Meeting of the Federal Open Market Committee

February 11-12, 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 Tuesday, February 11, 1986, at 3:10 p.m. and continuing on Wednesday, February 12, 1986, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan,1/ Vice Chairman
Mr. Angell
Mr. Black
Mr. Forrestal
Mr. Johnson
Mr. Keehn
Mr. Martin
Mr. Parry
Mr. Rice
Ms. Seger
Mr. Wallich

Mr. Guffey, Mrs. Horn, Messrs. Melzer and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele,1/ Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman,1/ Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Broaddus, Kohn,1/ Lindsey, Prell, Scheld, Siegman, and Ms. Tschinkel, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. Cross,1/ Manager for Foreign Operations, System Open Market Account

1/ Entered meeting after action to approve minutes for meeting of December 16-17, 1985, and acceptance of the report of Examination of the System Open Market Account.

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Danker 1/ and Mr. Stockton,1/ Economists, Division of Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Fousek,2/ Executive Vice President, Federal Reserve Bank of New York

Messrs. Balbach, J. Davis, T. Davis, Lang, Rolnick, Rosenblum, and Scadding, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Cleveland, Kansas City, Philadelphia, Minneapolis, Dallas, and San Francisco, respectively

Messrs. Higgins and McNees, Vice Presidents, Federal Reserve Banks of Kansas City and Boston, respectively

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

1/ Attended portion of meeting relating to the Committee's discussion and action on monetary growth ranges for 1986.

2/ Entered meeting after action to approve minutes for meeting of December 16-17, 1985, and acceptance of the report of Examination of the System Open Market Account.

Transcript of Federal Open Market Committee Meeting of
February 11-12, 1986

February 11, 1986--Afternoon Session

[Secretary's note: At the beginning of this meeting the Committee took the following actions: approval of the minutes of the previous meeting; acceptance of the Report on the Examination of the System Open Market Account; and, after hearing Mr. Sternlight's report, ratification of the transactions in domestic open market operations since the previous meeting. For the text of Mr. Sternlight's report, see Appendix.]

MR. CROSS. [Statement--see Appendix. Secretary's note: There were no transactions to be ratified.]

CHAIRMAN VOLCKER. Comments or questions?

MR. RICE. Sam, are there any other explanations that you know about, other than the [reaction to] statements of foreign central bank and government officials, to explain the movement in the exchange rate after the lowering of the discount rate in Japan? As you said, after the Japanese lowered the discount rate and their interest rates generally moved down, the dollar weakened further and the yen went up. I gather, as you said, that the explanation related to the statements of government officials. But was there anything other than that?

MR. CROSS. Many people saw this just as part of some underlying weakness of the dollar. There was some view at that juncture that there might be a move by the United States and others very short after the Japanese action. Some people attributed some of the attitude to that expectation. But as I said, during this period--and this is seen somewhat as a sign of the weakness in the currency--the fact has been that when events which in other circumstances might have been expected to cause the dollar to show some strengthening, it doesn't seem to have happened.

MR. RICE. Very puzzling.

VICE CHAIRMAN CORRIGAN. Steve, or Sam, or Ted--somebody: Where are the exchange rates today?

MR. CROSS. The rates are down a little: 2.37-1/2 was the last DM quote we saw and about 187 [yen].

MR. AXILROD. They're roughly where they closed yesterday, so they have been essentially flat this morning.

CHAIRMAN VOLCKER. Any other questions?

MR. PARRY. Do you think the long-term effect of lower oil prices will be negative for the dollar? Can a case be made that longer term it could have favorable effects, particularly in relation to sterling and the Canadian dollar?

MR. CROSS. Well, this question of the effect of oil prices is very, very complicated. I guess anybody can come to his or her own view. Certainly, I would think that over a long period of time a

declining price of oil is going to be of great value and importance to the United States and has to be helpful. But I don't know when or how that comes about or in what kind of time period. But right now, as I said, the [market's] concentration seems to be on the fact that it is of greater help to those who suffered most when the oil price went up and to those who had a greater reliance on imports--in particular the Japanese. For the Japanese, it's an enormous part of their total imports and it has an enormous benefit.

MR. TRUMAN. One view used to be that higher [oil] prices helped the dollar because the people who were accumulating assets had a stronger preference for dollar-denominated assets in terms of accumulating wealth. One argument would be that you could run that view now in reverse and say that that would be one explanation for the dollar's weakness. Given the fact that most of those countries have been decumulating assets for a fairly substantial period of time--several years now--that argument probably has less weight than it would otherwise. That asset preference argument probably has less weight than if the oil price decline over the last several years had happened all at once.

CHAIRMAN VOLCKER. If there are no other questions, we'll turn to Mr. Kichline and company.

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

CHAIRMAN VOLCKER. That was an exhaustive, comprehensive, and analytically complete briefing. Now, what questions can anybody ask?

MR. MELZER. Jim, on the current services budget, it dawned on me that maybe the reason the market hasn't reacted so badly in the long end to this unconstitutionality aspect of Gramm-Rudman has to do with the thinking that is evolving with respect to the current services deficit. Looking out to 1991, as I understand it, with nothing further done than what is already on the table, and that would include the fiscal 1987 actions, I guess--no it doesn't; it's just the fiscal 1986, right? You probably wouldn't agree, but I would be interested in your view: Is that a viable scenario? Seeing the CBO come out with similar numbers is what caught my attention.

MR. KICHLINE. Right, I think that's an important feature. And that's very different from the last four or five years, as you know, with current services estimates shown to grow substantially into the $300 billion plus range five years out. We do not have all of the details available on the CBO estimates. I must say that one might assume that there is some agreement on what current services estimates mean but that turns out to be very wrong. This year is a classic case. For example, the Administration's current services number assumes that the defense baseline is 3 percent real growth. Well, after the Gramm-Rudman March 1 cuts, they jump up spending but assume that the spend out rate is very slow. CBO assumes that no Congressional action is zero real growth, but recent experience has defense spending much faster than the Administration [assumption]. The net result is that in 1991 there is a mere $35 billion [difference] between the two on defense alone, but there are offsetting changes. Interest rates are different; they are worth $20 to $25 billion. Inflation rates are substantially different, with the

Administration having inflation drifting down to 2 percent in 1991 and hence indexed programs grow at the much slower rate; under the current services estimates, that's worth something on the order of $25 billion or so by 1991. So, if you want to mix and match all of these things in your own way, instead of 1991 numbers that drift down essentially to $100 to $110 billion without further action you probably could have anything from $50 to $200 billion and be perfectly consistent with all of these numbers. The problem, I think, is that there is a great deal of emphasis on the notion that it's very different even without further action--that the budget will be improving--and I think that's probably faulty. Hidden behind this, there's a lot more going on.

MR. MARTIN. I would like to ask Ted Truman about his vertical bar chart, chart 16, on the changes in consumer prices in foreign industrial countries and in the United States. Could you disaggregate that a little for us? What are you and your people projecting for the Federal Republic [of Germany] and for Japan? I was at a European conference recently and there was a lot of talk about zero inflation in the Federal Republic and I wonder what you are--

MR. TRUMAN. We are projecting very low rates for both those countries: 1-1/2 percent for Japan; and 0.9 percent, if you want to be inappropriately precise, for Germany.

CHAIRMAN VOLCKER. At [a per barrel price of] $10 for oil?

MR. TRUMAN. With a $20 oil price. That doesn't take quite as much off, as I explained, because there are high taxes. So, although the dollar component of it helps, the fact that they halve the [rate] of consumer price--

VICE CHAIRMAN CORRIGAN. Where oil was yesterday could easily have given you a negative--a small outright decline in consumer prices in Germany and Japan.

MR. MARTIN. I heard that too.

MR. TRUMAN. Well, one percent for the year measured from the fourth quarter over the fourth quarter is the number I have. Obviously, within anybody's forecasting range, that could mean that in a given quarter there could well be a negative number. For other European countries like the Netherlands and Switzerland we also have less than 2 percent.

MR. MARTIN. What are you assuming about policy in the Federal Republic and Japan vis-a-vis their interest rates? When you get to the capital flow, what are you assuming--no change, whatever change we do?

MR. TRUMAN. Little change, I think is a fair [description], or maybe some slight drifting down of interest rates. We have not made any abrupt assumption of change; for the average of these countries it's maybe something like 50 basis points over the forecasting period.

MR. MARTIN. So the totality of that analysis wouldn't be particular downward pressure on the dollar, just from matters such as the interest rate spreads and inflation spreads.

MR. TRUMAN. Well, in some sense, the fact is that their inflation rate is coming down more than ours and interest rates are not coming down as much as ours. In fact, implicit in this forecast is that real interest rates will be going up slightly in those countries. Depending on what you think is going to happen to real interest rates here, that could be viewed as somewhat negative to the dollar.

MR. WALLICH. Why should that be negatively viewed, in the case of negative interest rate [spreads]?

MR. TRUMAN. I am just saying that if Germany cuts its inflation rate from last year to this year in half--by 100 basis points or more--and you don't think German interest rates are going to [decline] by 100 basis points, then that would tend to depreciate the dollar or appreciate the yen--I mean the deutschemark. I had the wrong currency there!

CHAIRMAN VOLCKER. Two strong currencies, anyway. They were referring to chart 16; I had a small point on chart 15. That Economist index looks like it went up all last year. You said, if I understood you correctly, that in the last two months it has gotten higher than a year ago. It sure doesn't look that way on the chart.

MR. TRUMAN. This is zero. So those are year-over-year changes; anything above those--

CHAIRMAN VOLCKER. These are year-over-year changes?

MR. MARTIN. I thought the index flattened in October, but if you are using year-over-year figures, I don't know how it works out.

CHAIRMAN VOLCKER. It was decreasing at a slower rate of speed. Now it's right.

MR. TRUMAN. In fact, on this index there's about a 6 percent increase against the lows in the summer. Now, this is a broader index because it includes food, particularly coffee, than just an industrial supplies index. The industrial supplies index, instead of this positive number here, shows something on the order of a 3 percent decline.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Yes. Ted, I am asking a question around chart 16, but I don't see what I am really looking for. It has to do with the LDC countries; you slipped in a rather quick comment about the Baker plan and what it would do for those countries. But I would think that since the announcement of the Baker plan last year the funding needs of those LDC countries, particularly Mexico, would have been altered rather significantly. My question is: Does that have implications for real growth, for stability? How does that feed into your analysis?

MR. TRUMAN. I think the answer is yes, in some. In fact, when we started to put this forecast together we were inclined to have a somewhat more [upbeat] outlook in the non-OPEC developing countries than is shown in this chart. By looking at such considerations as the

oil price and how that might affect them and some of the uncertainties that might be associated with that, we were led to scale back somewhat; it was sort of a netting factor that we wanted to put in there. The Baker countries themselves, which include Mexico and several OPEC countries like Venezuela, Ecuador, and Nigeria, on balance, are hurt by lower oil prices. We have maybe something like $7 billion, based on the price decline, built into this forecast. It is also true, however, that the decline of the dollar does, on balance, tend to help these countries. To the extent that they have followed flexible exchange rate policies, their exchange rates more often than not are biased toward the dollar, or [move] relative to the dollar. That's especially true in Latin America. A number of them--Brazil is a good example--are gaining in competitiveness vis-a-vis the other industrial countries, as we do. Korea is another example. You may have seen a lot of stories about that: how the rising yen has put Japan at a competitive disadvantage vis-a-vis Korea. Well, Korea is one of these non-OPEC developing countries; therefore, you might expect that, to some extent, to give them a somewhat better picture.

CHAIRMAN VOLCKER. I expect this is a non-collapse scenario?

MR. TRUMAN. This is certainly a non-collapse scenario.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Jim, for the past couple of years, we have had a lot of financial structure problems. Now today, if not before, we'll certainly add to that list the potential problems that the oil price could cause. Looking back over the shape of the U.S. recovery, where is it that we see these problems reflected in the recovery? Do we see them in housing, business investment, balance sheets and so forth? Do the sectoral problems just all wash out by the time it all gets to the national average process? What has been the effect?

MR. KICHLINE. Well, that's rather broad. We can start with Ted's comments, because I think part of the problem that we are facing --and it certainly influences our thinking--is reflected in what has been happening in the Third World countries and the debtor nations. And that, in part, is a reflection of what has happened to the dollar, which we think basically relates back to some structural developments over the course of the recovery with respect to the deficit and the way our economy has grown and our relatively high interest rates compared to the rest of the world. Mike referred to some debt problems in the consumer sector. We have taken what I think is a moderate picture there and have assumed that there are going to be some problems but that they will be manageable. At the same time, we know we are generating a great deal in the way of additional financial assets and wealth; and we assume that consumers as a group will be willing to run with relatively low interest rates. But I think hidden there in the consumer sector is a substantial problem that could be magnified as this [expansion] goes on. For example, in the Southwest we see the oil pressures evolving. We know that there already are some debt problems in the Texas and Louisiana areas. Both consumer debt and mortgage debt in the nonresidential structures area [could present problems]. So I think that the problems are there. But, in our view, continued economic growth in the aggregate will help us go through that process without a great deal of strain. The corporate sector is a bit more difficult because there are tremendous problems

in that sector, if you look at individual balance sheets. Again, some of them on the energy side I think are quite risky. And some who a few years ago paid a heavy price and went into debt essentially to diversify their interests by moving into energy have a big problem. But again, we have assumed that those problems are essentially manageable. I think it is important to consider that we have a growth environment and relatively unchanged--certainly not substantial increases in--interest rates. And in that context, we don't think the micro problems will escalate into big macro problems over time. But throughout all of the major sectors, it would be very hard to think that there are not problems for certain groups and individuals or individual firms or countries. I don't know if I have answered the question.

MS. HORN. It's a good start.

CHAIRMAN VOLCKER. Mr. Parry.

VICE CHAIRMAN CORRIGAN. Jim, on chart 21 where you talked about the impact of lower oil prices, it seems to me that the pattern of effects is a little puzzling. Wouldn't one expect, for example, that the impact of lower oil prices on real GNP would be felt more in 1987 than 1986--that it takes time for these oil prices to work their way through in terms of increased income for people to spend and lower costs for corporations to increase their spending? I would say the same thing, but maybe with not quite the same lag, about the deflator. It isn't only the direct effect of lower oil prices on inflation; there are many indirect impacts that probably would show up more in 1987 than in 1986.

MR. KICHLINE. I think that's right. We have rounded these numbers and you caught the right direction in which things were rounded; actually, on the lower oil price side the effect is about .35 or so and I rounded it up to a half and for 1987 I rounded it down. But the sense really is that the real impacts will take a while to feed through. That's true on the prices too, except that there is a bigger question on prices. The Board's quarterly model that we used here has a much larger impact on prices in 1987 and very little in 1986; we judgmentally adjusted some of these because we think there will be substantial pressure and the direct effects will come along in a major way. So, in effect, we fiddled with the numbers there. Our best sense is that we will get some of the direct effects [in 1986] but that the important feedback effects will filter through on into 1987.

MR. PARRY. I like your model forecast.

MR. KEEHN. Ted, could you go over chart 17, the agricultural export chart, again? Apparently, you're forecasting an increase in export volume in the first half of 1986, then a decline, and then back up in 1987.

MR. TRUMAN. Again, that's partly because these charts are done on a year-over-year basis; that reflects the fact that the first half of 1985 was so weak. In fact, looking across the 1986 patterns, we do not see the kind of increase that is presently [unintelligible] while this decline in the first half of this year from the last half of 1985 has assumed some fairly large shipments; and that's basically

the explanation for the dip shown in the second half of 1986. I wanted to be consistent in the numbers used, but in this case I think it generated more in the way of wiggles for the agricultural picture than our forecast suggests is likely to be going on.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Jim, I have a similar question back on chart 21 with regard to the response to further declines in the oil price. My question is more a question of magnitude than of timing. When I look at another $5 a barrel drop, which is I guess the alternative assumption here, I'm surprised at the relatively small magnitudes one gets from that. Some work we have done suggests that the magnitude could be a lot larger. The direction I would agree with; it's just that our research suggests that the magnitude could be a lot larger, even allowing for some errors around the range. I am rather puzzled by this response.

MR. KICHLINE. This is our general sense. Basically, it boils down to a rough rule of thumb that for a dollar change in the price of oil the response is a tenth on real GNP and a tenth on the deflator, in opposite directions. If one is talking about prices, it is very clear that the impact on the consumer price index is much larger--roughly double. Our thought is that a $5 change in the price of oil would translate into a percentage point after four quarters in the rate of change in the CPI. But I think this is fairly standard. I have seen a DRI forecast--

CHAIRMAN VOLCKER. [Unintelligible]; maybe I don't understand it. You have one percentage point lower prices; it just takes two years to get it. You have 1/2 percentage point in each year.

MR. KICHLINE. That's 1/2 percentage point off the rate of change in each year from what it otherwise would have been. If prices had been running at 3 percent, when you change the oil price, prices are then running at 2-1/2 percent in each year--minus 1/2 percentage point. So that is the marginal impact of that change.

CHAIRMAN VOLCKER. It's not an additional 1/2 percentage point the next year?

MR. KICHLINE. Yes.

CHAIRMAN VOLCKER. So it's 1 percentage point over two years.

MR. KICHLINE. Yes, that's right.

