

Meeting of the Federal Open Market Committee

December 15-16, 1986

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, December 15, 1986, at 3:30 p.m. and continuing on Tuesday, December 16, 1986, at 9:15 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey
Mr. Heller
Mrs. Horn
Mr. Johnson
Mr. Melzer
Mr. Morris
Ms. Seger

Messrs. Boehne, Boykin, Keehn, and Stern, Alternate
Members of the Federal Open Market Committee

Messrs. Black, Forrestal, and Parry, Presidents of the Federal
Reserve Banks of Richmond, Atlanta, and San Francisco,
respectively

Mr. Bernard, Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Balbach, J. Davis, R. Davis, T. Davis,
Kohn, Prell and Siegman, Associate Economists

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

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

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International
Finance, Board of Governors
Mrs. Loney, Economist, Office of the Staff Director for
Monetary and Financial Policy, Board of Governors
Mr. Simpson, Deputy Associate Director, Division of
Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant,
Board of Governors

Mr. Oltman, Executive Vice President, Federal Reserve Bank
of New York

Messrs. Broaddus, Lang, Scheld, Rosenblum, and Ms. Tschinkel,
Senior Vice Presidents, Federal Reserve Banks of
Richmond, Philadelphia, Chicago, Dallas, and
Atlanta, respectively

Messrs. Beebe, Fieleke, and Miller, Vice Presidents,
Federal Reserve Banks of San Francisco, Boston, and
Minneapolis, respectively

Mr. Guentner, Securities, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
December 15-16, 1986

December 15, 1986--Afternoon Session

CHAIRMAN VOLCKER. We need to approve the minutes. No objections. Foreign currency operations.

MR. CROSS. [Statement--see Appendix.] Mr. Chairman, I have no transactions [to be approved].

CHAIRMAN VOLCKER. Any questions or comments?

VICE CHAIRMAN CORRIGAN. Mr. Cross was so clear.

CHAIRMAN VOLCKER. With all this silence, we'll go to domestic open market operations.

MR. HELLER. One quick question: You mentioned the Japanese-U.S. agreement. So far, has all of that been holding together on the exchange rate side just by the market perception that there could be intervention?

MR. CROSS. No, I think there have been other factors involved. There is the feeling that the yen really had moved quite far in terms of the situation in Japan. I think there is an expectation that further movement could lead to some developments within Japan that would cause more problems there. I don't think it has been done just with smoke and mirrors. I think there has been a difference in the actual impact of the exchange rate changes that have occurred in Japan vis-a-vis the effect of the exchange rate changes that have occurred between the United States and the Europeans.

MR. HELLER. You don't see, say, capital flows into the United States now to a greater extent because there is greater confidence that there would be--

MR. CROSS. We are still seeing capital flows into the United States from Japan; we have seen them all along. The one factor that has changed is the extent to which these inflows are offset, in effect, by measures in the exchange market to hedge against further exchange rate changes. But we are still seeing the inflows.

MR. HELLER. Do you see that hedging more or less?

MR. CROSS. The hedging? Well, going back to when the dollar was considerably higher, there was a lot of hedging taking place. We don't really have very good information on all of this, so what I am telling you is what we deduce and what the Japanese tell us. Just after the middle of this year, when the exchange rate had changed a great deal--the dollar was, say, at 150 yen as compared to 260--there was a change in their attitude about hedging against this, and they were taking some of their profits. Now it is a little uncertain as to whether they are still investing on a hedged basis or whether they are taking some risks.

MS. SEGER. What about looking ahead on swap lines? One reads a lot about Brazil, Argentina, and the Philippines. Do we anticipate being asked by them for swap lines?

CHAIRMAN VOLCKER. It's never impossible. The Philippines are not actually asking for money--just refinancing.

MS. SEGER. Is there still quite a bit of activity in the foreign exchange markets around the year-end by multinational corporations? I remember that used to be the pattern.

MR. CROSS. There are still some purchases of dollars by companies to kind of balance off their balance sheets at the end of the year. That is one of the factors that seem to have caused the dollar to show some strength recently because, as I was saying, as these corporations buy dollars the banks don't really seem to want to change their positions very much. So it goes right through the market and tends to have an impact on the rate and to send the dollar up a little. That has been a factor tending to strengthen the dollar so far as we can tell in the last couple of weeks.

CHAIRMAN VOLCKER. Let's go back to this swap question, just to avoid any misunderstanding. I answered on behalf of the United States; The Federal Reserve hasn't done swaps with anybody except Mexico anyway. The United States has, the Treasury also--it's kind of a division of labor.

MR. MORRIS. We don't even have a swap line with Brazil.

CHAIRMAN VOLCKER. They have agreed to a lot of Mexican ones.

MS. SEGER. Did the other banks sign on yet for the Mexican credit? Or is that still a--

CHAIRMAN VOLCKER. We have reached that critical mass, but still haven't got the uncritical mass. A lot of significant banks are not in.

MS. SEGER. But the uncritical is still out there?

CHAIRMAN VOLCKER. There are a lot of these LDC things coming together. The Philippines has just been hanging there; that's just a refinancing. Brazil, Argentina, Chile, Ecuador, and Venezuela have all come together and the mood is not good. It depends on how one interprets it. Paying off some--

MR. JOHNSON. What is the feeling about Brazil? Is there a growing feeling that they need a significant amount of new money?

CHAIRMAN VOLCKER. I think it is impossible to judge. They ran into a very bad time. The story of Brazil is they have to [unintelligible] for a while; instead of saying inflation went away, it was frozen out of the system. They have had very rapid [inflation] growth this year. Furthermore, there was a great loss of confidence in the weeks before the election. People knew they were going to have a program. They had capital flight and their trade position went to the devil, partly because of leads and lags and partly just because domestic growth was so bad. They lost a lot of reserves over the

course of the month, or 6 to 8 weeks. So when they finally took the measures--and I think they haven't lost any reserves since then and they probably have regained some--they were pretty well depleted, in the sense of what they think they need anyway. So their confidence that they can get through next year without significant new monies from the banks has evaporated. But how much they really need depends. The IMF patted them on the back on their program; there is no formal way [unintelligible] Paris for rescheduling. Rescheduling is fully anticipated but no money which is [unintelligible]. Whether this new money is \$2 billion or \$4 billion--

MR. JOHNSON. But they don't anticipate any further adjustments to meet the financing as conditions [unintelligible].

CHAIRMAN VOLCKER. They may have some [unintelligible] measures growing out of this program but they don't want to agree specifically to part of this rain dance--kabuki dance, I guess, is a more apt description--where they took these millions that they more or less thought would be approved by the international [unintelligible]. It is quite a big program; it is very disturbing and it is mostly excise taxes, what little excise taxes apply. You stick a 100 percent tax on automobiles, and I guess a 70 percent tax on some other items, so you get this tremendous price distortion.

MR. JOHNSON. They devalued a couple of times.

CHAIRMAN VOLCKER. Well, a small devaluation. They did a small devaluation to keep up with their own inflation, which is rising again. They manipulated the price indices so that these things that are really whacked will not be so heavily weighted in the price index for poor people so they won't have to raise wages. But it is a big program in terms of the budgetary impact, if they can carry it through--if people don't stop buying cars, which is one of the risks [given that] so much of the revenue comes from cars and other durables. They really whacked these out of sight in terms of the taxes; other things they didn't tax at all and continue to subsidize. Some internal distortions in the program [unintelligible] that just in sheer budgetary magnitude may be 4-1/2 percent of the GNP; I guess they already said 3-1/2 percent.

MR. HELLER. The sad thing is that they are going back to indexation, at least partially. If you didn't weight--

CHAIRMAN VOLCKER. Well, the big thing in this program, of course, was to pretty much get rid of it and then they took another step to try to get rid of the last debts. And that is what they are back on, informally. They took a massive step to get rid of it, so you wonder whether they will do some more backsliding. That is right. The actual backsliding compared to what they had is very small.

MR. TRUMAN. The latest measures didn't include any new indexation. In fact, they took off [unintelligible].

CHAIRMAN VOLCKER. I think you will find they put something back on.

MR. HELLER. I think they allowed bank deposits back. Do they link back to--

MR. TRUMAN. Well, they changed the taxation of certain deposits so you didn't get taxed on inflation--on a portion of the interest rate. Look at that as just not taxing the inflation portion of the interest base. Taxation limited [unintelligible].

CHAIRMAN VOLCKER. Mr. Sternlight.

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

MR. JOHNSON. Mr. Sternlight does have a sense of humor.

CHAIRMAN VOLCKER. Any questions?

SPEAKER(?). Peter, [do you see] any shift in the maturities that the Japanese in particular seem to be buying?

MR. STERNLIGHT. I heard more about them coming into the market after that Baker/Miyazawa agreement that Sam referred to. I am not aware of any great shift in the maturity area. They certainly have been interested in the intermediate and longer end and I guess if anything there perhaps has been a little renewal of interest in the longer end. Early in the year they were in the long end, and then were more in the intermediate area, and have shifted back somewhat to the long end, or a mixture of different areas anyway now.

MS. SEGER. Could you just educate me on a rather basic point? It seems to me that when CRR was introduced--almost three years ago or whenever it was--that one of the points made at the time was that it would give the Fed the opportunity and the ability to better control reserves and the money supply. And yet as I hear discussions on an ongoing basis it sounds as if we [still] have problems forecasting or estimating required reserves, etc. So, did I get the message wrong almost three years ago or has something changed between then and the implementation of this?

MR. STERNLIGHT. Well, I think there was probably a mix of views at the time as to how much improvement we would get.

MS. SEGER. I probably read some propaganda from somebody.

MR. STERNLIGHT. From the very start, CRR meant that we had to live with ongoing revisions of required reserves as we went through a reserve period. That's been something we have had to cope with.

CHAIRMAN VOLCKER. It depends upon what you are interested in controlling. The rationale for CRR was to get a very [unintelligible] between M1 and reserves. If you are interested in evenness in the federal funds rate and predictable nonborrowed reserves and predictable excess reserves, then it's [unintelligible].

SPEAKER(?). It is ironic that as soon as the Board approved CRR, its interest in M1 declined precipitously.

MR. ANGELL. So we continue to learn to live with the worst of both worlds.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. JOHNSON. [Unintelligible.]

MS. SEGER. Well, there are some people in banking who remember when [the reserve requirement] was contemporaneous the first time. It has changed and changed again.

CHAIRMAN VOLCKER. [Unintelligible] quick control over M1. No more questions on this? We will turn to Messrs. Kichline and Truman, [but first we need to ratify the open market] transactions.

VICE CHAIRMAN CORRIGAN. Move it.

MS. SEGER. I'll second it.

CHAIRMAN VOLCKER. No objections. We will hear precise, careful, thoughtful estimates of the internal and external outlook.

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

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

SPEAKER(?). Ted, one question: Maybe I misunderstood you when you spoke of the third-quarter net export number being \$151 billion. In the Greenbook, I believe--oh, the trade deficit. I beg your pardon.

MR. PARRY(?). [Unintelligible.]

MR. KICHLINE. Around 2-1/4 to 2-1/2 percent. So in terms of what we have for 1987, we are essentially growing a half point faster than that; given our translation, it is really worth 1/2 point or so. What, indeed, is the trend growth of productivity? The more recent numbers have been rather disappointing, closer to 1 percent rather than what we had thought--1-1/4 percent or even higher. So I think it is an open case at the moment. I don't view this as terribly out of line with our sense of potential growth in the economy. I suspect there are folks who have numbers all over the lot. Some outside forecasts [show unemployment] down to 6-1/2 percent; others have 3 percent growth and unemployment rates rising. So there is a good deal of variability.

MR. ANGELL. Jim, how much different does productivity look if you differentiate between the service sector and the goods producing sector?

MR. KICHLINE. Well, we don't really have good data, as you know, for well over a year. The evidence that we have suggests that manufacturing productivity is probably rising 3-1/2 to 4 percent. Service sector productivity is just really quite poor. So, we are getting strong productivity gains; that is important in this forecast. In terms of potential growth, we are trying to look at trend productivity for the economy in total, but there is a great deal of variation among sectors.

MR. ANGELL. Then it is possible that we really don't measure productivity in the service sector and don't measure the value of output in the service sector. We just assume productivity is going to be zero in the service sector, and lo and behold it is.

MR. KICHLINE. No, I think there is a little more information than that. Let's say it is open to question but there is a little more information than an assumption of zero.

MR. PRELL. That wouldn't enter into President Parry's question because, as you know, it would affect the GNP growth as well. It wouldn't affect our estimate of the likely effect of the growth numbers that we have on unemployment.

MS. SEGER. Jim, could you supply me with some dollar numbers? It helps me to think of the real GNP change--to look at the total dollar change expected fourth quarter over fourth quarter and then to look at the specific contributors. Mr. Truman just said that net exports are expected to provide about a third. If I am reading your numbers correctly, the fourth quarter over fourth quarter change in real GNP is expected to be about \$102 billion. On the right line, you say about a third of that would be supplied by an improvement in net exports. Where do you--

MR. KICHLINE. \$28.2 billion is the dollar amount [for net exports]. Ted's one-third is roughly focused on the growth rate of real GNP fourth quarter over fourth quarter. We have a growth rate of 2.8 percent, and if you take out net exports it is something like 1.8 percent.

MS. SEGER. Okay. Looking at the \$102 billion, where is it going to come from?

MR. KICHLINE. [Our forecast has]: \$60 billion in personal consumption; \$7-1/2 billion in business fixed investment; virtually nothing in residential construction; nothing, or perhaps a billion or two, in business inventories; \$28 billion in net exports; and \$5 billion in government purchases.

MS. SEGER. Okay, thank you.

MR. BLACK. I think Martha has a good point; you used to supply dollar figures [in the Greenbook] and then removed them awhile back. Sometimes [unintelligible].

MR. KICHLINE. You would like those sort of numbers in the green sheets?

MR. BLACK. I would and I gather that Martha would. I don't know--

MS. SEGER. It is hard for some of us who are not mathematical whizzes to take the rates of change and to equate them to specific numbers.

MR. STERN. Jim, I continue to have problems getting a real handle on the budget outlook. I see in the Greenbook that you have a \$180 billion deficit for the current fiscal year. That is very close to the current CBO baseline, which I guess is \$184 billion. I can think of a number of things that are likely to push that deficit up, starting from the CBO baseline, and not a heck of a lot that are likely to push it down. So it seems to me that the deficit is likely to exceed that \$180 billion, perhaps considerably. I am having

trouble reconciling that with what you mentioned might be the latest OMB projections.

CHAIRMAN VOLCKER. What is the latest OMB projection?

MR. KICHLINE. The number floating around that is still preliminary, I think, is \$163 billion for the current fiscal year. That's still subject to change but it's in the \$160-\$165 billion area. Keep in mind: that is the same number that just a matter of a few months ago was \$143 billion; so they have added \$20 billion. It's a case of how much you want to up the ante. We have added another \$20 billion. I think there is a danger of going too far in that direction, because there were legislative changes enacted that will begin to bite. One of the issues relates to defense. We had a lot of defense spending in the second and third quarters of last year. It is our sense that the level of that spending is now quite high. We have had major weapons systems deliveries that are now coming in; they are producing these things at a very rapid rate. But we don't expect defense spending to continue to grow in real terms at a fast clip. Rather we expect, as we get into the first part of next year, that we will probably have constraints on defense spending--in part because appropriations were cut back at the Administration's request. I would say that if we are wrong, I would probably add more; that is the safe way to go now. A big question mark is the agricultural area; we have substantially more dollars in there than does the Administration. My experience over the years is that even when we do that we are always low. It looks sort of outrageous but basically it turns out to be a really important issue. I think it is too pessimistic to say that things weren't done. I think they were done. And I think they will begin to show up as time goes on.

MR. JOHNSON. One of the problems with the defense budget is that when you initially have a defense build-up and add to authority, you build up a lot of authority in the system; then, as you start cutting back that budget authority, the actual outlays start to speed up because you have a lot of backlog in the system. And that can go on for quite some time. It is a strange anomaly: when you are actually cutting budget authority you see outlays increase. But that can happen; I know that has happened a few times before.

MR. STERN. There was something in the news today about the Administration requesting some additional defense funds for the current fiscal year as kind of the quid pro quo for a modest increase in 1988. It adds to that--

MR. HELLER. You have a nice chart on the effect in the Greenbook. I can't find it right now, but it is kind of startling: the authority goes down and the outlays are going up. I don't know what page it is on, but it really makes the point nicely.

MR. PRELL. Page 17.

MR. JOHNSON. It really does happen.

MR. HELLER. Page 17.

CHAIRMAN VOLCKER. What do you make of the decline in unemployment insurance claims?

MR. KICHLINE. We had a lot of employment growth.

CHAIRMAN VOLCKER. Not as much as in some earlier months, when unemployment claims didn't do anything, if I remember correctly.

