. Oh, a couple of quarters!

VICE CHAIRMAN SOLOMON. I think there's as solid an intellectual argument for 5 to 8 percent for M2 as there is for 4 to 7 percent for M1. Why would the assumption of roughly, let's say, 0 to 1 percent velocity of circulation for M2, be any different than a 2 percent assumption for velocity of circulation for M1? I don't think that's any shakier. We've been running about 1 percent, haven't we, for velocity of circulation for M2?

MR. AXILROD. It's a little higher than that recently, but it's very erratic.

VICE CHAIRMAN SOLOMON. What's surprising about M2 is how low it has been running.

MR. GRAMLEY. What would the secular trend be on M2?

MR. AXILROD. Well, we keep saying it's zero, but I would take that with a grain of salt.

MR. MORRIS. It depends on the model one is predicting from.

MR. WALLICH. But wouldn't you say that M3 at any rate has a lower velocity than M2?

MR. AXILROD. If my memory's right, historically, the growth of M3 runs a little higher than that of M2 so its velocity growth would run a little lower, and that has been our very recent experience. It might be worth giving our point estimates for 1985, Mr. Chairman: On an assumption of M1 growth on the order of 5-1/2 to

6 percent, we would have M2 growth around 7 to 7-1/2 percent, M3 growth on the order of 8 percent, and debt [growth] declining to around 10 percent for 1985.

CHAIRMAN VOLCKER. That's based on your economic forecast?

MR. AXILROD. On 8 percent nominal GNP growth.

CHAIRMAN VOLCKER. What did you say for M1?

MR. AXILROD. We've assumed 5-3/4 percent as a point estimate; 5-1/2 to 6 percent seems to me the area--

CHAIRMAN VOLCKER. But that's with only an 8 percent nominal GNP, which I remind you is lower than everybody's forecast except the staff's.

MR. CORRIGAN. Personally, an 8 percent nominal GNP as a goal--as distinct from a forecast--is very appealing to me because I think the optimum that one could reasonably think about for 1985 is something like 4 percent [real] and 4 percent [on prices]. In my mind, to the extent that nominal GNP grows faster than that, it would increase the likelihood that more of it would be prices and less of it would be real. So, primarily for that reason, if I think about '85 from a policy viewpoint and what we should be shooting for, I come out with around 8 percent nominal. In terms of the targets I am more than a little attracted to Tony's thought, but my initial thought had been 4 to 7 percent for M1. But as I said, Tony's point has some merit. Personally, I would go with 4 to 7 percent, 5-1/2 to 8-1/2 percent, leave M3 where it is, and use 8 to 10-1/2 percent on credit. The bottom of the credit range doesn't matter at all, but I do think that shaving a half point off the top of that has some value. As I've said before, I am really troubled by this explosion of credit that we are seeing. That consumer credit number yesterday is another indication of this. Gosh--a 30 percent annual rate of increase in consumer credit! That's where I would be.

MR. MARTIN. Jerry, you mentioned around 8 percent on nominal GNP for 1985; I'd be more in the 8-1/2 percent area or, optimistically, even 9 percent. I think we'll do better on the deflator again as we've done better on the deflator repeatedly in very recent history. I demur from the staff's productivity projections, as you know. And on that basis, I would leave the ranges for the aggregates where they are for now, as under alternative Roman numeral I. Then I'd be hopeful that in the review of 1985 a few months from now, we could either take the top of M1 down to 7 percent or, more importantly, take the top on M2 down to 8-1/2 or even 8 percent, as we see what happens to velocity. The velocity variability has been so substantial that I'd hate to have the Chairman saddled with those assumptions in his testimony.

VICE CHAIRMAN SOLOMON. Let me ask a basic question. I don't understand Jerry's remark. If you're presenting the range of views of the FOMC and all of us are above the 8 percent that the staff has, are you going to come up with an 8 percent figure and ignore the FOMC members? Is it the staff who make that assumption? Don't you have to adjust to an 8-1/2 percent [assumption for GNP] or whatever it may be?

CHAIRMAN VOLCKER. I suppose theoretically we can say that everybody thinks it's going to be higher but, ideally, we want it lower. That's what we seem to be saying.

MR. CORRIGAN(?). Tony, that's not what I--

MR. GRAMLEY. The staff's views are of less value than the FOMC's! [Laughter.]

MR. MORRIS. Those numbers are not very useful, if we agree to standardize an assumption on the value of the dollar. Certainly, our number would be lower on that assumption by 1 percentage point.

MR. PARTEE. Mine too.

CHAIRMAN VOLCKER. Because the deflator would be lower.

MR. MORRIS. Yes.

VICE CHAIRMAN SOLOMON. Yes, but there are some other things you have to assume.

MR. CORRIGAN. I think you've misunderstood what I was saying. I was not suggesting anything like what you just said; I was making a different point. A forecast is one thing. But part of the objective of policy isn't to accept the forecast; part of the objective of policy is to try to influence the way in which the economy behaves. I am simply saying that.

CHAIRMAN VOLCKER. Well, you have a bit of a problem, I think. At this stage that's right. But once you've set the policy, you should go back and look at the forecast, theoretically, I guess.

MR. CORRIGAN. You start off with the policy too, but in the latter context of trying to have policy influence the economy in the most constructive way--

VICE CHAIRMAN SOLOMON. Yes, [but] 8-1/2 percent is still a pretty ambitious target.

MR. MORRIS. In regard to this year?

MR. PARTEE. He means in terms of cutting [inflation].

VICE CHAIRMAN SOLOMON. I mean considering the price inflation--keeping that [moderate]. After all, this is the third and last year of a recovery! [Laughter.] In the two previous ones the inflation hit what--12 to 14 percent at the peak? If we can confine it to 5-1/2 percent, that's going to be quite a triumph, I think.

MR. MARTIN. But my point is that the economy is going to function in such a way that it will be confined. It won't be exclusively [the result of] what we do.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, we forecast an 8-1/2 percent nominal GNP for 1985 and that includes some depreciation of

the dollar. Now, that's a forecast. I also think that that would be a pretty good objective to try to reach as well. With that in mind, as I look at the specifications for the monetary aggregates, I'm inclined to go with alternative II. I think that M1 range of 4 to 7-1/2 percent is about right. It gives us a bit of maneuverability at the top end. I'd leave M3 and debt where they are. M2 gives me a little trouble. I would like to show some downward movement in that aggregate. On the other hand, it has been growing at a fairly slow pace, as we all know. The Bluebook mentions the fact that we're going to have some financial changes due to the [regulatory] decrease in the minimum level of various accounts and indicates that those changes probably will have a minimal effect. On the other hand, even a minimal effect might have an impact of moving M1 in the direction of more rapid growth than we've had. What I'm saying is that there's not much maneuverability if M2 moves a little faster than it has. So for that reason, I think one could make an argument to move the M2 range up to 6 to 9 percent.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I would feel most comfortable with alternative II. I think it does send out the signal of continuing this longer-term goal of reducing inflation. It still gives us some flexibility, and I think it's consistent with our general ignorance about next year.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I also would opt for alternative II. I'm puzzled, however, why there is a narrowing of the [M2] range to 2-1/2 points as opposed to 3 points and, as a result, I would alter alternative II to 5-1/2 to 8-1/2 percent [for M2]. We also came out with 8-1/2 percent nominal for 1985 and alternative II may or may not be consistent with that; but I am persuaded by Tony's strategy, if you will, to do 1/2 point now and if it looks as if in February some other change could be made on the down side, then I would opt to do it then. It leaves us some flexibility for movement in February.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. To speak about M1 for a moment: When we revised the M1 targets because of the problems we were having with velocity and the NOW account assumptions and so forth, if my memory serves me right, we moved them up 1-1/2 percentage points on the bottom of the range and 2-1/2 percentage points on the upper end of the range. Now, with the threat of future inflation and the course of fiscal policy being slow [to adjust] in the future and, of course, with our increasing confidence in velocity of M1, I'd like to see the M1 range narrowed first and lowered second. I would narrow it because of the reduced uncertainty. That brings me to something like alternative III. I suppose between the two options [for M1] in alternative III, the 4 to 7 percent is more appealing to me because I think the upper end of the range has been particularly meaningful to us in the Committee as we've operated. But I'm a little uncomfortable even with 4 to 7 percent because I, like some other people around the table, like the idea of 8 percent nominal GNP as a policy objective. And I'm a little uncomfortable with assuming 2 percent velocity [growth]. I

think we might get velocity coming in a bit higher than that. So, as I say, the two things I'd like to see are a narrowing of the M1 range and a lowering of the M1 range. And 4 to 7 percent doesn't quite make me comfortable at this stage.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, Karen has pretty well made my talk except that I feel comfortable with a 4 to 7 percent range. I would go with all the ranges under alternative III. But I'd just like to emphasize a bit more perhaps than she did that I think equally important is our decision on the emphasis that we will put on M1. With velocity picking up and the money market models tracking M1 much better than usual, that suggests to me that M1 may be reassuring its more traditional relationship with GNP. So, I would like to make another quick pitch to restore M1 to at least its former full position of equality. Of course, I'd like to push it a little more.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. In my view, the options are between alternatives I and II. One could make a compelling argument for "I" on the theory that, given the forecasting uncertainties that we talked about yesterday as well as the now compounding velocity considerations, we could just simply leave the present ranges in place and suggest that when the year is over and we're setting the targets more firmly in February, we will take another look. But a bit more compelling is the message that would be conveyed. Therefore, I would come down on option II with the thought that it is a continuation of a program that we have been embarked on. I [support] Tony's argument that if, as we get into next February, the history is such that we could go down to 7 percent, that would be appropriate too. So, I think it's a close balance, but of the two I'd come down for option number II.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. I agree with Tony that the intellectual argument is for 4 to 7 percent, with Lyle that the message is much more important than the tactics, and with Karen that narrowing is the critical thing at this point. I think we need to have a strong message. We have a very strong momentum going here and I'd much rather see us, if necessary, run over [the range] and say we're working toward something that we think is satisfactory in the long run, which is what we're talking about here. So, I would prefer to see us have a 4 to 7 percent band on M1 and that range should be very comfortable whether velocity growth is 2 or 3 percent.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. In deciding between alternatives II and III, I'm influenced by our staff's forecast of velocity for the coming year. We expect it to continue to show a significant rise--certainly above the less than 2 percent that the Board's staff has forecast. After all, the first half of this year is up, with a 4-1/2 percent annual rate. We look at it on a quarter-by-quarter basis; we've had three significant rises in velocity and we expect that to go up further in 1985. Who is right, of course, remains to be determined. But based on that and based on our views of long standing here that we really

need to restore M1 to at least its former position--I agree with Bob Black on that--I would come down in favor of alternative III, using the 4 to 7 percent option.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I don't think we ought to reduce the lower end of any of the ranges. Regardless of whether or not they have been an issue, they would become an issue if there should be a flagging in the economy and [monetary growth] should drop down toward them. And it seems to me that at this stage of the recovery there's no reason we should want to have very low rates of increase in any of the aggregates. So, that leads me to alternative II. Leaving M3 and debt as they are this year is certainly reasonable and appropriate when one considers that growth is going to be over on both of them this year. So, I think that's right. I would cut the top on M2 to 8-1/2 percent as alternative II does. I'm sympathetic with Lyle's point. We don't really know what has been going on there, but my view is that we ought to show some progress and if, in fact, something has been odd about it, we'll just have to run over a bit. On M1, I'm sympathetic to the idea of narrowing the range and I would make it 4 to 7 percent--choosing from alternative III in that case--accepting not the midpoint as our target but someplace within the range, and very possibly toward the upper end of that 4 to 7 percent range.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. Perhaps because I live in Si Keehn's District, I'm inclined to emphasize the uncertainties that we seem to face today and the lack of our ability to hit bull's eyes with forecasts. Therefore, I think it makes sense to go either with alternative I or possibly to pick up for M1 the 4 to 7-1/2 percent range, which would be simply a signal of narrowing the range a bit. This would leave us with the option in February to review the situation and at that point take off another half point from the upper end. It leaves us more latitude to move.