MR. TRUMAN. But consumer prices will be--

MR. KICHLINE. Prices would be down one percentage point in the first year. Essentially, our view on the CPI is double that effect in the first year. I don't know how to answer the question. Basically, there are lots of alternative views on this, but I think this is one that is fairly standard.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Just an informational question with regard to the debtor oil-producing nations such as Mexico: Is most of that debt denominated in dollars so that they are getting a double whammy with respect to the drop of the dollar as well as the oil crisis?

MR. PARRY. Yes.

CHAIRMAN VOLCKER. But the drop of the dollar helps them to the extent that they export--well, Mexico is mostly a dollar exporter. If a country has some mix of non-dollar exports, that helps them.

MR. PARRY. But the debt is denominated in dollars.

MR. TRUMAN. Not entirely; that's the problem. A large fraction of it has been shifted--or will be shifted in the context of this arrangement--at the bank's option. Many of the European banks have switched back into their own currencies.

MR. GUFFEY. And will it carry a LIBOR? If it carries their interest rate, the repayment will be in their currency which could have a--

MR. TRUMAN. It depends on whether you think the dollar is going to decline more or less rapidly than the interest rate differential.

CHAIRMAN VOLCKER. Mr. Johnson.

MR. JOHNSON. Jim, I have a question about chart 21, too. This is an exciting chart.

MR. KICHLINE. I had some questions about whether I should include it!

MR. JOHNSON. You have a somewhat asymmetrical treatment of real output and inflation under the assumption of 1-1/2 percent higher money growth. That 1-1/2 percent higher M1 growth feeds through as a 2-1/2 percent change in the deflator by 1988 whereas the effect on real output up front is only 1-1/4 percent. The net effect is really a strong effect on prices. That 2-1/2 percent seems awfully high given the 1-1/2 percent--

MR. KICHLINE. What happens in the model here--and I guess I wouldn't blame this on the model because [our forecast reflects] a mixture of some staff judgmental adjustments to a model result--but basically in answer to your question, if I had extended this over a longer time period we would get back on track. It's simply that the price impact would be smaller in later years so that you are going to retreat to path. You will note that the unemployment rate under that policy is down about 1-1/4 percentage points from its starting level, so it would be in the mid five percent range. In the model and in our thinking, the natural rate is believed to be around 6 percent or a shade under. So what is happening here is that in the second year the unemployment rate starts to plunge below the natural rate and stays there; and that generates intense upward pressures on prices and wages. Now, if you continue this year after year, the model would turn right back to a nice sensible path and everything would work out.

CHAIRMAN VOLCKER. But--if I understand the chart--you are saying that in 1988 in this hypothetical example the money supply would be 4-1/2 percent higher than otherwise, right? And only 2-1/2 percent of that shows up in prices.

MR. KICHLINE. No, you have to cumulate.

CHAIRMAN VOLCKER. Oh, okay.

MR. MORRIS. I would like to point out to Mr. Kichline that in 1985 we had a 5 percent greater rate of growth in M1 than we expected, which was associated with very slow growth and a declining inflation rate.

CHAIRMAN VOLCKER. This is, all other things equal [unintelligible].

MR. JOHNSON. I assume that has an assumption of no change in velocity.

MR. KICHLINE. Right.

CHAIRMAN VOLCKER. If we don't have any more specific questions, we're at the point where people can express their opinions about the general economic situation. With the wide range of opinions in what was distributed, I am sure we will have a lively discussion.

MR. WALLICH. How long has the [economy been growing] at this steady rate of 3-1/2 percent--maybe four years?

CHAIRMAN VOLCKER. 3-1/2 to 4 years. Are you suggesting that is a long time?

MR. WALLICH. Yes.

CHAIRMAN VOLCKER. Would you care to speculate whether this steadiness will likely be interrupted on the up side or the down side?

MR. WALLICH. Well, if it stops on the way down, it stops itself. If it becomes a continuous reduction, I think we could get excessive movements from that. I think that that could be dangerous.

CHAIRMAN VOLCKER. We are hoping for steadiness. I guess what we are supposed to be debating now is the likelihood of that. Mr. Morris.

MR. MORRIS. I think the course of 1986 is not likely to be as steady as the quarterly projections [indicate]. Looking at the numbers that we have gotten in the past months, it seems to me that we are likely to start out the year stronger in the first quarter--at least stronger than the 3.3 percent [forecast]. The breadth of the strength in the numbers suggests to me that the economy is starting out stronger.

CHAIRMAN VOLCKER. These forecasts were made up before the latest numbers?

MR. KICHLINE. Before the January unemployment numbers were available.

MR. MORRIS. Presumably, you would have revised the first half.

MR. KICHLINE. Well, the first quarter, anyhow. Our best guess at the moment is that we would be more inclined to have a 4 percent number for the first quarter.

CHAIRMAN VOLCKER. You wouldn't want to expound beyond the first quarter?

MR. MORRIS. Well, as I said, 4 percent seems much more likely for the first quarter. Beyond that, I don't have any strong conviction. I think 3 percent for the year is probably still about right. I think what we may be seeing is the end of the inventory adjustment, as you mentioned; and that could lead to a stronger first half unless there is more inventory rebuilding than we're expecting at this time.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. As far as the forecast goes, my own forecast is a shade stronger in real terms than the staff's forecast--3.4 percent versus their 3 percent. As best as I can recall, there is no one difference that accounts for that--just a bit here and there across the board. My inflation number is also a little stronger, although I might be inclined to shade that down at least a little, simply because the oil price has fallen further--and I think is likely to [move down] further--than I would have guessed 10 days ago or whenever that forecast was made.

As I said a month or six weeks ago, we can play around with these forecasts until the cows come home but I think there is a variety of factors that transcend the forecast, which Mike and Jim and Ted referred to in various parts of their commentaries. On the exchange rate side, for example, we have seen something that smells to me like a basic change in market attitudes towards the dollar, partly because of some of the official announcements and all the rest. I think that has been reinforced by the combination of the oil price situation and perceptions as to how that will affect the LDCs, and in turn how that in combination with some of the other problems that are perceived at least to be there in the banking system will affect [the situation]. I think those considerations, at least at the margin, do have a decided influence on the attitudes toward the dollar right now. So, I view the dollar as not only lower by 5 to 7 percent from when we last met but I guess I consider it a good deal more vulnerable on the down side than it was six weeks or so ago. What will happen to the oil price is anybody's guess. It could stabilize in the $18 to $20 range; it could go down further; or, if the Saudis are able to reach a meeting of the minds with the British or somebody else, the problem is that it could go up--particularly if it got down to, say, the $15 or $13 range. In some ways the worst of all worlds is to have the oil price go down that low only to come back up, even if it only came back up to $22 or so. I don't think one can rule that possibility out. How that will play out is an enormous uncertainty; but almost regardless of how it will play out, I think it has caused the LDC

situation to deteriorate significantly. Mexico's problems are clear; to me the great danger is if Mexico gets so out of control that it forces other things to become unglued a bit. So, I think that situation is also a good deal more tender, to put it mildly.

I remain concerned about this whole debt issue, which again, Jim and Mike touched on. I don't see it getting much better. If I look at Mike's flow-of-funds forecast for 1986--and I know how hard it is to forecast the flow of funds--in an underlying sense I don't see anything that constitutes a real improvement there, particularly when you take account of the special blip in state and local borrowing at the end of this past year growing out of tax considerations.

On the inflation side, I guess I am a little more concerned. I think the probabilities lie on the side of an inflation rate that looks like the ones that are more or less represented in the forecast in front of us. But it is not hard for me to see how the inflation picture could be worse, notwithstanding the oil prices. Productivity is lousy. I don't see that getting any better. The exchange rate has already come down 20 to 25 percent. I don't see any hard evidence of any feedthrough on prices coming from that, though I don't rule it out. I don't know what the natural unemployment rate is either. Some people say 6 percent; it might be higher than that. The fact of the matter is that, looked at it in that light, the unemployment rate isn't all that far from the point where it could put some pressure on the price level. Beyond that, just in a behavioral sense, the kind of unit labor cost/price behavior relationships that are in the staff's forecast and my own basically have profit margins sitting still in a context in which it is very clear to me that businesses are going to grasp at every straw they can find to try and raise prices. So while I agree with the price forecasts that are on the table, especially in the context of the oil price situation, I must say that I do have some concern that by the latter part of the year we could get an unfortunate surprise on inflation.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I always feel very nervous at times like this since I don't have much confidence in anybody's ability to forecast. And with the Gramm-Rudman effects upon us and a [potential] drop in the oil price of unknown magnitude, we have two additional complications. Our reading of the tea leaves is very close to what Jerry Corrigan has just described. We're guessing that we'll be a little higher on real growth and inflation than the staff has projected, and I guess we have more confidence in our projection of real GNP than we do in prices. We have a figure of 3.4 percent for real GNP; essentially, we think that the rapid growth in M1 last year, the recent declines in interest rates and in the dollar, the substantial recent increase in employment in January, and now the drop in oil prices are all going to combine to give us greater real consumer spending and greater business fixed investment than the staff has projected. Indeed, I think the latest monthly data suggest that this could be upon us right now. On the price side, we put in a figure of 4 percent for 1986, 4th quarter to 4th quarter; we are basing that upon this exceedingly large rise in M1, the acceleration in real activity that we seem to have had recently, and now the declining dollar, which is going to put increased pressure on prices. Of course the drop in oil prices would have a mitigating effect on

this but nobody knows how much. If it persists for a long time, it could well be that the staff's projection is going to be closer than ours. From the standpoint of policy I think we have to realize that this oil price decline is a one-time effect in a sense and is likely to be short-lived. And all the other factors that I see out there suggest that the pace of inflation is apt to be up somewhat from where it has been. So, we are getting a little more nervous about that than we have been.

CHAIRMAN.VOLCKER. Governor Martin.

MR. MARTIN. I appreciate the timing of my turn, getting to debate with my friend, Bob Black. It seems to me that the indications for future prices are quite the other way. I see no turnaround in the commodity price situation around the globe. It seems to me that there still will be almost a dumping behavior and that in some cases the LDCs will be [induced] in various situations by oil price declines and necessity to dump something else into the markets. In terms of the oil price change, I think it is more fundamental; I respectfully differ with you in that regard. I consider the faint possibility that some day the Iranians and the Iraqis will stop the killing of each other and there will be an augmented supply from that part of the world. It seems to me that gluts beget shortages down the road, but it takes many years. We have experience from the two oil shocks that we have been through and now we are in a glut situation. I believe the inflation outlook is positive from those points of view.

I don't know, Jerry, about productivity; I am as puzzled as anybody else. I certainly missed forecasting that over a period of time, but I don't share your negative approach to productivity. It seems to me that we have yet to realize our trend rate of growth. I think 3 percent is too low a guess with regard to potential GNP; the gap could be a couple of hundred basis points that we are falling short by. And I am not comfortable with the staff's projections of export growth. There is a table in the Greenbook in current dollars that shows an increase--I don't remember the percentage anymore and I've scratched over it once--of about 25 or 30 percent in five quarters. I don't think we are going to make that for the very reasons that this special report detailed. I won't take the time of this rather large Committee but you may remember the 7 or 8 points made in that report, which added up to a delay of the impact: the long-term contracts, fixed investments, special factors and so forth, that we all read in that report. I don't think we are going to be able to take market share back; I try to [unintelligible] my experience with Sears World Trade, which goes back a few years, but I just don't see our being able to compete in the manufacturing area with the Koreans and others around the globe. I don't think we are going to get that share back, and I think we still are going to be struggling with the difficulties of competing with imports.

I think the fiscal drag situation is spelled out very nicely in two of the line diagrams in the staff's presentations: we're swinging from a growth in real federal purchases of about 12 percent in 1985 to a decline of almost 8 percent in 1986--and then you add on to that state and local government, as the chart graphically displayed. Will that be offset by some of the more positive factors that have already been reviewed? I suppose it will, but I don't think we are going to get rates of growth of 4 percent past the first

quarter. I go along with Frank Morris' estimate of something more like 3 percent. When the Chairman polled us not too many months ago as to what we thought about 3 percent growth, I said it's inadequate. It is particularly inadequate when you think of the debt that we have to service in this country; every sector is this country has a huge debt. Add to that the less developed country situation and the Germans and Japanese headed for a 1 to 2 percent inflation posture.

It seems to me that if we are erring in any direction in terms of the economy, it is that we are understressing the risk of even more inadequate growth after the first quarter. The first quarter is fine; but once again we are all so impressed with two months' data, not all of which were positive, yet we are talking about monetary policy that is going to impact the third and fourth quarters of this year and the first quarter of next year. The first quarter of next year will be the fifth year of expansion, as Governor Wallich has already reminded us. It is a pretty old expansion. Whether or not it is obvious where the structural imbalances are, we know they are built in there. Goodness knows we have had enough changes in the economy sector by sector, as Karen pointed out, and in industry by industry--in manufacturing, the thrifts, nonresidential construction and so forth. I don't think we are going to achieve the numbers that are in the Greenbook for business fixed investment. Looking at the fourth quarter and all the shipments and contracts on Sierra--well, IBM is a fine institution and all that, but you can certainly get distorted data from one quarter's move there. I don't think we are going to have big upswings in business fixed investment and nondefense durable goods orders. The Defense Department finally seems to be waking up a little with regard to what they are about over there. It just seems to me that the risks are on the down side and that we have an opportunity here because there is some disinflation in the totality. We have an opportunity to look at monetary policy with a little more action space than in a different economic situation.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Thank you, Mr. Chairman. I generally agree with the broad outlines of what I thought was a first rate report [by the staff]; I might lower my original unemployment figure a bit. But it does strike me that this is a rather paradoxical macro forecast that we have here. It is the fourth year of a recovery. We have a litany of micro problems that we all have recited many times. Texas is becoming a micro problem. And yet I think the macro outlook in this forecast--and, as I say, I agree with it--is a good bit better than we probably deserve, adding up the micro pieces. In my District, and it is one of the stronger Districts in the country, I find that while people generally are optimistic about 1986 the expectations don't run very deep. I don't think they run very deep around this table either, because in November and December a number of us were looking at the numbers coming in and thought the risks were on the down side. Today I gather that most of us feel that things are a good bit better; and I think the numbers have been better. My point is that as we formulate policy--I am getting a bit into tomorrow's agenda--there is this paradox. These expectations are not very deep; our mood can change. I think we need to allow ourselves some room for maneuvering as we set these long-term targets tomorrow. We have some room on the bottom but I think we also need some room on the top because we could very well be sitting here in March or May and our expectations could change

again in the other direction just as they changed from Thanksgiving to now. So, I accept this forecast; I feel a little uneasy about it because somehow the parts don't add up to the whole, even though I agree with the macro numbers that the staff put out.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Our forecast of real GNP is really quite similar to that of the Board staff's; it's just a couple of tenths higher. There are significant differences in the composition, however. When I look at the differences that we have in residential investment, I actually think that I would be more comfortable with the Board staff's forecast; consequently, we might even conclude that our forecast would be even stronger relative to the staff's than I first thought.

CHAIRMAN VOLCKER. Let me just interject for a moment to remind people that you get a chance immediately after this meeting to revise the forecasts [you have submitted]. You all have made some comment, but I don't know when you look at them whether you'll change them or not. What unemployment rate are we talking about here? Are we talking about the civilian or the total?

MR. KICHLINE. The civilian rate is what I think we have been getting in the numbers given to us. The difference is a tenth and when push comes to shove, to be consistent with the Administration, at the end of the report we will just add a tenth to whatever anybody gives us.

CHAIRMAN VOLCKER. The Administration projects the total?

MR. KICHLINE. The total.

CHAIRMAN VOLCKER. So you subtract a tenth from theirs. I just wanted to remind you as you talk about the outlook that you may change your forecast after this discussion if you want to. Excuse me for interrupting you.

MR. PARRY. One other point I would make is close to that made by Frank Morris. Given recent developments, I think there is an excellent chance that growth in the first half will be stronger than indicated by the Board staff's forecast--and for that matter, by our own. But I have a feeling growth is going to be more in final sales than in inventories because I don't think there is much indication that inventories are going to grow at a very rapid pace in the first half of the year. There is a fairly significant difference between us and the Board staff on the rate of inflation; actually, we are almost a point higher in 1986 and somewhat lower as it turns out in 1987. That mainly reflects the differences in the way we see the interaction of the effects of a lower value of the dollar and oil prices. As I mentioned before, we see lower oil prices having their major impact on inflation in 1987 whereas the dollar's major impact on inflation is centered more toward the end of 1986. In any case, if one looks out to the price level at the end of 1987, I don't really see much that would differ.