MR. KICHLINE. Over the last two months or so, they have been averaging about 20,000 to 23,000 per week under what they had been running during the summer. In October-November we did have increases in manufacturing employment; and that is the circumstance where you often see the [effect on] initial claims showing up very promptly. The employment growth for those two months is very strong. It has been a reliable leading indicator and I would say it is supportive of a strengthening labor market. That is what I would make of it.

CHAIRMAN VOLCKER. You'd make something of it?

MR. PRELL. Another facet of the recent data is that the household employment series is not showing gains as strong as the payroll series. If there were some catch up, as there might well be, we could see the unemployment rate tick down and be more consistent with this pattern that we have seen in the claims recently.

MS. SEGER. How is it handled statistically when these masses of people who are in middle management get pink slips and are given a severance package or are given psychological treatment for two months or something to help them adjust? Do they show up in the unemployment statistics immediately or do they have to wait to apply for--

MR. KICHLINE. I don't know the answer to that question.

MR. PARRY. I think on the payroll survey they wouldn't show up, because many of the companies that do this actually keep them on the books for maybe a three- or six-month period.

MS. SEGER. I see.

MR. PARRY. So I don't think they would show up.

MR. PRELL. I gather, though, that once they have been severed, even if they have gotten some payment, you can expect to see them listed as unemployed and eligible for unemployment insurance.

MS. SEGER. Okay. We may be seeing some of that.

MR. JOHNSON. I have another question. There is a further 10 percent depreciation of the dollar built into the 1987 forecast. How important is it if that does not come about? Or is the lag long enough that it doesn't affect 1987?

MR. TRUMAN. That is a very difficult question to answer. I can really only answer within the context of the way we think about these things. The way we put this together it has quite a significant impact on the forecast--not on the export side itself, because there the price lags and the quantity lags are longer and, in some sense, we have already constrained that forecast to be less ebullient than one would think would come from the current pace of exchange rate changes. But you get a faster move on the import side; you would get more and more import growth if things stayed unchanged. And you get a quite

rapid impact on gross investment income from abroad; we still get a considerable amount of investment income from abroad and that gets translated very directly into higher dollar value. In the way we put together our deflators and price indexes, you get quite a rapid increase from a 10 percent depreciation over this period.

MR. JOHNSON. On the import side.

MR. TRUMAN. On the import side. The bottom line, if I remember correctly, is that if you kept things at the current level maybe about two-thirds of the improvement would go away.

MR. ANGELL. Do you have import prices moving up this year by 5-1/2 percent?

MR. TRUMAN. Actually, we have had it at a little above 5 percent.

MR. ANGELL. And you have import prices moving up in 1987 at 10 percent. Now, let's posit that they would turn out not to be that strong. Let's suppose that import prices were to move up next year more like they do this year; I presume that means that the real trade doesn't improve as much.

MR. TRUMAN. That's right.

MR. ANGELL. Real GNP isn't as favorable, which would also mean slightly better on the inflation.

MR. TRUMAN. I think, on net, things would deteriorate.

MR. ANGELL. On balance it deteriorates. If you do that, then in the scenario in which the foreign exchange rates remain about constant, rather than depreciating 10 percent, that together weakens the entire--

MR. TRUMAN. Right. I would emphasize, in answer to Governor Johnson's question, that there are a number of ways to view this--that honest men and women get different results from essentially the same set of initial conditions, including what might or might not be in the pipeline. That is partly just a function of the fact that you have so much relative price change already. If you thought imports were going to be much more responsive to the price change you have already had, and you stopped the depreciation where it is, then you are going to get significant improvement on the real side. And you would likely get an improvement on the nominal side because, essentially, you have had most of the price change and the quantity change, by hypothesis, coming down a lot. But as I said, to get the \$28 billion that Jim mentioned earlier we stabilized things at the fourth-quarter level, and we get, in real terms, about \$21 billion. About \$12 billion of that is on the trade side and \$9 billion is on the services side--most of it from higher real imports.

MR. ANGELL. Do you have any interest rate assumptions for the United States vis-a-vis--

MR. TRUMAN. Not built into that scenario.

MR. ANGELL. The interest rate assumptions are built in or are not built in?

MR. TRUMAN. In running that kind of experiment, we didn't change the--

MR. ANGELL. So U.S. interest rates--

MR. TRUMAN. They were lower; U.S. interest rates probably fell. You still earn more--

MR. ANGELL. I didn't quite understand you.

MR. TRUMAN. The question is: How does the lower interest rate affect our net payments? It affects how much we receive in interest payments. And [unintelligible] stocks are such that a lower interest rate--leaving aside dividends and those kinds of things-- [unintelligible] still gives you less net receipts.

MR. ANGELL. Are there any corporate profit assumptions that are explicit in this forecast?

MR. TRUMAN. Well, just on the international side, as I said, most of that \$9 billion at an annual rate does add up to corporate profits; it is real. At least in the accounting it is a consequence of exchange rate changes. Those numbers are very large.

MR. KICHLINE. We do the income side of the accounts, as well, so we have corporate profits. In economic terms they are barely higher in 1987 than in 1986; and if you take profits after tax, they indeed would go down because of the \$15 to \$20 billion tax increase that we have built in for the new tax law. So essentially, corporate profits in an economic sense are little changed next year.

MR. HELLER. May I ask you a different question on the domestic side? The hourly earnings index has been declining very sharply, and there has been a lot of publicity recently given to new entrants into the workforce being paid barely above minimum wage. Is that improvement in the index entirely due to new low-wage workers entering the workforce? Or is it across the board for existing workers as well? In other words, is the mix--

MR. KICHLINE. The hourly earnings index that we focus on adjusts for inter-industry shifts in employment. So it is not average hourly earnings as such; the index adjusts for that. As you know, it popped up in November by about four-tenths; it is volatile from month to month. Contract construction was up very strongly and there were wage increases as well in finance, insurance, and real estate. That has been a hot area--particularly the real estate, where there has been a lot of employment and maybe there has been some bidding up of wages. But I don't know that we have noticed anything in particular about rapid growth in the minimum wage area. I would note that other information that we are looking at for contract construction does not tend to support this sense of a very rapid sustained increase in construction wages. Did I answer your question?

MR. HELLER. Well, actually I wasn't focussing on the November numbers. I was looking at the quarterly numbers because the

monthly figures are so volatile. The quarterly figures show a sustained downward trend and I was really wondering whether the new entrants are pulling the average down or whether that reflects just low settlements across the board.

MR. KICHLINE. Some of it is lower settlements. We do have information there: the average of settlements in the Bureau of National Affairs series, which includes all settlements of 50 or more workers, continues to drift lower. One other feature that is influencing the labor market data on the wage side, in a major way, is that many of the agreements provide for bonuses and lump sum payments that do not get cranked into the hourly earnings. That's sort of straight time salary. But this bonus feature pops up a great deal and that may be one thing that--

MR. HELLER. That's outside the index?

MR. KICHLINE. Yes, the index is straight time hourly pay; it takes away overtime and all these other things. That particular feature is captured in compensation measures but not in the hourly earnings index. And that seems to be spreading.

MR. TRUMAN. If I may correct myself, Governor Angell. An increase in interest rates would deteriorate the current account. [Unintelligible] on balance that way. Now, on the GNP net exports-- because you net out government interest payments--it would go the other way.

MR. ANGELL. Ted, thank you.

MR. FORRESTAL. Ted, can I go back to what you said before about the exchange rate? Did I hear you say that if the exchange rate remains the same in 1987 that two-thirds of the improvement would disappear from the trade balance?

MR. TRUMAN. That is the conclusion that we have come to.

MR. FORRESTAL. If that were to happen you would then--

MR. TRUMAN. This is in the real [balance]. It would be less than that amount of deterioration on the imports, on the net current side, because you don't have the right [unintelligible].

MR. FORRESTAL. I am thinking about what that does to the overall forecast. You said that one-third of the forecast is dependent upon improvement in the trade balance. If you remove two-thirds of that improvement, your forecast is 0.6--

MR. PRELL. Well, that is assuming--

MR. TRUMAN. In retrospect it would be 0.6 percent.

MR. KICHLINE. I think there are other things that happen. You may well have different price behavior, for example, or different interest rates that come out of the forecast, or different consumption spending. Basically, the inclination is not simply to adjust the domestic forecast down by the full amount because these other things could be happening to help shore up--

CHAIRMAN VOLCKER. Subject to your correction, you have about the lowest price forecast of any of these standard forecasts. Would you explain why I should be so reassured?

MR. KICHLINE. Well, Mr. Chairman, [unintelligible] says that we are going to get [unintelligible].

CHAIRMAN VOLCKER. [Unintelligible] remind us that we've all been too high [unintelligible]; next year we are in the clover, it seems.

MR. KICHLINE. It depends on what you assume about the oil price and, as Ted mentioned, we have that drifting up to \$16. So that is clearly different from 1986 but it is not a major problem. Another big issue is what you assume about import prices and how they will be reflected in domestic prices. We think we have something reasonable there. I don't know how some of these other forecasts track that through. In addition, our sense is that we have at the moment fairly moderate wage growth, in terms of measured expectations of inflation. You say we are at the low end, but I guess when we talk about numbers that are four or five percent I would want to be at the low end. I wouldn't want to be there all the time, but I am perfectly happy sitting there in December 1986.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. KICHLINE. Right.

MR. JOHNSON. DRI has a somewhat [unintelligible] forecast. I don't know if you know why, but they also have more improvement in the trade balance than we do.

MR. KOHN. They are pretty close to our basis.

MR. JOHNSON. It is a similar forecast.

MS. SEGER. Isn't DRI the major model that is also concerned about a recession?

MR. PRELL. [Unintelligible.] I think we are lower in compensation than they are but less optimistic about productivity growth.

MR. PARRY. Ted, you focused on net exports for 1987. The growth that you have for the fourth quarter of 1986 is very large.

MR. TRUMAN. Two-thirds of that, or a little more than half of that, is the oil. About \$15 billion of that reflects the change in the fourth quarter in the volume of oil from the high level. We have different sources of preliminary data for November, too, and we are more confident about that number than about some of the others.

MR. PARRY. It is certainly interesting to note that the growth in real terms is \$28.6 billion for the fourth quarter of which \$27.2 billion--

MR. TRUMAN. A lot of it is based upon two assumptions: one is that the oil imports will behave this way; and the other has to do

with what is or is not picked up in the national income accounts on counterpart inventory. Such a very little amount was picked up that we could find [unintelligible] in the third quarter, assuming that we treat it symmetrically in the fourth quarter. Much of it is oil; a small part of it is non-oil imports. And agricultural exports have been quite strong. Again, we have both October [data] and some other information on November agricultural exports; it seems [unintelligible] special factors which are not carrying through that expansion in the forecast period. But we have had a \$4 billion annual rate of increase in ag exports, which largely [reflects] Japanese purchases, and then some continued improvement on the [non-ag] export side.

CHAIRMAN VOLCKER. I think we might call on Mr. Kohn for comments about Mr. Simpson's paper.

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

CHAIRMAN VOLCKER. I think the question we might devote a little time to--[not] this afternoon but tomorrow morning--in setting the stage for our next meeting is what targets we want to use, if any. I have been assuming that we would have targets for M2 and M3. M1 looks a lot more doubtful to me. I think we might go some distance in establishing a framework so that when we come to the next meeting we'll at least know what targets we are going to have, if any.

MR. HELLER. If any? You are required to have them, right?

CHAIRMAN VOLCKER. I think you are right. It is a matter of law; we've got to cook up some target. That was a little too [unintelligible]; I don't want to [unintelligible] my view yet.

MR. JOHNSON. The broader aggregates we never [miss] that badly. As for M1, a big question mark in my mind is whether we even want a target for next year. I would hate to get into the same situation we got into this year with M1. That could really constrain the markets quite a bit at the beginning of the year--if we set a target assuming another stable pattern of velocity for the year and end up with something [close to this year]. There just seems to be too much uncertainty about it, period. The study even indicates that there is so much uncertainty around M1 that it doesn't seem to have any great advantage. Maybe if velocity patterns stabilized a little more during the year we could re-establish a target at midyear.

MR. HELLER. I think it is not only the disinflation impact on M1 but also the very sharp shifts that we get in the components right around that borderline of M1, those between M1 and M2. We get growth rates up and down, near 20, 30, or 50 percent sometimes. And it is right on that borderline; it's very difficult to draw a line right there. If we want to have an M1 target we might want to look at the old M1A, or something like that, which apparently has been a little more stable.

MR. JOHNSON. It has done better.

MR. HELLER. Maybe somebody from the Research Department could--

CHAIRMAN VOLCKER. [Unintelligible.]

MR. JOHNSON. [Unintelligible.]

MR. HELLER. No, I am not going to advocate the old M1A. I am just saying between that and the current M1 it would be the lesser evil.

MR. JOHNSON. You mentioned the sensitivity of M1 to a change in interest rates. But what about the spread between NOW accounts and time deposits?

MR. KOHN. Well, when I mentioned interest sensitivity, I was thinking of something that really encompassed the opportunity cost, so that would be relative to that time deposit--.

MR. JOHNSON. So when you mentioned a percentage point decline in interest rates, you meant a compressing of the spread?

MR. KOHN. Right. Or a widening.

MR. JOHNSON. A decline in the opportunity cost.

MS. SEGER. Could you tell us more about the new model that you have that does a better job explaining the relationships?

MR. KOHN. The most recent version basically encompasses what we think is a little better fit on the offering rates--establishing those in the model. But mostly the reason it gives a better performance is that it has been refitted and it has much higher interest sensitivities and that happens to--

MS. SEGER. Just because you added the additional experience.

MR. KOHN. We added additional experience and I think the models are influenced by the most recent experience in some way. I have my own concerns that we may have over-reacted econometrically, in some sense, to the most recent data--that some of the shifts that we've gotten in M1 are really very substantial shifts in reaction to a change in the state of the world from a high interest rate, high inflation world to a lower interest rate, lower inflation world. My concern is that when we look back a couple of years from now, by incorporating that into the interest sensitivity term we may have overstated what actually could happen as interest rates fluctuate in a cyclical sense in much smaller waves around a lower level. I can only emphasize the tremendous uncertainty at this point.

CHAIRMAN VOLCKER. Let me summarize what I think I heard you saying. As a central point, if one assumed no change in velocity with unchanged interest rates M1 would go up 5.5 percent. If interest rates then moved up 2 percent we should have about a 14 percent increase in M1; in a different environment, if they moved down by 2 percent we should have minus 3 percent.

MR. KOHN. The other way around. But you are right that a 2 percentage point change would imply maybe an 8 percentage point effect; I used one percentage point and got a 4 point effect. Now, that is--

CHAIRMAN VOLCKER. You multiplied by 2.

MR. KOHN. Right.

VICE CHAIRMAN CORRIGAN. But that too is opportunity cost.

MR. PARRY. Are you saying that in the estimation the interest rate elasticity may be somewhat higher than is really the case--that it may be more of a one-time shift?

MR. KOHN. I have that suspicion. Obviously, I can't show it. It is true that the newer models with the higher elasticities do pretty well this year; they show about a 12 percent growth. So they've got that on their side. I just have the suspicion that in some sense we may have overreacted. But I think that M1 is going to be very interest sensitive, very sensitive to opportunity costs--in part because, as Governor Heller was saying, it is closely substitutable for other kinds of short-run liquid deposits and insured deposits. And as those things shift then--

CHAIRMAN VOLCKER. When you say a one percent change in interest rates, you are talking about a one percentage--

MR. KOHN. One percentage point change in interest rates. In my own calculation I was using the funds rate.

MR. JOHNSON. I thought you said--

CHAIRMAN VOLCKER. Absolute change. All you are talking about is a change in the funds rate from 5 percent to 6 percent or from 5 percent to whatever.

MR. JOHNSON. I thought you said there was some opportunity cost--

CHAIRMAN VOLCKER. [Unintelligible] the opportunity cost is between--

MR. KOHN. That implied that there was some adjustment by the institutions, but a slow adjustment. That is, this was taken from the table in the last part of the paper that referred to a slow adjustment of the offering rates. It didn't imply that offering rates didn't change--only that they changed slowly as they have this year. So it is not necessarily a one percentage point change from opportunity cost; it would be something less than that. It would be, say, a one percentage point change in market interest rates on January 1st and then a very slow adjustment of offering rates to that.

MR. ANGELL. You assume this interest rate sensitivity works both ways on the same demand function?

MR. KOHN. The way we have it now, it would. But for large changes, I am not certain.

MR. ANGELL. [Unintelligible.]

MR. PRELL. The symmetry of the response of the banks to this is a further complication.

MR. ANGELL. If it did have symmetry, that would mean that if we were ever to get back into a higher inflation scenario and the need for higher interest rates one might argue that the correct path for M1 might be zero. This thing works both ways.

MR. KOHN. It's not likely to be symmetrical from the current levels since offering rates are above where they need to be anyhow. If you raised interest rates from the current level, presumably you'd short cut a certain adjustment that otherwise would be happening. So it is a more complicated kind of thing. But if you started from an equilibrium relationship of offering rates--

CHAIRMAN VOLCKER. If the market rate that you use changes by one percentage point, what is the elasticity of M2 and M3?