My basic reason for going this way is that I'm impressed by the slowing that I see in the economy. Certainly, at least in the Detroit area, [economic activity] is way above where it was two years ago and yet the rate of increase is definitely slowing. And I'm also impressed by the chances for an auto strike this fall. No one knows for sure, certainly, but I think that definitely is a possibility; and if it does occur, chances are good that it would be [against] GM which would put a big dent in overall economic activity. So that's on my mind. Also, I think we have made some tremendous changes in the economy that are not showing up yet in the econometric models, etc. In terms of our basic inflationary problem, I think the capacity figures are underestimating what the capacity is in this country; therefore, I believe the capacity utilization rates show us operating much more closely to our ceilings than, in fact, is the case. Also, looking in a very microeconomic way industry-by-industry, it's hard for me to find one that's in a boil or is really bumping against or even close to its ceiling. So, that influences me.

On the productivity question, I think there are changes going on in the business community that are really dramatic: a great commitment in manufacturing to modernize, to adopt the latest

technology, and to gut existing factories and put in more modern kinds of equipment. I think management today realizes that they either have to do this or they are not going to survive very long; that commitment is really there. Also, with the improved profits, they are able to fund some of these improvements, which is very important. It probably doesn't show up in our productivity numbers right this minute, but I think it definitely will show up. In non-manufacturing industries also, I think management has a commitment to greater efficiency. The profits squeeze back in '81 and '82 and a little in '83 really punished them. There's a bottom line discipline in business that maybe people in government don't understand. And I think that also is going to show up more and more. Finally, in terms of wage settlements, there are obviously the union settlements that the Chairman referred to, but there are also a lot of nonunionized workers and a lot of small businesses that Mr. Boehne's personnel department doesn't bother to include in its survey. And many of these employers haven't given any wage increases for the last couple of years; a lot of people were just darn happy to hold onto their jobs which, again, is a big change in attitude. And the fact that we have had good inflation numbers in '82 and '83 and so far in '84 is convincing management that they can be tougher. Furthermore, they are doing more discriminating in the good sense of the word; that is, they're trying to reward the producers and the high achievers very well and the "dud" types can get zero or something less than zero. So, all of this to me suggests that the inflation outlook for next year is probably somewhat more optimistic than I've been hearing around this table. Thank you.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I'd say M1, 4 to 7 percent; M2, 5 to 8 percent; M3, 5-1/2 to 8-1/2 percent; and debt, 7-1/2 to 10-1/2 percent. When the chips are down, I think it's the upper end of the range and not the midpoint that really sticks in peoples' minds. Four to seven percent, therefore, means--if we're lucky on velocity--nine percent on the nominal GNP, or it could be ten percent. And I think that's too high. That does not give us a chance for a soft landing. As between M2 and M3, I would like to introduce the old differentiation there because I sense that there is a difference; but I don't have a very strong conviction. On debt, it troubles me very much to see this rapid expansion. The consumer credit numbers are not the results of any buyouts or mergers. So, I would be very reluctant to see that raised simply to adjust to what may be a reality. We ought to indicate that this is a target rather than a projection.

MR. CORRIGAN. It's kind of like a hippopotamus, Henry!

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, being a bit of an outlier in terms of the forecast, I don't think it is overly surprising that alternative III has appeal to me. I'd take 4 to 7 percent for the M1 range and M2, M3 and --

CHAIRMAN VOLCKER. Because it's so inconsistent with your forecast.

MR. BOYKIN. I would take the [alternative III] M2, M3, and debt ranges as presented in the Bluebook. I will concede that Tony's

argument, in terms of the presentation and the flexibility it would give us, has some appeal. If we were doing this in February, I would feel much stronger in that view than I do right now. But I lean toward "III."

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I think it's much more logical for us to be setting targets for '85 in February than it is in July the preceding year. In the past we have typically--

CHAIRMAN VOLCKER. We tried that once.

MR. MORRIS. Well, that is one reason that I like alternative I--that is, no change in the guidelines for the moment. That's not with any conviction that we wouldn't want to change them in February but, obviously, we'll have a lot more information in February in setting these ranges than we do now. That seems to me a good argument for staying with the present guidelines, with the understanding that we might, and probably would, want to change them in February. I think that would be a better procedure than doing what we've done in the past when we have changed the guidelines at midyear and then felt that we were more or less stuck with those guidelines in February when we really ought to be doing our basic thinking

CHAIRMAN VOLCKER. I really don't think that option is open to us. If you will recall, everybody was on the Committee when we tried precisely that one year and got sent back like bad boys to go do our work over again. We were told to come up with the guidelines for the following year in July--that that was what the law required.

MR. MORRIS. Well, I'm not saying that we don't present some numbers.

CHAIRMAN VOLCKER. Well, you're coming pretty close to saying that.

MR. BLACK. We also would be operating for at least a month, or more than a month, before we really decided what our targets for that period were.

MR. MORRIS. Well, that's true, but the kinds of changes we're talking about here are not so dramatic that that is particularly operational.

CHAIRMAN VOLCKER. Does anybody else have anything to say? Well, let me try this in reverse order. After listening to this, I come out very close to where some other people came out, but without a complete sense of conviction. On debt, we are all conscious that we're running way above and I don't hear any great sentiment to reduce that very much. You put down 8 to 11 percent; that bothers me a bit. No, let me start differently. From what I hear people saying, in terms of policy--and this encompasses most people's, but not everybody's, forecast--we are talking about a nominal GNP of 8 to 9 percent. There aren't many at 8 percent--only the staff. There are a lot between 8-1/2 and 9 percent and some above 9 percent, to be sure. But in terms of a policy objective I sense that that's about where we are. If that's where we are, a debt range of 8 to 11 percent, which

is unchanged and allows for a larger growth in debt than GNP for the third or fourth consecutive year, is not an entirely happy circumstance.

MR. MORRIS. Well, the midpoint of that range would be compatible with an 8-1/2 percent growth in nominal GNP.

CHAIRMAN VOLCKER. Well, it's 1 percent higher.

MR. MORRIS. Yes, but I think one would expect that in a third year of expansion.

CHAIRMAN VOLCKER. What I'm saying is that if I had any question about it, just as a normative proposition, I'd make it 8 to 10-1/2 percent or someplace in that neighborhood. For M3, 6 to 9 percent seems to reflect a lot of the thinking, I guess on the basis that the debt has been running high and it certainly allows us enough room on the down side. On M2, we get more questionable. If we're giving weight to running high on the others, we might give a little weight to running low on M2, and in the interest of showing some decline go with a range of 6 to 8-1/2 percent. I don't know; it may be psychological, but perhaps it doesn't look too bad. When we get to M1--. What has nominal GNP been in the first half of this year?

MR. KICHLINE. 12 percent.

CHAIRMAN VOLCKER. On M1, I get a little concerned. It has run about 7-1/2 percent so far this year--within the range--with the 12 percent nominal GNP. If we're aiming for an 8 to 9 percent nominal GNP, based upon recent experience it seems to me that the range ought to be lower or we will give a rather peculiar signal. Then it's a question of how much to lower it. If you allow a 2 to 3 percent velocity increase, 4 to 7 percent seems all right and gives the right signal. Then we get into this tactical question of whether to do a half point now and maybe do a half point later. Just sitting here, I don't have any absolute final conviction about this. It has been running 7-1/2 percent so far this year; announcing that we're satisfied with 7-1/2 percent next year but are looking toward a decline in the nominal GNP on the order of 3 to 4 percentage points strikes me as a bit peculiar. I'm assuming here that we don't put tremendous weight on the midpoint and that the most operative thing tends to be the upper limit. A number of people have said and a lot of people would interpret that as the same growth in the money supply next year as this year with a hope or stated objective of having substantially lower nominal GNP growth.

VICE CHAIRMAN SOLOMON. Well, except that we expect the velocity of circulation to come down significantly from the 4-1/2 percent it has been running over the first half of this year.

CHAIRMAN VOLCKER. That would be true even if it were cut in half; the 7 percent would allow for that.

VICE CHAIRMAN SOLOMON. I think there is an intellectual argument for 4 to 7 percent.

CHAIRMAN VOLCKER. What I just put down here is the same as a couple of people have suggested: 8 to 11 percent; 6 to 9 percent; 6 to

8-1/2 percent; and 4 to 7 percent. And I think implicitly we weight them all equally. There are a whole lot of caveats around all of them, as Mr. Axilrod suggested.

MR. BOEHNE. The problem that I see with that is that if we use 4 to 7 percent, I can conceive of a situation next February where 7 percent might be too low. And it is difficult, I think, to raise it; it's easier to drop it. I'm not sure we convey any more of a message if we drop it by a whole point now and couch it in all these "iffy" terms. That's the main problem that I see with going all the way to 7 percent now. It does tend to foreclose on some of our flexibility.

CHAIRMAN VOLCKER. Well, what could happen next February? None of us knows. Let's suppose we're running above that [range] next February for good and understandable reasons; that must mean that we're worried about something--interest rates or something in the economy. In that kind of scenario we would go [to Congress] and say, "Look, you haven't done anything about the budget. We can't hold it by monetary policy alone without running undue risks. We're going to have to raise this target and that is all the more reason [you] ought to be working on the budget deficit."

VICE CHAIRMAN SOLOMON. If we raise the target, then they are going to feel less pressure to work on the budgetary deficit.

CHAIRMAN VOLCKER. Well, we haven't made the decision. It's at least debatable. I don't know whether they will or won't.

VICE CHAIRMAN SOLOMON. You have more faith than I do.

MR. PARTEE. We would do that, I think, in a situation of considerable upward pressure on interest rates and then say, "Well, we just can't hold the money."

CHAIRMAN VOLCKER. I think the circumstance in which we couldn't hold the money is when we're having significant upward pressures on interest rates.

MR. MARTIN. A 7-1/2 percent top for M1 wouldn't be enough of a signal?