If I may make a few comments about the Twelfth District: It appears to us that the District's economy is expanding at a faster pace than the national average. Geographically, it seems that the

strength is centered in California, Arizona, and Hawaii. One of the more striking numbers that we received on Friday was that California's unemployment rate fell to 5.8 percent; that's a huge drop in the last two months. I wasn't able to get the numbers on where all of the growth in employment was but I would suspect that it was in services, where it always is strong, and in addition to that in construction since the weather has been quite good. By industry, the strength is in consumer spending, particularly for services and durables; we see good growth in residential construction and in addition, defense-related aerospace and electronics. The weakness centers in nondefense electronics, where there is so much foreign competition; in agriculture, which continues to suffer from some of the same ills that it has for the past two or three years; and in mining and oil drilling and forest products, although one can make a case that there is a slight light at the end of the tunnel with regard to forest products. Our expectation is that for 1986 the District will outpace the growth of the rest of the nation by probably 1 percentage point; if one were to focus just on California, I think it could be even greater.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, our forecast is marginally different from the Board staff's forecast both with respect to growth and inflation. We think that growth in 1986 is going to be somewhat higher, about 0.3 of a percentage point. It is not in any particular area but pretty much across the board. On the inflation side, we think inflation is going to be a little higher than the Board staff's forecast. I am not really as convinced about that personally as my staff is, but what is driving that forecast of higher inflation basically is the unemployment numbers, which would seem to point to pressure on wages and prices later in 1986. And that combined with lower productivity would certainly indicate a higher inflation rate. The effect of the lower dollar and the drop in the oil prices obviously work in different directions in terms of the effect on inflation, if you leave out the timing question. I don't know how that washes out; maybe those two factors tend to net out to not too much effect on inflation. But one thing that I am concerned about from time to time is the drop in the dollar in terms of our trade-weighted index, which is pretty well weighted toward the European countries. Obviously, the drop of the dollar doesn't affect trade with some of our other trading partners, particularly Canada, where the dollar actually has appreciated. So I think that does have--

CHAIRMAN VOLCKER. Canada does have a big weight in that index and that's why it doesn't go down very much.

MR. TRUMAN. Its weight is multi-lateral, so it's less than its weight in our trade. I think I'm supporting your point, Mr. Forrestal.

MR. FORRESTAL. I focused particularly on Canada because people in my District--the lumber people, for example--took some comfort originally from the decline in the value of the dollar until they realized that it doesn't have any effect on their trade with Canada.

CHAIRMAN VOLCKER. No, there is no effect on those lumber people.

MR. FORRESTAL. That's right. In fact, it's the opposite effect. In any event, our forecast gives somewhat more weight to the unemployment number than the Board staff's forecast, so we are higher on growth and a little higher on inflation. If I were to take out that unemployment situation, I personally would be less concerned about inflation. One concern that I have, which others have alluded to previously, is the less developed country situation and particularly the effect of the drop in oil prices on Mexico. I think that is going to be a very, very serious problem for that country, not only for its economy but socially as well. Already it is having that effect, and it certainly is going to have an effect on banks around the country, particularly the money center banks. Having said that, I am not sure what monetary policy can do to help that situation; but it certainly is a problem.

CHAIRMAN VOLCKER. I want to remind you all that these forecasts in the last analysis are yours; I'm reporting to the Congress that they are personal forecasts. Mr. Stern.

MR. STERN. With regard to the outlook, I too have a stronger forecast than that depicted in the Greenbook. Statistically, across components, it's broadly based; it's simply shared among a wide range of sectors of the economy. A couple of interesting things are going on, it seems to me. It's not just that the latest statistics looked pretty positive, although they did. I have talked in the past about a two-tiered economy and the distinction between what has been happening in the metropolitan areas as opposed to the rural areas. At least in our District, I am afraid now that I have to talk about a three-tiered economy. The metropolitan areas continue to do pretty well. The problems in the agricultural part of the rural economy are still there, of course, but in the non-agricultural rural economy I think there are some signs of improvement in our District. This is evident most vividly in terms of re-openings or expansions or building of new plants, particularly in the mining and the pulp and paper areas. There are new pulp and paper plants in Duluth and in the Upper Peninsula, and copper mines in the Upper Peninsula have reopened. Some may well reopen in Montana. Taconite plants are reopening in Northern Minnesota and there are some new processes being developed there that may lead to some expansion in taconite output. It's really rather remarkable.

CHAIRMAN VOLCKER. I am nonplused by the copper mine opening.

MR. STERN. The White Pine Mine, which is largely worker-owned, reopened several months ago in the Upper Peninsula. They seem to be doing all right, and they are going to add employment shortly--another 300 workers. I have forgotten what the original base was but it was probably at least that size. There are plans afoot to reopen the big [unintelligible] at the former Anaconda operation.

VICE CHAIRMAN CORRIGAN. You are kidding?

CHAIRMAN VOLCKER. Who is working on this?

MR. STERN. The man behind that is a guy by the name of who has been a building contractor; he is looking to get some breaks from the state in terms of tax legislation and so forth. I don't know what he is going to work out with the unions. I presume

he intends to work out something. That plan is not signed, sealed, and delivered; I don't want to suggest that. But they clearly are working on it in a serious way. As I say, it's a rather remarkable turnaround and that's why I am talking about this three-tiered as opposed to two-tiered situation, at least in part of the District. But I guess the real reason I am more optimistic about real growth has to do with things like the decline in energy prices and what that means for production and productive capacity, wealth effects stemming out of the rise in stock prices and bond prices, and the other side of that coin, of course, the somewhat lower interest rates we have relative to a year ago.

On the inflation side, I must admit to being quite uncertain, as I guess others are also. I am concerned that the favorable effects of the decline of energy prices may be offset to some appreciable degree by the weaker dollar. I have a sense that labor markets are tightening certainly and that labor attitudes are getting a little more aggressive as well. And that gives me some concern. But beyond that, I would not be inclined at this juncture to change my inflation outlook much one way or the other. I am just concerned that perhaps some of the good things that are falling in place are simultaneously being offset.

MR. BLACK. Minneapolis certainly did improve when Jerry left, didn't it?

VICE CHAIRMAN CORRIGAN. As soon as I left!

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Our forecast for the year is in substantial agreement with the Board staff's forecast. We have a little less in terms of real GNP; that may reflect a Midwestern prospective. We are a touch higher on the deflator, primarily because we have not forecast such a significant decrease in the price of oil. Within that broad sense of agreement, though, we have some differences. Our housing start numbers are a bit lower than the staff forecast, based primarily on the input of 2 or 3 of our directors who have had a pretty good track record on that in the past. For commercial structures we are significantly higher; we think that the level of starts will taper off very considerably and significantly, but there are enough projects on the drawing boards that are committed to at this point that that ought to carry us through this year.

Turning now to a couple of comments about the District: Since the last meeting I think there has been a perceptible improvement in tone and attitudes, at least among the people I talk to. I talked to a large retailer who just had an excellent January--16 percent over January of last year and the best month they had ever had. They will have given a lot of it back in February, but they have a very ambitious objective for the year and they think they are going to make it. On the auto side, people I talk to in Detroit are forecasting a slightly lower auto year than we are--10.3 to 10.4 million units. But the production schedules for the first quarter are a bit heavier than was the case last year and the production schedules for the second quarter are about level, despite the fact that GM has this enormous inventory on its hands. In heavy manufacturing there is some improvement, with backlogs up just a bit. They are nowhere near the

peak levels reached before and they are never going to get back there; nonetheless, the attitude is somewhat better there.

On the agricultural side, I can't suggest that we are going to see any improvement necessarily in 1986, but I think at least the rate of deterioration is moderating. Land values have got to be getting down to some point of stability; and certainly, we do see a decrease in the rate of decline in land sales. Farm [unintelligible] improved farm liquidity, and I think the work that has been done with the Farm Credit System at least clarifies an area of significant uncertainty. A couple of negatively pervasive comments that I hear are Gramm-Rudman and tax reform. Tax reform was described by one man, a [corporate] chairman, as the worst piece of legislation he had seen in twenty years. On the positive side, [my contacts are] very pervasively positive on inflation. I am talking to people who still are negotiating wage contracts three years long which tend to be in the 3 percent range commonly, or even 2 percent on the low side. And I do think that there is something of a sea change out there on the part of organized labor; their attitudes as they go into the contractual process are entirely different now than in the past. Pricing--

CHAIRMAN VOLCKER. Wait a minute; let me understand that comment. It depends upon what "past" you are talking about. Are you suggesting it is lower than it was in the past or higher?

MR. KEEHN. I am saying it's lower than it has been in the past. Whereas people in the past have had--

CHAIRMAN VOLCKER. It's a sea change from the '70s and a continuation of the recent '80s.

MR. KEEHN. Yes.

CHAIRMAN VOLCKER. Okay. I just wanted to make sure I understood you.

MR. KEEHN. Again, three-year contracts are being negotiated at a 2 percent annual cost on the low side and 3 percent as a common tendency but importantly with good work rule changes also; therefore, productivity prospects are improved. I think pricing [unintelligible] continues to be very, very tight. The margins are holding and there seems to be very little room for price increases, so that aspect of the inflationary equation ought to be pretty good. As we look at the year, we think it will be a positive year, pretty much in line with the Board staff's forecast.

VICE CHAIRMAN CORRIGAN. Si, if I just could ask: What does Detroit think their effective production capacity on automobiles is these days?

MR. KEEHN. Jerry, the number for the second quarter--sorry, I don't have the numbers here. It was about 2.2 or 2.3 million, I think, for the first quarter, and that was about flat out. Ford is running flat out; GM has pulled back a bit.

MS. SEGER. It depends on the composition, though, doesn't it? At any one time, they will be short of capacity for a certain

model or a mini-van or something and have space to accommodate other kinds of cars.

MR. KEEHN. Ford attempts to be pretty general throughout their line. They are running very rapidly. They are increasing the line speed and they are working Sundays.

CHAIRMAN VOLCKER. Mr. Boykin, we all remember those bumper stickers about freezing in the Northeast!

MR. BOYKIN. Well, Mr. Chairman, I guess I am wearing two hats. On the broader picture, I have just a couple of comments. We see the economy generally pretty much as the Board staff does. We see a little more strength than we first thought because of the oil price developments; my own guess is that if we are wrong, we probably are not seeing it quite as strong as it's going to turn out to be. On the inflation situation, while that has been doing very well and looks like it is going to do very well, I have a little problem about becoming very complacent because that could change, and I think it could change fairly rapidly.

Reference already has been made to the fact that we have a micro problem, so I will take just a minute and talk about that. In the Dallas District, [business conditions] continue to deteriorate; while the steep decline in the price of oil is on balance beneficial for the U.S. economy, it's depressing economic activity in parts of the Eleventh District. I should add, however, that while the price declines are unprecedented in modern times, they are not as great yet as is usually alleged by the media, which typically focuses its attention on spot and futures markets where only a small fraction of oil is traded and where prices tend to be highly volatile. Most oil is traded at prices posted by refineries; and that market, while a lot more stable than the spot market, is still disorderly. For example, posted prices on West Texas Intermediate last Friday ranged from $18 to $23.85 a barrel. Posted or contract prices have fallen by 25 percent from November levels, in contrast with more than a 50 percent drop in spot prices over the same period. Adjusted for inflation, oil prices are probably about where they were in 1974.

Adding to our District's economic difficulties is the overhang of office and other commercial buildings. We had expected construction activity to decline for some time. The volume of new construction contracts plunged by 25 percent in the fourth quarter; it's down by 40 percent from August 1985 and this downtrend is expected to continue. The weakness in construction and energy, of course, is causing financial strains on our District's financial institutions. Manufacturing activity, especially that related to energy and construction, has been declining. Retail sales growth is weak. Furthermore, the agricultural outlook is dim in some areas and even foreboding in others. In spite of all of the negatives I have just outlined, we have experienced some employment growth in the District, perhaps about one percent. That [could be maintained] if oil prices remain at current levels. Any further drop in oil prices would produce zero or negative employment growth in the District. Mr. Chairman, that concludes my rather gloomy report on what's going on in the Eleventh District.

CHAIRMAN VOLCKER. You had a one percent increase in employment over what period of time? Over a year?

MR. BOYKIN. Just in early 1986, looking year over year.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Mr. Chairman, my forecast is for 3 percent real growth and 4 percent prices, so I wouldn't characterize myself as being unduly worried about the strength of the economy or future inflation right now. Nonetheless, in terms of my feelings of discomfort with the forecast, they tend to be on the side of looking at that list of things that mean the economy is stronger than we have seen it and might get even stronger than we are forecasting. The list has been given by several people around the table and it includes the fact that whatever the margin of excess capacity in the U.S. was, it's lower today. The sharp decline in oil prices will mean stronger economic activity in countries such as ours. The resource shift implied by the exchange rate decline also will strengthen business economic activity. So, that list of changes that have brought about a stronger economy is very much on my mind.

Turning to the inflation outlook, again there has been a list given; I would add one more item to the list of areas of potential concern about the inflation outlook and that is the labor calendar for this year. There is quite an active labor calendar this year and from the point of view of size, maybe it's a chance to make more gains. I really don't want to analyze it except to say that.

CHAIRMAN VOLCKER. I forget: Is the auto industry up in this calendar year?

MS. HORN. No, steel.

In the Fourth District, there hasn't been much change in activity, but I think there has been a perceptible change in mood. The mood is one of growing confidence and growing optimism though, as I say, without any changes in order books or production schedules to back it up. That may be what is characterized as a shallow attitude of confidence, but we do have that in the Fourth District.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I am generally not that far off from the staff forecast either. I have about the same number for nominal GNP growth --about 7, 7-1/2 percent--although I too am a little more optimistic about the real side. I see the economy moving closer to the 4 percent range for real growth, since I had the advantage of factoring in some of the recent information from the last month of two. I do think things are looking a little better. I don't expect any great inventory buildup but that should play into the situation, certainly for the first half of the year. So, I see the mix more toward 4 percent real and I am really optimistic on the inflation side. I see most of the spillover from the lower dollar maybe filtering more into 1987 than into 1986; so I see inflation closer to the 3 to 3-1/2 percent range for 1986 partially because of the oil price decline, [the effects of] which I think will show up fairly strongly later in the year.

In addition to that, the budgetary situation looks very promising. Although I am not betting a lot of money on Gramm-Rudman targets being met perfectly, I think we are seeing a change in the budgetary environment that we haven't experienced in the last few years. Everybody has been waiting for this turning point on the budget situation, and I think we see it. We are seeing it now as a consensus among budget estimators; CBO and Fed staff as well as the Administration and many other private forecasters are now seeing the structural budget deficit at a turning point. I am not expecting this to do fantastic things but, given no further change in policy--locking in the [unintelligible] in outlays for 1986 alone--the CBO estimates show the budget deficits getting down to the $100 billion range toward the end of the planning period. Relative to the size of the economy in that period, it's quite a different debt/GNP ratio than we have been expecting in the past. I think that's going to have quite an effect on inflationary expectations. Some of that already has been discounted; but even if this process doesn't work its way out completely, there is additional optimism being built into the inflationary expectations side. One of the major factors creating concern in the past was the potential for the budget and political environment to pressure this organization into partially monetizing the deficit and then inflation might result from that. I think some of that pressure is starting to subside and I am fairly optimistic about that. Now, that doesn't mean that issue is no longer with us; it's going to be with us for awhile. But I think the oil price situation along with reaching a turning point in the budget is promising, and that's why I see a little brighter inflation picture.

I do worry a bit about the progress on productivity growth; that has been fairly discouraging. I may be wrong but, if you look at that closely, I think one of the major reasons behind that is obviously the employment growth. But you have to ask why we have gotten such a strong employment growth. A company doesn't just go out and hire because it's fun to hire. Obviously, the relative cost in this component of production is relatively cheaper. If you look at the growth of wages at this stage of the economic expansion and compare it to all other postwar periods, you will find that unit wage costs are relatively cheaper than they have ever been in the postwar period at this stage of the cycle. And I think that's one of the reasons why we are seeing a lot of substitution toward the employment side, despite some of the advantages to capital purchases [unintelligible], especially in the equipment area. One of these days we are going to see all these computer purchases show up in productivity, I hope.

CHAIRMAN VOLCKER. I'm waiting--within the Federal Reserve.

MR. JOHNSON. But still, I'm fairly optimistic. We are only at about 80 percent industrial capacity, and I think we still have a ways to go before we see that full employment unemployment rate pressure set in. I don't know how far that is because I have no idea what the full employment unemployment rate really is. But it's hard to match up 80 percent industrial capacity with 6.7 percent unemployment and say that we are there. It just doesn't look like it to me, compared to anything I have seen in the past. So, I think we have a fairly promising year ahead but I do worry about the dollar situation. Most of the effects of that probably are going to show up in 1987 and I think we really have to watch that situation carefully

and [determine] what the lags look like in terms of commodity prices and how that filters all the way into other production prices.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, very briefly I want to say that my forecast is very similar to the staff forecast, deviating marginally with respect to the projection for prices; our projection is a bit lower than the staff's. Picking up on what Governor Johnson has just noted, I think there will be a greater impact on prices coming from the decrease in the oil price than there will be from the effects of the dollar, and I think the dollar effects will [begin to] show up later in 1986 and have a greater impact in 1987. Therefore, I would look for inflation to be somewhat lower than the staff forecast.

With respect to the Tenth District, I am delighted to hear that there is some brightness being exhibited in the Ninth District. Maybe it will flow with the cold air down across our part of country!

CHAIRMAN VOLCKER. Did you find a copper mine in Colorado?

MR. GUFFEY. We have several copper mines; I am afraid the Ninth District may have a jump on us. Talking to people in the urban areas of the Tenth District after Christmas, I would characterize the outlook as fairly optimistic because of a fairly good Christmas season, though retail sales were up only modestly on a year-over-year basis. Secondly, throughout our District the month of January has been very warm and as a result that increased the optimism, I guess, of virtually everybody. But outside of the urban areas the major activities are agriculture, mining, energy, and aviation industry and very little has changed except for lower asset prices with respect to the agricultural sector, for example. There have been some new orders in aviation that should have some positive impact on the Tenth District, but not a great deal. So, I don't see any real change from that very low level. There is very little optimism outside the urban areas, and I am not sure that the Tenth District is going to share in this nice forecast of 3 to 4 percent growth that the nation may enjoy in 1986. I will just make one observation with respect to the energy situation and how it may impact my District. Energy is made up in the District not only of petroleum crude but also natural gas and coal. Natural gas prices have not reacted to the [drop in] crude prices; coal is in less demand and perhaps over time will be fairly severely impacted. But overall, I think there will be less of an impact in the District just from a reduction in crude prices simply because of the various kinds of energy resources that are found there.