MR. KOHN. I don't have an M3 elasticity, but M2 with a slow adjustment would be .09 elasticity. So .09 times about 16 percent would be about a 1-1/2 percentage point change in M2. The elasticity with respect to M1--this is over a year--was .23.

MR. BLACK. Don, in expressing doubts about the new model, are you explicitly assuming that you will have more rapid adjustment on the offering rates?

MR. KOHN. Well, that is another thing that could happen here. It could be, particularly if interest rates moved down, that the cost pressure on banks would be so large that the competitive dam would break and you could get offering rates moving much more promptly than that--

MR. BLACK. You are seeing some movement--

MR. KOHN. You would have smaller elasticities but they would still be large.

MR. ANGELL. It would be relatively [more] comfortable than living within an M1 pattern for 1987 of between 2 percent and, say, 16 percent.

MR. MORRIS. Mr. Chairman, I think that we have come a long way on this subject in the last [few years]. A few years ago, we were sitting around here talking about M1 as if it were synonymous with transactions balances. I should hope that that concept may be seriously damaged. And we were talking, either directly or indirectly, about the causal relationship between the rate of change in transactions balances and the rate of change in nominal GNP. As you know, [I have been] arguing that we can't measure money anymore and that we really should start to think in terms of gearing policy to the rate of change in liquidity. In that connection, I think one indicator that we might want to use--if you think there is safety in numbers and in the past that has proven to be the case--is total liquid assets, if you can displace M1. I would certainly strongly urge that we use total liquid assets if we want a third [target]. Last year its behavior relative to the nominal GNP was less defective than any of the other indicators. It wasn't too great, but it was less defective.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. MORRIS. Well, there was one year when it was [unintelligible] but so did all the others--everything did well--and that was 1982. Since 1982 its velocity has been less than tranquil, I see, but the deviation as compared to M1 trend velocity is very small. I am not saying that any of these is anything that we should tie our [unintelligible] to in any rigid way. What we have learned is that none of these monetary aggregates has an extremely stable relationship to nominal GNP. But the fact is that in four out of the last five years we have not met our initial M1 target, and I think that is something we ought to pay a little attention to. Despite the deviation of the relatively broader aggregates from trend velocity, we generally have been hitting the [targets for] the broader aggregates. We have had ranges wide enough to encompass them. And we have done that this year. If we are forced to go with these, and under current law we are, then I think it makes sense to go with--I wouldn't call them targets--but indicators of monetary policy that we are more likely to hit. And I think the situation with M1 now is such that M1 velocity is completely unpredictable. We need to forecast M1 velocity, as Mr. Kohn's paper indicates. But first we need to know what is likely to happen to interest rates, what the relationship between nominal GNP and interest rates is, and also how the bankers are going to respond to any change in interest rates. And it seems to me that all that adds up to the proposition that the current M1 velocity is not predictable.

CHAIRMAN VOLCKER. Suppose we had a situation where interest rates were rising, say, one percent or more and M1 was rising at the same time, say, at least faster than the nominal GNP. Does that tell you anything?

MR. ANGELL. Yes, it certainly does. It seems to me that Frank wants to throw away too much. During a period of accelerating inflation, from even very low levels, it seems to me it's the case that there is still a rather stable relationship. There may be a stable relationship during periods of disinflation, but we may not be willing to admit to what that is. That is, we may not be willing to admit to the negative velocity that would entail. What I think we know is that when you shift from an inflating [unintelligible] economy to one of disinflation and outright deflation, then those relationships are unstable. And I think that every such period in history would demonstrate that to be the case.

MR. MORRIS. I am just saying that I have no objections to using M1 for whatever information you think it may be giving you. What I do object to is using it as a published target of monetary policy when the uncertainties are so enormous.

MR. JOHNSON. I agree with that point. I think Wayne has made a good point too. You can visualize times when this relationship gives you a lot more accurate assessment of nominal GNP, and I can see a time when more stability would return to M1. When you have big shifts, as you say, from a high inflation, high interest rate economy to low inflation and low interest rates, you expect big changes and unstable conditions. I wouldn't want to throw M1 out altogether; but I certainly feel uncomfortable publishing a target range for 1987 in the middle of a transition period like this. And giving people the impression that we are going to make some attempt to hit that target really bothers me.

MR. ANGELL. Maybe we should call it a monitoring range.

MR. MORRIS. Even if you do that the New York Times is going to publish a picture of it every Friday showing M1 way [outside]--

CHAIRMAN VOLCKER. What [velocity] increase do you get with, say--just to keep the arithmetic easy--a 6 percent increase in nominal GNP and no change in the discount rate?

MR. KOHN. For next year we would have, because of some of the lagged effects of the declines in interest rates--

CHAIRMAN VOLCKER. Suppose there are no lagged effects in interest rates.

MR. KOHN. Then I would say we'd get about a 5 percent increase in M1 and I would expect about a one percent trend increase in velocity.

CHAIRMAN VOLCKER. You still have a trend?

MR. KOHN. A little one; between zero and one, backing off a little. I think there could be some trend from having demand deposits and currency in there. It is not all NOW accounts that might have a trend growth of about zero, the way M2 did. So I can't rule out that there would be some trend in there.

MR. STERN. That would imply very slow growth over the last three quarters of next year given the first quarter.

MR. KOHN. No. I didn't think that was a projection for next year but rather if we were in equilibrium. For next year we would have much faster growth for the year given that we have lagged effects from this year.

MR. ANGELL. What kind of velocity would you have if you had a 5 percent nominal GNP and a 100 basis point decline in interest rates?

MR. KOHN. I guess I would have about a minus 3 percent, using my 4 percent minus the one.

MR. ANGELL. So that would mean an 8 percent--

MR. KOHN. This is not for next year; this is starting out from the position--

MR. MORRIS. What if the banks continued to pay the current rate when the market rates really went down by one percentage point? Then M1 would balloon.

MR. KOHN. That is right. Now, my calculation assumes even with a 4 percent reaction, which is a huge reaction to a one percentage point change in interest rates, at least some slow adjustment of those offering rates. I don't know what--

CHAIRMAN VOLCKER. You get interest rates back up to 21 percent again; you won't have any money supply at all.

VICE CHAIRMAN CORRIGAN. That's the question I want to ask. I am not sure about that. Within the framework of this revised model that you are working with Don, is it plausible--this is not, obviously, an operative question for 1987--that you could get a pattern of pricing behavior by banks that would produce a real credit crunch in the old fashioned sense of the word? Is it plausible to get pricing by banks that becomes so aggressive that you are not even sure of the algebraic signs?

MR. KOHN. I guess by credit crunch you mean a situation in which interest rates are rising. They could raise their rates on NOW accounts by even more because of the concern about lowering-- I suppose M1 could swallow M2 at some point here but that sounds rather extreme.

VICE CHAIRMAN CORRIGAN. It depends on what kind of market they want to--

MR. ANGELL. I don't see how the crunch can occur, Jerry, without [interest rate] ceilings. Deregulation shouldn't mean that you are going to price so that the quantity demanded--

VICE CHAIRMAN CORRIGAN. I realize this is a highly implausible circumstance, but in that circumstance if the banks decide that what they really have to do to protect themselves, or to keep away from hot money positions themselves, is not just maintain their deposit base but increase their "stable deposit base" they could get very aggressive in pricing retail deposits in a crunch type environment.

MR. ANGELL. Well, then they have negative margins, don't they?

CHAIRMAN VOLCKER. It seems to say that retail deposits are more volatile than--

VICE CHAIRMAN CORRIGAN. I think it says that they are not more volatile, but that in order to keep them the competitive pressures get so intense that banks have to respond by pricing those deposits more aggressively.

CHAIRMAN VOLCKER. It is hard for me to see the situation in which they would price those deposits more aggressively than the marginal deposits. Mr. Parry.

MR. PARRY. As I recall our discussion about M1 in July, after lengthy discussion, I think we came to the conclusion that it would be best to show a range for M1 and that we would stick with the current range and note all the uncertainties associated with it. In 1986 we have had very sharp declines in interest rates. We are now expecting, at least on the basis of the general discussion, that interest rates are going to be flat. So it seems to me that one could repeat what we set out as a tentative target and feel a little better about it.

CHAIRMAN VOLCKER. The argument on the other side--just to put forth the argument--is that if it is going to be so volatile in

either direction, with relatively modest changes in interest rates, does that serve us well?

MR. MELZER. One thing that struck me in reading this paper is that the advantage of a narrow aggregate is that we can influence it. When you get out to M2 and M3, our ability to influence is somewhat limited. Just from an operational point of view it is desirable, at least the way I see things, to have something there that we can influence should we choose to do so. The other thing that struck me is that the NOW account aspects of M1 are really going to cause ongoing problems in that regard. There may come a time when we want to go to some more strictly transactional base, whether it is M1A or some other type of narrow aggregate. This isn't the time, I don't think, to lay a new narrow aggregate on the table because there are still a lot of uncertainties. But I do have this feeling that it is a desirable thing, if we want to choose a regime around a narrow aggregate, that we could control it--that we have the concept of that intact in some way, in terms of how we set targets.

MR. MORRIS. May I object to that argument? We cannot control M1 unless we do not have an interest rate policy. In other words, if we want to have a strict monetarist regime and decide we are going to produce X amount of M1, we can do that, but we have to surrender any influence over interest rates. You really are going to have to add that to your operational--

MR. ANGELL. That is always the case.

MR. MORRIS. What's always the case?

MR. ANGELL. If you want to focus strictly on M1, you have got to give up interest rates.

MR. MORRIS. I would argue that we are never going to give up some kind of interest rate policy. Nor should we. And, therefore, the idea that M1 is controllable has no merit whatsoever.

MR. BOEHNE. There is a value to the monetary aggregates that goes beyond the control issue and that is their value as an indicator variable. We can use interest rates to control nominal GNP but one of the problems is we don't know what nominal GNP is except with a considerable lag. Something like M2 can give us information about what is going on in the economy, in an indicator sense, even though we don't control it. And it seems to me that there is some value in having an indicator variable that has a lag that is shorter than nominal GNP. If you look at M2, it has not been all that bad even though we have had a drop in velocity this year. If we had used M2, for example, and had followed it more as an indicator value, it would have signalled the need for lower interest rates during the first part of the year, sooner than in fact we did lower them. And if you look at it now, what it is signalling is that we don't need further reductions in short-term rates at the moment. You have to look at an indicator variable in the context of a whole lot of other things. But I think one could have a framework for arguing the value, in an indicator sense, of the broader aggregates--both M2 and M3--that is quite separate from this control business.

MR. JOHNSON. I can conceive of a time when M1 would be [unintelligible]. I don't want ever to get in a situation like this, but 1979 was a very convenient time for an M1 target. It is a disguise, maybe, for a high interest rate policy; but it certainly avoids a lot of the politics of having to--

MR. MORRIS. The broader aggregates would do the same thing.

MR. JOHNSON. Well, I don't know. If I remember right, M2 was right on the target.

MR. HELLER. You could go the other way. If you go on the control issue raised by Mr. Melzer, what is wrong with going to the monetary base? Then you have something that is really under our control, and it probably has been performing better than the current M1 at least.

CHAIRMAN VOLCKER. Damning with faint praise!

MR. ANGELL. [Unintelligible.]

MR. JOHNSON. There is something to at least having a measured narrow aggregate that we can influence, if we can. But I think the point is still this: I don't see that the uncertainties around M1 or the base are any more improved than they were when we started out last year. I realize that we didn't forecast the decline in interest rates that we got last year. I am just saying--

MR. HELLER. What about the base? You don't get that kind of shifting that you get around the artificial line drawn on M1 and [in response to] what you call financial deregulation.

CHAIRMAN VOLCKER. You get that kind of shifting; it is just once removed.

MR. JOHNSON. That is right. The magnitude is not as great, but it is there.

CHAIRMAN VOLCKER. With shifting into NOW accounts, as I recall, you get a higher reserve requirement relative to the base, all other things equal.

MR. JOHNSON. Definitely.

CHAIRMAN VOLCKER. You don't have to accommodate it but--

MR. JOHNSON. Who is to say, Bob, that we won't get a shock with energy prices or something. What if OPEC--? We could get a big surge in interest rates and we would end up looking vicious on M1 and need to go, as you say, even temporarily to negative rates of growth.

MR. ANGELL. It seems to me that there are several ways we could go here. But one thing I feel is very important is for the market to understand that if inflation were to reemerge as a threat we would move quickly to a monetary aggregate targeting--we would make that our primary responsibility. I don't know whether we have it out there--

CHAIRMAN VOLCKER. Does anybody else have anything burning to say? At this stage I just want to give you a little homework. I was listening to this and I think we ought not come to any obviously final judgments; but it would be very helpful if we had a good sense of the framework in which we should approach the necessary numerology, recognizing that we can't get away from that. Is there any sympathy for a new narrower aggregate?

MR. BLACK. Yes, I have some Mr. Chairman, which I will talk about tomorrow.

CHAIRMAN VOLCKER. Is there any sympathy for any new aggregate at all? Responses in the morning. I even want a consensus in the morning, as nearly as we can get one. Do we want to have a normal type target for M1 at all? And I would have a sub-question to that, which may be quite important. In the absence of a normal target--which says to me that we have a target of X to Y and if we're outside it, we're outside it--is there anything that we would want to say about movements of M1 in relation to other things, such as things that would alarm us or reassure us? And finally, the question is: Do we retain M2 and M3? If we answer all those questions with a "no" we don't have any targets. So you have one constraint on your remarks tomorrow: you can't answer no to all the questions.

[Meeting recessed]

December 16, 1986--Morning Session

MR. BLACK. Did you ask if anybody wanted to comment, Mr. Chairman? At the appropriate time, I would like to.

CHAIRMAN VOLCKER. The appropriate time is [now].

MR. BLACK. I don't see much point in setting a range for M1 because it has been misbehaving so badly. We could simply omit the range but I think it would be worthwhile if we substituted a range for M1A. I know there are problems with trying to target M1A, just like there are problems with any of the other aggregates; but the long-run interest elasticity of M1A reported in the staff paper is low enough to make it, I think, technically feasible to set a range of 4 to 5 percentage points [in width], which is what we have done customarily. It seems to me likely that the interest elasticity of M1A will remain relatively stable even if the depository institutions began to adjust their deposit rates more flexibly in response to changes in market rates. And I just think that some sort of discipline like that could be very useful in reminding the public that we are serious about inflation. Also, if we get to the point that we need to tighten up, we are going to need something to [unintelligible]. Remembering back to October 6, 1979, I think a lot of people voted for targeting the aggregates because they thought it provided an excuse to raise interest rates more than they otherwise could get away with; and I think this kind of aggregate target could be extremely useful in that capacity when that time comes, if it ever comes. I would do this along with--

CHAIRMAN VOLCKER. It's in large part ex post rationale. Do you have any studies of the elasticity of M1A as opposed to M1, Mr. Kohn?

MR. KOHN. Yes, we do, Mr. Chairman. I think there is some information in the back of the paper--table 3 in Mr. Simpson's memo. You can see that M1A elasticity over a one-year period is roughly comparable to that of M2.

MR. BLACK. The last paragraph on page 15 is a good one to read on that. For me, it's easier to interpret that sort of thing than to look at the elasticity tables. It says that a 50 basis point change in market interest rates would alter M1A growth and its velocity by less than 1/4 of a percentage point at an annual rate in the short run and about 1/2 of a percentage point over the year--not perfect, but not bad by the standards of the other possibilities, I think.

CHAIRMAN VOLCKER. Do we have any confidence, assuming that one was going to have a target for M1A, about where it should be?

MR. BLACK. I was going to ask Mr. Kohn what he thinks it ought to be.

MR. KOHN. I didn't really think about a target range, Mr. Chairman, but I would say in terms of our experience with M1A over the last year or two that we have found it not nearly as bad as M1 as a predictor of GNP. It is better, but not that much better. The problem here is that demand deposits have been growing even faster

than we would have predicted on the basis of past experience. We have had about a 9-1/2 percent increase in M1A this year and I think on the basis of past experience we would have predicted something more on the order of 6 percent. So we have added, in some sense, an overshoot in our demand deposit growth relative to the growth [unintelligible]. As we look at this phenomenon, we see that the current interest elasticity of demand deposits seems to be increasing year by year. Now, I think there are a couple of possibilities here. One is that to the extent that demand deposits had a large block of sort of "excess deposits" in them before businesses began to manage them more efficiently that helped to hold down the elasticity. As cash management has spread into medium and smaller sized businesses, those excess demand deposits are more and more typically out of the demand deposits and are being held as compensating balances for cash management and other services.

MR. MORRIS. Do you know if the additional growth is almost entirely in business accounts?

MR. KOHN. Well, yes it would have to be. In our ownership survey, household accounts were about 1/4--I think 26 percent--of demand deposits, and that proportion hasn't changed very much. So by definition it is primarily businesses that account for the growth. But, returning to the original point, M1A has been better than M1.