CHAIRMAN VOLCKER. Well, I think that's what we're debating here. I don't know whether it's enough or not, but it looks pretty mealy-mouthed. It depends on how one interprets it. If one interprets it as the midpoint, it's okay. If one interprets it more as the operative [number], what one really gets concerned about is breaking through the top, which I think is more the reality in this situation. And it looks like not much.

MR. BOEHNE. But in the context of M1 running high in its range, it would signal more of a constraining message, I would think.

MR. GRAMLEY. Not too bad an idea.

MR. BOEHNE. I'm not saying it's a bad idea, but I'm saying if you're looking at how it is going to be interpreted--

CHAIRMAN VOLCKER. Well, we're using the present projection, which is for substantially slower growth in nominal GNP than we're now getting. The whole thing is based upon that assumption. It may be wrong. Who can tell all about it? But I think that is the assumption either as a forecast or as an objective that we're faced with.

MR. GRAMLEY. I think one ought to put this in a somewhat longer-run context also. That is, if the Federal Reserve is still setting as an objective a long-run return to price stability, we do have to contemplate a gradual reduction in growth in all the monetary aggregates over time. This is now the fifth year of this long-range program and we are talking about setting targets for the sixth year. And we begin to worry about an upper limit of 7 percent? That looks a little bizarre to me in the context of where we're supposed to be going. After all, if the long-run growth of velocity is 2 percent or thereabouts, with no rise in interest rates then we're going to have to get M1 down somewhere in the neighborhood of 2 to 3 percentage points--given what we think is potential growth--to get back to price stability.

CHAIRMAN VOLCKER. I don't know. There may be no long-range growth in velocity. I don't discard that hypothesis entirely in the present world, in which case this is going to be too low and we will just have to say that. We don't have the evidence to make that case right now.

MR. RICE. Well, assuming that you are right and that Lyle is right, don't we get more psychological impact if we reduce the upper limit twice--one-half point now and one-half point in February, if things still look promising--rather than going down one point now?

MR. PARTEE. It might be pretty hard to make that second half-point reduction.

MR. RICE. Why?

MR. PARTEE. Well, there would be a new Administration setting out on a new term and all that. I can see that there might be some political problems.

MR. MARTIN. But the election would be over.

MR. PARTEE. I know it would be over. And whichever party wins, there would be the new plans for the next four years.

CHAIRMAN VOLCKER. Well, let me forget about M1 at the moment, just for the purpose of advancing the discussion. Do the other three look broadly acceptable or even narrowly acceptable?

SEVERAL. Yes.

CHAIRMAN VOLCKER. Are we just talking about M1?

MR. GUFFEY. I would like to raise a question again about M2. Why narrow the range of M2? What's the impact and what's the purpose of that?

CHAIRMAN VOLCKER. Only, I guess, that nobody can envision its growth being below 6 percent.

MR. GUFFEY. Well, neither can one envision it being below the other ranges. It is a change that doesn't seem to net anything to me. Why do it?

MR. GRAMLEY. It's a really gutty move.

MR. GUFFEY. Really gutty, yes.

VICE CHAIRMAN SOLOMON. Well, what would you do then--5-1/2 to 8-1/2 percent?

MR. GUFFEY. Sure. Keep the 3 percentage point range. We have narrowed the M1 range; however, we come out to a 3 point range. Why then would we take one additional step and narrow the M2 range? It makes no sense to me.

MR. PARTEE. Well, it just seems to me, Roger, that we wouldn't want 5-1/2 percent growth in M2.

MR. GUFFEY. Nor, I should think, would we want perhaps the 4 percent of M1.

MR. PARTEE. No, I can live with four percent, but I couldn't live with a lower M1.

VICE CHAIRMAN SOLOMON. I think Roger has a point. We wouldn't want M3 to come in at 6 percent. I don't know; I guess it depends on what you place more importance. I assume people are not going to be looking at the bottom of the range in this recovery period, although it might become important at the end of 1985. It's the scenario--

MR. GUFFEY. As analysts look at it, they will detect that there is an area of the range that they won't have an explanation for. And we don't have an explanation for it, so why do it?

MR. MORRIS. One thing we ought to keep in mind is that the staff assumes that the reduction of the minimum on the Super NOWs and money market deposit accounts from \$2,500 to \$1,000 is going to have no effect or a minimal effect. Now, if that assumption is wrong, then we might need a larger M1 than we're currently contemplating.

MR. PARTEE. That's possible, Frank, but I think we would have to say that at the time. We're not even going to know that on the first of February or whenever it is we have to set the ranges; that [Super NOW change] takes effect, I believe, January 1. It might be that the way [the banks] would market this is to say that people could give up the MMDA and put all the funds in a Super NOW and the bank will pay the [MMDA] interest rate. But we've got to see that happen before [we change the range]. That's an institutional change and, therefore, we would say that there has been an institutional change.

MR. MORRIS. We have a little knowledge of what--

MR. BLACK. Well, to put a little meat on what I think was a very excellent statement by Lyle, we rebased last year and went to 5 to 9 percent on M1 and we came out at about the midpoint. If we're lucky enough this year to come out somewhere near the midpoint of 6 percent, that would be two years in a row that we are moving in the direction we want. And if we come out somewhere near 5-1/2 percent next year, that will add a lot to what I think is already a very high credibility of our anti-inflationary stance. But I do think it is vital that we continue to move in that way because, as Lyle said, we still have a long way to go to get where I think we all ultimately want to be.

CHAIRMAN VOLCKER. I'm off M1 at the moment.

VICE CHAIRMAN SOLOMON. Right. You're talking about the other three. I think Roger has a point. I think it helps send a message that we're going to be following a tough policy, and I don't see the reasoning for narrowing the spread. We certainly cannot answer that we have slightly more certainty about hitting the M2 range than the others, which would be the only justification for narrowing the spread.

CHAIRMAN VOLCKER. I think that's the justification. It may be completely wrong, but M2 in fact has been behaving much more stably for quite a while than the other two have. It has been a nice, even-- and it may be a total illusion but--.

VICE CHAIRMAN SOLOMON. I thought Steve was saying that the velocity of circulation of M2 has been very erratic.

CHAIRMAN VOLCKER. Well, historically it has been. It is erratic this year, but the [average] number has been quite steady.

MR. AXILROD. I averaged it out for the past 22 years. The average is close to zero. But there is hardly a number in any year near zero.

CHAIRMAN VOLCKER. Velocity has been erratic because the [annual M2 growth] numbers have been so stable while the GNP [growth rate] has been changing.

VICE CHAIRMAN SOLOMON. What's your objection?

CHAIRMAN VOLCKER. Well, we're not talking about a big deal here; 5-1/2 percent just seems awful low to me.

MR. MARTIN. Jim, the ranges the Chairman has tentatively suggested would produce some upward pressures on interest rates according to your analysis here. I've been trying to re-read this and I can't quite put it all together.

MR. AXILROD. I was talking to President Balles. I didn't hear you.

MR. MARTIN. I was asking Jim.

MR. KICHLINE. In the forecast we have assumed M1 at around 7-1/2 percent and for 1985 we have 5-1/2 to 6 percent for M1. We're

talking about something close to the midpoints of these ranges, in any event. So, I don't see anything significantly different than in the staff forecast.

MR. MARTIN. There would be some upward pressure, you think?

MR. KICHLINE. Yes, we had that in the forecast. That's right.

MR. MARTIN. And that would remain?

MR. KICHLINE. Correct.

CHAIRMAN VOLCKER. With these near the midpoint?

MR. KICHLINE. Correct.

CHAIRMAN VOLCKER. Were there any other comments on anything but M1? This question has been raised about M2. Let me narrow it down to M2. Is there any feeling about 5-1/2 to 8-1/2 percent versus 6 to 8-1/2 percent?

VICE CHAIRMAN SOLOMON. I could go either way on that one.

MR. PARTEE. I have a slight preference for the 6 to 8-1/2.

MR. MARTIN. I do also.

MR. RICE. So do I.

CHAIRMAN VOLCKER. Well, let me return to M1. I don't think that I'm going to press this to an absolute vote right at the moment. We can come back and pull everything together in light of [our decision on] the short run. But I think we're between 4 and 7 percent and 4 and 7-1/2 percent. That seems to be the general range of [views].

MR. PARTEE. Only Karen wanted a lower range.

MR. BALLE. Mr. Chairman, this is an observation about what we've done in the past. I've just been asking Steve what the record shows. My recollection has been that whatever targets we set at midyear, we very seldom--in fact, I thought never--changed them. He has come up with one exception, in recent years at least, and that was in February of 1983 when we apparently did depart from what we'd set in mid-1982. I don't recall [why]. In any event, for whatever reason, I never quite understood why we didn't allow ourselves the flexibility that at least in theory we ought to have. But the record shows that when we've adopted a set of targets in July, we apparently have felt compelled for some reason to go along with those again in January in almost every case.

CHAIRMAN VOLCKER. I think "in almost every case" is a correct statement.

MR. CORRIGAN. In terms of the M1 target, as I said before, I would prefer the 4 to 7 percent. That's what I keep coming back to in thinking about it. Again, I could probably live with something like

Tony suggested. What really is at stake here is not just trying to have a policy that will produce a result that will look something like the staff forecast in 1985. It's beyond that. I don't think it's inevitable that 1985 has to be the last year of the recovery. But my view is rather strongly that if it's not going to be the last year of recovery, it has to be a year in which we have the kind of more moderate growth that we're all talking about. So, personally, I think policy should lean on the side of the result that not only enhances the possibility of growth and modest inflation in 1985, but being able to sustain it beyond that. And I think the risks are very clearly that the more we deviate from that on the up side, the more it increases the likelihood that it will be the last year of the recovery.

CHAIRMAN VOLCKER. Well, we're down to a very narrow issue. How many of the Committee members prefer the 4 to 7 percent? Six. Maybe some are indifferent. How many prefer the 4 to 7-1/2 percent? All right. Let's look at it in the light of our short-run decision. What do we have to do yet? We have to listen to Mr. Sternlight-- [Mr. Meek, today]--and Mr. Cross first. Now is as good a time as any to get that in. Mr. Meek.

MR. CROSS. Did you call on me?

CHAIRMAN VOLCKER. Well, whoever goes first. I guess you go first.

MR. CROSS. I usually go first.

MR. ROBERTS. Stay in there, Sam!

MR. BLACK. Fight for your rights, Sam!

CHAIRMAN VOLCKER. I think we ought to follow all the precedents.

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

CHAIRMAN VOLCKER. Questions or comments?

MR. BOEHNE. I have a question on this decoupling of foreign interest rates from U.S. interest rates. Some foreign central bankers take a great deal of pride in talking about that. Does anybody have any sense as to whether that indeed has been successful and what the outlook for its success is?

MR. CROSS. Well, it's awfully hard to speak very generally. The conditions vary a great deal from country to country and situation to situation. Obviously, the Canadians found great difficulty in keeping their interest rates very far away from reflecting the rise in ours. The Germans have been seeking to avoid following the increases in U.S. interest rates but, as I said here, it has resulted in quite large amounts of intervention in the exchange market.