CHAIRMAN VOLCKER. Were coal prices down earlier? Has there been any downward movement in coal prices?

MR. GUFFEY. Yes. As a matter of fact, one or two of those open pit mines up in Wyoming actually closed because of [falling] demand. There is one being opened momentarily, but they don't think they can go on into production.

CHAIRMAN VOLCKER. I am out of [names on] my list here. There are a few people who haven't commented. We should finish up this discussion this evening and then start afresh in the morning with everybody having made some initial comments. If Governors Angell,

Rice, Seger, or Mr. Melzer want to say anything, this is your chance or forever hold your peace until tomorrow.

MR. RICE. I will just say that I go along with the staff forecast with all the caveats and uncertainties. Accordingly, I am raising my forecast for real GNP by 1/4 of one percent and I am lowering my price number by 0.1 of one percent.

CHAIRMAN VOLCKER. My word, 3.9 percent! Governor Seger.

MS. SEGER. One nice thing about being last is that so much of what I was thinking has already been stated; but I will just make a couple of points. One is that my forecast for this year's real GNP growth is a touch below the staff's. The main reason is that, although I would like to see exports respond very rapidly to the deteriorating dollar, I am not convinced that they will. Also, I would like to think that imports would respond negatively to the deteriorating dollar but, unfortunately, I am not convinced that that is going to happen either. So, I don't think that we are going to have net exports contribute as much this year as our staff numbers suggest. Also, I am a little more negative about plant and equipment spending. I am concerned that questions about tax reform and what the proposals will do to business tax bills will discourage a lot of investment of that type; as long as those proposals are out there and as long as they look as negative as they do, that's going to happen. So, those are the two places where my numbers deviate from the staff's. On the inflation side, I am a little more encouraged about the impact of the deteriorating dollar on inflation. I just don't see these higher prices being passed through quickly. I am very convinced that the foreign competition, having gotten their toe or foot or whole body in this market, rather love it here, and I think that they are going to want to maintain market share and are not going to do themselves in through hasty price adjustments. That's what my sense tells me; I hope it's not just wishful thinking.

CHAIRMAN VOLCKER. Whether you are going to be last, I guess, depends upon Governor Angell.

MR. ANGELL. I hesitate to make Governor Seger incorrect on that point. I feel as if I am the boy from the farm. After listening to all of these big city reports, it makes me aware of the fact that places like Boston, St. Louis, and even Minneapolis are big places when you come from the farm. There is a different perspective in the rural areas that [stems from] the immediate emotional impact of all that has happened and continues to happen. Those forces tend to affect people's willingness to take on debt because the entrepreneurs all have run for cover and besides that the lenders don't want to lend. So a really different mix is occurring and I suppose that gives a different perspective. However, I must admit that I have been very impressed by Jim Kichline and Mike Prell and their staff and the reports they gave. Looking at my forecast and comparing it to theirs, I come back with a question that I want to be sure that I am right on before I proceed. Jim, I understand that your projection has built into it a decline in interest rates over the year of what--75 basis points?

MR. KICHLINE. That's about right. Our thought was that the bill rate will get into the area of 7 percent, with the funds rate

drifting down to about 7 percent. But heaven knows what will really happen on the funds rate.

MR. ANGELL. With that kind of projection on interest rates, then, I guess my forecast wouldn't be so different from yours. I must admit that I made my forecast based upon a continuation of the present level of interest rates. If we get that kind of movement in interest rates, the timing of that certainly would have something to do with what the forecast might be. I admit to having probably the lowest inflation prediction of anyone here; I'll claim the 2-1/2 percent inflation number. I don't mind doing that because I've been around economists for some time and they all told me how inflation was going to be higher than it turned out to be; so I don't mind having been on the right side of this issue for the last five years and continuing to be on that same side.

I think Governor Seger is correct in analyzing the foreign sector in regard to the competitive level there. Their economies are very price and wage flexible and, consequently, they are going to take the steps necessary to continue, or maybe to add to, their position in our markets. But the impact of the deflationary environment is certainly there, and I just don't see any signs of any change in inflation psychology. Now, I see the expectations there; but if the inflation expectation remains above the actual rate of inflation it seems to me that we are going to see that in such areas as inventories. The forecast of the inventory accumulation that might occur is not going to be very plausible if the actual rate of inflation is lower than the anticipated rate. In the area of oils and chemicals and farm products, it seems to me that with the declining price scenario one would want to hold fewer inventories, not more inventories. So I have some questions in that regard.

I am also somewhat hesitant to believe that equipment is going to do as well in this kind of environment as some might expect, but that might be influenced in part by my own perspective in regard to equipment in the farm sector. I don't know when John Deere has their wage negotiations, but they probably coincide with the auto industry and it seems to me that they are a long way from re-entering that market. My last comment is in regard to the natural rate of unemployment. I don't know what it is, by the way; but whatever it is, it seems to me that it's falling faster than unemployment is falling. In fact, it may be dragging the unemployment rate down so that any margins that we had are still there. I do not see any wage negotiations that indicate we are getting closer to the natural rate of unemployment than we were.

MR. MELZER. First of all, I would say that on the real side I tend to be among the more [unintelligible] camp. I think monetary policy was generally stimulative last year, so we are coming into this year with a good deal of momentum in terms of employment gains and how that will spill through to income and retail sales and so forth. On the inflation front, I would be among those who are somewhat more concerned about it. I am concerned about the change in psychology toward the dollar that was referred to earlier and what the impacts of that are going to be over the course of the year. I also react to the fact that we have record employment levels and we have this question of what the natural rate of unemployment is. In some areas, financial services in particular, we are going to see pretty hefty wage

increases. For example, one executive of a large insurance company mentioned to me that they are looking at 6 to 7 percent wage increases in the coming year. Basically, I guess I am at the extremes in both camps. I think we will have a pretty good year on the real side but I am concerned about the rate of inflation we could be looking at. Apart from some of the effects of oil and so forth, I think the behavior of some of these other indices is something that ought to be watched. There are some special effects in terms of food prices in there, but we see this Economist index has shifted as well.

CHAIRMAN VOLCKER. Well, I think we are at the end of today's agenda. Let me give you some materials that will be presented to the Board on Gramm-Rudman, if you would like them. It'll come up at lunch tomorrow. We will have some discussion there but it has to be a discussion not leading to a decision. I don't know how we will manage that but we will not be in the sunshine and we will manage it somehow. This Open Market Committee meeting is over--not over, in suspense. We have the meeting scheduled to start at 9:30 a.m. tomorrow morning. It might be a little safer if we moved it up a bit, if that doesn't bother anybody. Do you want to move it up at least to 9:15 a.m. or to 9:00 a.m.? Does everybody want to move it up to 9:00 a.m.? All right, we will move it up to 9:00 a.m.

[Meeting recessed]

February 12, 1986--Morning Session

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

CHAIRMAN VOLCKER. One small point of clarification, Mr. Axilrod. You referred on a number of occasions to "further" declines in the price of oil. I don't know what you are looking at in terms of "further" declines as opposed to declines that have already taken place.

MR. AXILROD. Well, as you know, we have a $20 per barrel imported oil price. The spot price varies but it has been around $16.75 or $16.60 recently. I was assuming a little further decline from that spot price and the spot price itself getting reflected finally into the imported price of oil. So, I was thinking [of a decline of] $4 or $5 more on the imported price of oil.

CHAIRMAN VOLCKER. If there were a further decline in the imported price of oil, that would be a reasonably safe bet I would say.

MR. RICE. Mr. Chairman, could I just ask Mr. Axilrod if he thinks that alternative I would be consistent with an expectation that there is no threat of slow [M1] growth in the first half of this year but there is some danger of slow growth in the second half of the year?

MR. AXILROD. I think so, depending on how slow a growth you anticipate in the second half. We might begin to get relatively rapid M1 growth if interest rates were to decline substantially in the second half and that would begin pressing the upper end of this range more, unless it was widened a little. Generally the answer would be yes, but it depends a little on the pattern of rates one expects to be consistent with that kind of projection.

CHAIRMAN VOLCKER. Let me make two small observations and see whether they will command support. First of all, you have very small changes between all your alternatives here. It's hard for me to see the significance of these changes other than pictorially and psychologically. Therefore, I don't think any of these necessarily imply one thing or another in terms of very current policy. The other observation is that your changes are almost minute on the M2 and M3 categories and there is nothing that says the Committee has to be bound within the bands of your hypothetical examples here. But just in the interest of perhaps slightly simplifying our discussion I want to ask a general question. Are there really significant questions among members of the Committee about the M2 and M3 tentative ranges? Obviously, I think, there will be questions on what weight to put on M1 and what the M1 range should be. Is that all we have to concentrate on this morning at this stage? I don't want to forbid anybody from talking about M2 or M3 if any of you really want to, but I just thought in making comments, people don't have to make a point about M2 or M3 and don't have to keep repeating their ranges unless there is really a disagreement. It seems to me hardly worthwhile to horse around with a half percentage point on those ranges, unless somebody has a bigger concern about that.

MS. SEGER. If we are off on velocity as we were last year, should we have [higher] ranges for all of them--M1, M2 and M3--to allow for that?

CHAIRMAN VOLCKER. Well, that's a question you can raise. Of course, we were within the ranges, so velocity didn't look bad last year.

MS. SEGER. Well, we were in for M3 and we just barely got in for M2, didn't we, by the end of the year?

CHAIRMAN VOLCKER. It depended on whether you were using the parallel line or the cone. We were pretty much in the range all the time using the parallel lines. Of course, it was toward the upper end; there's no question about that. Well, I couldn't if I wanted to, but I don't want to [unintelligible] not discuss the wider aggregates. But the principal concern, I suspect, is on the weight to be given to M1 and on the ranges for M1. Perhaps we could concentrate more on that, anyway. Does anybody want to say anything?

MR. MARTIN. I would support that view, Mr. Chairman. It seems to me that our experience last year using the parallel lines that you alluded to, as well as the various projections, are consonant with M2 and M3 ranges of 6 to 9 percent, even. On a pragmatic basis, I don't think there's a big argument to go to 6 to 10 percent or something like that. M1 is different.

CHAIRMAN VOLCKER. Well, why don't we proceed and talk about M1; but if anybody wants to make some [unintelligible] comments about M2 and M3, obviously, you are free to do so. What do we do with M1 next year?

MR. MORRIS. I have had a proposal for a number of years about that: [I would get rid of the M1 range]. I think it has been a bit embarrassing that in three of the past four years we have not been able to set a range for M1 that is compatible with a reasonable nominal GNP outcome. That doesn't seem to have hurt our credibility in the marketplace too much; but the fact is that we keep on setting targets that we don't meet. And I think last year was particularly difficult because we rebased in the middle of the year and then we still couldn't bring M1 within the range. Now, it may well be that M1 is going to be well behaved in 1986 and that we can get through the year and be within one of these ranges; but I don't have any confidence that we can be sure of that. The other thing I would get rid of is the debt measure, but for a different reason. I think it is pretty clear now that if we are going to use a debt measure, we better have some adjustments to eliminate debt that is clearly not related to economic activity--that is, the substitution of debt for equity which has been very big in the last couple of years. There is this practice by state and local governments of putting out debt and investing the proceeds in government securities; we count both of those. It seems to me that if we are going to use debt, it has to be an adjusted debt concept to take account of these things. If we can't make that adjustment, I think we ought to drop the debt aggregate. So I would propose, Mr. Chairman, that we set a range of 6-1/2 to 9-1/2 percent for M2, M3 and total liquid assets.

CHAIRMAN VOLCKER. You are going [unintelligible] the M2?

MR. MORRIS. I am a little concerned about our practice of continually picking upper limits with the expectation that that's where we are going to end up. It seems to me that it would be prudent to have a little margin, and if we say 6-1/2 to 9-1/2 percent for these three measures I don't think we would get any negative feedback from the marketplace.

CHAIRMAN VOLCKER. This is not where we would expect to end up this year, is it Mr. Axilrod? Your projection doesn't put us at the top of the M2 and M3 ranges, does it?

MR. AXILROD. Yes, for debt we would be projecting--

CHAIRMAN VOLCKER. I am not talking about the debt--[just] M2 and M3.

MR. AXILROD. No. For M2 and M3 we are very close to the middle of the ranges.

MR. MARTIN. But it does for M1, right? 7 percent?

MR. AXILROD. Yes. Our forecast for M1 is between 6-1/2 and 7 percent. Jim says near 7 percent. In the model we rely on most it is literally 6.8 percent. We have others that are a little lower and one that is higher.

CHAIRMAN VOLCKER. But M2 and M3 are not expected to be so near [the upper limits].

MR. MORRIS. I don't think the half percentage point is [critical]; 6 to 9 percent would probably work out all right. I just like the idea of having a little extra margin.

CHAIRMAN VOLCKER. We'll get the rebuttal from Mr. Black.

MR. BLACK. What led you to that conclusion? I do think it's good at the time we set these long-run targets to take a longer-run look at this and the reasons we are setting these ranges. We have been at it now for 10 years and I don't think anyone would claim that they work perfectly. But I do think they have helped us focus our attention on our long-run objective of trying to return to price stability. The remark that Steve made a while ago about the importance of avoiding signals to the market suggests that the prudent thing for us to do at this point probably is to reaffirm the ranges that we had adopted tentatively at the middle of last year. Now, even though Steve made a very excellent case for using all of the aggregates, I still believe--rightly or wrongly, and maybe just on the basis of blind faith--that, of the three that we look at, M1 is going to end up over the long-run being the best one to use. A lot of these institutional changes are behind us and I don't think we have the same sort of change in inflationary expectations that we had in the past that affected the behavior of the aggregates. I am well aware that the velocity of M1 may behave the same way it did last year, maybe even worse; but I think it's also reasonable to think that at some point it's going to resume some part of its normal behavior and I think that we ought to bear that possibility in mind, at least, in setting our targets. And I think the 4 to 7 percent range does encompass those possibilities. We have language in the Bluebook on

the long-run objectives that I think gives us enough flexibility to take care of that if we do have this aberrant behavior of M1 velocity. If we want to recognize it explicitly, then I think we could use something like the 3-1/2 to 7-1/2 percent range suggested in paragraph 10 in the Bluebook. I would be opposed to using the 4 to 8 percent band because that would involve widening the range only at the top, which I think would be noted by the markets and probably interpreted by them as some weakening of our anti-inflationary resolve. So, I would stick with what we did at midyear.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I decided not to go last today. One other aspect of M1 that I would mention is that it bears the closest relationship to what we do, and for that reason I think it's important to maintain it as a target and not just as a monitoring range. Also, as I expressed yesterday, I tend to be among those who are more concerned about possible inflationary developments--what Steve cited in the first instance. And in that context it may be desirable to have M1 as a target. If we find ourselves in a position where we might have to exercise a greater degree of restraint during the course of the year, an M1 target could add to that argument. At the same time, I recognize the uncertainties about the behavior of velocity and for that reason I could be persuaded to expand the band at the upper end somewhat. I don't think there would be adverse market reactions to that. In fact, if we found ourselves in a position where we continued to have very aberrant behavior of velocity, we could deal with that in the same fashion we did [last] year without losing a tremendous amount of credibility. In any case, I do think it's desirable to have the M1 target. I could settle for a 4 to 7 percent range, although I think the chances are that we would be running near the upper end of that. I wouldn't mind providing more room. In fact, it might be inappropriate to shoot for, say, the middle of the 4 to 7 percent range, given the rate of money growth we had in 1985; but I do think we ought to lean toward slowing that down and, under certain circumstances, I wouldn't necessarily rule out aiming for the lower part of a 4 to 8 percent range--if other factors led us in that direction.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I approached the question of the annual targets in terms of the likely contingencies that we might have to face and what they mean. I don't think we can anticipate everything but, for example, if the economy is weaker or if velocity continues to run badly astray, I agree with Mr. Melzer that policy can respond to either of those two developments without a great deal of difficulty. I don't want to say regardless of the targets, but policy can respond within a fairly broad framework.

On another front, if something goes wrong on the LDC side or in the financial sector, the response inevitably is going to be dictated by circumstances, and I don't think we could build that kind of thinking into the targets themselves even though situations could arise that might require some response. So, I don't think we can deal with that directly. On the other side of the ledger, if the dollar falls further--and especially if it falls significantly further in the face of what surely will be the very sizable, persistent, savings gap

that we have--it seems to me that interest rates will tend to rise on their own. But in those circumstances, we might be faced with a need to tighten, even though it would be very, very difficult to explain that when the dollar is seen by so many people from a trade perspective as the boogie man. That would be a much more difficult situation to deal with from [a policy] perspective than either of the first two examples.

If the economy is stronger--or even worse, if inflationary pressures do begin to materialize--the policy response would be even more difficult, keeping in mind that over the long run I think the thing that would be the most difficult, both for policy and the economy, and for the LDCs and the financial system, would be a build-up in inflation and the inevitable response that would have to come to that no matter how delayed the response might be. So, I find that from a policy perspective, either a fall in the dollar or a rise in inflation or a very strong economy are much more difficult to deal with than the other sets of circumstances I mentioned.