MR. ANGELL. It also has another feature and that is that it is somewhat more controllable in regard to altering its opportunity costs, I would presume. Do your studies show that to be the case?

MR. KOHN. Well, the market rate is the opportunity cost, the way we look at it, because there isn't an explicit offering rate on demand deposits. So it's true, as I think President Black said, that it is not subject to some of the uncertainties that we would see for M1 associated with how depository institutions are going to price their NOW accounts; I think that greatly adds to the uncertainty.

CHAIRMAN VOLCKER. Presumably submerged under this is how depository institutions price their services.

MR. KOHN. To the extent that there are switches between compensating balances and fees, that would affect M1A as well.

CHAIRMAN VOLCKER. What interest credit do [they] give?

MR. JOHNSON. It's hard to say that demand deposits have been less volatile in this whole mess than OCDs. Isn't that right?

MR. KOHN. I'm sorry?

CHAIRMAN VOLCKER. Intellectually, I presume that if you want to go this way, the excuse would be that we have had all of the shift from demand deposits into NOW accounts that we are going to get and they are less substitutable at the margin for other types of liquid funds.

MR. MELZER. That's what would trouble me. As I said yesterday, I think it's desirable to have a narrow aggregate, but it would trouble me to roll another one out right now when there is still

this uncertainty in general about the behavior of velocity. That could not only discredit that aggregate but also could raise questions about what we are doing because, when we roll the new one out, we are implying a higher confidence level in that aggregate and in aggregates targeting in general.

MR. JOHNSON. I think that's a good point. It looks like we are really starting to get desperate--fishing around for something.

MR. HELLER. That may give you the perfect excuse in a way. You may want to say at the beginning of the year that you are studying the possibility of reintroducing narrow monetary aggregates and at the present time you are conducting studies to determine if M1A, or something along those lines, might be appropriate. If so, at a later moment in the year you may want to set new targets. Therefore, it's clear that you want to go back to targets but you avoid having to set a target at the beginning of the year that you will clearly overshoot.

CHAIRMAN VOLCKER. M1A has somewhat peculiar characteristics to me. It says we are very interested in business demand deposits and currency but we don't care what transactions balances individuals hold per se.

MR. BLACK. Mr. Chairman, I have a more radical idea.

CHAIRMAN VOLCKER. Let me recognize Mrs. Horn first.

MS. HORN. Well, I agree with many people who think that this is not the time to set an M1 target.

CHAIRMAN VOLCKER. We are only talking now about what we are going to do regarding a [new] narrow--

MS. HORN. Oh, sorry. That's not what I am talking about.

CHAIRMAN VOLCKER. We will rapidly get to the [M1] question.

MR. BLACK. I didn't mean to overstate the case about M1A because I don't think it's going to be all that good; I don't think anything is going to be all that good. What I would really like to see us consider is setting inflation targets for the next three years or so. I don't have in mind that we would set up any kind of automatic operational procedure that would cause us to in any kind of predetermined way do something if we deviate from this target. All I am recommending is that we set forth an explicit objective. I think that would have more than a cosmetic effect because, first of all, it would help preserve our credibility in the sense that the public would know that we were going to have to take some kind of action to try to get inflation in line if we saw signs that we were deviating from the target. The second reason I mentioned a while ago--that it is awfully nice when the time comes that we have to take the unpopular step of tightening to have something that we can point to other than interest rates. If the aggregates are weak, we don't have a lot to point to and something of this sort could give us some political insulation at a time when we need it.

CHAIRMAN VOLCKER. We will return to the question a little later. Mr. Stern, do you have something [to say] about the new M1?

MR. STERN. I was going to say that, from a strategic point of view, I thought Governor Heller's suggestion was a good one-- particularly because I think we ought to take another look at the monetary base as a narrow target. We have some evidence that suggests that, at least in recent years, its basic relationship to things like interest rates and inflation and output has been more stable than that of the other aggregates. While I am not prepared at the moment to say that the evidence is sufficiently convincing to me that I would want to push it, I do think it's worth some further investigation. And that would fit in rather nicely, it seems to me, with the kind of approach Governor Heller was suggesting.

CHAIRMAN VOLCKER. I don't detect any strong enthusiasm for introducing a new narrow monetary aggregate as an actual target at this point.

MR. JOHNSON. I would be in favor of continuing to study it if we can, as Governor Heller said. Maybe at midyear if we felt more comfortable with a narrower target we might look at it.

CHAIRMAN VOLCKER. Let's return to that. The next question I have is: Do we want any new aggregate at all? I think Mr. Morris proposed one.

MR. MORRIS. My proposition was that L would be a suitable swap for M1 but only if we wanted to stay with three targets.

CHAIRMAN VOLCKER. Do you push this with enthusiasm or with just a feeling that if people want to try that we--

MR. MORRIS. My thinking is that it is probably a better measure of liquidity than M2 or M3. If I had to choose only one of the three I think I would take L.

CHAIRMAN VOLCKER. L suffers from the grievous defect that the figures come in months late.

MR. MORRIS. But they don't have to. If we wanted an early estimate we could get it, I am sure.

CHAIRMAN VOLCKER. Would the staff like to comment on L?

MR. KOHN. A couple of levels of comments: one is that-- returning again to the results we get in looking at L relative to the other aggregates--it looks better in terms of St. Louis type reduced-form regression estimates than the narrow aggregates but about the same as M2 and M3 in predicting GNP. Before we decide really to pay a lot of attention to L, I would like to take a close look at some of the data problems. It is supposed to include Treasury securities under one year that are in the hands of the public, outside the banking system. We don't know quite how many Treasury securities under one year are in the hands of the banking system because the Treasury used to run a survey on that and they don't anymore. It doesn't include agency securities, for example, because we are not sure how many agency securities are out there [in the hands of the public], although it does include commercial paper. It has some very peculiar things; I think it has a lot of data problems. We probably could work around some of them, but my temptation would be to work on

those data problems and also on getting more timely information before we get serious about L.

CHAIRMAN VOLCKER. Does anybody else have any views on L or any other broad aggregate?

MR. FORRESTAL. Mr. Chairman, maybe what we should do is set the M2 and M3 targets in conformity with the Humphrey-Hawkins Act and have staff study a menu of possible aggregates--M1A, L, and whatever else people think might be appropriate--and try to deal with that later in 1987.

CHAIRMAN VOLCKER. Any other comments? I do not detect any strong urge for adopting L as of--

MS. SEGER. We ought to go back to targeting interest rates.

CHAIRMAN VOLCKER. Too radical! Let me just take my questions out of order. Does everybody agree with what seems to be the implicit assumption of some people that we will have an M2 and M3 target in the traditional form?

MR. BLACK. Since we can't accept anything else, I would be afraid to throw those out.

CHAIRMAN VOLCKER. I guess we have that assumption on M2 and M3. So the other question is what we do with M1. I think there is a question, clearly, as to whether we should have an M1 target, stated as either a target or monitoring range, in the form in which we have had but didn't initially [adopt in July]. Do we want to say anything about M1? We can obviously say some things that have been suggested about looking at various alternatives and studying these things.

MR. BOEHNE. I don't think we can have M1 as a normal target. I think that is fairly clear and obvious, given all the problems. But I do think there are some advantages to keeping it as a monitoring range, for the simple reason that it may be useful to us sometime in the future under a different set of circumstances than we have now. It also has the advantage of some history, so we aren't rolling out something new. We can say that it once worked; it's not working now, but it may work in the future. And I would couch it in terms of: Here is a range; we don't have a whole lot of confidence that we can hit it but we want to keep it on the shelf so that we can use it; it would only be used in the context of a whole lot of other information, so don't think that a deviation from the target in and of itself means that we are going to change policy; it's in a state that we are going to look at it and we may bring it back to play a more useful role. So, I am for a monitoring range with some kind of numerical values to that range.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I would be in favor of continuing to follow M1 and certainly reporting on it, but I would be a little reluctant to re-establish the range at this point because the results are going to vary, probably, from whatever we target. And as we go through the year, if the relationships tend to re-emerge and/or if GNP growth or inflation growth were to begin to move away on the high side, then at

that point I would re-establish the range to use it effectively. But I'd establish a range that seems appropriate at that time.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I would join those who would opt to maintain M1 as an aggregate and also to set a monitoring range. To be sure, I'd adopt language not unlike what we have done in most recent times--that is, that we will pay attention to it, but only in relationship to M2, M3, and other developments--and as a result keep it in front of the public for purposes of going back to it sometime in the future, which I'm convinced we will have to do.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. I would agree with Si Keehn. That is to say, I would keep M1 for its informational value and because we might need it in the future. I wouldn't want to set a range for it because I think it's getting a little embarrassing and boring trying to explain why we keep missing it. Moreover, the market seems--and as far as I can tell the Congress seems--fairly comfortable with our stance on M1; so I don't think we have a lot to lose by keeping it [for its informational value] and just dropping the range entirely.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. The idea that I am fooling with is a variation on several themes here. First of all, I do want to keep M1 in the ball game, even if it is on the bench, partly because when I look at the behavior of M2 and M3 it seems that they basically grow within a 6 to 9 percent range, regardless of what's going on in the economy, inflation, interest rates, or anything else. There's a certain amount of comfort that you can draw from that, in that you have a good chance of hitting the targets but not much comfort in terms of what hitting the targets may mean. The thought I had would be to keep the M2 target, and presentationally--

CHAIRMAN VOLCKER. The M2 target?

VICE CHAIRMAN CORRIGAN. Keep M2, M3, and maybe a monitoring range for debt like we have had in the past. Presentationally, what I had in mind is that they would be prominently displayed in the box that is always part of the testimony. Also in that box in a prominent place we could have a brief paragraph that would say something like "While the Committee has not adopted a formal target for M1 for 1987, it will continue to monitor its behavior closely. Consistent with that, the Committee expects that in the context of GNP growth of, say, 6 percent and relatively stable interest rates, M1 growth should be in a range of 4 to 8 percent." And then add something along these lines: "However, in the unlikely event that income is growing rapidly and velocity is increasing the Committee might be prepared to re-establish a target [for M1]." You could maybe combine that idea with Governor Heller's suggestion and broaden it to say something to the effect that in the intervening period the Committee is restudying these relationships and definitions and so on. Some notion like that has some appeal to me, both presentationally and substantively, even if it does mean that M1 in some sense is on the bench rather than in the ball game.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. I basically agree with what Jerry said. It seems to me that having M1 still play a role--and with a range--makes some sense.

CHAIRMAN VOLCKER. I am not sure you are agreeing with him. Maybe you can be more explicit. I am not sure whether you are or you aren't.

MR. PARRY. Well, he stated a range. He even stated a specific range for M1, but a monitoring range.

CHAIRMAN VOLCKER. That seems to be somewhat different. Perhaps it's more nuances--. If I understood Mr. Corrigan, he said don't present a range even as a monitoring range; present one as a footnote under certain assumptions.

VICE CHAIRMAN CORRIGAN. It's a little more than a footnote. I'd have it in a prominent place in that box that is always the focal point.

CHAIRMAN VOLCKER. I have a little difficulty visualizing your paragraph as part of a box.

VICE CHAIRMAN CORRIGAN. I added in close physical proximity to the part that lays out the quantitative targets for M2 and M3.

MR. HELLER. An off-balance-sheet item.

VICE CHAIRMAN CORRIGAN. An off-balance-sheet item.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. That is an interesting possibility, but my views are even more basic. I would simply explain the problems we have had with M1 and then say that, given those problems and the uncertainties that still lie ahead on M1, we are undertaking a study on narrow aggregates in general but that under the circumstances now we are only publishing an M2 and M3 target. Perhaps at midyear when we have had more evidence on whether velocity has stabilized for some of these narrower aggregates, we would have a chance to choose one of them--and maybe M1 is the one again--and we might publish a new target range. I don't see that it serves us any good purpose to have a range at all for the first six months of the year. As a matter of fact, if we published a range, I think we would all feel uncomfortable saying that we ought to have a range that includes 12 or 13 percent growth for M1, even though that has been the experience [because] of velocity; I think we would be constrained to want to say something like 5 to 8 percent or 6 to 9 percent. And then we would run into the same potential problems, it seems to me, of running above the targets initially in the year and having the markets ask: What's the Fed going to do about M1? Even if they don't believe we will do much, it could be a matter of weeks that they are uncertain about it. It could affect the markets in a way that I don't think we would really want. So, I would be in favor of announcing that we still think there is an important function for a narrow aggregate but we are going to study the issue; it could be that M1A or some other narrow measure responds

better than M1. And we could also get a better feel for velocity later. But I am for going with an M2 and M3 target.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. Unfortunately, my view is the same as it was last July--which was that we should not publish an M1 target range because the aggregate was behaving so weirdly. I felt that it would--and as a matter of fact it did--confuse the financial markets and market participants, regardless of how many qualifications we put out with it and despite our saying that we were not paying as much attention to it as we used to. As long as it can be graphically presented every Friday by The Wall Street Journal and The New York Times, people will pay attention to it. Those footnotes don't get transmitted because newspapers don't transmit everything and the readers don't want all of that baggage. They are looking for easy answers. So I would go along with Governor Johnson's view that it's best not to establish a range for it now but to indicate that we are doing a thorough study of this and looking for some sort of narrow aggregate. I would publish an M2 and M3 range.

MR. JOHNSON. An afterthought on what I said is one thing on the other side too. If we were to establish something like a 5 to 8 percent or a 6 to 9 percent monitoring range, and if we did have an upsurge or sudden increase in velocity, it could really be just as appropriate to be thinking of 2 or 3 percent money growth. We would be just as constrained by the minimum on that range as the upper side.

VICE CHAIRMAN CORRIGAN. What I am talking about does not contemplate a range in that sense.

CHAIRMAN VOLCKER. Let's come back to that. Mr. Morris.

MR. MORRIS. Mr. Chairman, if I read Mr. Corrigan and some of the others who have spoken up for a monitoring range correctly, it reflects a feeling that at some point in time we may face another 1979 situation and that at that point we will be able to resurrect M1 again and pursue a more restrictive policy than we otherwise would have been able to do because of the mystique attached to M1. I think that's not a very realistic proposition. I think M1 did have that kind of mystique in 1979 but it certainly doesn't have it now. If we go to the Congress and say we can't have M1 growing more than 9 percent, they are going to say: Well, you let it grow at 15 percent in 1986 and in 4 out of 5 years in the 1980s you didn't meet your target and nothing happened. Why do you think you have to meet an M1 target this year? I don't think you can put M1 back in the box and pull it out that easily anymore.

CHAIRMAN VOLCKER. You don't want a range, I take it.

MR. MORRIS. No sir.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. M1 is not going to go away. We are not going to keep a chart out of The Wall Street Journal or The New York Times. I presume we are going to continue to release weekly figures, four-week averages, so it's there. I think too much attention has been given to

it. I prefer that we keep it as a monitoring range. I would prefer not to change it; to tinker with the numbers is like tinkering with M1A. We are not going to tinker with the numbers and have them be large enough that we have a chance of being within them. So, I would like to have a monitoring range, a historic range that we have been using, and simply indicate to the market that there may come a time when M1's velocity will return to this more historic relationship.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. That is essentially where I would be. I would set a range and then put language around it like we did in July indicating that we wouldn't necessarily expect to hit it. In connection with that, that's where we could bring in Governor Heller's point that because of the interest elasticity of M1, we are looking at other narrower aggregates that would have less elasticity. I don't think we have lost a lot of credibility by having the range and then not meeting it. My own view is that it doesn't create a lot confusion in the marketplace as to what we are doing. I think when the market gets worried about rapid M1 growth, it may well be against the backdrop of other developments like, say, a weak dollar, a steeper yield curve, and so forth. They're not making judgments about rapid M1 growth solely based on what our range is.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. My preference would be to go without a range for M1, basically for some of the reasons already mentioned--that we think the relationships between M1 and the other economic variables we really care about have broken down or at least we don't understand them very well. To set a range in that context, it seems to me, is difficult and hard to justify. I certainly would not be uncomfortable with some language to the effect that we are going to continue to watch what happens with M1 and evaluate it along with a variety of other incoming information. As a kind of fallback position, it seems to me that if we are going to set some sort of range it ought to be somewhat more realistic than the ranges we have been adopting, simply because I don't think we are achieving very much by specifying ranges that our best estimates suggest are going to be too low.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I agree pretty much with what Tom Melzer has just said. I would set a range and I would try to explain it. It seems to me that whatever credibility we had on M1 we have lost. The markets have adjusted to that loss of credibility. They seem to be accepting the fact that we don't know. If we come up with something else, it would be an implication that we know what we are doing. If we lose on that, we double our credibility loss. I would rather ride with what we have for a while and, obviously, be looking for better ways. But I guess I have not heard anything proposed that gives me a lot of confidence that it would be any better than what we have been doing over the last several months.