CHAIRMAN VOLCKER. Let me make a general comment on the subject. More generally, as I read the situation, economic developments abroad are quite unsatisfactory in terms even of earlier expectations, which weren't all that buoyant. I don't want to

CHAIRMAN VOLCKER. I would think that most people would say intellectually that the dollar ought to decline, but they're not willing to bet on it right now.

MR. CROSS. That's right. Those who have are now in the hardware business!

CHAIRMAN VOLCKER. Any other questions? We have to ratify some transactions.

MR. CROSS. Yes. We did \$135 million.

VICE CHAIRMAN SOLOMON. So moved.

MR. CORRIGAN. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Meek.

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

CHAIRMAN VOLCKER. Comments?

MR. MARTIN. What is your evaluation of, let's say, the intermediate-term strength of the fears and the difficulties with regard to bank CDs, bank soundness, interbank market availability and so forth? Is it a passing phase associated with Continental, Argentina, and so forth? Or is something going on here that's likely to be a malaise going forward? What's your feel for it?

CHAIRMAN VOLCKER. I don't know what Mr. Meek's view is, but I'll tell you my opinion is that there's no chance that it's a passing phase that is going to evaporate in a matter of weeks or months.

MR. ROBERTS. One should give some consideration to the fact that banks have been expanding CDs very rapidly in recent months, however. I don't think this entire widening of spreads would be as qualitative as you analyze it. Spreads always widen when they pump CDs up.

VICE CHAIRMAN SOLOMON. One significant indicator--and I feel it's going to be with us for a while--is that it's very hard now to get term money in the Eurodollar market.

CHAIRMAN VOLCKER. Unless you're a Swiss bank.

VICE CHAIRMAN SOLOMON. I'm talking about the U.S. banks. The maturities have shortened, and it's very significant.

MR. ROBERTS. But in that context, the banks have expanded their loans tremendously, and have financed it with expansion of domestic CDs. That is my point. And you would expect that to result in a widening of spreads, notwithstanding the fact that, obviously, Continental and Manufacturers Hanover have been a qualitative factor in the market. The market really, I guess, has worked pretty well.

MR. WALLICH. Well, it seems that the banks have not only had to finance their domestic operations but apparently also their branches abroad, because those have no longer brought in money but

apparently have needed money. That suggests that there are those funding problems.

CHAIRMAN VOLCKER. I don't want to have a prolonged discussion right now because we need to get on; we can discuss it a little later if you want. But just symptomatic of this, among other things, the Comptroller has developed a new plan for evaluating oil loans, which may not be overly conservative in some theoretical or abstract sense. But there is a certain fear--I don't know about this, but it needs some testing--that application of those standards to national oil credits will result in billions of dollars of loans being put in classified status because they won't pass the stiffer hurdle that's implied by the new evaluation. The only sense we have of that in a direct measurable sense is that they have done it to Continental and it has added \$200 to \$300 million to their classified items in a bank that already has had its oil portfolio examined and reexamined. At one point I heard a figure of \$350 million. Maybe you know the figure as a result of the examination.

MR. PARTEE. No, I don't.

MR. KEEHN. It's in that magnitude. The loss category for Continental, including oil credits, is going to be \$575 million. And that is largely the result of a different set of standards for credits.

CHAIRMAN VOLCKER. That's loss since the last examination, which was 6 months ago.

MR. KEEHN. Right. That's as opposed to the deterioration of the assets themselves; it's a very significant amount.

CHAIRMAN VOLCKER. I think we can return to these questions, but I just don't want to interrupt the continuity of the market discussion entirely. Are there any other questions?

MR. PARTEE. It is true, isn't it, that we've had a couple of bad bank reports? certainly couldn't have been much worse than it was and looks like a continuing problem, and it doesn't seem to have shaken the market any more.

VICE CHAIRMAN SOLOMON. The shareholders, who are very strong in both those cases, are putting up more capital and the markets know this. assures us that they bent over backwards to write off everything and reserve everything they possibly could. And they are going to show a substantial profit this quarter. And I think \$80 million more capital was put up. Also, of course, we know that Midland is now offering to buy out the minority shareholders in Crocker and has a complete commitment to Crocker. So, that's why it didn't really get hurt.

MR. MEEK. My sense is that some of the anxiety that was present in the markets in late June has gone out of the market since then.

CHAIRMAN VOLCKER. [Unintelligible] I think is right.

VICE CHAIRMAN SOLOMON. Temporarily.

MR. WALLICH. Paul, could I ask you a question? The last few weeks seem to have produced an example of the relative workings of a borrowed reserves target or assumption versus a net free reserves target or assumption. We seem to have stuck more or less with a borrowed reserves assumption. That has led to an increase in net free reserves. So, had we been on a net free reserves target, that would have led to higher borrowings and tighter policies. Is that the correct way of looking at this?

MR. MEEK. I think that's a fair statement.

MR. WALLICH. So there is a difference between the two policies and, in this particular case, it has meant an easier approach.

MR. MEEK. Well, it has allowed us to accommodate somewhat the extraordinary demand for excess reserves by the major banks early in the period.

VICE CHAIRMAN SOLOMON. If we hadn't accommodated the extraordinary demand for excess reserves, we would have gotten even more of a rise. The Committee last time assumed that a billion dollar borrowing assumption was going to give us [a funds rate] in the neighborhood of 10-3/4 percent. Instead, we ended up with 11 to 11-1/2 percent.

MR. WALLICH. That's what I say. It was an easier policy and, given that interest rates were rising anyway, was preferable to a policy that would have driven rates up more. I just want to bring out the analytical difference.

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

MR. MARTIN. Move the ratification.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. We'll go to Mr. Axilrod and then to a coffee break.

MR. AXILROD. Mr. Chairman, I can be very brief. Alternative B is the alternative that assumes the continuation of a billion dollars of borrowing. We believe the general constellation of money market and other conditions that go with that reserve increase would be consistent with rather moderate M1 growth from June to September-- on the order of around 5-1/2 percent. That growth rate would bring the growth in M1 from Q4 to September down to 7 percent and we believe that would be on a reasonable track, hopefully, if the Committee so wished, to end the year close to around 6-1/2 percent growth. We would expect, and of course it's only an expectation, that that particular constellation would involve about the current level of interest rates and that this level of interest rates has some restraint in it that would carry forward into the fourth quarter. Alternative A suggests dropping the level of borrowing initially, by about \$250 million or so from the \$1 billion, and borrowing under Alternative C is commensurately higher. If attitudes with respect to the federal funds market and bank markets in general stay as they are,

we would expect Alternative B to involve a funds rate around 11 percent or a little higher; Alternative A would have funds moving down closer to 10-1/2 percent and Alternative C moving up closer to 12 percent. As Mr. Meek suggested, these attitudes could change. If they did ease off and banks were viewed more favorably, or if the money supply came in on what the market interprets as the reasonable side so that expectations of a monetary policy tightening edged off, or if the GNP data were weak, then the funds rate [pressures] could also probably subside some. In any event, Alternative B does have a funds rate range of 8 to 12 percent and Alternative A has a range of 7-1/2 to 11-1/2 percent. The present range is 7-1/2 to 11-1/2 percent. We've suggested that somewhat higher range in connection with the billion dollars of borrowing, simply to reflect the shifts in attitudes that have occurred in the past two or three weeks.

CHAIRMAN VOLCKER. Well, let's have a coffee break.

[Coffee break]

CHAIRMAN VOLCKER. [Unintelligible] about the perspective with which I, at least, approach this operational decision we have to make. This has somewhat more importance, I'm afraid, than worrying about the long-term ranges that we've been debating, anyway. I think we are at a critical point from a number of directions. I don't have any doubt about that; how much influence we can have is another matter. I am struck by the problems in the banking system. We touched upon that a few moments ago. As I understand the situation, I think the funding abilities of the multinational banks are virtually uniformly stretched. Psychologically, I think none of them has great confidence that they can do more funding than they are doing in any substantial amount. One evidence of that is the way [investors] all ran away from Continental even when they thought it was in better shape than, in fact, it was. Nobody was prepared, when they thought about it, to take on the funding risk that would be involved even for the biggest bank in the United States, even in considerably shrunken form. I think there is no doubt that they are all worried about their funding in varying degrees. In fact, it's probably not too much to say that a good many depositors would just as soon get out of bank paper if they knew where to go. If they don't know quite where to go, some of it hangs more than it otherwise would on customer relationships and all the rest.

VICE CHAIRMAN SOLOMON. They're going to have more of an opportunity now with the abolition of the withholding tax.

CHAIRMAN VOLCKER. Maybe. I do feel fairly confident that these problems aren't going to go away for a very simple reason. They reflect the fact that there are a lot of weak credits in the banking system. And they seem to be coming more into the open rather than the reverse--even discounting the LDC problem which, of course, sits there as the most looming threat. I might say, as a side point, that my impression is that they are adding to the weak credits in the banking system with new loans every day. I'm not full of pride about the supervisory performance of the United States in general or the Federal Reserve in particular. It's a very difficult area, but I think it's something that we have to concern ourselves with a lot more. One aspect of that is the holding company situation. When there is a condition of crisis, as with Continental Illinois, we find out that we

don't have a very good handle on the holding company and how it is funded and how its assets match up with its liabilities. We just haven't been analyzing these things in this way. One doesn't imagine that they would ever get into this kind of difficulty, but we're at the point where they are in this kind of difficulty, and I think we have to do some rethinking in that area. I might say in that connection that this is not entirely a side issue in terms of monetary policy. We are going to be raising the capital ratios for holding companies and banks and the FDIC and Comptroller have already made some announcements in that direction. It's not final yet, but this is going to be done in the next week or so. We will be talking about moving toward a more building-block approach with respect to capital in the holding companies. Now, apart from the supervisory implications of that coming at this particular time--while the move is not drastic in the sense that most of the multinational holding companies will be able to meet the new capital ratios of 5-1/2 percent, which I presume is where it will end up--some of them aren't going to be very far above it. And I think there will probably be a little accompanying music [suggesting] that this is another step toward still higher ratios in the future. The net result, I think, moves in the direction of restraint on asset growth. It may even be more potent than monetary policy--at least if we did it a little more aggressively--at this particular point in time. So, that's just some background.

VICE CHAIRMAN SOLOMON. Two of the banks are going to fall short.

CHAIRMAN VOLCKER. Well, I don't know; two or three will fall short, I think. will certainly fall short.

VICE CHAIRMAN SOLOMON.

CHAIRMAN VOLCKER. was getting there; I forget whether they were there. But I think most banks will want to get more comfortably above the new ratio than they are at the moment, so there's a degree of pressure there.