Now, as I said yesterday, I don't see that a rise in inflation especially is inevitable. But I think that we have to be careful, so I approached the question of long-run targets with the need for an insurance policy, if I can put it that way, in mind. To me that means keeping M1 as a target because I think it does serve a useful purpose. I think one can plausibly argue also that there is a possibility that velocity will be at least more normal, given the fact that the sizable declines in interest rates that have produced part of this aberrant behavior in velocity are probably behind us and that the institutional factors should not be as big. So, I would keep M1. I would have a preference for 4 to 7 percent but I could live with 3 to 8 percent. But if we're going to raise the upper end, I would also favor dropping the lower end and ending up with something like what we had for the second half of last year. I think that sends two signals. It says that we know M1 is still a little funny looking, but that there might well be circumstances in which we would be comfortable with M1 growing at quite a modest rate, even though we don't perceive those circumstances right now. I am happy with M2, M3; I am not happy with debt at 8 to 11 percent, but I don't think that we can do anything about it. So, I would keep M1 as a target; I have a slight preference for 4 to 7 percent but could live with, and in some ways I guess favor, 3 to 8 percent.

The only other point I would make, Mr. Chairman, is that I would at least raise the question of whether somewhere in the verbiage that goes with the policy statement about the long-range targets, it might not be a good idea to have a phrase in there saying that we would indeed be prepared to resist any build-up in inflationary pressures, even though we don't see them on the horizon right now. It's not formally in the record; it's on page 16 or 17 in the Bluebook. There is a long, long set of words that we have used in the past in the operational part of establishing the '86 ranges, all or most of which has been crossed out. Somewhere in that I wouldn't mind seeing a phrase that would indicate that in the _unlikely_ event that inflationary pressures do in fact begin to materialize we would be prepared to resist them.

MR. MARTIN. Mr. Chairman, it seems to me if there's one term that applies to the difficult forecasts that were so well done by the

Board's staff and so widely supported yesterday, it is "uncertainty." We do face a degree of uncertainty that even for a forward-looking group of economists is notable. It seems to me that this is epitomized by a comment on page 6 below the alternatives for the long run as we futilely define it here: the reference to the substantial portion of the rapid demand deposit growth of last year, which is unexplained by any concept of interest elasticity. Of course, we could experience that again this year. I join President Corrigan in the expectation of not putting a great deal of weight on it, but expecting that we probably won't have that continued growth. But we don't understand it. And if there are difficulties in the Southwest and in some of the oil-exporting developing countries, certainly that phenomenon or something like it could return. But we don't understand the very interest elasticity that now characterizes M1, or at least components thereof. Therefore, adding these two factors together, I would favor a 3 to 8 percent range around M1 to give the Committee flexibility and to reflect the uncertainty generally--not just the demand deposit uncertainty, but our lack of ability to forecast M1 right now in this context. I would not favor taking the 1984 approach, though, of putting M1 too deeply out of the show because I do feel that the money managers in banks will learn reasonably shortly--the market is going to force them to learn--how to price various instruments and what the interest elasticity in their submarkets is. That aspect of the interest elasticity, in the institutional sense, will tend to be more understandable over time, I think.

So, I would favor keeping M1 in the pantheon, widening the range because of the uncertainty with regard to velocity and other aspects of it, and giving us the flexibility in implementing policy to deal with the unexpected. Think of the unexpecteds we have before us right now. In the last 10 hours the flow of news [has included] that: the Conference Board's consumer confidence index is down; Minister Takeshita again is hinting about a further discount rate cut by the Japanese; and of all things, IBM is substantially cutting the price of its brand new CPU mainframes just as their deliveries are taking place. I think we really have to expect the unexpected. We need wide ranges. With regard to President Corrigan's comment about the language, Mr. Chairman, I would like to see symmetrical language indicating that if economic growth falters very substantially--and I think there is a real risk of that occurring--we would be prepared to adjust even our targets but certainly the way in which we implement our monetary policy, regardless of what aggregate or aggregates we were focusing on. I think Steve's comment about the triumvirate is impressive. And I would join Frank Morris in wondering why we still cite the debt [aggregate], which we can't control. We can affect that only marginally; there's no way to hit any kind of target or any kind of monitoring number on the debt range.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, it seems to me that the risks of slower growth or higher inflation that Steve alluded to are fairly well balanced. That makes it particularly difficult to make a choice on these longer-term targets. Because of that, and because of the uncertainties that several people have alluded to, I think what we ought to strive for in 1986 is flexibility. Flexibility also is important, given the staff's projections for M1 growth in 1986,

because of the experience that we had with M1 during 1985. It would be very nice if we were able to come within the targets or reasonably close this year. I would keep M1 but, because of the need that I perceive for flexibility, I would opt for the 4 to 8 percent range specified in alternative II--although I could support a 3 to 8 percent range as well. I think it is important to move from the tentative target of 4 to 7 percent to provide some additional flexibility, particularly on the top side of the range.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I too would favor retaining a range for M1 and treating it at least equally with the other aggregates. When I think about what we did in 1985, it seems to me that M1 played a very valuable role--not in the operational sense, but in the sense that at least on several occasions it caused us to stop and take a very careful look at what was going on and to make a determination about what we wanted to do from there. Those exercises were quite valuable and we didn't get that [message] from the other aggregates. So, for that reason, I'd be inclined to retain M1. For many of the reasons already cited, I think that some widening of the range is a good idea. We just are more uncertain than we typically have been about the relation between M1 as a policy instrument and economic performance. I'm relatively indifferent between widening the range to 4 to 8 percent as opposed to 3 to 8 percent; either one is acceptable to me.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. I would emphasize the continuing uncertainties with regard to the demand for money and that leads me to argue for a wider range; I would recommend 3 to 8 percent. I think we ought to keep in mind that M1, even with a 3 to 8 percent range, is likely to grow at the upper end of the range. Since the Board staff's forecast calls for 6.8 percent growth, I think it's important to keep in mind that nominal growth in our forecasts seems collectively to be a bit above that and, therefore, growth in the upper end of even a 3 to 8 percent range would be likely. Finally, I would favor retaining M1 as a target for 1986 for the reasons expressed by quite a few others and particularly by Mr. Melzer.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. I prefer to keep M1 as a target. I think the range should be maybe 3 to 9 percent. With velocity at a negative 3 percent, the staff's dollar nominal GNP forecast gives a 9.7 percent rate of growth in M1. I believe the marketplace would have a better understanding if we really communicated the range that we think is plausible. That would give us the opportunity on the quarterly short-range targets to specify [our objective] more clearly as economic events develop and as the velocity of M1 becomes better known. I keep being reminded of the events of 1917 to 1946 when M1's velocity fell from approximately 4 percent to approximately 2 percent. So it seems to me that it is entirely possible that velocity may not always have a long-term rising trend and we should accommodate that [possibility].

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I support a range of either 4 to 8 percent or 3 to 8 percent for the reasons that have been given. I also support the retention of M1, not because it has been a very good intermediate target in recent years--and I doubt very much that it will be useful in 1986--but I think we ought to limp along with it because it may be useful in the future. I think Governor Angell's point is well taken. In having a range of 4 to 8 percent or 3 to 8 percent, I would couch it with all kinds of caveats and would not hesitate very long to dump it, in effect, as we go through 1986, because I don't think it's a very reliable guide. But I do think it could be useful for a variety of reasons out in the future.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I think we agreed yesterday that the economic outlook is certainly positive, but I also heard an unusually long list of uncertainties that seem particularly serious. So I would favor adopting a policy that gives us reasonable maneuvering room; I hope that would convey that [uncertainty] to the market. We certainly want to avoid any unintended signals and just possibly changing the tentative ranges might do that. I also think that continuing the ranges that we have had in place this last year could, in fact, convey a continuation of our policy. So I would join those who suggest using last year's M1 range of 3 to 8 percent and continuing to view M1 as a guide in careful coordination with M2 and M3, as Steve has outlined. It seems to me that the broader range deals with some of the uncertainties and gives us some maneuvering room and that under the circumstances that would be the appropriate choice.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, for all the reasons already stated, I would join those who would retain M1 as a target and treat it much as we did in 1985 because of the uncertainties. Secondly, it's attractive to me to adopt what Si Keehn has just proposed: to retain the ranges for all the aggregates, including debt, at the [unintelligible] positions we had in 1985. That incorporates the 3 to 8 percent [for M1] and retains the debt range of 9 to 12 percent. Although there is some real concern about what debt means, the fact that it is monitored and that we have to take a look at it and try to determine why we missed the range is an important exercise. As a result, I would keep debt and retain the 9 to 12 percent monitoring range that we had in 1985.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, like almost everybody else, I would favor retaining M1, with its weight similar to that of the other monetary aggregates, for the reasons that have already been mentioned by several people. I would favor that not so much because M1 should be a rigid guide to policy but because, as Jerry and Ed pointed out, we may need it in the future to explain some policy moves that we might want to take. I would favor a 3 to 8 percent range, but I suspect that probably would be seen as too wide and might be interpreted as a signal that we are moving away from targeting M1. So, perhaps a narrower range of 4 percentage points would be better received. I would both lower and raise the range a bit to 3-1/2 to

7-1/2 percent but I would be perfectly willing--in fact I would prefer it if most people feel we could get away with it--to go with a 3 to 8 percent range. On debt, I have a good deal of sympathy for the point Frank made; I think we ought to look seriously at the feasibility of an adjusted debt range. I would urge the staff to look into the feasibility of moving in that direction. However, until they do, I would favor expanding the range a little to take into account what we expect to happen. We expect that debt will grow a little faster than 11 percent, so why not move the range out to 8-1/2 to 11-1/2 percent?

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I would like to keep my [comments as brief] as I can. I hope you'll [understand] my difficulty in expressing my intentions, which I think will be resolved in a month or two. I would take the M1 range lower limit to 4 percent [unintelligible].

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. As I went over these various alternatives in the last couple of days, it seemed to me that there were really very narrow differences between them.

CHAIRMAN VOLCKER. You had difficulty in discovering the difference?

MS. SEGER. That's right. I kept going over the alternatives and then I would reread the expected outcomes from the various alternatives. They suggest to me a degree of precision in forecasting that in my 20 months here I'm sorry to say I just haven't seen. So, I think the way we retain credibility with the financial markets is to level with them. I think the way we do that is to say that we don't hit both sides every time. We are not perfect forecasters, as no one is even on Wall Street. So if we set wide bands, that really would be a positive factor for our credibility; it would not be viewed as our turning into inflationary "wackos." It just would be a more honest indication that we're impressed with the uncertainties in the economy, with the changed relationships between the various monetary aggregates and nominal or real GNP growth, and all the things that we discuss here regularly. Whatever we do, if it's explained in this way--and, of course, the Chairman has a good opportunity next week to go through all the explanations--it can be handled. Therefore, I would like to suggest that we use all the information we can and present everything we can so it will not look as if we're holding back any information, whether it's on M1, debt, or whatever. I think we should present [the ranges] but have very broad bands and not suggest that we can [be precise by using] 1/2 percentage points. I think that's ludicrous. For M1, I could live with either 3 to 8 percent or I could live with 2 to 10 percent. Today I just don't want to suggest that any sort of nice bull's eye targeting is possible. For M2, I could even go 6 to 10 percent. Again, these are ranges; that's not saying that we're shooting for 10 percent. For M3, I'd favor 6 to 9 percent or thereabouts. I would keep some sort of debt measure, but clean it up as Frank Morris suggested for these various events that are going on in corporate and state and local government finance that really are not tied to economic activity. So, that would be my preference.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I think all of the important things have been said. I agree with what seems to be a consensus that there are a lot of uncertainties around M1 velocity, that we need to keep our options open, and that the best way to do that is by a symmetrical widening of the bands. I support something generally in the range of 3 to 8 percent for M1; I think that's satisfactory. But I think it's very important that we have language associated with this that makes it clear that the options available within the 3 to 8 percent range are not options for more or less inflation but in fact a range of possibilities that we think [appropriate] and that the need to move to the upper end of this range is still a non-inflationary alternative. In other words, it depends on what happens to monetary velocity if we can detect it; and if we move to 8 percent M1 growth during some point during the year, or even well along the top of that range, that has no implications for price stability. We simply would be moving the [unintelligible] associated with what we perceive to be continued abnormal performance in M1 velocity. To me language like that is important because I think we experienced recently what a change in policy rhetoric can do with respect to the dollar. I don't think the fundamentals associated with the dollar have changed that much, although they have some. But there is a different attitude out there about the dollar simply because a lot of people who are in charge of policy are saying things differently. We certainly don't want to create any impressions that we're leaning toward an easier policy and that that means we're trading off inflation for real growth. It's very important to point out that we would not be making those kinds of trade-offs; we simply would be pursuing an easier policy toward 8 percent money growth because of velocity conditions and demand for money. The closer we can come to language like that, the better off I think we'll be.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Mr. Chairman, because of the uncertainties I favor wide ranges, and for M1 a 3 to 8 percent range would be appropriate. I think the words that you use in your testimony perhaps will be more important than the ranges we choose. And I think where we come in with respect to M1, and for that matter with regard to the other aggregates, will have a lot to do with the conditions in the economy and perhaps some financial conditions as well. Some words on the type of reaction we might have if the economy comes in stronger than expected I think would be very helpful.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I also would keep M1 and give it the attention that we have been giving it. On the M1 range, I share a lot of the uncertainties--

CHAIRMAN VOLCKER. When things start happening, how do you interpret that?

MR. BOYKIN. I beg your pardon?

CHAIRMAN VOLCKER. How do you interpret--

MR. BOYKIN. I don't know [unintelligible] different. But I still think that M1 is important and that we ought to look at it. As Gary Stern said, when it's not behaving at least that causes us to rethink periodically, so I would pay attention to it. As for the range, I share all of the uncertainties [alluded to by others], and moving the upper end to 8 percent would be acceptable to me. [For the lower end] either 3 or 4 percent is okay.

MR. BLACK. Just as long as it doesn't get to the point that everyone tells you the same thing about M1, you'd be pleased!

MR. BOYKIN. Right.

CHAIRMAN VOLCKER. Well, the band of disagreement isn't particularly wide; it's rather narrow. I'd just raise a couple of points based on listening to this. I'm not sure we know what we're doing. I guess the psychology of this is that most people talk about widening the range for M1 for obvious reasons and then we end up with something like 3 to 8 percent or 4 to 8 percent. I'm not necessarily opposed to that but I just raise the point that we will be asked the question: Why did you do that? It makes a 1 percentage point difference on the up side. Does that mean that we're really going to get the 8 percent this year and that we have reduced the option for doing what we did last year, which is say it's not confirmed by other factors in the economy but it's running a little slow? I don't get the sense that that is what you want to do but I'm asking: Is that what people are going to read into it--that there's going to be more importance attached to M1? [Will people think that] we went to the great trouble of changing the range to 8 percent and that's a more liberal number, so we better stay within that 8 percent? In some sense and in some conceivable conditions that has the opposite intent of what I detect the sentiment is. That's one question I raise. On the debt issue, which is a lesser question, I do think there probably is a difference given what is essentially double-counting in the state and local area. I don't know what the magnitude of that is; I asked the other day [unintelligible] the answer. I probably have one, but they didn't see it. You go up against them--

MR. PRELL. It depends on how you do the accounting. Our rough estimate is that the impact of the accelerated financing activity last year that was attributable to the concerns about tax reform would tack on roughly a percentage point. If you wanted to include all advance refunding activity, much of which was stimulated simply by the fact that interest rates were lower or by other technical considerations, that would move in the direction that President Morris was talking about and you would get a slightly larger figure; it might move toward 1-1/2 percentage point.

CHAIRMAN VOLCKER. Don't forget, it's not just the advance refunding but all this mortgage financing is double-counted too, isn't it?

MR. PRELL. Well, yes; I think there's no end to this. And that's the problem, ultimately, in having an adjusted measure. All sectors of the economy tend to borrow and build up assets at the same time. Sometimes we can identify special financial strategies that are peculiar, like advance refundings or seasonal debt by corporations, where if we had the data we could chop those amounts off. But the

fact is that homeowners may borrow more than they need to when buying a home and use that extra cash to build up their liquid assets. So if you start taking all these things out, you get down to fundamental sectoral balances which you really can't identify with growth of a debt aggregate.

CHAIRMAN VOLCKER. Well, I'm not sure; theoretically I think that's right. In practice I'm not sure that there isn't a difference between an advance refunding by a state and local government and some consumer--

MR. PRELL. It's hard to choose where the lines should be drawn.

CHAIRMAN VOLCKER. It's hard to know where the line is, that's for sure. But I think there is a difference. And it might affect our judgment at some particular time, whether we lean in one direction or another. I think it is a question of whether it would be useful--and a couple of people made this point--to have some kind of a benchmark out there [against which to judge whether] it is excessive or not. In those terms I rather like it, but in fact the numbers that we have here seem rather excessive, even as a benchmark of excessivity. We start out with very high numbers, but that is a relatively minor point.

MR. MARTIN. Mr. Chairman, since it is almost a duty of your office to express the policy and views of the central bank, how could we drop it? I am speaking now from a political point of view, not from an economic point of view. From an economic point of view I think we ought to drop it, but politically how could we when it is your role, and properly so, to indicate that the leveraging of America has gone too far--that there are dangers and risks in it. How can we then turn around and drop it out of the pantheon?