MS. HORN. Mr. Chairman, I am with those who think we should not set a target range for M1 but I suppose, in the end, a monitoring range is a possibility. The words that we associate with what we do with M1--and for that matter with monetary targeting in general--I

think are very important. And I would like to see some words that maybe go back a bit to Bob Black's point about the targeting of inflation, or just some words that say monetary targeting is not an objective of the Federal Reserve System--that whether it's M1, M2 or M3, we are not expecting to control the aggregates, but we are setting ranges that we think are consistent with such and such a pattern of prices, employment, and total spending. I would indicate that, basically, we began setting target ranges publicly and in Congressional testimony as a way of assuring the Congress and the public that we were in fact intent on getting to a certain point with inflation, and that at the moment the connection between monetary targets and inflation is not what it used to be, and that we are talking here about what monetary targets we think are consistent with our ultimate objective.

MR. BOEHNE. May I make a comment on the suggestions for studies? If Don Kohn checks his files, I think he will find a whole stack of studies that we have done on this particular topic. I think our words ought to be couched in terms of "we will continue to study this subject on an ongoing basis" rather than make a reference to a new major study that we hope will somehow enable us to find the truth, because six months or a year from now, when the results of this study come out, I think they may be somewhat disappointing. I just don't think we want to set ourselves up for that.

MR. JOHNSON. Well, we can always say we studied it and didn't find anything.

CHAIRMAN VOLCKER. Did you express yourself explicitly on this subject, Governor Heller?

MR. HELLER. Yes. I would stay away from setting an explicit target right now and then note that we are thinking of re-establishing a target at some later time.

CHAIRMAN VOLCKER. Well, we have a range of opinion. I don't see anybody saying we should have a target of the traditional type, as opposed to a monitoring range. I will make a couple of observations. I think I am repeating what other people said but--even setting forth a monitoring range the way we did [in July] or as we do for debt I don't think is very helpful, because we are likely to be either way above or, in some conditions, way below. I would hate to be in a position where every indication was to tighten up and we've got all of these interest elasticity [unintelligible]. I'm not particularly expecting that in the short run but, over time, we may want to tighten up and if we have great interest elasticity and M1 runs low people will say: You are running below that 5 percent target, how can you possibly tighten up under those conditions? So I have a real concern in both directions about setting forth a target, even a monitoring range, just pure and simple.

I share some of the concerns about promising too much from a study. I would suggest that we say we are going to get back to it at midyear. It seems likely that the study is going to show that almost anything we look at has a lot of interest elasticity and that gives us the problem that we are not going to be in any position--. Obviously, nobody can oppose a study. It's just a matter of the way it's stated, as Mr. Boehne just said. However, I think we can say something that

would be useful. And that probably would be something along the lines--I haven't quite visualized a box, but that's a subsidiary point--that we think we know something about M1 and how it behaves in a very broad way. I think we probably could say something like: under normal or specified conditions, we would think it would rise at a pace somewhat around nominal GNP and we think that a nominal GNP--I'm not sure I'd state it quite this way--of around 5-1/2 or 6 percent is appropriate. And if interest rates weren't changing, that's what we would expect. But if other things happened and interest rates went up, we would expect M1 to run low, and the public shouldn't be surprised by that; if interest rates were declining and the economy was soft, we would expect M1 to run high. If inflation is down, we wouldn't be disturbed by a higher figure; if inflation is rising and interest rates are rising, we wouldn't be disturbed by a lower figure. Everyone ought to understand that that's the way we will appraise M1--as a kind of supplementary device to the other targets, without putting it in the box, or setting a monitoring range per se. We might footnote it or something. I don't know how much one can say in a box. It's a visual point, but I think we could have a useful discussion of M1 indicating the kinds of conditions under which we would be disturbed or not disturbed by a big slowdown or a greater increase. That might be more useful than anything else.

VICE CHAIRMAN CORRIGAN. I didn't mean literally within the box. All I meant to say is that I thought it should not be buried on page 28 of the testimony--that it should get some prominence.

CHAIRMAN VOLCKER. Page 16?

VICE CHAIRMAN CORRIGAN. You know what I mean!

CHAIRMAN VOLCKER. I think we could have a discussion of M1. Maybe we could mention studies and all of this other stuff. I didn't look at it very carefully, but I think we could say that we are not ignoring it, but that we find ourselves unable just to give a simple range that encompasses all the significance of it. [How we view] it would depend upon circumstances, and we can try to describe the circumstances. The trouble is that this is getting too complicated, obviously. The basic point that we would make is that we think M1 has a lot of interest elasticity and an increase or a decrease should not be a surprise if there are changes in interest rates that may be appropriate for other reasons.

MR. ANGELL. But, of course, without a change in interest rates now for four months, where we normally have an interest elasticity problem, it seems we also may have an increase in demand for financial assets that may continue even in a period of stable interest rates.

CHAIRMAN VOLCKER. I think that is correct. If you thought that was a great big possibility, unlike those nice little equations Mr. Kohn has, the less you can say about it or the more vaguely you say anything--

MR. BLACK. I think Jerry's concern is that if you bury it too deeply then you may not be able to exhume it if you need it.

CHAIRMAN VOLCKER. I don't know what "exhume it if you need it" means. If it really has a lot of interest elasticity, I am not sure what the exhumation means.

MR. BLACK. Well, that may change some over time. I hope--

MR. JOHNSON. The one thing that might be possible, if we want to have any kind of picture at all to illustrate it, would be to have two sets of parallel lines imposed on the same graph instead of having a cone shaped target.

CHAIRMAN VOLCKER. Have three-dimensional graphs?

MR. JOHNSON. You wouldn't need a three-dimensional graph; you could have one inside the other. One would be associated with stable interest rates and the other would be associated with volatile interest rates.

MR. HELLER. Make it out of rubber!

MR. ANGELL. One thing we might do is, without any monitoring range, to suggest that the Federal Open Market Committee might reinstitute quarterly ranges at any time that it deemed appropriate. That would give us the chance, in case circumstances changed whereby we believed that we had an inflationary tension that needed correcting, we could then institute a quarterly target without setting up an annual target.

VICE CHAIRMAN CORRIGAN. That is kind of the thought that I would mention at the end of what I suggested: that the range we have isn't really a monitoring range in the sense that we have used that term historically; it's just a statement of what we would expect to happen in somewhat normal conditions. But we could add on to that the thought that, in a context in which GNP, velocity, and inflation were rising, the Committee would be prepared to reconsider M1 as a target-- or something like that without being specific about a quarterly target.

MR. ANGELL. Even though I asked for a monitoring range, I am happy to join this consensus.

MR. BOEHNE. Instead of monitoring range, maybe a better term would be an observation area, or something like that.

CHAIRMAN VOLCKER. Well, implicit in what I am saying, anyway, is that we will continue to observe M1. I don't know exactly what the right wording is, but we would observe it within some analytic framework, if we could state it. [Unintelligible], I'm afraid, unless Mr. Kohn can give me a little more reassurance than he gave me yesterday.

MR. KOHN. I think the model would say it's close to one percent, but I think it's still in a period of evolution.

MR. MORRIS. Plus or minus one percent?

MR. KOHN. Plus one percent, in terms of velocity.

MR. JOHNSON. Adjusted for income and interest rates.

MR. KOHN. Well, adjusted for interest rates.

MR. BLACK. Don, how likely do you think it will be that eventually we will get to the point where these rates paid on other checkable deposits will vary pretty directly with market rates?

MR. KOHN. I think that's possible but, as I indicated yesterday, I think some of the interest elasticity that we are observing now may be exaggerated. If the offering rates begin to move up or down with market rates then we would observe what the elasticity is with respect to market rates. But it's still going to be very substitutable, at the margin, with other closely related deposits. I don't think that we will get back to where we were before.

CHAIRMAN VOLCKER. I sense we have gone about as far as we can go on this subject this morning. I have a little work to do before the next meeting. Does anybody want to express any views, in a very preliminary way, about the M2 and M3 targets that we settled on tentatively last time? What were they: 5-1/2 to 8-1/2 percent [for both]? Does that still seem about right or does anybody have a strong view for something different than that? This would be very tentative at this point.

MR. MORRIS. I have been trying to think about why it is that the broader aggregates, including L, have been growing more rapidly relative to the nominal GNP. The only thing that I have been able to come up with is that in recent years, with the decline in interest rates, we have had a big increase in the value of financial assets in the hands of consumers and businesses--a big increase in stock prices and bond prices also. In fact, financial assets have been growing more rapidly than nominal GNP. So if an investor wanted to maintain liquid assets at a constant proportion of his portfolio and the other financial assets were growing more rapidly than GNP then his liquid assets would have to grow faster than nominal GNP as well. Now, whether that is the answer to it, I don't know, but--

CHAIRMAN VOLCKER. Your projection [would be] that if we had a great crash and stock prices went down people would want to hold less liquidity then, if your argument is symmetrical.

MR. MORRIS. They would, certainly; if we had a great depression then liquidity would go down.

MR. ANGELL. What kind of depression?

MR. MORRIS. [Unintelligible.] What Paul is talking about is a great crash.

MR. ANGELL. I thought you said great deflation.

MR. MORRIS. Well, a stock market crash would lead to a reduction in the rate of growth of liquid assets, even if people tried to improve their position or maintain it. If incomes are dropping, that's going to be difficult to do. But if that theory has any validity to it--and I am not sure it does--it means that when the financial assets start growing at about the same rate as nominal GNP,

you would expect that the liquid assets would go back to their prior growth rates relative to nominal GNP. I don't know whether this makes any sense to you, Don, or not.

MR. KOHN. Those wealth variables we have do, I think, have bearing on M2 growth and on the broad aggregates; it makes some sense.

CHAIRMAN VOLCKER. Does this lead you to the conclusion that the targets should be changed?

MR. MORRIS. It leads me to conclude that we probably should not reduce the ranges for the broader aggregates. My tentative idea was to cut half of one percent from the 6 to 9 percent range for this year. I don't see that there is any case for doing that.

CHAIRMAN VOLCKER. Well, you can argue the opposite on the basis of your knowledge.

MR. MORRIS. Not, I think, while interest rates are still high relative to the inflation rate. If you promise that interest rates are going to continue to move toward their normal relationship to the inflation rate, and if that stays low, then you would expect the value of financial assets to continue to rise relative to GNP for a while.

MR. HELLER. Mr. Morris makes an important point there, because I think it really explains a lot of the past behavior that we have seen. The trouble with it is that if you are trying to use it for forecasting purposes you first have to forecast what the stock market and the bond market are going to do, and that's probably just as tough as anything else that we've seen. But you can get more stable functions that way; I fully agree with you.

MR. JOHNSON. There may be some reason to believe that. I don't know how long this stock adjustment will go on either, because of the change in the environment, but it wouldn't bother me--and it might give off an important message--if we could find a way to lower those broader targets a bit.

MR. BLACK. Particularly if we drop the M1 target, I think it has a message there.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Under the assumption of little or no change in interest rates in 1987 and the kind of nominal growth that is incorporated in the staff's forecast, on the basis of the staff's analysis and some analysis that we have done we think we would get growth of M2 and M3 at the lower end of the tentative ranges. In fact, we got 5 to 6 percent on M2 and 6 to 7 percent on M3. It seems to me that one could argue for perhaps a 1/2 percentage point reduction in the existing tentative targets [for 1987]--to somewhere around 5 to 8 percent.

MR. MORRIS. Well, maybe that's something that we need to get further counseling on from Mr. Kohn--[whether his work] indicates that half of one percentage point is not a matter of major consequence.

VICE CHAIRMAN CORRIGAN. I would just make the observation that for every one of those financial assets there is a financial liability, too. One of our problems, looking a little beyond M2 and 8-1/2 or 9 percent is the liability structure of the economy as a whole. In some ways it is what's driving the increase in some of these asset-based measures. And I think that is still a major concern over the long haul. That's one of the things that creates a preference on my part to try and shave off that half point, even though I am under no illusions about it.

CHAIRMAN VOLCKER. Shave it more?

VICE CHAIRMAN CORRIGAN. No, just shave the half point because in the long run--

CHAIRMAN VOLCKER. Keep it where we have it?

VICE CHAIRMAN CORRIGAN. Yes.

CHAIRMAN VOLCKER. Mr. Angell.

MR. ANGELL. It seems to me that we have no evidence that 1987 is going to be substantially different from 1986. I look at the 1986 M2 and M3 target bands and see that in January and February we were running a little below. And if we want them as targets I presume that means that when they run low we ought to be easing; and hindsight, I think, would tell us that it would have been okay to have some accommodation in that [early 1986] period. But we also found a period of time when we ran up to the 9 percent range. Now, if we wanted to be at 8-1/2 percent--if the targets mean anything--we would have to say that we should have screwed it down a little tighter in July and August and September. I am not sure that there is evidence of that [being desirable]. I would prefer not to get into wishful thinking about bringing the M2 and M3 [ranges] down until we have evidence. I might be persuaded at the February meeting that 8-1/2 percent and 5-1/2 percent are satisfactory, but hindsight might suggest that 9 percent may not have been too bad.

MR. PARRY. But the forecast for 1987 is quite different than the experience for 1986 in terms of interest rates, and that's one of the most significant factors in determining the growth of the aggregates. So why wouldn't that make a difference in your view?

MR. ANGELL. But if you went back a year ago and asked the FOMC what its interest rate forecast was, some of what has happened may have been unexpected. It may very well be that we do not know whether the economy, for sure, is going to be growing at a 4 percent real path--or 3 percent, or even 1-1/2 percent.

MR. PARRY. Yes, but you have to base your determination on expected values and we are expecting--or at least the staff forecast is--that there will be no change in rates. If one thought that rates were coming down, that would certainly give a lot of reason to support that. If you buy the idea that rates were not going to change very much, why wouldn't you expect a significant slowing?

MR. ANGELL. Well, because I am not so sure that the economy will be growing at a 3 percent real path or a 6 percent nominal path.

It may very well be that we will have been inaccurate or not have been able to foresee that. We might be on a path that is conducive to lower interest rates; if so, would we want to have an M2 target that restrained us and caused us to tighten in an environment in which the economy was growing at a real path of, say, 1-1/2 percent and a nominal path of 4 percent?

MR. PARRY. Change it.

CHAIRMAN VOLCKER. You're coming perilously close to having no target at all. Mr. Keehn.

MR. KEEHN. It seems to me that last July we established the tentative ranges and reduced them by 1/2 of a percent, really, to deliver a message--namely, that we were going to continue to control inflation. That must really be an important part of any kind of mechanistic result. Changes at this point, if we don't have a substantial reason for doing them, would give a rather false message. Therefore, I would be in favor of maintaining the tentative ranges that we set out last summer to continue that message.

CHAIRMAN VOLCKER. Anybody else want to offer some comments on this subject? I will take silence as indicating at least that you are not more than 1/2 point away from the range in either direction. I guess we have established a broad band.

MR. JOHNSON. I think the elasticities for the broader aggregates are such that there is a lot of tolerance in the current ranges. We can still see 15 to 16 percent M1 growth as consistent with 6 to 9 percent [growth in the broader aggregates]. That's why I don't think a 1/2 point reduction, or some small symbolic reduction in the target, is a real danger.

CHAIRMAN VOLCKER. We will give Mr. Kohn the last word. Just refresh our collective minds, given your assumptions or Mr. Kichline's assumptions: What is the probable range in which M2 and M3 are likely to come in?

MR. KOHN. Well, Mr. Chairman, that's a difficult question in part because the models, as Mr. Parry said, give us some pretty low numbers for [monetary] growth next year--especially if you assume that depository institutions are going to adjust down their offering rates, increasing the opportunity cost of holding M2 [assets]. However, I am not sure I believe the models in many cases, but particularly in this case. So if I gave you a purely model-based forecast, looking across different models, I could give you anywhere from 9-1/2 percent for the Minneapolis VAR model to the 5 to 7 percent that the non-VAR models are clustered around.

MR. JOHNSON. That sounds almost like General Motor's range.

MR. KOHN. Similar to General Motor's models. But when you look under the hood, that sounds low to me; so I think a little higher than that would be more likely.

MR. JOHNSON. It is true, I think, that after-tax real long-run interest rates are even slightly negative. If you take the marginal [income tax] rate off the nominal interest rate and then take

[out] about a 3 or 4 percent inflation expectation, you have a negative number on longer-term rates.

CHAIRMAN VOLCKER. I think we can turn to what we have to decide this morning. Before we do that I would open the floor for comments on the [economic] situation and outlook. Mr. Boehne.

MR. BOEHNE. In the Mid-Atlantic part of the country, economic performance is mostly positive. We have sensed a pickup in manufacturing activity in recent months; retailers report fairly brisk sales; construction, both residential and non-residential, is doing well; and loan growth in my District is running about twice the national rate. Unemployment rates are well under the national rate, particularly in New Jersey, Delaware and the Southeast quadrant of Pennsylvania. We are also seeing some wage hikes that are higher than the national average, as one would expect, particularly in the growing industries in our District. The outlook is generally positive although bankers doubt that loan growth will continue in 1987 as it has in 1986.