Looking at the rest of the financial climate: We referred a bit to the problems abroad. I don't have anything to add to what I said earlier about the problems of the developed countries. Let me just say a word about the LDC problem. I don't think there is any question that the general psychological attitude in LDCs has deteriorated in terms of the determination to adjust and pay their debts. The focus of that, of course, is in Argentina. It's a little hard to tell what is happening in Argentina now. It's rather at an impasse. But that feeling has affected other countries, even though we can show objectively that countries like Mexico and Venezuela and Brazil are doing better than expected. It is not just an economic problem but an increasingly difficult political problem. This last increase in the prime rate coming one day after the Cartagena meeting convened, when there was a great effort to restrain the radicals in Latin America, hit our friends like a kick in the solar plexus in terms of keeping the political situation under control. I'm not saying, certainly not economically, that some further increase in interest rates in the United States follows like night after day. But that situation falls apart. I don't think that is true economically but politically I think we are increasingly close to margins of

tolerance. The significance of that, of course, is partly that it feeds back into our domestic credit situation and the confidence in our own banking system. Now we have that whole set of problems. It's a set of problems we have not seen the likes of, in my opinion, since the early 1930s or late 1920s. One of the reasons we have the problem is that it has been so long since we've had it that no bankers could imagine it was going to happen again. So they went out perfectly happily and got rid of all their liquidity and filled up the balance sheet with less-than-strong loans.

When you look at the real side of the economy, as I said yesterday and I guess the view is widely shared around here, there is just a lot of plain forward momentum. I see very little [slowing], except possibly in housing, and that's not clear. We get a housing starts figure tomorrow. I did see a builder survey yesterday that shows a further decline in sales; it was an attitudinal thing-- traffic, sales prospects, and all the rest, which continues the trend that started two or three months ago in a fairly decided way. But that's a limited piece of evidence. Generally, I think the momentum is very strong in the domestic economy and is propelled by a lot of factors. If I were just sitting here looking at that without any of the financial problems, I wouldn't have much doubt about what I would do within the limits of monetary policy. I would be more restrictive because, just looking at that, I think that's where the risks lie. When I look at the financial system, I get quite a different picture of what maneuverability we have. To put it another way, I do think we have something of a knife's edge problem. If we are too easy, then this momentum in the economy will be excessive and will materialize in more strength than we'd like to see. If we are too tight, it might pull out the rug from the whole thing in a rather sudden way due to the financial concerns. I hope the knife has a dull edge rather than a sharp edge, but dull or sharp, it's not very easy to keep on a knife's edge. In a sense, I think we're coming close to running out of maneuvering room in terms of monetary policy alone. I don't conclude from this, as I guess I implied, that any kind of easing signal is justified or appropriate. But I do conclude, given everything we know at the moment, including that for the moment the monetary aggregates look reasonably quiescent, that it's not time to take a strong initiative in the restraining direction. So, that reduces the choices, in my mind, to a fairly narrow range. I am not saying that there is no room for some tightening down the road if the momentum of the economy continues and the aggregates move high and all the rest. I'm not saying [we wouldn't ease]--although I find this pretty far-fetched--if something happens that makes the economy on its own look considerably weaker. I really don't expect that. I do not discount the possibility of more financial stringency and difficulties that could arise from any number of directions, most likely from the LDC side. But it could arise from purely domestic or even developed country concerns. All of this leads me in terms of specifics to something like not doing very much right now, but remaining poised to tighten a little if we have to in terms of what happens down the road in the coming weeks. I guess I'll stop right there.

VICE CHAIRMAN SOLOMON. At the risk of sounding "me too-ish," that's exactly my view of it. I think we should not tighten further; we should simply consolidate the tightening that has taken place in the market. And we should certainly not ease. So, it seems to me that alternative B is what is indicated. I might argue--and this is a

nitpick--that on M3 I'm not sure it makes sense to put in 9-1/2 percent instead of 9 percent when 9 percent is the upper end [of the long-run range] and we're running over that. I don't know whether that one-quarter period is significant enough to aim for something that's over. But, with the exception of that nitpick, I would go with [alternative B]--\$1 billion for borrowing and moving the funds range up that extra 1/2 point to 8 to 12 percent. I assume that the general language would permit room so that if the banks relax further and \$1 billion of borrowing ends up giving us something in the neighborhood of 10-3/4 percent [for the funds rate], there would be flexibility to tighten a little so that we stay in that 11 or 11 plus percent range.

CHAIRMAN VOLCKER. Let me just clarify one thing. I said I think the aggregates are quiescent for the moment; that's based upon what information we have and estimates for July. And, of course, the last couple of weeks of July are a guess, but the first two or three weeks of July look like they're not really above the June average. So, we could have a reasonably low July figure.

MR. ROBERTS. Wasn't June rather high?

CHAIRMAN VOLCKER. There's no doubt that June was on the high side; the average with July may not look too bad. May was high but the average with April was not out of line.

MR. BLACK. You were saying the level was approximately what it was in June rather than the rate of growth?

CHAIRMAN VOLCKER. Yes. Oh! I'm not saying the 12 percent rate of growth, I'm saying [the level].

MR. BLACK. Yes. I think maybe Ted thought--

MR. ROBERTS. Yes.

CHAIRMAN VOLCKER. It looks pretty safe that it will come in at what, Steve--about a 5 percent rate of growth or less?

MR. AXILROD. Yes, and we'd need an increase in the second half of July.

CHAIRMAN VOLCKER. We would need a substantial increase in the second half to get it up to 4 or 5 percent.

MR. BOEHNE. The analysis that has been given is one that I feel comfortable with. The real side of things would tend to lead one in the direction of some snuggling up. But I think the problems on the financial side are sufficiently scary that they put a constraint on that. So, about where we are seems to make a lot of sense to me.

CHAIRMAN VOLCKER. Mr. Martin.

MR. MARTIN. I would certainly subscribe to the Chairman's summary analysis of where we stand. I'd support the status quo. I'm not sure whether alternative B is that entirely; I will in a minute comment on those numbers for the aggregates. In support of the Chairman's position about the evidence of some precariousness in the financial system, I remind the Committee of the size of the largest

savings and loan holding company, the Financial Corporation of America, which is now at about \$32 billion with 80 plus percent of its deposits purchased, and the FSLIC insurance fund is running at \$6 billion or so. I would name also the

[all of] which the FDIC has indicated it will move on promptly. And we're talking about assets of \$5.6 billion at \$6.6 billion at and \$7.5 billion at

Add that to the ongoing negotiations with Continental and you get some interesting arithmetic. Let's not run the signal flag up the mast, but the arithmetic [indicates] that there is certainly a vulnerability. The small banks have those agricultural loans, which are not improving. Well, there's no point in going through the risks; the Chairman has subsumed them in his comments.

I would hope that in the implementation of alternative B there will be flexibility, frankly, on the accommodative side. I have a slight difference from previous commentators in that I think the risks are rather imminent. And I would hope that the usual good sense is applied by the people at the Desk and the people here, as was evidenced in the very recent past so that as these crises develop and as the attitudinal waves pass through the money and capital markets, there will be flexibility on the accommodative side, which hopefully we can pick up coming round the barn, so to speak. We should all be aware, if alternative B is the consensus here, that relative to the March-to-June pace for M1 and M2 we're talking of moving from an 8-1/4 percent M1--I believe my numbers are right here--to 5-1/2 percent on M1. We're talking about M2 moving from something like 10-1/4 percent March-to-June to 7-1/2 percent. To me, that's too much. So, I'm somewhere between "A" and "B." I don't want to give the false signals of trying to soften interest rates that A implies, if I read this correctly. Nevertheless, I'm uncomfortable that we're bringing these aggregates down too fast as implied in "B." So it seems to me that we should give authority toward "B" but--yes, Steve?

MR. AXILROD. You gave the M3 growth. That was 10.2 percent; M2 was quite a lot lower than that.

CHAIRMAN VOLCKER. Yes, there's something the matter with M2.

MR. MARTIN. Oh! What is it for the March[-to-June period]?

CHAIRMAN VOLCKER. I just have the monthly figures here. Well, it was a quarterly growth rate of about 7 percent.

MR. MARTIN. Oh, all right. I'm sorry. So it's true for M1 but not M2.

MR. AXILROD. Yes, the figure you gave was for [M3].

CHAIRMAN VOLCKER. The quarterly average for monthly rates of 6.9, 8.7, and 7.3 percent--

MR. MARTIN. I stand corrected.

MR. KOHN. It's 7.7 percent for M2.

MR. MARTIN. For the three months?

MR. AXILROD. Yes.

MR. MARTIN. So, I'm an "A to B" type, Mr. Chairman.

VICE CHAIRMAN SOLOMON. What are you on borrowing?

MR. MARTIN. I'd like to see the borrowing at \$1 billion but, as the difficulties develop, I'd like to see if we could go to \$900 to \$1 billion. In other words, Tony, I'm arguing for a little flexibility on the accommodative side because I take these risks and these vulnerabilities very seriously.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, we seem to be close to the situation where the central bank has the choice of facing the threat of a financial debacle or risking inflation. It's something that has often been talked about, but it never looked quite as stark and immediate as now. On the side of forbearance and status quo, one could argue that we've had a rise in interest rates and its effects may not be fully embodied in our projections. It may slow down the economy. There are financial difficulties that may be on the rise and may themselves exert a restraining effect on the real sector. So it seems not unjustified to wait and consolidate, as Tony said, the recent interest rate increases. But, of course, there is the risk that if the aggregates and inflation expectations do expand, then the need to act is only postponed and the level of action may have to be higher. Six weeks or twelve weeks from now we may be sitting here and wish we had done a little now in order to forestall the need for more later. One thing that leaves me unsure about the proper action is that, with \$1 billion of borrowing, the funds rate may drop back to the 10 to 11 percent range from the 10-1/2 to 11-1/2 percent range, and I think that would be a mistake--to give a signal of the rate dropping. If the present relationship of \$1 billion of borrowing and 11 to 11-1/4 percent holds, that would be a reasonable thing to do. But I would then want to see flexibility in our assumptions with respect to excess reserves that would offset any effect of \$1 billion of borrowing in the direction of depressing the funds rate. On the aggregates, all I have to say is that "B" seems consonant with these general propositions, and I have no particular exception to make with "B," always bearing in mind that the projected funds rate there is 11 to 11-1/4 percent. Thank you.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. Well, I think there is a time to do some snugging, and there's a difference between snugging and a gross move. What I would like to see is sort of a "B+", which would be something like a 5 percent growth from June-to-September because--

CHAIRMAN VOLCKER. That's a "B-" in the normal nomenclature.

MR. ROBERTS. Well, "B-," if you want to call it that way.

MR. MARTIN. I like the first story!