CHAIRMAN VOLCKER. I could argue it the other way. I just argued against not keeping it. One could argue that these numbers are so high anyway that we can comment on the excessiveness of it without having that benchmark. So, I guess you could argue it either way; it's not all that critical. On the M1 range, I'm not arguing substance here but I just want to make sure we really think about whether we would be ahead of the game or behind the game by changing the upper limit. We are going to have some language in here--language that we may want to take a little time to play with--indicating that we are not going to be locked into this M1 figure, depending upon a lot of other developments. Given that kind of language which is not yet defined, unfortunately, if we change the range I think there is at least a risk of it getting read as if 8-1/2 percent, let's say, really is bad. To make my case in extreme form--I'll make my case but I don't feel all that strongly: Suppose M1 were running at 9 percent and all things considered we didn't want to do anything about it. That's a modified example of what we had last year, which wasn't very troublesome. Is that more troublesome if we have just raised the upper end of the range to 8 percent? Does that raise more questions about why it's running at 9 percent than if we haven't raised the upper limit of the range from 7 percent? That is my simple question.

MR. GUFFEY. It seems to me that that may be the best argument to readopt the range for M1 that we had for the last half of

1985, that is the 3 to 8 percent, as no change. It is a wider range, and from the 4 to 7 percent that we gave tentatively for 1986 in July we've widened it on both ends.

CHAIRMAN VOLCKER. You can argue that we're doing the same thing that we did for the second half of last year; but it means changing what we said for 1986, which is what most people will be looking at, I think. But you can argue that point.

MR. GUFFEY. It doesn't seem to me that enough certainty has come into the ability to forecast M1 growth that we should adopt what we thought might be appropriate in July of 1985 for 1986. Indeed, the track record suggests that we are still uncertain and that the wider range is more appropriate.

MR. MORRIS. I think we need to be able to finance 7 percent nominal GNP growth. An upper limit of 7 percent means that if velocity continues negative, we are going to miss the target again.

CHAIRMAN VOLCKER. My presumption is that the 7 percent wouldn't be a real upper limit any more than it was last year under those circumstances.

VICE CHAIRMAN CORRIGAN. When I spoke about this earlier and said that I had a slight preference for keeping 4 to 7 percent, it was partly for the reason that you mentioned. To me it's a question of these contingencies. If the economy is soft and so forth, I think we can deal with that much more easily than the opposite. I don't think it is just a question of the signal of the upper limit of 8 percent versus the upper limit of 7 percent. That is why I think the language is very important.

CHAIRMAN VOLCKER. Maybe we ought to think a bit about the language we should use. Unfortunately, I don't have a good suggestion to put before you. I wasn't crazy about what was in the [draft in the Bluebook], although that is the minimum we would have to say--that there are great uncertainties about M1. We can say more. Should we say more than that?

MR. ANGELL. Mr. Chairman, my preference for the 9 percent was strictly in response to your query. That is, it seems to me that if we raise the limit and don't mean anything by the new limit, we haven't accomplished much. We've increased market uncertainties. I would prefer to go to the 9 percent because I think that's enough room. I do not believe as much financial innovation change will occur in 1986 as we had in 1985. So, it seems to me that 9 percent will provide us reasonable opportunities to stay within the range and then we could take the language out, which I believe is confusing and could have adverse effects upon [market] views of the dollar. I would prefer [providing] some more certainty to the market. If a real emergency occurs and is recognized, that would have to be dealt with.

CHAIRMAN VOLCKER. You put my point in extreme form; you raised it even higher. But then you really get tied to it.

MR. ANGELL. You really get tied to it. But if we want to express to the markets what we mean, it seems to me that that is the least risky path for us. But it would be a mistake--

CHAIRMAN VOLCKER. Unless you get velocity like last year.

MR. ANGELL. Well, I think velocity like last year is rather unlikely. I don't see why money demand would be apt to increase at a rate faster than last year, and it would seem to me that financial innovation changes ought not to contribute as much as they did last year. Mr. Prell, do you have any idea what proportion of our growth rate last year was due to the deregulation?

MR. PRELL. Mr. Axilrod may want to speak to this, but there were no major deregulatory steps last year that had the immediate effect of shifting funds from one category to another. The more cosmic issue in this context is what the cumulative effect of deregulation has been on the character of the aggregates and the associated interest elasticities. We think it has altered the character and may explain why there was such an apparent sensitivity to the declining interest rates.

MR. AXILROD. In a large sense, Governor Angell, the unknown portion last year was basically the demand deposit behavior. And I don't think that had anything to do at all with deregulation. The question in our minds was whether it had something to do in a broad way with the aftermath of E.F. Hutton, with banks and corporations beginning to look much more carefully at their cash management practices and banks their overdraft practices. A question also was whether it had to do with some of the failures that occurred in terms of clearings and whether banks began looking at overdraft practices and began to take the Board's policy seriously in terms of daylight overdrafts. All those things together could have added a bit to demand deposit growth--that which we can't explain through normal interest rate and income relationships. And that is the sort of thing we were thinking might not be repeated this year. Of course it may, but we think it will not; therefore, we were thinking demand deposit growth would be considerably less than the 8-1/2 percent [in 1985], absent a very sharp drop in interest rates. Those are our conjectures on that.

MR. MORRIS. May I remind you that a year ago at this time we were sitting around this table talking about the fact that there had been a one-time adjustment in the demand for M1 which was behind us. When Steve talks about M1 in 1970, he's talking about a different animal. We [now] are talking about an M1 that bears a market rate of interest. It is an entirely different phenomenon and yet we keep on deluding ourselves that what we call M1 today is the same thing it was in the '70s. It isn't. And it seems to me that's the fundamental source of argument about how to forecast M1.

CHAIRMAN VOLCKER. I am reminded that there is a side issue that we had a little discussion about. I don't even know what we call these things. Do we call them weighted monetary indexes? I don't think they helped us very much, but I thought it might be a contribution if we had a short appendix to our report describing this work. We would intend to add it to the Humphrey-Hawkins Report, if that is agreeable, just as an explanation of the work in progress. It would not be long, but would describe the characteristics and tell the world that we are looking at these indexes anyway. I take it there is no objection to that.

MR. MARTIN. I think it would be very appropriate.

CHAIRMAN VOLCKER. I scribbled down a couple of sentences here dealing with this M1 issue. I don't know whether I like them myself, but let me try this out on you. Substitute for what's there: "With respect to M1, the Committee recognized that based on the experience of recent years the behavior of that aggregate was subject to substantial uncertainties in its relationships to economic activity and prices depending upon, among other things, its responsiveness to changes in interest rates. It agreed that an appropriate target under existing circumstances is--whatever we make it--but it intended to evaluate movements in M1 in the light of its consistency with other monetary aggregates."

MR. MARTIN. It would be appropriate to have language which would say "and therefore a wide range has been set"--if we set a wide range.

CHAIRMAN VOLCKER. This would explain the wide range, I think--well, assuming whatever range we decide [is wide].

MR. BLACK. It would rationalize a narrower range too.

CHAIRMAN VOLCKER. I think it is independent of the range. Maybe I ought to get this typed and we can look at it. Nobody can read my writing, I suspect; I have it scribbled here. We clearly need some language. A range of 6 to 9 percent seems to represent the consensus on M2 and M3. I don't know what the consensus is on debt; most people thought we ought to keep something. We had scattered views as to what it should be if we kept it. If we want to avoid half percents, we could use 8 to 11 percent or 9 to 12 percent. Can we dispose of that one? Was it 9 to 12 percent last year?

MR. AXILROD. Yes.

MR. RICE. What is wrong with half percents?

CHAIRMAN VOLCKER. Well, nothing.

MR. RICE. If you think it is going to come within the half--

CHAIRMAN VOLCKER. Let me just ask for preferences. How many prefer 8 to 11 percent? Seven; we have a majority already. How many prefer 8-1/2 to 11-1/2 percent? We have one, anyway. Let me just get preferences of Committee members at this point. Who prefers 9 to 12 percent? Four. Well, there is a clear preference for 8 to 11 percent. Can we live with that? The compromise is Mr. Rice's [8-1/2 to 11-1/2 percent].

MR. RICE. Well, we have reason to believe that we are going to miss the 8 to 11 percent.

CHAIRMAN VOLCKER. We have reason to believe that we might miss it. But those estimates last year were off by 2 percentage points or so.

MR. MARTIN. We haven't anything to do with whether or not we miss it. What difference does it make?

CHAIRMAN VOLCKER. I think the point is that if we put in something like Frank Morris' caveats about mismeasurement, nobody will care about 8 to 11 percent.

MR. MARTIN. I am denying we missed it last year.

CHAIRMAN VOLCKER. Nobody pays great attention to this as an operational variable. I think "monitoring" is absolutely the precise word to describe it. We look at it in a general way but it doesn't have much policy significance. This is no federal issue to me. We have a majority for 8 to 11 percent; we have a substantial minority for 9 to 12 percent; the obvious middle course is 8-1/2 to 11-1/2 percent, but that looks like fine tuning. What do you want to do?

MR. FORRESTAL. As one who voted for 9 to 12 percent, I think the half points do imply a precision that we are never going to get. And people really don't look at this very much anyway. So, I would be just as happy to go with 8 to 11 percent.

MR. PARRY. Why not widen the range on that one, if there are so many uncertainties?

CHAIRMAN VOLCKER. 8 to 12 percent?

MR. PARRY. Sure.

CHAIRMAN VOLCKER. That's another way to compromise.

MR. AXILROD. That's fine.

MR. RICE. I could go with 8 to 12 percent.

VICE CHAIRMAN CORRIGAN. This is really a small point, but there is this tremendous concern about debt in the economy. I don't care what adjustments you make for advance refundings or anything else, it is a tremendous concern. The numbers don't mean a darn thing, but we have a published target on the record of a monitoring range of 8 to 11 percent. Given all the concern in the marketplace about debt and given the concern abroad about debt accumulating in the United States, what signals does it send to raise it from the tentative target of 8 to 11 percent to 9 to 12 or something like that? I'm not going to go to war over it, but I think it is sending the wrong signals.

MS. SEGER. But we don't control it. I think that is the point.

VICE CHAIRMAN CORRIGAN. That is beside the point. I'm thinking of it in this benchmark sense.

MR. ANGELL. I agree with Mr. Corrigan.

MR. BLACK. I do too.

CHAIRMAN VOLCKER. Tentatively, it looks like 8 to 11 percent. On M1, I expressed my only concern about M1; I think we have--

MR. JOHNSON. You made an important point, I think. If it's just slightly above target, we run the risk of having the markets take it very seriously--much more seriously than if it were running way above and it was fairly clear that it would be impossible to try to get it back into the target range as well as that it obviously was not a major concern. I do worry about financial market uncertainties when M1 is hovering a percentage point or so above target and there is a lot of uncertainty about whether the Fed is going to try to take action to get back within the target or let it go. I think it is important; how important--? There is a July hearing, right? Is it often changed then? I really can't remember.

CHAIRMAN VOLCKER. Three or four times.

MR. AXILROD. The Committee has changed M1 quite a lot.

MR. BOEHNE. We did it last year.

CHAIRMAN VOLCKER. I think it is not typical, but it is not really unusual either.

MR. JOHNSON. My point is that most of this is a forecast, but at least the data for 1-1/2 months of the first quarter don't look too bad. Of course this could turn around quickly in one quarter, but if we are going to set a target, a wider path, we ought to take it seriously at least until midyear. And if we have reason to change it then we can change it--unless we are going to put out some statements along the way that make it clear to financial markets that a slight amount of excess above target does not imply policy action. There are uncertainties around not meeting it during this intermediate period. I don't know what is going to happen either, but if we are going to set a target we ought to take it fairly seriously and then take some formal occasion to adjust it. If July is a formal occasion for doing so, that might be a good time.

CHAIRMAN VOLCKER. There is nothing to say that we can't change these targets other than in July. I don't know that we ever have. But we have announced other than in July or February that we were not observing--. There was some rigamarole that got some attention when it shouldn't have last October/November when we tried to say in an unobtrusive way, because people were conscience stricken, that we clearly weren't going to meet the targets. We thought we ought to tell people that we weren't really trying to meet the targets and we did tell them. It got a lot of attention at the time and had a little market effect for a few days. We obviously weren't [going to meet them] anyway. But we do that if we make a decision that we are, in effect, giving up on the target.

MR. JOHNSON. Well, maybe that's the best way to do it: to provide information carefully along the way about how seriously to take the level of M1 relative to the target. We don't have to say anything if it is on target, but obviously we need a lot of communication if it is not.

VICE CHAIRMAN CORRIGAN. If in May or June or something like that, M1 is growing at 9 percent and the economy is lousy and velocity is either empirically or otherwise declining, I don't think the market is going to worry at all. As a matter of fact, I was amused reading a

memorandum that one of Mr. Sternlight's people gave me yesterday, by some fellow--I don't know who it was--who said that [at his firm] they don't even stay around on Thursday afternoon until 4:30 any more to get the money numbers so that they can trade on them; they go home at 4 o'clock. The problem is on the other side. If we get out there in 1986 some time and, just to take an example, money has grown at 8 percent and velocity is increasing and nominal GNP is rising by 10 or 11 percent, you are darn right the market is going to worry about that. The question is going to be how we respond to that. That is the tough one.

MR. JOHNSON. They ought to know how we'll respond: that we've got to do something about that.

CHAIRMAN VOLCKER. After listening to all of this, the initial preference of most people--but not everybody, for sure--was 3 to 8 percent. We have one 3 to 9 percent and some at 4 to 7 percent or 4 to 8 percent. You heard my reservation, but I don't feel all that strongly about it. Whatever range we have, we need some [explanatory] language. Does 3 to 8 represent the best consensus we have? I don't hear any opposition to that. You want to change the tentative range, with caveats. Well, that sounds like where we are tentatively. I guess we can vote, but I don't know whether we should vote without seeing the language. Why don't we turn to the language for the ranges and see what other comments people might have? This draft language takes out all the business saying that we might be in the upper part of the ranges. I don't think we are saying that, if I understand correctly, with respect to M2 and M3--or at least I need guidance on this. We have at times in the past, not infrequently, said that we expected to be in the upper part of the ranges. We are not saying that this time; the estimate says that we ought to be roughly in the middle of the ranges, right?

MR. AXILROD. Or thereabouts. We had put some language in that said [the Committee would] continue to examine it in light of velocity, which by implication would take care of the need--

MR. BLACK. I think Steve makes a good point, Mr. Chairman. The language says M1 is subject to substantial uncertainties. I wonder if it wouldn't be better to say the velocity of M1.

CHAIRMAN VOLCKER. Well, I'm looking at the earlier version, the part that's crossed out. At midyear sometimes we have said that we expect to be in the upper part of the range. We're not saying that this time.

MR. AXILROD. We substituted.

CHAIRMAN VOLCKER. [Unintelligible] we take that out.

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. I'm not saying that's inappropriate; I just want to understand. We're not saying that.

MR. AXILROD. We tried to cover it by implication on both sides on the--

CHAIRMAN VOLCKER. Yes, that covers it on both sides. Now, my language is a substitute for that capitalized language in the first sentence, but not for the second sentence. It's pretty standard boilerplate or close to it: "The Committee understood that policy implementation would require continuing appraisal of the relationships among the various measures of money and credit, their velocity trends, and indicators of economic activity and prices"--this is apart from smaller grammatical errors--"depending among other things on its responsiveness to changes in interest rates. It agreed that an appropriate target would be," I suppose.

MR. MARTIN. "Target" or "target range"?

CHAIRMAN VOLCKER. "Target range" it should be. I'm not sure that last phrase quite captures what--

VICE CHAIRMAN CORRIGAN. How about if in that last part we said "in light of its consistency with the monetary aggregates, developments in the economy and financial markets, and the need to resist any buildup in inflationary pressures" or something like that?

CHAIRMAN VOLCKER. That is all right with me. I guess if we did something like that it almost replaces the next sentence too.

VICE CHAIRMAN CORRIGAN. Yes.

MR. MARTIN. It tilts it toward the inflationary pressures--

VICE CHAIRMAN CORRIGAN. No, the first thing is developments in the economy.

MR. MARTIN. There's disinflation in the economy with the oil price [decline]. Does that sound consistent with all we've just heard--that oil prices may go down another $5?

VICE CHAIRMAN CORRIGAN. Well, the point is it's contingent. It doesn't say that it is going to happen.

MR. MARTIN. Yes, I appreciate the contingency so long as it is symmetrical.

VICE CHAIRMAN CORRIGAN. I envision it as symmetrical. That's why I would put "the developments in the economy" first.

CHAIRMAN VOLCKER. What did you say?

VICE CHAIRMAN CORRIGAN. "It intended to evaluate the growth of M1 in light of its consistency with the other monetary aggregates, developments in the economy and financial markets, and the need to"--maybe "resist" is too strong a word--"be mindful of any buildup in inflationary pressures that might materialize over the course of the year."

MR. MARTIN. "Developments in the economy that might indicate weakness"?

VICE CHAIRMAN CORRIGAN. That is fine because, as I said, I had in mind to be symmetrical about it.

MR. MARTIN. That makes it symmetric. That was your intention.

CHAIRMAN VOLCKER. All things to all people. What I really contemplated in doing this--and maybe you don't want to do it--was not to cite M. in the first sentence of the targets. We could start out by establishing ranges for monetary growth measured from the fourth quarter for M2 and M3. And then this would cover the M1 target.