On the national economy, I find myself in broad agreement with the staff: 2-1/2 to 3 percent real growth and around 4 percent or so on inflation, which for the fifth year of a recovery isn't all that bad. The only word of caution that I would pass on--and it's largely anecdotal and I don't know what to make out of it--is that our examiners are reporting more noticeable deterioration in consumer loan portfolios, especially the credit card portfolios of some of the big credit card issuers in Delaware. I had lunch with some merchants in part of the District a week or so ago and they reported that more and more potential sales are being turned down because people are hitting the ceiling on their credit cards. And I had lunch with some credit card people and they talked about something called a special lending option program--SLOP for short--for people who have bad credit ratings. They lend to them with higher interest rates and extra collateral and so forth. Again, I don't know what to make out of that. But there is somewhat of a pawn shop mentality in banking with home equity loans and all that; and maybe the consumer is running out the string to some extent and bankers are not being all that prudent in trying to put some limits on that.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Mr. Chairman, our view hasn't changed much since the last meeting. We are substantially in agreement with the staff forecast, and for the Fourth District that staff forecast, if it came true, would not be a bad outcome. It would give us some more time to carry through the further restructuring process that is under way in our heavy manufacturing sector. We continue to experience plant closings and structural changes and, of course, the size and speed of the adjustments is closely related to the impact of the exchange rates. A period of slow growth would be basically a good outcome for us on that front. There is a hopeful note on the export side in our District. In talking to our directors and to other businessmen, we don't have a profusion of new export orders to report but we do have a significant increase in the number of inquiries from foreign customers, and their attitudes seem to be much more receptive than we have noted in the past. Beyond that, there is also a feeling that the thrust of imports into specific markets has not been as strong as it

was. We have hope on another front as well--on the employment growth in our District. To take the Ohio numbers alone, in the last year Ohio employment has grown faster than the nation as a whole, significantly fueled by employment in the services sector, and within that, in the business services sector. On the negative side, not only in our bank but in our District many feel that the risks connected with the 1987 forecast are on the down side. That feeling stems from the straightforward reasoning that the trade accounts may not turn around as much as anticipated in the forecast and that the business investment sector may not be particularly strong. So it's easy to picture an economy that won't, in fact, be growing in the 2 to 3 percent range. It would be nice to be able to identify some truly bright spots to counter the skepticism but so far I haven't been able to do that. On the retail sales side, we see in our District much of what was reported yesterday as the national trend; we see soft retail sales with a slightly stronger durables component. Our retailers say they have plenty of traffic in their stores but that just isn't resulting in the kind of sales they expect. They are, of course, reacting with discounting and waiting to see what the last few days [of the Christmas shopping season] will bring.

I will end with a note on the agricultural situation in our District. We have a fairly small agricultural sector and it's fairly diverse. But I report this just because it seems rather interesting. Up until just a few months ago, three months ago maybe, the attitude in our District was that somehow the agricultural situation--land prices and income pressures on farm banks and on good farmers--had reached a plateau. This view has shifted significantly in the last couple of months under the weight of good crops and the low prices associated with them and the huge federal outlays. We now have a view among quite a wide range of people--from bankers to other observers in our District--that there is going to be another significant adjustment in land prices and in farm programs as well.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Our forecast is about as close as one could get to that of the staff. We feel confident that the fourth quarter will show strength of 3 percent or more; I think the available national statistics on production, sales, inventories, and employment would support such a conclusion. Plus, what we see in the Twelfth District is indicative of a strong economic picture for the fourth quarter. When I look at 1987, one of the things I would note is that, first of all, we do have a fairly sharp slowdown expected in the first quarter; and we have a fair amount of uncertainty about how sharp that slowdown might turn out to be. We expect it to be centered on weakness in both nonresidential and residential investment spending. We still don't have much of a handle on what the effect of the tax reform is likely to be in 1987. It seems likely that it is providing some strength to the current quarter and also, given the timing of some of the changes in taxes in 1987, that it will be a negative for next year. With regard to the trade sector, which we have talked of as a key factor, we did some studies based upon alternative assumptions of the speed of passthrough of import prices and what that might do in terms of the demand for imports. And any statistical study we did produced a greater improvement than we have in our forecast and that the Board staff has in its forecast. In addition, regional anecdotal evidence suggests--

CHAIRMAN VOLCKER. Does that mean you get a high price for imports?

MR. PARRY. No. Even if one uses some of the series that do not have much of a passthrough, you still get a sharper slowing in imports than is included in our judgmental forecast and in the Board staff forecasts that we have seen. So I think we are running on judgmental forecasts as far as imports.

MR. HELLER. How about import prices? Do they go up? Is that what you are saying?

CHAIRMAN VOLCKER. Import prices don't go up all that much. What he is saying is that you get a big improvement.

MR. PARRY. Right--faster than what we have. In other words, if you look at the statistical studies, we all seem to be taking conservative positions with regard to the net exports. That's not very comforting, given what we have seen to date. We have some regional anecdotal evidence that suggests more signs of a pickup in export volumes in the Twelfth District. There has been a strong pickup in foreign demand for aircraft. We have had foreign orders for electronic products, including computer graphics and certain measuring devices. There is some additional demand for agricultural exports and not much sign at all of any declines in imports, I might point out. It appears as though the bottom line, as far as the net export sector is concerned, is that there is a chance of some positive surprises in the trade account.

CHAIRMAN VOLCKER. On that happy note we will hear from Mr. Melzer.

MR. MELZER. In the Eighth District, conditions continue to be pretty good. We have had good non-ag employment growth in the last three-month period--about a full percentage point greater than nationally. Retail sales are a little slower than the national growth. In a sense, a surprising area of strength continues to be both residential and nonresidential construction: in the most recent three-month period through October we have had annual rates of growth of 20 percent in residential and 16 percent in nonresidential. Following up on that, real estate lending has been very strong at District financial institutions; there also has been a notable pickup in commercial lending activity. I would say that some anecdotal comments we hear tend to bear that out. In Louisville, for the first time since I have been involved, I have heard people mention a pickup in manufacturing activity there, particularly among smaller manufacturers. Homebuilders in the St. Louis area are expecting to do next year maybe 90 percent of what they have done this year in the single-family area, with multifamily construction down substantially. There continues to be anxiety about the Christmas selling season; there is evidence of a lot of promotional activity in the newspapers and some talk of price cutting, but that still remains to be seen. I would say that in general the anxieties remain what we have heard about before--in terms of the consumer in the first quarter of next year, capital spending early next year, and so forth.

Overall, our outlook on economic activity would be somewhat stronger than the Board staff's, though not substantially. On the

price side, we believe there is somewhat greater risk. But in general I would be quite satisfied if we achieved the 2.7 percent growth that the Board staff is looking for next year. As Mrs. Horn was saying, that sort of growth rate tends to facilitate the kind of adjustment that we need to see in order to get the trade situation into better balance.

CHAIRMAN VOLCKER. [The staff's forecast is] 2.8 percent, to be precise. A few people were talking about housing starts; a housing starts figure came out this morning, which I am sure Mr. Kichline can report to you.

MR. KICHLINE. Housing starts were at a 1.6 million unit annual rate in November. That's just about 2 percent below October. All of the decline is in the multifamily area and, regionally, all of the decline is in the South. It's a shade weaker than we had built into the forecast, but not much.

MR. MORRIS. What about building permits?

MR. KICHLINE. They are up and very close to starts. They are up about 2 percent, surprisingly all in the multifamily area.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Conditions in our District remain very much unchanged and are certainly consistent with the trends that have been in place for so many months now. The unevenness which has been a feature of this whole cycle in our area certainly continues. The plant closings are a tangible sign of all of this. The last time we talked a bit about the GM plant closings that we thought would take place. That announcement, of course, has been made and it certainly has had an enormously negative impact on the District, particularly in Michigan where they are going to be fairly hard hit. Since then there have been quite a number of plant closings announced, and I must say that I find it distressing at this stage of the cycle to keep having this phenomenon take place.

As I look ahead to next year--to say the obvious, I suppose--the two major questions are: 1) inflation; and 2) the trade picture. On the inflation side, I have this feeling that once we get the energy and food effects through the cycle we are going to be into a fundamentally higher underlying rate of inflation; but no one that I talked to confirms that. My sense is that market pressures are very, very tight. People are holding down on their raw material purchases very substantially and, in turn, aren't able to pass price increases on their products through to the market. Of course, the operating ratios and the continuation of favorable labor contract settlements tend to confirm that. Our outlook, therefore, for the inflation number next year is quite similar to the staff's. The issue of the trade picture I find equally perplexing, given the large decline in the value of the dollar. It just has to make sense that we are in a better position at this point than we were before; and I would say that the people I talked to are sensing better export opportunities than they had before and, certainly, an improvement in the trade picture is fundamental to our outlook for next year. But one issue that I find a little troubling is the enormous disparity between our wage rates and those of some of the major foreign competitors. To

give an example of this: I was in _____ last week and had a chance to talk to the general manager of _____ with six or seven plants around the world; and they have a good one in Mexico. Wage rates in _____ are \$23.00 an hour; wage rates in Mexico are \$1.00 an hour. Not only is that surprising but the productivity in Mexico is better than it is in _____ and even more surprising, the quality standards in Mexico are better than they are in _____

CHAIRMAN VOLCKER. Are they investing more in Mexico?

MR. KEEHN. He says they are investing more in Mexico, given that it's a pretty easy decision. The thing I find bothersome about that is that you can have an awful lot of currency value decline and you can't quite make up for that kind of disparity.

CHAIRMAN VOLCKER. We need a 95 percent depreciation in the Mexico peso!

MR. KEEHN. Admittedly, that's a pretty narrow product line. Putting it in a broader perspective, our anticipation is that there will be improvement here. I would end my comments by saying that our outlook with regard to the growth picture as well as the other major economic indicators is very much in line with the staff's forecast. We certainly expect a continuation of the expansion through the year.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, our forecast is very much like the Greenbook's and I too would be very happy if we got 2.7 or 2.8 percent, whatever it happens to be. But I would repeat what I said last month: that I think the risk is on the down side.

With respect to the regional economy, developments show continued strength in almost all of the urban areas but weakness in the rural areas, particularly in the agricultural and energy-dependent sectors. Christmas retail sales have been fairly good so far, again in those urban areas, although in a lot of the large urban centers there has been a rapid proliferation of stores and that has kept the unit gains fairly [modest]. The black spot in our District, of course, is Louisiana, which is basically in a depression. The only good news that you can find there at all--if indeed it is good, but you grasp at almost any straw here--is that the rig count has stabilized and maybe even picked up a bit. People down there are now saying that a \$15.00 oil price would be a viable price to begin to accelerate some exploration. Now, that's a lower price than we have heard before. The farm sector also is fairly depressed in most areas of the Southeast. We are looking for greater liquidation, mostly due to the drought that we suffered last summer. More and more farmers are being forced to the wall and land prices continue to plummet in many areas. In the housing sector, we are finding generally that single-family home construction is picking up in several areas in response to sales of new homes. I don't know how that squares with the latest numbers, but that was the information that we had. Nonresidential construction is off. So it's a very mixed picture, Mr. Chairman, in the Southeast. Despite that, there is still a fair degree of confidence among most people outside of Louisiana that we are going to have continued expansion in 1987. There is the evidence that the trade situation is turning around and there is an expectation

on the part of people in the export-related areas that they are going to see improvement in 1987.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, the Eleventh District has remained much the way it was when we reported at the last meeting. We continue to think that we are at the trough, statistically at least; we think there is going to be some improvement in 1987. We just did our own forecast for the District and we think we will do about half as well as the national forecast. That does key off the national forecast, because we think that's where most of our strength is going to be--the spillover effect from that--and we do pretty much agree with the staff's forecast. Also, if oil prices are in the \$13.00 to \$16.00 range we have a little optimism there, and that's built into our forecast. We have had a little improvement in non-ag employment in the District, although the Texas unemployment rate is still holding at 9-1/2 percent versus 7 percent for the nation. Of the eight highest unemployment rates [for cities] around the country, we have five of them in Texas. It depends on where you happen to be; if you are in McAllen, Texas it's 19 percent. Agriculture presents a bit of a mixed bag. If you are in the livestock business, it's looking pretty good; if not, it still looks bad or not very encouraging. The high-tech and related areas look pretty good.

One reason I said that, statistically, we think we are at the trough is that, anecdotally, we are about the only ones who think that. Comments of our directors and reports from around the District tend to be more negative in that we get very little encouragement. In trying to figure out why that is, I think it is probably that our directors don't have the same view of the national economy's growth that we have. In other words, they have a feeling that growth is not going to be as strong as we think it will. So, while there is not anything really to brag about openly, we are going to go along and gradually improve.

CHAIRMAN VOLCKER. A little vignette in Texas is actually going to try to export some steel to Japan. That's a--

MR. BOYKIN. I'd say two things about that: it's an unusual plant and it's an unusual individual.

MS. SEGER. Will they let it in or will it have to sit on a boat for three years?

MR. BOYKIN. That he is going to find out.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. The economic recovery in the Ninth District remains intact, with all of the imbalances that we have discussed in the past persisting as well. Anecdotally, it seems that holiday sales, at least in the metropolitan areas, are pretty good so far. I have not heard any concerns expressed recently about how that was shaping up.

At the national level, certainly, the latest spate of evidence seems to me to be consistent with something like the staff's Greenbook forecast. My own view is that there is some chance--or that it would not be that difficult at least to try to build a case--that in fact we might do a little better over the next four or five quarters than the Greenbook suggests. When I consider that, I come back to the view that maybe something like the Greenbook outlook is what we will achieve, in fact. It seems to me that ongoing imbalances, both in the economy and in fiscal policy, are likely to restrain the private sector sufficiently that perhaps something like the Greenbook performance is what we will get and is about as good as we can expect to get.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. I think the staff's projection for real GNP is still reasonable both for the fourth quarter and for 1987. Like everybody else, we were impressed by the November report on employment; and I think the staff was right to revise their figures up on that basis. But I really believe that the near-term outlook is more uncertain than it has been for some little time. It seems that one month we get a series of good reports and the next month they are all bad; we keep flip-flopping back and forth as these reports come in. But for three reasons, I am now concluding that the risk may be on the down side. One reason is in the foreign trade sector. I am particularly uneasy about the rapid improvement of the net exports of goods and services projected for the fourth quarter by the staff. Even taking account of the likely slant in petroleum imports, I think there's certainly better than an even chance that we are eventually going to see some improvement on the trade side; at the same time, this strong and increasing competition from some of the smaller Asian countries and rather lackluster performance in the German economy in the third quarter lead us to think that the improvement might not be quite as great as most people are assuming. I guess it was Bob Parry a while ago who suggested that it might be stronger now, and I certainly hope that he's right on that. I am a little worried by it.

We are disturbed for a second reason by this continued deceleration in residential [construction] and new home sales; and we got a new figure that sort of confirmed that this morning. Finally, we are not as confident about the prospects for consumer expenditures as we were at the last meeting.

the head of a large department store reported that sales had literally dried up right at Thanksgiving, after having been very good before then. This was a nationwide phenomenon rather than something simply confined to the area; we get the same kind of reports from other retailers in our area. And I can't help but think that some of this strength we are seeing--even in items other than automobiles--is an acceleration of purchases by those few people who itemize their sales tax deductions in order to take advantage of that this year on big-ticket items before next year when the tax is not deductible.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Our view is very close to, and consistent with, the Greenbook forecast. I think that is an acceptable outlook, and I would join those who say that if we achieve

2.7 or 2.8 percent growth in the fifth year of recovery, that's a pretty good record given the projection for prices.

On the regional front, the situation has not changed greatly from what has been reported before--that is, we have an uneven recovery, with severely depressed conditions in the energy, agricultural, and aircraft sectors of the economy. I suppose we can take some comfort from the fact that our most recent agricultural survey shows that the decline in agricultural real estate values is moderating. That is the second quarter in a row in which declines have averaged only 2 percent, as contrasted with earlier declines of 6 to 7 percent in each quarter. Those values now are roughly 50 percent of what they were in 1981 at their highs. I take some comfort from the discussion about exports, particularly Ted Truman's indication yesterday that agricultural exports have picked up. I must tell you, however, that we don't see any of that activity in the Tenth District. As a matter of fact, the crop this year has been a bumper crop virtually across all crop lines, and the good news is that the red meat industry--both beef and hogs--together with the government subsidies are returning some cash income to our agricultural producers.