MR. ROBERTS. I think of that as a "B+." I note that the quarterly average under "B," in fact, accelerates to 7.7 percent. And

I think we ought to be raising the borrowing target modestly to, say, \$1-1/4 billion, so that there is less opportunity to spill over inadvertently into a rapid growth in money as we maintain a borrowing target and provide reserves to get used and transferred into money. I think the momentum of the economy fully justifies this and I think the market has probably already significantly discounted something like this together with an increase in the discount rate.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I support your position. I think the evidence does suggest that the economy is decelerating. The leading indicators available for June suggest a further slowing ahead of us. If we were in the situation where the evidence clearly suggested the opposite, the decision would be a lot more difficult. But, I would certainly support alternative B.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, like a lot of other people, I've been waiting expectantly for some moderation in the growth of the economy. And while we've had some, the question is whether that moderation is enough. In my judgment, it isn't. I think that the economy at the moment is growing too fast to be sustained and that under normal circumstances such conditions in the economy would suggest that we ought to be doing something affirmatively to brake the economy somewhat. Even interest-sensitive sectors of the economy, with the possible exception of housing, are not really showing much effect from higher interest rates. On the other hand, we are not seeing inflation, as evidenced by the fact that commodity prices and gold and the price of the dollar are not indicating inflationary expectations on the horizon. However, some of that at least can be explained by exchange differentials. Ordinarily, because of those factors and believing as I do that we ought to be taking some firming action, I would like to see us somewhere between "B" and "C,"--a "B-" or "C+"-- with borrowing at around \$1.2 billion. Now, I don't know whether that degree of snugging, if that's what it is, would really exacerbate the financial situation domestically and internationally. I, too, have a lot of concern about what is happening. So, if that situation is as dire as you have indicated, then I would be happy with alternative B. The real concern that I have is that both of these problems--certainly the LDC problem and the domestic financial situation--are going to be with us for some time. These are not temporary problems. So, the question is: How long can we wait before we do something and how long are we going to be constrained by these forces?

CHAIRMAN VOLCKER. Let me just comment on that: Perhaps for a long time. I think the obvious economic policy approach in these conditions--where we are getting too much strength in the real economy and we have the financial difficulties--is tightening up on fiscal policy. I can't rub my genie to produce that, but the inability to produce it doesn't say there's another answer. Governor Gramley.

MR. GRAMLEY. I agree with Tony's and Henry's version of "B": Use the specs of "B" and if, in fact, we see some different attitudes of borrowing develop, inch up on the borrowing number rather than let interest rates go down. I do think, from a macro standpoint, that our

real concern is that this slowdown in economic activity which the staff foresees, and which I could foresee also, may or may not happen. It is still primarily a forecast. The concrete signs of that are precious and slim at this point. We have to keep hoping that it will occur. And if it doesn't occur and we have upward pressure on interest rates, then we're going to have some very, very serious problems about what we should do. Henry is right: The choice for the short run is either more inflation or a financial debacle. I think the best we can do about this is not to let inflation happen, but just to hold to a rather steady, sensible policy. And if we don't get some budget restraint, then there's going to be no way to avoid this.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I would accept alternative B also. I'm considerably affected by the moderate numbers projected in alternative B and would remind you that they are projections. If, in fact, the economy doesn't begin to slow as everybody is hoping, the numbers may well be higher than that. And if they're higher than that, then I think we'll have to take some action. I'm as concerned about the financial situation as anybody but, as I said yesterday, I feel that the real problem would come from having an excessive expansion that leads to inflation that [in turn] leads to significantly higher interest rates, which would not just take [down] the Financial Corporation of America but about 100 other savings and loans with it. I guess I wouldn't do anything to try to save Financial Corporation or Bowery or somebody like that if what I were doing was risking losing a great many more further on.

CHAIRMAN VOLCKER. Which particular institution is savable?

MR. PARTEE. So, I would pay a lot of attention to the performance of the aggregates in this period. I don't like to fine-tune the funds rate. I'm shocked that Henry is fine-tuning it to 1/2 of a point, because I always thought he believed that we ought to run on more basic things than just the funds rate. But I guess maybe it's because he doesn't want it to go down and that's why he would fine-tune it. But I would say that if it flexed down, I wouldn't have any problem with that. In that sense, I guess I join Pres. I don't want to bias the result. I'd take \$1 billion [on borrowing] and the specs of alternative B, and if the funds rate happens to move down 1/4 or even 1/2 point to where it was just a few weeks ago, I wouldn't have any great problem with that.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I have a strong preference for the aggregate targets in alternative C. As I mentioned before when I latched on to what Lyle was saying, I think it's vital that we continue our stated long-run policy of working the aggregates down. There are obviously risks if we try to push M1 down too fast after this rate of expansion, but I think there are also risks if we let it grow at a rate of 7-1/2 percent for the last half of the year as it did in the first half. And I hope, of course--and I even have some faint expectations--that the rate of growth in the economy will slow somewhat so it won't be necessary for us to take any action to try to deal with the aggregates. I'm very much encouraged by Steve's projection of M1. So, despite my ordinary predilections to do a

little now in the hopes of avoiding a more disruptive and stronger move later on, I would stick with the \$1 billion borrowing target now and raise that only if the aggregates show greater strength than it now appears that they're showing.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I'll stick with the Solomon/Gramley version of alternative B.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I also would go with what Jerry just characterized as the Solomon/Gramley version. I have a concern about the uncertainty with respect to the \$1 billion borrowing and its relationship to the current interest rate levels of 11 to 11-1/4 percent. Because of that uncertainty, then, I would focus more upon that [funds rate] itself, whether that's fine-tuning--Chuck's terminology--or not. We haven't had good evidence of a slowing of the [growth in the] economy yet, which I think all of us would like to see. The market essentially has taken us there, but for policy purposes it would seem to me more appropriate to focus on a federal funds rate because of that uncertainty in the period ahead. In other words, I would not let it go up or let it go down below the 11 percent level. It also says to me that if that's the general consensus, there should not be a movement in the discount rate, which is on the table before the Board. That's simply because if we follow the usual procedures, a 1/2 percentage point increase--if that were the number--would imply a 1/2 point increase in the funds rate level, which I think would be quite inappropriate.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, I would come out probably at "B-." I recognize the very real risks that you described, and they are real. On the other hand, I think there are risks on the other side. A perception that we were accommodating a lot of things could be almost as bad. I think, as Ted said, the markets have discounted quite a bit. I could see certainly holding where we are and maybe slightly more restraint. I would be inclined to go even farther except for the fact that our next meeting is coming up fairly soon and we will have another opportunity to discuss it and, obviously, we'll know more than we know now. On the borrowing level, I'd probably opt for about \$1.2 billion or \$1.25 billion.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. What I see is a difference of opinion between the Sun Belt and the Rust Bowl. Coming from the Rust Bowl, as I said earlier, I think the economy does show signs of slowing--not that we have gone into a decline, certainly, but the rate of growth is slowing. Also, I don't feel that the participants in the economy have fully adjusted to the interest rate increases we've had so far--for example, the last increase in the prime rate, which was rather recent. Business people don't adjust overnight and not even in a week or two weeks; I think we have to factor that in. Also, like the Chairman, I'm extremely concerned about the condition of banks. I don't think it's just Continental. Out in the other states there are banks with

problems and there are also tremendous problems with the thrifts. The ones that squeaked through the '81-'82 period by holding their breath have certainly had a little chance to get healthy, but they need more time to get healthy. And even with that 25 basis point increase on what they have to pay for funds we're going to have a lot of them in the soup very quickly. Also, there are tremendous consumer risks. I haven't heard this pointed out, I don't believe, but more and more consumer loans have become variable rate loans. While that has helped the financial institutions get rid of some of their interest rate risk, it has also enhanced the credit risk by a great deal. I think many consumers don't realize what they signed on for. I'm not just talking about ARMs; there are other kinds of variable rate consumer loans--car loans, etc. And I think there is tremendous vulnerability as I look at this whole package here. So, if I had to vote for "A," "B," or "C," I would go along with the "B" [specifications] and with the idea that the fed funds rate could range around 11 percent. I don't think financial market participants would think we had gotten sloppily easy if the fed funds rate were to drop, say, to 10-3/4 percent on a given day.

CHAIRMAN VOLCKER. You're going to have to vote.

MS. SEGER. Yes, I'm voting for "B."

CHAIRMAN VOLCKER. You don't have to vote right now, but you're going to have to vote either for it or against it at some point. I'm kidding!

MS. SEGER. Yes.

MR. BALLE. I generally support the position you outlined, Mr. Chairman, although my inclinations are to lean toward tightening because of a fear of inflation down the road. I'm also very much concerned about avoiding any rocking of the boat in the near future if we can avoid it. So I come out for "B" with the proviso that Governor Gramley added.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. I would support the Solomon/Gramley version of alternative B. And I hope it finds a knife's edge.

VICE CHAIRMAN SOLOMON. You have to wear gum shoes when I say that.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Maybe I'm missing something, but it does seem to be that there's a bit of a divergence of opinion around the table as to whether or not we have an overheated economy or one that is moving along quite well. For the reasons I stated yesterday, I fall in the latter category. I think the numbers are good and they're solid; but it's very, very uneven, particularly in the industrial sector. As a consequence, I would be very reluctant to see us make a move toward snuggling at this particular point for that reason and for the reasons that you suggested at the beginning. Importantly, also, I think my outlook for inflation is perhaps a bit more positive than some. I just don't see in the current signs or the prospective signs that

inflation really is likely to get away from us. So, as a consequence, I really do think this is good time to maintain a course that seems to be working. I would be in favor of alternative B with borrowing at a level of about \$1.0 to \$1.1 billion.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. By year-end I'd very much like to come out at the midpoint of our M1 range. That would tie into all the longer-term kinds of considerations we were discussing earlier about what should happen to those ranges. And that would cause me to choose something in the area of "B-," with a slight increase in the borrowing assumption, up to as high as \$1.2 billion. I do that, of course, with a considerable amount of discomfort because I think the financial strains that have been enumerated are very real and very serious. But the knife's edge has been referred to a number of times, and I think the strength in the economy and that need for a long-term policy are also very present.

CHAIRMAN VOLCKER. I would be sorely tempted, if we were operating the way the Open Market Committee operated 10 or 15 years ago, to say "Thank you, we have a consensus. Goodbye." I'm afraid we have to be a little more nitpicky. We're down to nuances. Just to be clear, I don't mean to suggest myself that we can do much about these financial problems by these minor decisions. But, in the range we're talking about, they're not going to go away if we stand pat; and in the range that we're talking about, all these domestic things aren't going to suddenly collapse on us. The international situation, at some point, might collapse in the range in which we're talking. But it's a question of how much justification we need, in some sense, to take an overt step at this stage. And I think we need a little more than usual.

There is obviously some small difference of opinion here; I suspect the prevailing view is what has been referred to as the Solomon/Gramley approach. I interpret that as: We don't do much now; we'd be very cautious about anything interpreted as any easing; and we might have to tighten if things come in stronger. I referred to the economy as having a lot of momentum; I may be wrong. I'm not sure I fully see all the slowing down so far in domestic demand, but M1 looks fairly quiescent in July. It could be anything in August. I wouldn't drop out of my seat if August came in with some very high numbers, in which case we may have to respond. But then we would have the evidence of that in front of us.