MR. MARTIN. If we don't make that amendment, then we really are featuring M1; we are starting with M1 and finishing with M1.

VICE CHAIRMAN CORRIGAN. Do you have in mind that they are of roughly equal weight? You don't have in mind a monitoring range?

CHAIRMAN VOLCKER. No, I don't have in mind a monitoring range, but in some sense I think this doesn't give it equal weight.

VICE CHAIRMAN CORRIGAN. Good; it shouldn't have equal weight. That is all right with me if we can avoid specifically denoting it as a monitoring range.

MR. MARTIN. Yes, I wouldn't.

CHAIRMAN VOLCKER. No, I wouldn't do that. But another way of doing it is to put a sentence like this in first.

MR. MARTIN. Yes.

CHAIRMAN VOLCKER. And then follow with the--

MR. ANGELL. Yes, I would prefer that.

CHAIRMAN VOLCKER. Let me see how this flows here. How does the first paragraph start out? We need another transitional sentence if we put it first, I guess. "In furtherance of these objectives, the Committee agreed to establish ranges for monetary growth measured from the fourth quarter of 1985 to the fourth quarter of 1986. With respect to M1--"

MR. AXILROD. --"the Committee agreed on the following ranges" period. "With respect to--"

CHAIRMAN VOLCKER. If we take this other tack, I think I would say "The Committee agreed that an appropriate range in the existing circumstances would be" whatever that is. "It intends to evaluate movements in M1 in light of its consistency with the other monetary aggregates, developments in the economy and financial markets and potential inflationary pressures." That is a simpler way of saying it and covers everything, it seems to me.

MR. MARTIN. It is a little weighted toward fear of inflation whereas if it said "[developments] in the economy that might indicate weakness"--

CHAIRMAN VOLCKER. We are going to be responsive ultimately to developments that indicate excessive strength.

MR. MARTIN. Sure.

CHAIRMAN VOLCKER. I think this is kind of neutral. What about the number? Is 3 to 8 percent what we want it to be, after due consideration?

MR. ANGELL. There seems to be a consensus.

CHAIRMAN VOLCKER. Then I guess what we'd say is: "In furtherance of these objectives, the Committee established the following ranges. With respect to M1, the Committee recognized that based on experience in recent years the behavior of that aggregate was subject to substantial uncertainties depending on, among other things, its responsiveness to changes in interest rates. It agreed that an appropriate target range under existing circumstances would be 3 to 8 percent. It intends to evaluate movements in M1 in light of its consistency with the other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures. It adopted a range of 6 to 9 percent for M2 and 6 to 9 percent for M3. The associated range for growth in total domestic nonfinancial debt was--" What did we say?

SPEAKER(?). 8 to 11 percent.

CHAIRMAN VOLCKER. --8 to 11 percent." Then I guess we don't need that other sentence at all and that's the end of the paragraph. What we don't say specifically is that we'll evaluate those other target ranges depending upon velocity. I'm not sure that's necessary. Do we know what we are voting on? Does anybody have anything else to say? If not, [let's vote].

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Black	Yes
President Forrestal	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Martin	Yes
President Parry	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. We can turn to the discussion on the short term or whatever else we are going to do.

MR. AXILROD. Mr. Chairman, in light of the discussion on the long run and the narrowness of the ranges I should mention, as the Committee members surely know, that the width of the alternatives is narrower than the likely range of error in the outcome.

CHAIRMAN VOLCKER. That's usually true.

MR. AXILROD. The Committee at its last meeting had established wider [short-run] ranges for M1, M2 and M3 than had been the practice for some time. Because of the width of the ranges, and

given the fact that December turned out to be pretty close to projections and January is coming in low--lower than we had projected --two of the alternatives, A and B, are consistent with those ranges that had been established. As you can see, alternative B is predicated on no further change in bank reserve pressures from what had been adopted at the last meeting. Under Alternative B, we expect growth rates to be close to the lower end of the 6 to 8 and 7 to 9 percent ranges adopted--

CHAIRMAN VOLCKER. What did we have? We had 7 to 9 percent for M1 and 6 to 8 percent for the two others?

MR. AXILROD. Right. And that assumes that January growth in fact will be about 1-1/2 percent by the time we put out the new numbers, which are virtually completed. Alternative A assumes some further easing of bank reserve pressures and would have an accelerated growth, we think, in M1 and M2 in February and March. But over a four-month period, the average would still be at growth rates within the ranges adopted by the Committee at the last meeting. I think alternative C is not particularly relevant, if the Committee accepts the staff view that that was predicated on adopting a tighter alternative long-run target than that adopted. Although, of course, in some sense, those ranges are not inconsistent with the long-run ranges that the Committee has adopted--except possibly for M2; [the aggregates] just move down in those ranges faster.

Mr. Chairman, I really don't have much more to add. I should mention that, in the past, the Committee has sometimes moved to a December base at this point in the first quarter. We have suggested leaving the November base because the likely growth is not too far out of the ranges that the Committee already has adopted. So there is a possibility of simply leaving [unchanged] the directive and the ranges covering the period through March whether or not the Committee decides to keep reserve pressures unchanged or to ease them. The alternative would be to move to a December base; but in that case I think some of the numbers would have to be lowered from what had been adopted.

CHAIRMAN VOLCKER. Let me just deal with that pictorial question. Ordinarily we would change to a December base at this point, but there is the peculiarity this year that we had a very high December, at least for M1, and a low January. So, presumably, if we moved to a December base, we'd have to lower all these figures quite significantly just to reflect the fact that when we leave out December we start off with an exceptionally low figure. Arithmetically, you arrive at the same result; it is just a question of whether we want to stay close to or the same as what we had [in the directive] last time.

MR. AXILROD. I should say in that context, Mr. Chairman, that generally we attempt to review at the mid-quarter meeting whether the targets set at the beginning-of-the-quarter meeting are feasible. Our general feeling was that they seemed feasible; it is just this matter of the November or December base. We didn't see a great need to change it.

CHAIRMAN VOLCKER. Do we accept that method of proceeding?

VICE CHAIRMAN CORRIGAN. I would.

SEVERAL. Yes.

CHAIRMAN VOLCKER. Why don't we take a break right now and come back and resolve this issue?

[Coffee break]

CHAIRMAN VOLCKER. Let me just make a couple of comments with respect to this decision; these all relate to the operational decision, which I presume will be on the level of borrowing. I think that most people are [not] going to want to change our approach radically at this meeting. The setting that we are in--Governor Martin used the word "uncertainty" and that is one way of putting it. The synonym is "confusing." That is what I got from listening to all of you yesterday. You have varying views about the outlook. You emphasize quite different things, and that is quite understandable. All of the individual views are quite persuasive, but they are not all consistent with each other, which I think is the confusing aspect. Obviously, we have had stronger data recently; the employment data in particular have been very strong. One is left with this uneasy feeling that that is not matched by equal strength currently or prospectively in a number of the key sectors of the economy. It is a little hard to piece [together] just where the strength will come from through the year. We have had a lot of monetary expansion and a lot of debt expansion, and from that standpoint there seems to be ample liquidity. But I hesitate to believe this recent good data or to believe the part that states there are potentially weak sectors out there, looking ahead a year or so. I am reminded of the old adage of Charlie Kindleberger: In this kind of situation, just don't do anything; stand there. I suspect that may be good advice in this circumstance.

I get more concerned as time passes about an underlying factor here. I had assumed that we were at least a year, or maybe 2 years, off from any concern about general pressures on the economy or capacity, looked at very broadly. These productivity figures sure look pretty sour. And that raises a question about what our growth potential really is. We have had unemployment declining something like a half percentage point over the last six months, if one believes this last figure. Maybe we will get a reversal of that in February so that will look different. But where we are now, getting a sizable decline in unemployment with the economy growing--I don't know what it has averaged over the last 6 months--less than 3 percent hasn't it? Well, that looks low; it makes you wonder. On the other hand, you wonder how much we can take without pushing the unemployment rate pretty fast. None of the projections suggests that, but the projections are not consistent with what has happened over the last five or six months either in the relationship between economic growth and unemployment. Maybe it is a fluke; maybe it will all go away in the figures over the next couple months. But it leaves me with more questions in my mind than I had before about what our growth potential is.

And, of course, that bears on the inflation picture over time. I don't know who Governor Angell was referring to [in his comment] that people are overestimating the inflation rate. I think that has been generally the case among economists and others surveyed on inflationary expectations; people pretty consistently over the past

few years have overestimated inflation. We have an unblemished record as a Committee of overestimating inflation collectively for 5 consecutive years. I don't know if that is going to change; the expectations have been reduced somewhat in this latest set. I think we are seeing some good things in reference to a change in the labor bargaining situation. I suspect a lot of credit for that has to go to deregulation. I think the air controllers' strike five years ago had something to do with changing this trend. From my viewpoint, it is a very healthy development in the manufacturing sector and in some other big labor union sectors. The situation has never looked so great on the financial side. Si or somebody referred to one insurance company anyway, but that has been fairly typical of the service side of the economy. That is, I suspect, where we are getting on balance particularly poor productivity performance. My own bias is that once we lose that favorable inflationary [climate] it is the devil to get it back again. I don't think we have lost it yet, but these underlying factors raise some questions. The biggest threat is clearly from the dollar side. Can we absorb this kind of a reduction in the exchange rate and have just a temporary influence on inflation without affecting the whole climate, which has been improving? From that standpoint, I suppose we should count ourselves very lucky that we may have this decline in oil prices coming. It may not be at the superbly right time, but it's about as good a time as one can ever imagine in terms of offsetting the potential--and I think they will be actual--effects from the exchange rate side of the equation. Here we are getting a tremendously lucky break. Because of the oil situation, can we get through some of the exchange rate adjustment effects without the same degree of impact that otherwise would have occurred?

The oil situation, on the other hand, obviously raises all those questions of financial fragility--questions like Karen Horn raised yesterday. I guess the only answer is that while there is in fact a lot of fragility, it has been contained and diffused; so we really haven't had a test of what happens to the economy if something really happened in a way that was not controlled. We have the clear and present danger in that respect internally, but I think in terms of the general risks--if one looks for the one place where things might break down with unknown consequences--just because of the sheer magnitude, it is still in the area of the LDC problems. On top of that are a lot of continuing domestic struggles. We can't handle all that with the monetary policy. I guess the challenge continues to be to keep monetary policy on track while those things get handled primarily [in other] directions, although they obviously could affect the tone of monetary policy at times. We have to continue to do so. But it all adds up to me that we are about as easy as we can be without actually forcing excess reserves on the market. There may be a bit of margin there, but we've been pretty accommodative. The most recent business news looks a lot stronger, but we get fooled lots of times. The most recent monetary news doesn't look disturbing, at the least in a very short time perspective. So it doesn't seem to me a situation where we want to make any very violent changes. With that much introduction, what have you got to say? Mr. Black.

MR. BLACK. Mr. Chairman, I agree with you completely on that. I would also like to agree with Pres on something. He talked about the need for symmetry a while ago, and in view of what you have said, I think we ought to put a "would" instead of a "might" in that last part of the clause. I know you don't think this makes any

difference. It does to me. We now have a "might" and a "would," and the emphasis of your comments suggests to me that a "would" ought to be where "might" was.

CHAIRMAN VOLCKER. Okay. We don't want to do all the drafting [of the language] right now, but your point is noted. [What] way do you come out on these numbers that we have to put down because of this?

MR. BLACK. I would go with "B."

CHAIRMAN VOLCKER. Let me just make an immediate comment. Presumably, we don't want to go with short-term targets down to the 1/4 of a percentage point. When I look at "B" I would assume that we don't want to go with 5-3/4 or 6-3/4 percent.

SPEAKER(?). As I understand Steve's earlier comments, "B" is roughly consistent with what we had initially specified.

CHAIRMAN VOLCKER. Well, we said 6 to 8 percent then, so it is fine for M3 and it is okay for M1. It isn't okay for M2, just talking--

MR. AXILROD. That's what I was [thinking]--rounding in my head a bit.

CHAIRMAN VOLCKER. I would normally interpret these as saying 7 percent, 6 percent, and 7 percent, [for M1, M2, and M3, respectively]. Is that what you mean, Mr. Black?

MR. BLACK. That would be fine, Mr. Chairman.

MR. JOHNSON. On the borrowing range, what currently is our objective?

CHAIRMAN VOLCKER. Theoretically, we are aiming at the lower end of the range which, as we discussed last time, is $350 million or so. But we have been taking chances on coming in somewhat below that. You get to comment on that point for the sake of completeness.

MR. BLACK. I would stick with that "Volcker $350 million," although if we run into these problems with the federal funds rate not being what we expected, we get the borrowing that you are talking about. I think people very properly understood the context of the Committee's remarks the last time, saying that the Desk should give a low preference to the federal funds rate and it did so. What is the borrowing related to that? What has it been coming to?

CHAIRMAN VOLCKER. Well, for just these last two weeks--we are all finished but one day and--

MR. STERNLIGHT. It is averaging just a little under $200 million.

CHAIRMAN VOLCKER. The market is acting peculiarly today so I hesitate to say what it will be. All the numbers say there are lots of excess reserves out there, but the funds rate went up today. So, I don't know whether that means we are going to get a lot of borrowing

on the last day of the statement week even though statistically we should get none. But, in fact, the [funds] market is on the firmer side today. Did we drain again today?

MR. STERNLIGHT. No, we didn't. Statistically [unintelligible], but funds were high.

CHAIRMAN VOLCKER. If you believe the projections, and there is only one day left, [reserves] are $400 million above the target with an allowance of $800 million for excess reserves. Excess reserves should end up at $1.2 billion, so the market is firming. It is probable that we will end up with borrowings below $350 million, but that assumes the market eases this afternoon again.

MR. BLACK. That's with an expected federal funds rate of around 7-3/4 percent?

CHAIRMAN VOLCKER. You can ask the staff but it used to be, historically, that when you had borrowings this low you would get the federal funds rate at the discount rate or below. But it's not happening now.

MR. JOHNSON. That is what I am getting at. Projected borrowings on alternative A are around $150 million. It sounds like we are actually close to that at the moment in reality. I just wondered--

CHAIRMAN VOLCKER. When [unintelligible] are low--assuming you are aiming that low--unless you are very active, even then you run into all sorts of quirks. Once in a while there is some miss on guesses by the banks on their reserves or something comes out that you don't expect and you get high [borrowings] on one day. And because the target is so low, you can't go below zero but you can go high on a particular day, and it is hard to get borrowings consistently to average that low.

MR. ANGELL. There is no economic incentive.

MR. AXILROD. In the two weeks ending January 29, Mr. Chairman, we had borrowings of $374 million and in the preceding two-week period they were $143 million. And, as you mentioned, for this period they probably will be somewhere between $200 million and $300 million or so by the time we are done. For the latest week that was published, the first half of this two-week period, borrowing was $240 million in that one-week period.

MR. JOHNSON. It sounds like what we really have is something below the $300-$400 million range you are suggesting.

CHAIRMAN VOLCKER. Yes, on balance, I think it is. We have been a little below because the market has been a little tighter than one might otherwise have expected. Mr. Melzer.

MR. MELZER. I would be in favor of alternative B. I might just say that down the road my tendencies possibly would be to lean toward a somewhat firmer policy. I am, as you expressed before, concerned about the behavior of the dollar and the change in psychology there. One interesting manifestation of that recently was

on the unconstitutionality of Gramm-Rudman. The bond markets here very quickly looked right through that; I am not sure the foreign exchange markets did. There are other factors there, such as how the low oil prices have differential impacts and what the credit implications are for the United States and so forth, but along the lines of the argument that bigger deficits are more stimulative. Maybe that would be positive for the dollar; maybe that subtle shift indicates that the dollar is starting to get to the point where there is concern about the inflationary implications of the deficits and the financial problems and what that might imply for monetary policy at this time. So in any case, for the moment, I would be in favor of "B." I would lean possibly, depending on future developments, toward a somewhat greater degree of restraint down the road. Given that I think there are difficulties in projecting money looking forward, I don't take a lot of comfort in the low projections looking out over this period. That doesn't make me say that maybe we ought to be tipping [policy] toward somewhat greater ease. I think we probably have been accommodative. In general I would tend to recognize this penchant I have of leaning a little in one direction toward trying to get to $350 million as opposed to being overly sensitive to the funds rate.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I think the advice not to rock the boat right now makes an awful lot of sense. The economic numbers have been better; they may not last, but they have been better. The outlook for inflation seems a little better; it may last, but we are not sure. I do think the international side is, if anything, more tender, so that where we are seems to be about as well as we can do. There is a bit of trickiness with this borrowing, but I would think that $300 to $400 million makes a lot of sense, perhaps altering that as we gather in the information that the federal funds rate might tell us as to the peculiarities of the borrowing range. Basically, I'd stay about where we are.

CHAIRMAN VOLCKER. Would you technically interpret that as "B" or what?

MR. BOEHNE. Yes.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. I come out pretty much the same place, Mr. Chairman. I think you analyzed the situation quite cogently. The economic numbers certainly look a lot better than they did the last time that we met and inflation looks pretty good. We have some complications on the international side, but I think we ought to heed the adage that you quoted and keep running in place--maintain the status quo or an even keel or whatever it is. My tendency would be a little different from Tom Melzer's in that the inflation picture to me doesn't look all that bad, and the question I keep asking myself is: What risk would we run by giving the economy a little boost? I don't think now is the time to do it, but I think that down the road perhaps I would tend to ease up just a little. At the moment, however, I would opt for alternative B with the specifications and the borrowing as indicated at $300 to $400 million.