On the energy side, there has been a bit of an uptick in the rig count from 215 to 223; that's cited as a great improvement in our District! But having met last week with a very small group of Oklahoma businessmen, I can tell you that pessimism pervades that part of the country, both because of energy and agriculture. And the situation regarding bank failures is very, very gloomy; they can see no light at the end of the tunnel, if you will, so they are just hunkering down and hoping that something magic happens that will bring them out of this depressed state. I don't see what that will be either, I might tell you. In the aircraft industry, there is a further decline--that is, layoffs, simply because they cannot compete on an international basis given the value of the dollar and there is no [new] domestic demand for purchases of aircraft, largely because of the very big pool of used aircraft. As companies have cut back over the years, one of the first things that went was their airplane. As a result, new aircraft just are not coming off the line or selling, so the industry is simply laying off the people. All in all, it seems to me that we have quite a long ways to go in the Tenth District to join the rest of the country in the recovery. But it seems to me that the Greenbook forecast is quite reasonable for the nation as a whole.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. Perhaps the story that Si Keehn mentioned about the plant closings in the Midwest and the hit that certain states, including my own, are going to take made me feel a little less optimistic about both the current state of the national economy and also the outlook for next year. I think that some of the apparent strength at the moment is related to tax reform and is primarily driven by businesses and some individuals trying to push their transactions into 1986 rather than do them in early 1987. Another portion arises from inventory building and, unfortunately, I think part of that is involuntary. In fact, using our own staff estimates I believe that \$25 billion out of the \$40 billion or so increase in real GNP in the fourth quarter comes from the inventory swing. So I'm just

wondering if maybe the first half of 1987 could be quite a bit weaker than we presently expect it to be.

If you'll allow me, I'd like to give you some comments I got from a top automotive analyst yesterday about what's going on there. I found them very interesting. He thinks that somewhere between 100,000 and 200,000 new car sales are being pushed into this year from next year for tax reasons, namely to get the sales tax deduction. Some other unknown quantity of sales was generated this year by the tremendous interest rate incentives that we all know about. Those too are likely borrowed from 1987 but the exact amount of the borrowing is not known. The bottom line of his analysis is that total new car sales in 1987 will be about 75,000 below what they're running in 1986 and that import sales will be flat. So the whole hit will come on the domestic side. Also he made a big point--and he does not work for General Motors by the way--about the inventory situation at General Motors. At the end of November GM dealers were already up to 85 days' supply of unsold new cars. More importantly, if you look at some of the individual models, their stocks are running above 100 days' supply. Earlier this year when GM had problems with excessive inventories their response was to launch another incentive program and try to "buy" sales, shall we say. But that was a very expensive way to go in order to maintain production stability and their market share. So the betting now is that when GM has this excessive inventory situation they are going to pare their production schedules. I don't sense that we have enough of that paring in our numbers, particularly what will likely hit early next year. Also, I'm not sure that we are taking enough out on the commercial building side. I just have a gut reaction that office construction could be a lot weaker than we are presently estimating. Salomon Brothers had an interesting presentation showing that over the past 12 months the new office construction put in place has been off about 14 percent and that the boom that has been running from 1979 to 1986 has raised the vacancy rate from 3.6 percent up to 24 percent in the suburbs and almost 17 percent in downtown markets. Using their estimates and running with current demand levels, they think we'd have to get a 50 percent decline in new construction in order to bring back single-digit vacancy rates by the early 1990s. I found that rather startling. Finally, I really believe that the tax reform is going to take another bite out of business spending and that it possibly will be weaker--not just in the first half of the year but in the whole year--than we're presently expecting. So, I just think that sometime we ought to ask ourselves if maybe we are running the risk of a recession sometime in early 1987. I'm not arguing that we are, but I think maybe we ought to consider that possibility.

CHAIRMAN VOLCKER. Who else wants to contribute to this?

MR. HELLER. Oh, I guess if we have to--

CHAIRMAN VOLCKER. [Unintelligible.]

MR. HELLER. Overall, I'm in broad agreement with the staff forecast. I think their numbers are eminently reasonable. I'm a bit more optimistic on the consumer; I'm not only looking at the high debt levels, but also at the high asset growth that they've experienced and some interesting data that were brought to our attention recently; the latter show that the net worth of the consumer is now at its highest

point in relation to personal income in the last decade. So, it really doesn't mean that the consumer has to fall off the cliff, as a lot of the debt-watchers would make us believe. Furthermore, tax reform will clearly be a positive picture for the consumer. Starting on January 1 there will be bigger pay checks--maybe even for the federal employees, who knows? The bad surprise for the consumer will only come in April '88 when he realizes that his deductions and the old tax shelters have been gone for the last year and that he has to come up with a tax payment. But I don't think it will influence consumer behavior a lot before then.

On the foreign trade sector--well, I hope Bob Parry is right. But I don't see an awful lot of growth in the foreign economies, and I think it is very difficult for American producers, given the current situation and current exchange rates, to increase their market shares. So, on the export side, I don't think we will see as much progress as has been hoped for. I think we will be making the progress on the import substitution side because American producers clearly are more competitive, although some of the numbers will be skewed--for instance by the automobile plant building in this country and foreign plants in general that have been [unintelligible]. On investment, I'm not quite as pessimistic as some people. I think it's important for the manufacturers to see the sales going up rather than just looking at the tax incentives; and as long as sales are sustained they will also start to invest again. Overall, as I said earlier, I'm in broad agreement with the staff's GNP forecast for growth of slightly below 3 percent.

MR. JOHNSON. I'm generally in agreement with the staff forecast, too. I think there are some risks, as indicated by the sensitivity of things to the exchange rate. That was illustrated yesterday by the notion about what's riding on the further 10 percent decline, to some extent. But even if you cut back [growth by] 6/10ths it's not the end of the world. After 4 years of expansion, I think it's very unusual and very comforting to know that cost/price pressures are as moderate as they are at this stage. I don't think we have ever, at least in the postwar period, entered a recession with the moderate kind of cost/price pressures [we are seeing] at this stage. So, I'm reasonably optimistic that the expansion will continue. I think it's a question of by how much. I think there is this continuing dichotomy in the [financial] system and in the economy that's still a bit troublesome. But over time, the change in the dollar is going to improve that. There's a long adjustment period still ahead to work out all of the inflation excesses of the past. But I'm fairly optimistic that expansion will continue. I'm a little concerned that the expansion in the first half of the year may show some transitory problems, and I think we ought to remain flexible for that; I don't think it's likely to be deadly. So, I agree with the staff assessment but I think the risks are a bit on the down side.

MR. ANGELL. My view is very similar to Mr. Johnson's and many others around the table, and that is that the staff forecast seems to me the most likely event. I would have a slightly lower CPI number. But I must admit that I only overestimated the rate of inflation one time in the last seven years; so I put my CPI at 3 percent, hoping that I'll have another overestimate in here sometime.

CHAIRMAN VOLCKER. What does the staff have for the CPI?

MR. ANGELL. 3.7 isn't it?

MR. HELLER. 3.7.

MR. ANGELL. 3.7 percent on the CPI, 2.7 percent on the fixed--

MR. KICHLINE. We have 1.4 percent this year and 3.7 percent next year.

MR. ANGELL. Yes.

MR. MORRIS. How much of that is attributable to the oil price increase assumption?

MR. KICHLINE. Well, let's see--

MR. ANGELL. Basically, my view is that taking food and energy out in an attempt to get a baseline is just not a very accurate way to go, because when you take food and energy out then you have the services sector, which is such a large portion of what's left. So I feel uncomfortable with any inflation forecast that takes food and energy out because then we have what I call a measurement problem. I think many of you see that measurement problem in the service sector, and I think that just keeps our baseline inflation rate a little too high. So, I am a little more optimistic on inflation, but I certainly appreciate what I would call the staff's "within the range" forecast there. My concern is that even though the fourth quarter seems to have some strength to it, it seems to me a very vulnerable strength; we could end up the quarter in a rather fragile and vulnerable position. I see that in terms of world imbalances. We continue to have these huge saving rates in Japan and western Europe and we have other countries that are almost synonymous to farmers and oil people in the United States that have these huge debts. There's nothing really happening internationally, it seems to me, to cause that basic structural position to improve. So we're kind of patching together an international problem which is of grave concern. It seems to me that we have a fragile circumstance in the import sector. I'm looking for import prices not to rise quite as fast as others because the Japanese automobile industry seems so attuned to doing what they need to do on the wage and price front in order to remain competitive, and I don't think we're going to see price increases there. And it doesn't seem to me that we're going to have much chance to lower our imports with our staff's projected real GNP path.

So, I think we do run some risks that the first and second quarters could cumulate to a lower level of output than we're forecasting. And if that happens, I don't know what's going to turn it around. If we get off to a weak start, I don't know what will lift us up because it seems to me that the pattern of consumer spending may worsen as fast as we get any export side improvement. I think there will be export side improvement, but I think it's going to be very slow and it's going to come only to industries that are very attuned to keeping costs low. Also, of course, if we end up with a lower growth than estimated, then we're not going to get quite as good a government budget outcome. If we achieve 3 to 4 percent real GNP growth, government spending as a percent of GNP has a chance to take a noteworthy downturn. I'm kind of uneasy but, like many of you, I

share the priority of maintaining stable prices, and I guess I'm willing to run a little risk here in order to achieve price level stability. But I think we have to be aware of how vulnerable we may be and we have to be ready for some unexpected events. It may not come out just like the forecast.

MR. KICHLINE. Mr. Chairman, the answer to this question about energy is essentially that in 1986 energy prices are declining at 18 percent. In our estimate they have a weight of about 10 or 11 percent, so the energy sector depresses the consumer price index by about 1-3/4 percentage points this year. Next year our guesstimate is that energy prices will be up 6 percent, so they would add 0.6 of a percentage point. So a major part of the swing is the energy sector.

CHAIRMAN VOLCKER. And that's only assuming [an oil price] of \$16; if it went to \$18 it would be more.

MR. KICHLINE. That's correct.

CHAIRMAN VOLCKER. If you get that kind of a swing in energy isn't the implication, when you're talking about the consumer price index, that you must have other prices going lower relative to that?

MR. KICHLINE. We have one other element that's important here: food. And it has a big weight, something like 18 to 20 percent. This year we're estimating food price increases of about 4 percent and next year 2 percent. So that is a major swing the other way. The other prices that we have in there don't change a great deal from one year to the next; it's not much of an acceleration.

MR. ANGELL. And food prices could be even lower than that given the fact that the red meat industry has the highest profit margins it has had for many, many years and given the fact that we had weather that adversely affected poultry prices. So we do have some possibilities for food being better and we have an underlying wage structure change in the service sector that's rather noticeable for next year compared to this year.

MR. JOHNSON. Service sector inflation is continuing to decelerate, I think, sort of gradually.

MR. KICHLINE. Yes. We have something like 5-1/2 percent in 1986 and our number [for 1987] is a little under 5 percent.

CHAIRMAN VOLCKER. Anybody else want to say anything? Let me ask a question. If the nominal GNP were higher than you're projecting would you think that it's more likely to appear in prices or in real GNP? Before you answer that, I know what the models show: that the prices will show up in 1990 and the real will show up right away. I guess I'm really asking where the risks are and how confident you feel about this inflation forecast.

MR. KICHLINE. Well, let me answer that in a less direct way than you might like. In looking at 1987, I think the risks are that in the first half the economy will turn out to be weaker rather than stronger. We can't identify how much spending is being accelerated but I think we probably underestimated it. I wouldn't be surprised to see a number in the fourth quarter that's greater than what we have

built in; and if that happens I might also look for a weaker first quarter and first half. Beyond that, I tend to think that we may run with stronger GNP rather than weaker as we get into the latter half of the year. On the price side I think there's a good bet that very little will happen in the near term. But if we're wrong at this point--again looking out--consistent with my view on real GNP I might be adding a few tenths to the inflation side rather than taking away.

CHAIRMAN VOLCKER. And you're projecting, essentially, a few tenths per month average increase in the consumer price index with oil prices tilted slightly higher?

MR. KICHLINE. And food prices slightly lower.

CHAIRMAN VOLCKER. And the food price tilt--you've only got a 2 percent difference and maybe it should be bigger. It probably will be, but I--

MR. ANGELL. It seems to me that if the price pattern is stronger we will then get more desire to hold inventories and the economy could turn out to be stronger than the staff estimates.

MR. TRUMAN. Well, there's another factor too. To the extent--

CHAIRMAN VOLCKER. Your argument is that they go together?

MR. TRUMAN. There has been a lot of discussion about import prices and I share the skepticism, both ways, that has been expressed on that. But to the extent that you get import prices moving more rapidly you would then have a direct impact in terms of statistical aggregate demand, because real GNP presumably would also accelerate in the process of import substitution that Governor Heller spoke of. So there is a direct link there even with the [unintelligible] of inventory.

MR. ANGELL. Yes.

MR. TRUMAN. Moving both at the same time is built in this four-quarter time period--

MR. ANGELL. It just seems to me, Ted, that we do have quite ample capacity at a lot of these manufacturers in basic industry areas worldwide. The evidence seems to point to increased determination to be competitive by one means or another, whether it's by subsidy or some other event. And I tend to feel that the world prices are continuing on a moderate plane. But much of it would be--

MR. TRUMAN. Well, [unintelligible] you're right about how the rest of the world is behaving. Your words about the rest of the world suggested an even soggier picture; that too could affect the base prices and then you don't have the given exchange rate change. Whatever you want to assume about [unintelligible] could be less--

MR. ANGELL. But it might not be so bad for us to go back to 4 percent CPI and get a little stimulus in here and then have to go back when M1 starts behaving well and tighten up interest rates--run them up 150 basis points. Maybe that's not too bad; I don't know.

CHAIRMAN VOLCKER. Well, Mr. Black raised an interesting question earlier about whether we should have an inflation target, more explicitly. It's a big subject. It's a nice question on how we can get the interest rate down. Maybe we ought to reserve a little time next meeting for being a little more explicit in our discussion about what we really are satisfied with and what priority to give it. Meanwhile, we will turn to Mr. Kohn and then go to coffee.

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

CHAIRMAN VOLCKER. Given what you were talking about earlier regarding the various models for M1 and given the relative stability of interest rates--in fact there has been a very faint increase of an insignificant amount, but it has been stable for quite a long time--why are you still showing a 12 percent rate of increase in M1? Are the lags that long?

MR. KOHN. Yes, and especially when the offering--

CHAIRMAN VOLCKER. How long has it been since short-term rates--

MR. KOHN. Well, August was the last discount rate cut, so--

CHAIRMAN VOLCKER. And that's about the last time short-term rates went down.

MR. KOHN. Now, if the offering rates were to adjust more promptly--. But they've been edging down very slowly. So we have very narrow opportunity costs, yet we continue to see huge growth in those--

CHAIRMAN VOLCKER. We haven't had a substantial increase in short-term market rates, since when--September?

MR. ANGELL. Four months.

MR. KOHN. Yes.

CHAIRMAN VOLCKER. And you're saying that the lag is more than six months?

MR. KOHN. Well, the total lag would be more than six months. The models probably were projecting a bit more of a slowdown over the last couple of months than we actually had.

CHAIRMAN VOLCKER. I wonder what they are projecting for the first quarter?

MR. KOHN. For the first quarter they are projecting anywhere from 11 to 14 percent, or 10 to 14 percent on this November-to-March basis.

CHAIRMAN VOLCKER. What would they project for the second quarter, assuming unchanged interest rates?

MR. KOHN. They would project a first quarter of 13 percent and a second quarter of 9 percent.

CHAIRMAN VOLCKER. Even then they don't get down to the [growth rate of] nominal GNP.

MR. KOHN. No. They would get there by the second half of the year.

CHAIRMAN VOLCKER. A one-year lag?

MR. KOHN. Well, it dissipates slowly in the model.

CHAIRMAN VOLCKER. We'll go and have a short lag for coffee.

[Coffee break]

CHAIRMAN VOLCKER. Well, after half of an afternoon and most of the morning we have to get to a decision. Who would like to say something? We have a volunteer--Governor Johnson.

MR. JOHNSON. I'll volunteer. After condensing all of this-- what I hear and the way I feel--I don't feel strongly about changing monetary policy from where we were before. I still think that a \$300 million borrowing target is about right. Although I favored [a tilt] last time, I feel a bit more strongly about it this time. I think we might want some asymmetric language in the directive because of the potential I've heard mentioned for a little more downside risks this time, at least in the first half of the year. I think the inflation picture looks a little less risky now than it did earlier, so we might want to change the mights and woulds in the directive to be asymmetric toward potential ease rather than tightness at this point. But I don't feel too strongly about it; I feel a little more strongly than last time, but it's just a suggestion.

CHAIRMAN VOLCKER. Who would like to pitch in? Mr. Parry.