Now, how do we put this in terms of a directive? I think the numbers are simple enough. We are really talking about the alternative B numbers. Some people said they were a little in-between but the only real difference, described as a quibble about the number, is whether we make M3 9-1/4 percent--which is an odd number to put in the directive anyway--or 9 percent. Let me say that this is no big deal with me, but in the interest of rounding, maybe 9 percent is the appropriate number to put in there. Does that make sense to people? I guess we are talking about 8 to 12 percent [on the funds range]. I don't think that affects the substance, but it will affect the visuals of this when and if it's announced. And I don't know how hard-pressed I'm going to be in testimony to indicate some of this. I don't interpret [raising the funds rate range to] 8 to 12 percent as meaning

anything significant, but the market or certain Congressmen will. That does not say, given that the rate is between 11 and 11-1/2 percent, that we should not do that. But I just note that that will be interpreted by some people as a tightening.

VICE CHAIRMAN SOLOMON. Do you expect this bill forcing us to disclose immediately to pass in this session?

CHAIRMAN VOLCKER. No. It will come up, but I just assume it won't pass simply because they don't have much time. But anything can happen in the wild last days of a Congressional session, and it's the kind of thing that could be tacked on to something and we would just deal with it. I just want an understanding here that we are talking about [a funds rate range of] 8 to 12 percent despite the fact that some people may view this differently and it will get interpreted publicly as a tightening. I'm not interpreting it as a tightening in and of itself, but just a recognition of the reality that the funds rate is up around 11 plus percent currently. So, we give ourselves a little more leeway. Is that where we are? I don't see any dissent on any of this, if I may say so, with these numbers. I'm just getting the numerology now. Now I will try to describe reality. And I don't know how to put it in words [in the directive]. One possibility, which occurred to me last night but I didn't look at it very carefully, is to have a directive of the sort that we had in December, which basically says we're not going to ease, we're not going to do anything right now, but we might tighten during the period if the aggregates and the economy are running strong. Does that catch what people are talking about?

MR. RICE. Does that commit us to tightening if they run strong?

CHAIRMAN VOLCKER. Well, it buys a little leeway; it suggests a willingness to do a little something if both the aggregates and--. How is it worded here? Specifically what we said--and this is not magic--is "The Committee seeks in the short run to maintain at least the existing degree of reserve restraint. The action is expected to be associated with growth of [the aggregates].... Depending on evidence about the continuing strength of economic recovery and other factors bearing on the business and inflation outlook, somewhat greater restraint would be acceptable should the aggregates expand more rapidly." We could change that "depending on" clause. I suppose we'd add something there about financial markets in these circumstances. The rest of it is pretty standard.

VICE CHAIRMAN SOLOMON. What you're saying is that you want it asymmetrical?

CHAIRMAN VOLCKER. Well, it's one possibility.

VICE CHAIRMAN SOLOMON. Because the way it was last time--

CHAIRMAN VOLCKER. It was symmetrical.

VICE CHAIRMAN SOLOMON. It was symmetrical.

CHAIRMAN VOLCKER. Or that was the meaning. Just remember, we had all kinds of nuances there, but it was basically symmetrical.

It wasn't, I guess absolutely symmetrical. Sometimes we use "would" in one sentence and "might" in the other. Maybe we were absolutely symmetrical last time. This would be asymmetrical.

MR. PARTEE. I couldn't support asymmetrical. No, I think that's the wrong thing to do. And I think it was very widely misinterpreted in December when it finally came out.

CHAIRMAN VOLCKER. I'm not sure it was misinterpreted last time.

MR. MARTIN. I could not support an asymmetrical directive. I don't know whether implicit in such a directive and not enunciated because of the sensitivity of it would be an understanding that if there began to be trouble in financial markets, we would move in the other direction. I take it not. It would not have that.

CHAIRMAN VOLCKER. Oh, we always have the option of doing whatever we feel like doing with a consultation. I think it would assume that we don't expect to run into that contingency. That's a hard thing to put in the directive anyway, even if we had it symmetrical.

MR. BOEHNE. Well, I have a little problem with that kind of asymmetrical directive. We might tilt it a bit in that direction by playing around with words like "might." For example, we could say "Somewhat greater reserve restraint would be acceptable and leave "might" [for lesser restraint]. That might tip it a little; something of that order I could stomach more than a really overt loading of the dice to push rates up.

CHAIRMAN VOLCKER. In defense of December, we didn't do anything in this directive in December and I wish, in retrospect, that we had. We didn't have the evidence for it between the meetings.

MR. BOEHNE. Yes, but when it was released, it was released in a different kind of context and even though we didn't do anything, it was interpreted as a bias towards tightening. And I guess I'd rather not have that bias at this point. I'm prepared to see rates go up under the right kinds of circumstances. But I also wouldn't want to create the image that that's where our biases are.

MR. BOYKIN. If that were interpreted as a bias, I would view that favorably because I think that's where the bias should be.

MR. MARTIN. Well, I'm not sure that's where the bias should be. I think it may be a view of our setting policy such that we're accused of bias in the sense that [people say]: "These guys always see inflation coming, no matter what the price figures are." I think we have to avoid that appearance.

MR. BOEHNE. That's my point, right.

MR. MARTIN. "Knee-jerk inflation fighters" is the quote. That's a very unfair remark, but we do receive it.

CHAIRMAN VOLCKER. A pretty good reputation.

MR. BOYKIN. Well, my response to that is--

VICE CHAIRMAN SOLOMON. That's what central bankers are supposed to have.

MR. MARTIN. Yes, but always?

MR. PARTEE. Well, I don't think we can see the future clearly enough to bias this. I think we could get both some very good news on inflation and a marked slowing in the economy. I don't think we ought to seem to want to raise rates at every opportunity and notch them upward over time. And that's what that suggests to me.

MR. BOYKIN. Well, governor, it seems to me the conversation has been that ex all of these other overriding considerations at the moment--LCDs, fragility, and so forth--the sentiment is that, all other things being equal, we would be [tightening].

MR. PARTEE. I wouldn't--not with an M1 projection of 5-1/2 percent. I would not be tightening unless M1 comes in above 5-1/2 percent.

CHAIRMAN VOLCKER. Well, that's all it says.

MR. PARTEE. And if it comes in below, I think the funds rate ought to flex down.

MR. BLACK. That's what shifted my position right there.

MR. GRAMLEY. I could certainly support an asymmetrical directive because I do think we have to worry lots more about the economy growing too fast than the economy slowing down too much. But precisely for that reason, I think a modest move in that direction along the lines suggested by Ed would be all right, in the sense that I think the chances that M1 growth is going to slow below 5-1/2 percent are about 1 in 10. I'm really not worried about that. I think the third quarter is going to be quite a strong quarter; unless something very unusual happens, we're likely to get more M1 growth in that [quarter]. I don't disagree with Chuck; if [M1 did slow to below 5-1/2 percent], I'd want to think about easing. But I don't think it's going to.

MR. PARTEE. Well, I don't really think so either, but I think it could.

MR. GRAMLEY. If what we did was take that operational paragraph and used the word "would" in line 81 [of the staff's draft] and left "might" in line 82, careful Fed watchers would say "Aha! a degree of asymmetry." So, we'd get our purposes served.

VICE CHAIRMAN SOLOMON. Well, you know the Oracle of Delphi used to have this kind of language in it--pretty subtle readings of pigeons' entrails. Having said that, I think it's probably okay to do that kind of thing. The very frankly asymmetrical approach is probably not the most advisable. So, I also would vote for a judicious mix of "mights" and "woulds" or "woulds" and "coulds" or whatever else we can use.

CHAIRMAN VOLCKER. Well, I do care, but I don't care that much. I'm perfectly happy to be asymmetrical. I just want the record to show that because the situation is asymmetrical without much doubt in my mind.

MR. WALLICH. I think the symmetrical solution, in the unlikely event that the aggregates or the economy slowed down, would not be bad. But the possibility of a fortuitous move down without any real change in the situation could be very adverse and would then be reversed. Subsequently, rates would go up again and we would have given the wrong signal. I don't think we ought to take that chance.

VICE CHAIRMAN SOLOMON. That's the same point I made, Henry, and I'm assuming that this language could be interpreted to guard against that just because of changing bank attitudes toward excess reserves. This would prevent a meaningful drop in the rates. We could use this kind of [wording] and the flexibility would be sufficient to cover that contingency as well. Would you agree with that?

CHAIRMAN VOLCKER. I would agree with that, certainly. It's preferable that we have enough leeway here so that we don't give a false sense of easing if the money supply is not declining and there isn't evidence of the economy slowing, and so forth. And that may take a certain amount of flexibility in the management of reserves.

MR. BOEHNE. I would think that the sentence beginning on line 83--"In either case such a change would be considered against" all these things--certainly gives us enough flexibility to use judgment to guard against these fortuitous events that might lead one down the wrong path. It has everything in there except the kitchen sink, really.

CHAIRMAN VOLCKER. Well, that's mainly because I thought we'd be clear about it. I take it the contingency that has been raised here, which strikes me as a real one, tends to say the aggregates are more or less on path. We're always guessing what they will be next month. Let's say we start out with [M1 growth in] July at 3 percent or 4 percent, but we have a strong suspicion that it's going to be higher later and the other aggregates might be a little on the low side in July. But we have a strong suspicion that they're going to be higher later as the business news remains fairly good and there is no big change in that. If the money markets began easing, we'd be very cautious about supplying reserves until there was further confirmation of low money supply numbers and all the rest.

MR. CORRIGAN. I think you have to have a margin of protection in that direction. It would be almost calamitous to end up with a situation in which interest rates went down in the third quarter and had to go up in the fourth quarter. That, to me, would be the worst of all worlds.

CHAIRMAN VOLCKER. That would mean something as long-lasting even as quarters. To get a great feeling of relief and then in the next month to see them go back drastically in the other direction with the money supply taking off would be unfortunate, I think.

MR. BOEHNE. So do I.

VICE CHAIRMAN SOLOMON. It also complicates the LDC political attitude. If they get a sense of relief and then they get whammed again, it just makes things harder.

MR. GUFFEY. I don't think I understand the rationale for the bias on the up side on rates. We're talking about a 4-week period until the next meeting.

VICE CHAIRMAN SOLOMON. Five weeks.

MR. GUFFEY. We're at the 17th now and we're talking about an FOMC meeting on the 21st of August. However many days that is, it isn't very many. And the amount of information that will come in to suggest that we would push rates up from the present level further--. That's unconscionable in my view because we have had rates in the last 30 days go from the 10-1/2 to 10-3/4 percent range to 11-1/4 percent. And to put a directive out that will be read 30 days from now that suggests that this Committee sat around and adopted an asymmetrical directive that suggests a bias toward further tightening when we talked about the LDC problems and we talked about the fragility in the financial markets makes no sense to me.