MR. PARRY. I would favor alternative B mainly because I think there are convincing signs of strength in the economy at the present time. But I share the view that the extent of the slowdown which we all seem to agree is likely to occur in the first quarter is uncertain and that, of course, should be noted in the policy statement as well. That could be done either in terms of asymmetric language or in some other more direct way.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I would also favor alternative B. I would not favor asymmetrical language. To an extent, I think we've already allowed for potential weakness in the first quarter; we've been pursuing a very stimulative policy. I would be somewhat concerned if we didn't begin to see some slowing in M1 with stable interest rates. We are having to provide reserves at a very high rate to maintain the funds rate at this 5-3/4 to 6 percent level. I don't know how long those lags are either, but if we continue to see very rapid rates of M1 growth against the backdrop of stable interest rates, there may be some pickup in economic activity and I'd be concerned. So, I favor alternative B, with no asymmetry.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I would favor alternative B without asymmetry, too, because the market, in a context of the federal funds rate going up, read a lot more--at least temporarily--into the last directive that we published with asymmetrical language in it than we intended. For that reason I would favor symmetrical language.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, I believe the forecast, although I'm somewhat nervous about it as I indicated earlier. But until the downside risks really begin to emerge I would favor no change in policy. Therefore, I would opt for alternative B as shown in the Bluebook. I would slightly favor an asymmetric directive suggesting greater ease. Also, I would like to see us adopt the language suggested in the Bluebook with respect to M1 and not continue what we have had--that we are continuing to look for a reduction in M1. I prefer the language that has been suggested by the staff.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. [I favor] alternative B with an evenhanded directive. [Although] it's true that we expect some weakness in the first half, we also expect some increase in inflation. But I don't think we are going to know very much at all about the first part of next year before our February meeting. So, I think it would just be too early to indicate to the marketplace, with an asymmetrical directive, that we're concerned about a downturn.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. I, too, would favor alternative B, Mr. Chairman. I prefer the proposed substitute language because I don't think we have any idea where M1 is going to be headed in the next two to three months and I don't think we'd react to it anyway, unless we were getting similar signals from the other aggregates. I always tend to favor a symmetrical posture and I think I would this time, [although] what Manley said certainly makes sense. I prefer "somewhat" over "slightly" because I think that indicates a little more willingness to react in case something unexpected occurs. And for the same reason I prefer the "woulds" over the "mights."

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I, too, prefer alternative B and I would advocate symmetric language. It seems to me that even if we get some weakness in the first half of next year, to some extent that is anticipated at this point. We are expecting an overall satisfactory economic performance and I don't think we would want to alter policy at that juncture if, essentially, the expected were happening. So it seems to me symmetric language would be appropriate and only if the economy or other measures, like the exchange rate, were deviating significantly from the general path we expected would we want to react.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I'd be in favor of alternative B also, perhaps for slightly different reasons. I would think that these minutes probably are going to be released just before your testimony, and that, therefore, these should be consistent with the last [directive]. I would think that would be a slightly better environment--symmetrical language, without suggesting any change to the market--as you go into your testimony.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. "B" and symmetric.

CHAIRMAN VOLCKER. You get to the heart of the matter. Mr. Angell.

MR. ANGELL. "B" and asymmetric. If we use symmetric language, I prefer "would" and "somewhat" to "might" and "slightly."

CHAIRMAN VOLCKER. You want to be asymmetric?

MR. ANGELL. I would like to be asymmetric because it seems to me that when the minutes are released they should be the best reflection we can provide at this time as to the general outlook. And asymmetric is a better reflection of what I heard around the table than symmetric.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. "B" and symmetric.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I clearly want "B". I get confused on the symmetries and asymmetries here, though. In listening to the conversation, I think we might want to keep the language symmetrical; but even if the language were symmetrical I don't think that would necessarily preclude some easing--to go back to two months ago--if things really got "oozy." But I think the point about having the language symmetrical in the context of the testimony is a good point.

MR. JOHNSON. That's a good point.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. "B" and symmetrical.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. Well, based on my views of the economy, I should be voting for "A," but in the spirit of Christmas I will go with--

CHAIRMAN VOLCKER. You've got to break this pattern sometime!

MS. SEGER. I will go with "B," but I would like asymmetric language allowing for some lesser reserve restraint should all heck break loose.

CHAIRMAN VOLCKER. Mr. Heller you're last in line.

MR. HELLER. Can't avoid it anymore. I also favor alternative B.

CHAIRMAN VOLCKER. "C" just for--

MR. JOHNSON. If Henry were here today--

MR. HELLER. Taking Henry Wallich's spot, I would want "C." But I think I'll go with the "B". And while I would not favor asymmetrical language, I agree that we should shade it in an asymmetrical fashion if it comes to that point. So I am taking Mr. Corrigan's amendments to Mr. Johnson's proposition.

CHAIRMAN VOLCKER. Well, we have unanimity for "B." Before we get to symmetries and asymmetries, let me see what that means. I'm happy with the language. We certainly would say "maintain the existing degree of restraint. This action is expected to be consistent with growth of M2 and M3 over the period from November to March at..." Well, I guess we have a choice: we can say about 7 percent; we can say 6 to 7 percent; or I suppose we could say 6 to 8 percent. What's your choice?

MS. SEGER. How about "about 7 percent"?

CHAIRMAN VOLCKER. Is "about 7 percent" all right with people? "Respectively" is not needed if we say "at an annual rate of about 7 percent." I don't know what you want to do about this M1 statement. It seems to me a bit vacuous to say the outlook for M1 remains subject to a great deal of uncertainty.

VICE CHAIRMAN CORRIGAN. However accurate.

CHAIRMAN VOLCKER. However accurate. It seems to me better that something be said in the [policy record] text rather than in the directive. That's--

MR. HELLER. But it would set the stage a bit for the February testimony.

CHAIRMAN VOLCKER. I have no objection to saying it at great length in the policy record or whatever we call it. This is an operational directive.

MR. BLACK. Well, you could say "in view--"

CHAIRMAN VOLCKER. It's a matter of taste. It just sounds odd to me to say in an operational directive that we have great uncertainty about M1.

MR. MORRIS. Take the sentence out.

CHAIRMAN VOLCKER. Well, that's one thing to do: just leave it out. Or we could just say "growth in M1 will continue to be judged in the light of--"

VICE CHAIRMAN CORRIGAN. That's good, yes.

SPEAKER(?). I think that's the one.

CHAIRMAN VOLCKER. We could say "monitor" instead of "judge."

MR. HELLER. Sure.

VICE CHAIRMAN CORRIGAN. Now you're getting into major changes here!

CHAIRMAN VOLCKER. It seems to me a slightly more--I don't know--

MR. ANGELL. "Viewed" makes a lot of sense.

MR. HELLER. [Unintelligible.]

CHAIRMAN VOLCKER. "Viewed" or "appraised"?

MS. SEGER. "Fretted over"! How's that?

MR. ANGELL. "Appraised" works pretty well.

CHAIRMAN VOLCKER. "Appraised in the light of the behavior of M2 and the other factors mentioned below." Isn't that a little better maybe? Then we get to symmetric or asymmetric. Let me try [unintelligible] greater support for the symmetric one. I'm not sure I understand this comment about being released before the testimony and being symmetric. What difference does that make?

MR. GUFFEY. Because that's what we had this past time. In other words, it's consistent with what we had in the last--

CHAIRMAN VOLCKER. Why is consistency a virtue in this case?

MR. JOHNSON. I think it all depends on what the economy is doing.

CHAIRMAN VOLCKER. Precisely. I think it will look good if the economy is a little soft or--

MR. KEEHN. I suggested it because, as Frank said, the market overread what we said the last time. It seems to me there could be an overreading at this point. [With no change] you would go into the testimony without that clouding the comments.

MR. ANGELL. But on the other hand--

VICE CHAIRMAN CORRIGAN. If the economy is weaker in such a way that the asymmetry was operational, it seems to me this language would be operational anyway. That's the point I was thinking of.

CHAIRMAN VOLCKER. Oh, I agree that if the economy were weak this does reflect a little substance as to how quickly we would move. It certainly is not a [big] difference. If it turns out that we have moved by the time this is released, we'll look better if it's a little asymmetric.

MR. PARRY. That's right.

CHAIRMAN VOLCKER. If we haven't, I am not sure it makes a lot of difference. But I--

MR. PARRY. Well, the questions could get a little harder at that point.

CHAIRMAN VOLCKER. I'm a little bothered--I don't want to be too bothered--but if, in substance, we feel we want to be a little asymmetric I'm not sure I see any compelling reason not to say that if, in fact, we feel that way.

MR. ANGELL. Yes.

VICE CHAIRMAN CORRIGAN. If everybody's right about the likelihood that the fourth quarter is strong--and we're not going to know a lot about the first quarter by the time of your testimony--what was going through my head is that if we have an asymmetrical directive but have decided not to use the asymmetry, then the questions are harder, I think. On the other hand, if circumstances are such that we decide we want to ease a bit, nothing here would prevent us from doing that.

CHAIRMAN VOLCKER. While I think it's certainly true that nothing will have prevented us from doing it, I think this difference is not enormous. It may just come down to a question that depends upon substantive views. If we really think the [likely direction of policy] is significantly tilted I would think on general principle that we ought to say something in the interest of truth; and if it's not that clear then--

MR. BLACK. What I heard was a feeling of uncertainty, Mr. Chairman, tilted a little in the way you say. But if uncertainty is the predominant feeling then the symmetrical language makes a little more sense to me because we could be wrong in either direction.

MR. ANGELL. But I think what we've written here--

MR. JOHNSON. I thought the tone was we could be wrong more in one direction than the other.

MR. BLACK. Yes, I agree with that; and I was on that side. But I don't say that with a great deal of confidence and I don't think any of us does.

MR. ANGELL. I only remember one person--

CHAIRMAN VOLCKER. One thing that hasn't been mentioned--so let me just mention it for the record--is that in terms of flexibility of action I think the performance of the dollar makes it easier to ease slightly if otherwise we wanted to than if the dollar was not behaving. Now, I'm not saying that dictates any action; I don't think it does. But I think we ought to reflect that properly someplace in the record, though not with too much emphasis. It could easily change, obviously, in many ways. But at the moment it is one difficulty that is removed in making [an easing move] if we wanted to do so, as I say, for other reasons. But I don't want to say this was too big a deal. I would have some slight tendency, as I say, towards

easing language if we feel that way. We have used asymmetric language lots of times to make this--

MR. MELZER. In connection with the dollar, could I ask a question? You may choose to answer [or not]. If the Germans were to cut their discount rate tomorrow would it necessarily follow, in an economic sense, that we should leap to match that? In other words, you could make the argument that, standing alone, that might be a salutary action over time to address the trade imbalance. I don't know whether that's something that--

CHAIRMAN VOLCKER. Well, I'll just give you my own reaction. I don't think we need to talk about it theoretically because I would be very surprised if Germany reduced their discount rate any time during this relevant period. I would say I don't see any need to, in your terms, "leap." If, in fact, the result was a significant strengthening in the dollar then I would think that might become a positive factor weighing in the balance toward some easing.

MR. ANGELL. Because that would take the dollar quite a ways from the staff forecast and might have some implications.

MR. HELLER. It would tilt our foreign trade balance the wrong way.

CHAIRMAN VOLCKER. I wouldn't put quite the same weight on the staff forecast. It might move it in the direction that was counterproductive over time.

MR. JOHNSON. I think that would depend on how the domestic economy was performing--whether it was really starting to show some signs of picking up.

CHAIRMAN VOLCKER. All I'm saying is that it would put weight in that direction if the dollar actually moved. It may not offset other things if it [unintelligible] but that's my own view on it.

MR. GUFFEY. But would you be easing policy through the Desk or would you be considering a discount rate decrease under those circumstances?

CHAIRMAN VOLCKER. Subsidiary questions. Well, you know this is not a federal case. Gee, we've got a whole hour that we can--

MR. BLACK. We can make a federal case out of it.

MR. MORRIS. Can we spend an hour talking about symmetry?

MR. BLACK. That would be making it a federal case!

CHAIRMAN VOLCKER. Let me write it down here. It took me some time to figure out how to spell it.

MR. BOEHNE. We've had less--

MR. JOHNSON. It seems like we can kill two birds with one stone with that. I don't think the implications are great one way or the other but if some sort of asymmetry in the language would

represent our current feeling--and maybe I'm wrong interpreting it that way--that we actually believe that the economy is going to show weakness, the timing [of the directive's publication] would be associated with the actual event.

CHAIRMAN VOLCKER. I think a fair summary of the discussion-- I'm not talking about the directive now--would be that there was somewhat more emphasis on the risks of a shortfall in the early part of the year than the other. Presumably, the directive will get interpreted in that light anyway, which [unintelligible] arguments. It's no big deal if we put asymmetry in here so long as that's in the background discussion. So I don't think this is a terribly great issue; but we're pretty closely divided as to what to do.

MR. HELLER. I'll certainly go along with that.

CHAIRMAN VOLCKER. We could fool around with the "slightly" and "somewhats" too. We could have one "slightly" and the other "somewhat;" that would be a new way of doing it.

MR. BLACK. And we can play with the "woulds" and "mights" too.

CHAIRMAN VOLCKER. Yes, that's what we usually do.

MR. BLACK. You've got three combinations.

CHAIRMAN VOLCKER. We could say "slightly greater reserve restraint or somewhat lesser reserve restraint would"--

MR. BLACK. Oh, we could really have some fun indeed!

MR. JOHNSON. I have a tough time telling the difference between "slightly" and "somewhat," but I guess just for variation--

VICE CHAIRMAN CORRIGAN. Well, I think it's easier to tell the difference between that than it is between "might" and "would."

CHAIRMAN VOLCKER. After all of this, is there any sense in saying "slightly greater reserve restraint or somewhat lesser reserve restraint might"? Either "might" or "would"--

MR. GUFFEY. [The press] would have a good story with this.

CHAIRMAN VOLCKER. I think "slightly" is better.

VICE CHAIRMAN CORRIGAN. I have a great compromise.

CHAIRMAN VOLCKER. That was an attempt at a compromise. Do you have a better compromise?

MR. JOHNSON. Yes: "slightly," "somewhat," and "would."

VICE CHAIRMAN CORRIGAN. I think the "slightly greater" is not really operational in a borrowing [unintelligible]. So what about leaving it "slightly greater, slightly lesser" and have the "would" apply to both? It's still symmetrical but "would" is a little more purposeful than might.

CHAIRMAN VOLCKER. But that's clearly symmetrical. It's only the reservation in your mind that is in the first part of the sentence.

VICE CHAIRMAN CORRIGAN. I don't have a strong feeling about this. The two things I'm worried about are the testimony and the year-end thing too. We are going to have crazy money markets here for the next--

CHAIRMAN VOLCKER. I don't know, maybe I'm wrong, but this testimony [issue] seems pretty irrelevant. In the testimony I'll say whether we've changed policy or not.

VICE CHAIRMAN CORRIGAN. But what I was thinking of is that if events work in a direction that we would choose not to [move] and we have an asymmetrical directive, then you have to answer questions that seem to me a little difficult such as "Why did you say you were going to change and you didn't?"

CHAIRMAN VOLCKER. I didn't say we were going to change; I said we might. In September we said we might tighten; in December we said we might ease.

VICE CHAIRMAN CORRIGAN. I don't feel that strongly about it either way.

CHAIRMAN VOLCKER. Oh, neither do I. I only feel strongly that we've got to reach a conclusion next time. And I would prefer a conclusion that satisfied the maximum number of people. Does it appeal to anybody apart from Governor Johnson to say "slightly greater reserve restraint or somewhat lesser reserve restraint would"?

MR. ANGELL. I would much prefer to say "slightly greater reserve restraint."

CHAIRMAN VOLCKER. Could we just try it again? "Slightly greater reserve restraint or somewhat lesser reserve restraint would."

MR. JOHNSON. Yes, that was my suggestion.

MR. ANGELL. That's what I would do. I think that most accurately reflects the discussion. There was only one individual that I recall who said [the economy] might be stronger and yet it didn't appear that it would be strong enough to require some action. There were quite a few who said it could be weaker.

CHAIRMAN VOLCKER. We could really make it asymmetric by leaving out the possibility of [greater reserve restraint], but that's probably too asymmetric.

MR. JOHNSON. Yes, even I wouldn't want that.

CHAIRMAN VOLCKER. Well, is that acceptable?

VICE CHAIRMAN CORRIGAN. It is to me.

CHAIRMAN VOLCKER. Can I have a show of hands as to how acceptable "slightly greater or somewhat lesser would" is? There is

reluctance in some of those hands, but I see quite a few. You need an expert to read that asymmetry.

MR. JOHNSON. Yes, it's pretty--

MR. HELLER. We should publish a guide to asymmetry.

CHAIRMAN VOLCKER. In the [policy record] discussion I think we can reflect the fact that there was more uncertainty on the down side and, given that, a little more possibility of easing.

MR. ANGELL. It would be nice to have the economy perform better than we expected. That would be--

CHAIRMAN VOLCKER. And we keep the 4 to 8 percent [range for the funds rate]. There's nothing else that appears. Does that capture things? It's: maintain; about 7 percent; growth in M1 will continue to be appraised in the light of the behavior of M2 and M3 and the other factors cited below--which are the strength of the business expansion, developments in foreign exchange markets, progress against inflation, etc. Okay? We will vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
Governor Heller	Yes
President Horn	Yes
Governor Johnson	Yes
President Melzer	Yes
President Morris	Yes
Governor Seger	Yes

CHAIRMAN VOLCKER. The meeting is concluded.

END OF MEETING