MR. GRAMLEY. Well, I would not interpret this, Roger, as something we're bringing on just between now and August. Of course, this is the first meeting of a quarter. We're looking at quarterly growth rates for the third quarter for the first time. And we're trying to structure a directive that hopefully will last us through the quarter--not just until the next time--and give some indication about our basic concerns about how fast the economy is growing, the risks in financial markets, and so on. I would prefer to interpret it more broadly than that.

CHAIRMAN VOLCKER. I would add that there's no doubt in my mind--although I may be wrong--that the risks are that the economy is growing too fast. And on the inflationary side, the only thing that concerns me is the financial side. I'd be just as tight as I could be without precipitating that situation.

MR. GUFFEY. We may be there now.

CHAIRMAN VOLCKER. Maybe. We're not too far from it. But I'm always willing to probe a little further.

VICE CHAIRMAN SOLOMON. Aren't you going to be asked about current short-term policy when you testify?

CHAIRMAN VOLCKER. Probably.

MR. PARTEE. Quite strongly, I think.

CHAIRMAN VOLCKER. Yes, I think with any of these directives I would say, if I have to say something, that it has not changed.

VICE CHAIRMAN SOLOMON. Would you convey the flavor of asymmetry in your answers to those questions?

CHAIRMAN VOLCKER. It depends upon how the questions are asked.

VICE CHAIRMAN SOLOMON. Suppose the questions were asked the right way, would you do it?

CHAIRMAN VOLCKER. I might, yes.

VICE CHAIRMAN SOLOMON. Rather than symmetry?

CHAIRMAN VOLCKER. Well, maybe. I'm not going to say it just that way, I don't think. I might say that as I look at the situation with the economy moving the way it is and the inflationary risks, yes, there's a possibility we might have to tighten.

VICE CHAIRMAN SOLOMON. Particularly since you guys aren't doing anything on the deficit!

CHAIRMAN VOLCKER. Particularly since you guys aren't doing anything on the deficit--and as I evaluate the economy--I don't see great prospects for much easing. I might well say that.

MR. GRAMLEY. I would hope you would.

MR. BLACK. I hope you would.

MR. PARTEE. No great easing this time for the period. It seems pretty unlikely.

CHAIRMAN VOLCKER. Well, where we are and if that's the way you like it, is "seeks to maintain." We'll make it "would" instead of "might" and leave the [other] "might." We'll stick in 5-1/2 percent, 7-1/2 percent, and 9 percent. I think there's some understanding that some flexibility is necessary to prevent false [signals] and 8 to 12 percent. If we don't have any general consensus [to try] to improve on that, let's close it now.

MR. BERNARD.

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

CHAIRMAN VOLCKER. Now that we've disposed of that, we have to return to our other little problem here, if I can remember where we were. We have an issue yet. What we tentatively thought about was keeping them all the same; I began to worry a bit that if we keep M3 and debt the same, we actually ought to put a word in the directive itself. I don't know just what it would say. I don't remember what this boiler plate, which is pretty awful, says. We ought to add a sentence that while we reiterate the 6 to 9 percent and 8 to 11 percent, the Committee thinks there is a certain probability that growth will be above them.

MR. MARTIN. Because of certain--

CHAIRMAN VOLCKER. Well, what Steve was suggesting when I raised this question with him was to add a sentence immediately following the one on the ranges saying "It was anticipated that debt and M3 would increase at rates somewhat above their upper limits, reflecting in considerable part a rise in debt and the decline in equity financing related to recent merger activities." Maybe we should put a "however" in there. I scribbled down something, which I wasn't very happy with. In effect, it says that while this was anticipated the Committee felt that these [recent] rates were excessive in the longer-term perspective--excessive as a benchmark for evaluating the appropriate trend for credit and M3 growth. Let me try that out. That may not be so bad. Put a "while" in front of this.

VICE CHAIRMAN SOLOMON. That comes after the sentence you just read about mergers?

CHAIRMAN VOLCKER. No. Make it all one sentence. We state the ranges. They're unchanged. Then say "While it was anticipated that debt and M3 might increase at rates somewhat above their upper levels, reflecting in large part a rise in debt and decline in equity financing related to recent merger activity, the Committee felt that higher target ranges would provide an inappropriate benchmark for longer-term trends in M3 and debt growth."

VICE CHAIRMAN SOLOMON. But then we're putting ourselves on record that we're projecting--if I understand it right--a continued hectic pace of merger activity in 1985. Or are you saying that 1985 is going to be higher because of the mergers?

CHAIRMAN VOLCKER. This is a 1984 sentence.

VICE CHAIRMAN SOLOMON. Oh! I'm sorry.

MR. GRAMLEY. I would not like to put that "in considerable part" as the main reason why the credit variable is growing above the upper end. It's because the economy is growing so fast.

CHAIRMAN VOLCKER. We can take out the "in considerable part." Or we could take out the whole thing about merger activities and say "will rise somewhat above their upper limits, the Committee felt that such a rate of growth was an inappropriate benchmark for evaluating credit growth over time." Something like that tells them why we didn't raise the rate, even though we expect it to be higher. This is just for '84.

MR. MARTIN. I think that's reasonable.

CHAIRMAN VOLCKER. Well, without worrying about the particular language, but that it is something about this being too high a benchmark for evaluating what is right, is that okay?

SEVERAL. Right. Yes.

CHAIRMAN VOLCKER. Now we're set. Wait a minute. Do we need to change anything else? Maybe we ought to go over it. I'm looking at the typed-in language. "In furtherance of these objectives, the

Committee agreed to reaffirm the ranges for monetary growth that were established in January" etc. We take out this stuff about M1. Then we give the total debt range, which is reaffirmed. Then we put it in a sentence. And that's the end of 1984. We're accepting all the language the staff has here.

VICE CHAIRMAN SOLOMON. But what about the sentence at the end? "The Committee understood that policy implementation would require continuing appraisals of relationships--"

CHAIRMAN VOLCKER. I'm not there. I'm just talking about the ranges. I assume that will stay in, but I'm not talking about '85 yet, which is the next sentence. I'm talking about all the sentences on page 3, or whatever I have in front of me, which I guess is the same thing.

VICE CHAIRMAN SOLOMON. But doesn't the sentence I started to read, even though I jumped the gun, apply both to '84 and '85.

CHAIRMAN VOLCKER. Yes. I assume that will stay in, but we better [check]. Is that the general assumption--that that sentence stays in?

MR. PARTEE. What sentence are you talking about?

CHAIRMAN VOLCKER. The next sentence in the next paragraph. The one-sentence paragraph: "The Committee understood that policy implementation would require...." I'm just assuming that stays in. Apply it both to '84 and '85. All I'm talking about now is '84 and I'm just accepting the language that was prepared here, with the addition of the sentence we talked about. The effect of this language change from what we had before is to remove the probationary status of M1, but the other paragraph says that they are all to a degree probationary. With that, let us vote on 1984.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	Yes
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. Let me review the bidding on '85. We had a couple of questions. Is the consensus for debt unchanged at 8 to 11 percent? Some people did suggest 8 to 10-1/2 percent.

MR. CORRIGAN. I still like that, but I think 8 to 11 percent is all right. I assume you will be saying something about this horrendous pace of credit and debt growth.

CHAIRMAN VOLCKER. The general consensus is toward 8 to 11 percent, I take it. I think everybody was pretty much for 6 to 9 percent for M3. Is that correct? We have this little cosmetic point on M2. Let me just see: Among the Committee members, how many want it at 6 to 8-1/2 percent? Eight. [Secretary's note: Messrs. Boehne, Corrigan, Gramley, Martin, Partee, Rice, Ms. Seger, and Mr. Wallich.] There seems to be a clear majority for that. Can we live with 6 to 8-1/2 percent? That brings us down to the M1 number, where I take it the range is between 4 to 7-1/2 percent and 4 to 7 percent. We had a tentative vote on this before, but we were split. Let me try again. For 4 to 7 percent? Six. [Secretary's note: Mr. Corrigan, Mr. Gramley, Ms. Horn, Mr. Partee, Ms. Seger, and Mr. Wallich.] Does that mean the other five, excluding me, have a firm opinion or are some neutral?

MR. PARTEE. Tie.

CHAIRMAN VOLCKER. Who wants 4 to 7-1/2 percent? Five. That means everybody has an opinion.

MR. PARTEE. Now how about a "try to live with"?

MR. CORRIGAN. Well, we can try to live with 4 to 7-1/2 percent, but with some explicit statement that a further reduction to 7 percent might well be forthcoming.

MR. MARTIN. I don't have any trouble with that.

VICE CHAIRMAN SOLOMON. Then I think the tactical advantage gets lost because in a certain sense--

MR. PARTEE. He's not talking about publicly saying it. Are you?

CHAIRMAN VOLCKER. Well, I feel there is more to this than that. These are awfully weak reductions in these things if we don't go for 4 to 7 percent. I somewhat prefer going to 4 to 7 percent.

MR. PARTEE. Who can live with it?

CHAIRMAN VOLCKER. --ranges of 8 to 11, 6 to 9, 6 to 8-1/2, and 4 to 7 percent.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
President Boehne	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	Yes
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

MR. PARTEE. Everybody could live with it!

CHAIRMAN VOLCKER. I think we still have to do some talking about the uncertainty of velocity. This is based upon an assumption that it returns to more normal behavior. If it doesn't, which could be in the upper direction, we obviously have to reexamine it.

MR. CORRIGAN. But that last sentence you were talking about before provides for that.

MR. GRAMLEY. He means in the testimony.

CHAIRMAN VOLCKER. I'm talking about the testimony. All right, I guess we're finished. I don't know where we are on these projections. I think you ought to look at them again anyway. I don't feel that strongly about it, but I don't think we have to sit here and say we're assuming that the exchange rate is exactly where it is now. But I think an assumption that it does not decline [unintelligible] something like getting up toward 10 percent. We seem to have 5 percent up and down wiggles regularly, and I'm not sure that that's anything very much. But make an assumption that permits the Humphrey-Hawkins report to say that these projections are not based upon a severe, if that's the right word, depreciation of the dollar which would obviously have substantial, important and significant implications for changes in prices. The dollar remains substantially within the range of the last year. That probably allows for quite a decline, doesn't it?

MR. WALLICH. Wouldn't that have a substantial market effect?

CHAIRMAN VOLCKER. Well, I'm trying partly to avoid the market effect. We're saying we assume that the dollar is essentially in the range of the past year, but if it did decline a lot more than that, we would have more price inflation.

MR. WALLICH. We wouldn't intervene. That might be the conclusion of some.

VICE CHAIRMAN SOLOMON. I hope we're going to intervene in the deutschemark if the dollar goes above 3 deutschemark. That becomes a threshold.

MR. WALLICH. But I was thinking of supporting the dollar.

MR. MARTIN. You wouldn't have to take a calculator to Europe then!

CHAIRMAN VOLCKER. All right. I think Mr. Kichline would like to have [your revised projections] as soon as possible, which he interprets as midday on Thursday. What's today? Tuesday. I guess that's all we have, except the [confirmation of the August 21] date of the next meeting and sandwiches outside.

END OF MEETING