CHAIRMAN VOLCKER. Mr. Martin.

MR. MARTIN. Mr. Chairman, I note that the Greenbook's quarter-by-quarter projection has the second quarter of 1986 as a weaker quarter, at 2.3 percent. Whatever the error range is around that, that is still a stepping down of growth from the first quarter which, as I read the consensus around the table here, is for a pretty strong rate of growth--stronger than the fourth quarter of 1985. But what we do here today will have some effect on the second quarter of 1986, although one can debate the time period needed to affect activity. It seems to me that almost eliminates alternative C; there is no compelling reason to raise interest rates at this time. The markets, of course, are going to start speculating or already are speculating about what we are discussing here right now; certainly, they will speculate once the monetary data are released this Thursday. That will [result in] a little headline here or there when we start talking about much lower rates of growth of M1. We will release the record of policy actions for December in a couple of days, so we are going to release some interesting numbers one day and some interesting history the next day. And the history is going to point toward the very modest easing in that report for the December meeting.

Moving to the alternatives, it seems to me that the market has been telling us something. The market has been acting through the commercial bank mechanism and has been keeping the borrowing numbers low relative to our target of $350 million. It seems to me that now would be the time to recognize the market signals and begin to move the borrowing target first from $350 million to $300 million and then see what the market response is to that. If the response is appropriate--if the federal funds rate begins to come down a little--then I'd very carefully reduce the borrowing level another $50 million. I am not in favor of alternative A either for the same reason I reject alternative C. I think "A" probably takes us down to below the frictional level of borrowing. I don't know whether that is $150 million or $200 million or whatever. I think we ought to move in that direction, though, in a couple of stages. That would permit the Board of Governors to respond to the 5 or 6 remaining requests--I hope they are remaining--to lower the discount rate. In other words, it would give us some room to act in a way that would aim at that second-quarter figure and at the figures the staff has provided us for the rest of the way. So, I am a "B+" person here with a [unintelligible].

MR. PARRY. It seems to me that recent economic statistics suggest that there will be surprises on the plus side in the first half of the year. I don't know what that implies for the second half but in that kind of environment alternative B would seem to be the appropriate policy to follow. With the strength that may be present in the first half of the year, I don't think alternative A would be an appropriate policy to follow.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Mr. Chairman, looking at these alternatives, I see very little difference between "A" and "B." I discount "C" to begin with. There is virtually no difference between "A" and "B" with the exception that "A" implies lower borrowing and a discount rate cut. I might have been in favor of that six weeks ago, but it seems to me that a discount rate cut, in view of the good numbers that we

have had recently and the fragility in the dollar, might [not] be appropriate. Therefore, "B" at a stand pat level of $300-$400 million would be an appropriate prescription for the next six weeks.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I also would favor alternative B and, with that, trying to get the borrowings back up to the $300-$400 million range, assuming that nothing too unusual is happening with the federal funds rate. It doesn't seem to me that any of the incoming information on either the economy or the monetary aggregates suggests that we should want to make any changes at this juncture. That may be somewhat of an unusual position in recent history but maybe we should take advantage of that and, as the adage you cited suggested, just stand there.

CHAIRMAN VOLCKER. Mr. Angell.

MR. ANGELL. I am afraid I am with the consensus in regard to wanting us to stand still, provided that stand still means standing neutral. Unfortunately, we are in an environment in which we don't have M1 targeting that can really be a policy guide as it was in periods in the past. Since we don't have M1 targeting, we don't have any way to let interest rates respond to economic forces. So it seems to me that we have been pegging the federal funds rate. When I try to factor in a change in the price of oil from $28 to $18 over a period of time when the funds rate has been pegged at 8 percent, I do not get the same responses in the real sector that I would get if we had some other way of running monetary policy. I'd note that the market's judgment during this period of time has been that interest rates ought to come down. Market forces have brought rates down other than the rates that the Federal Open Market Committee controls. It seems to me that unless Messrs. Axilrod or Kichline or Prell can tell me otherwise, I would tend to view actual policy as being pegging interest rates. Now, I don't mind pegging interest rates temporarily during a period where the income velocity of money so misbehaves that we don't know what we are doing. But to run through a period, for instance, of a $28 to $18 change in the price of oil, natural gas, coal--the entire [unintelligible] of the whole economy with pegged interest rates seems to me just to be repeating exactly what happened in the 1970s when we had oil price increases and largely had a pegged and somewhat discretional policy--an adjusted pegged policy. It scares me, and I do not have enough foresight to be comfortable in this environment. If Messrs. Axilrod, Kichline and Prell can tell me that my concerns are unfounded and that the model really works--that the real growth occurs with no interest rate responses--I will feel much more at ease because I have a great deal of respect for their judgment.

CHAIRMAN VOLCKER. You may have less so for the Chairman's judgment. Let me say that I find the analysis of this oil situation a little ambiguous. Obviously, it is a plus on the price side but the famous analogy is to a tax cut on the other side and an expansionary influence on the economy. It seems to me to pull in the other direction from what you are citing. Be that as it may be, I think what you left out of your analysis is a big inflationary impact from the exchange rate which has gone down 25 percent or something like that over the same period, roughly, that the oil prices came down; I don't know how you factor that into your thinking. You are on the low

side of the projections; I hope you are right. But the projections collectively, for what that's worth, don't show much change in the inflation rate.

MR. ANGELL. I don't have more confidence in my ability to set the peg. I am expressing--

CHAIRMAN VOLCKER. I wouldn't interpret our policy as a peg, be that as it may.

MR. ANGELL. Well, would you explain to me what it is? I just don't understand.

CHAIRMAN VOLCKER. An unchanged discount rate during this period and we've been kind of sitting there with the economy moving without much change in either inflation or growth. I am not sure objective circumstances in the market call for great changes in interest rates. And that is what we have seen for the past year.

MR. ANGELL. But it seems to me that--

CHAIRMAN VOLCKER. I can't see getting into a long argument, but some people might say 12 percent expansion in M1 was not artificially increasing liquidity and keeping short-term interest rates lower than they would have been in an unfettered market.

MR. ANGELL. If oil prices were to move up from $18 to $28 and interest rates stayed the same, I would--

CHAIRMAN VOLCKER. You are taking one factor.

MR. ANGELL. It seems to me that it's a very big factor.

CHAIRMAN VOLCKER. Is it bigger than the exchange rate factor?

MR. ANGELL. I would guess so.

CHAIRMAN VOLCKER. I hope so, but I don't know. I would guess they are roughly counterbalanced; I hope they are roughly counterbalanced just on the pure inflation range. They are both expansionary in terms of the impact on activity.

MR. ANGELL. The models that I have run and can think of--unless someone can point out another model to me--would suggest to me that the path toward expansion in the real sector is through a reduction in interest rates. When you run a model of oil price changes and keep interest rates the same, then in that model I don't see how any real analysis is going to operate.

CHAIRMAN VOLCKER. It depends upon your model. If you use a strictly Keynesian model, you get a big increase in purchasing power from the decline in oil prices.

MR. ANGELL. Well, I never use such models.

CHAIRMAN VOLCKER. Well, that's why it depends upon what model you use. A popular thought when the oil prices were going up

was that policy ought to be more expansionary to offset the contractionary effect of the rise in oil prices--equivalent to a tax increase. Now we get the equivalent of a tax decrease.

MR. ANGELL. But I don't subscribe to popular views that we should have been accommodative during periods of price increases for oil. I would have thought we should not have been accommodative.

CHAIRMAN VOLCKER. I guess what we are saying is that there are different models of the world. I didn't want to divert you. Did you express a judgment as to what--?

MR. ANGELL. I cannot be satisfied with standing pat if it means that we peg interest rates at the current level.

CHAIRMAN VOLCKER. What alternative do you suggest?

MR. ANGELL. I would hope that we might be able to have some reemphasis of M1 targeting and that we might be able to watch commodity prices and see how they behave. If commodity prices behave by moving upward due to the exchange value of the dollar, and with the commodity price impact of the oil price change, I would want to take cognizance of that.

CHAIRMAN VOLCKER. I really don't want to press you unduly, but do you have a position on these targets--borrowings or whatever at the moment? It is not compelling that you express an opinion right now.

MR. ANGELL. I think I've expressed my view.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Given all the circumstances and the crosscurrents that we've talked about, it seems to me that at this particular moment maintaining the existing policy is appropriate. We are at a time when there is a reasonably short interval until the next meeting and, therefore, we have an opportunity fairly quickly to review what we are doing. Therefore, I would be in favor of alternative B and the borrowing range of $300 to $400 million, but with a careful eye on the federal funds rate. I certainly wouldn't want it to go over the 8 percent level. It seems to me that many of the problems we have talked about would be exacerbated by higher rates. On the other hand, we certainly want to watch the inflationary tendencies very carefully. Again, we have a fairly short period to deal with here and I think alternative B, the existing policy, is appropriate.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. [Unintelligible].

MR. RICE. I think Governor Wallich supports alternative B.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I just want to take one minute to bore you with some ancient history. I was looking at some of the numbers that we looked at a year ago and, at that point, we had seen a surprisingly

strong performance of real GNP in the fourth quarter. At the time of the December FOMC meeting we had been expecting real GNP growth of 1.3 percent. Lo and behold, it came in at 3.9 percent--or the Greenbook was showing 3.9 percent for the 4th quarter of 1984. As I recall, our reaction to this was somewhat like I sense our reaction is today to the strong employment numbers: Fasten your seat belts, we are about to take off. As I look back at 1985, other than that big expectation at the beginning of the year, I didn't see much of a takeoff. I read the numbers as a rather sluggish performance; I think real GNP growth for the year was something like 2-1/2 percent. I just mention that because I think it suggests that we can put too much emphasis on a current number and sort of extrapolate that, whether it is a strong number or a weak number. That is a risk. In terms of a specific vote, when I look at the actual numbers I have the same problem with these alternatives as I did with our long-range ones. We really don't have major differences between "A" and "B;" in fact, they are the same numbers, rounded, for M2 and M3. As for M1, I don't have great confidence in our ability to control that, period. So I am looking at the borrowing target. I prefer something closer to alternative A where the borrowing target would be closer to what we actually have been achieving. If we accompany that with a discount rate cut, I think we would find that the fed funds rate would not be hanging around 7-3/4 or 8 percent but would be down probably to 7-1/2 percent or below. So that is what I would like to vote for. In terms of a specific number for the borrowing target, that would be something in the neighborhood of, let's say, $250 to $300 million.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I think the employment numbers are not giving us a misleading signal on this occasion. If you look at the leading indicators in December, there was very broad strength in them. And, as I said yesterday, I think we are going to see a faster growth rate in the first half than we are now projecting. Sometime in the first half I think we will have to move to a firmer policy, but I think it is a little early to do so now. I would like to see the dollar come down a little further in the foreign exchange markets before we run the risk of halting that trend by moving interest rates up. So, I think the stand pat policy is appropriate for this meeting; I would support alternative B.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. First of all, I don't see that much difference in the alternatives either; I also rule out alternative C. But I am a little surprised that the difference between "A" and "B" is such a large difference in borrowings. I think "A" goes a little too far, if that is really the kind of borrowing level that we have to go to. But I don't want to close any options. I agree with Preston Martin to some extent that we ought to edge toward the lower end of recent experience in actual borrowings and leave the option open for a potential discount rate cut based on what we might see in the near future. I would like to keep that option open. There's talk of another Japanese discount rate cut, which could make it possible to [cut our rate] without the exchange rate fallout that might result if we did it under the current Japanese interest rate structure. We have some CPI data coming out, and it is going to be interesting to see what kind of CPI numbers or wholesale price numbers we get when we

start factoring in the oil price decline, which we haven't seen [in those numbers] yet.

CHAIRMAN VOLCKER. It may be too early. Just as a technical point, is that oil price decline likely to show up in either of those?

MR. JOHNSON. It may be too early, yes. I don't know.

MR. KICHLINE. We think there will be some effect in the CPI in January because spot gasoline prices have been dropping in retail markets. So we'll get a little, but very little.

MR. JOHNSON. When is that report?

MR. KICHLINE. February 25, which is Tuesday.

CHAIRMAN VOLCKER. I think we may have to wait a month or two beyond this January number to see any real impact, but I may be wrong.

MR. JOHNSON. There is some information there. Also, I think we ought to look carefully at the yield curve and how the yield curve is responding to all this information. Holding the funds rate at current levels and continuing to see the long-end rates decline and a further flattening of the yield curve--that is certainly not a warning sign of inflationary expectations. If in fact we continue to see that yield curve flatten out under these borrowing levels, then we ought to take the lead on that. And if the Japanese cut their discount rate further, I don't want to foreclose the option of another discount rate cut. So I would at least like to keep that option open and err toward the lower borrowing range in alternative B.

CHAIRMAN VOLCKER. Meaning $300 million?

MR. JOHNSON. Yes.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I think at least for now we pretty much have to stay with "B" as is--$300 to $400 million borrowing. I don't know what the future holds either, but trying to push it too hard now could back up on us.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. I also think we should hold steady at this point with alternative B and the borrowing range of $300 to $400 million with a little bias toward $300 million.

CHAIRMAN VOLCKER. Mr. Boykin or Mrs. Horn, do--

MR. BOYKIN. Alternative B, $300 to $400 million, would be my position.

MS. HORN. I support alternative B with the funds rate in the 7-3/4+ percent range.

CHAIRMAN VOLCKER. Well, we had no trouble arriving at a consensus for alternative B, whatever that means. What I think it

means in writing this directive is--. What did we say before? Did we say [unintelligible] as compared to 7 to 9 percent, 6 to 8 percent, and 6 to 8 percent? Is that agreeable? A more subtle, and I suppose important operational question, is how we play this. I don't even remember what the formal decision was last time on borrowing. Was it $350 to $450 million?

MR. AXILROD. It was $300 to $400 million and there was an outside range of $250 to $450 million, depending on--

CHAIRMAN VOLCKER. The outside range was $250 to $450 million and the inside range was $300 to $400 million and then it depended on all these factors, including the discount rate. Just for those who weren't there, the thought was that the higher borrowing would be appropriate with the lower discount rate rather than the reverse.

MR. BLACK. Absolutely.

CHAIRMAN VOLCKER. I think there are two things that bear upon how we conduct this from day-to-day; they're fairly obvious. One is that people have not wanted to encourage higher interest rates. On the other hand, I think the consensus was--though it may not be unanimous--that people didn't want to encourage a lower exchange market feeding upon itself, anyway, on the down side. As those two factors played out we ended up at least at the lower end of the range that we were discussing last time in terms of our intention. We're in a pretty narrow range here. I'm trying to sort out how to express it. I'm not sure we would capture all this if we said absolutely our lower limit on borrowing was $300 million. I'm conscious of the fact that we've been running below that. You can tell me, but I don't sense from the comments--basically the "stand-still" comments--that people would want to go up necessarily on the borrowing, or let's say, get toward $400 million right now, just for the sake of getting up toward $400 million if that meant the federal funds rate was moving up and the dollar was fine and all the rest. We might move up in other circumstances, but not in those circumstances. I wonder whether we capture this best with something like $300 million with some margin of flexibility higher or lower depending upon those other two factors particularly. Otherwise, maybe it could be worded as $250 to $350 million; it's the same thing, I guess.

MR. PARRY. Is a range of $200 to $400 million inappropriate?

CHAIRMAN VOLCKER. No.

MR. RICE. It's a wider range than we've been [using].

MR. GUFFEY. That might be--

MR. JOHNSON. It encompasses where we are now, though.

CHAIRMAN VOLCKER. Keep in mind that the borrowing at any time could be above even $400 million for some--

MR. RICE. A day or two.

CHAIRMAN VOLCKER. --for maldistribution or expectational reasons or whatever, but not as an intention. A $200 to $400 million range doesn't bother me, if it doesn't bother the Committee.

MR. BLACK. Can we ask Steve what the expected federal funds rate would be? Is it still 7-3/4 percent or--

MR. AXILROD. I'd defer to Peter, to a degree. If you lowered it down to $300 million, I think the odds on it being at 7-3/4 percent are increased and it might occasionally fall below that.

MR. STERNLIGHT. I think that's about right. In the context of, say, 6 weeks ago, when we were saying $350 million we were tending to associate that with 7-3/4 percent. But the intermeeting experience and changing market expectations about the discount rate would probably lead me to think that if you want even greater assurance of being around 7-3/4 percent, something centering around $300 million is more appropriate.

MR. RICE. $300 million did you say, Peter, would be consistent with 7-3/4 percent?

MR. STERNLIGHT. Yes, something centering around that.

CHAIRMAN VOLCKER. It's a matter of taste whether you want to say $200 to $400 million or $250 to $350 million, recognizing that even if you said $350 million it might well be $400 million or $200 million.

MR. RICE. I'd like a little above or a little below $300 million.

CHAIRMAN VOLCKER. Yes.

MS. SEGER. You would use $300 million to calculate the path either way, wouldn't you? If it went from $200 to $400 million or a little on either side of $300--

MR. AXILROD. We'd use whatever the Committee told us to use.

CHAIRMAN VOLCKER. Well, I think what you'd do is probably start off at $300 million, and that might vary, but be thinking that you might shade that as the week progressed depending upon what was happening. That's, in fact, what we do.

VICE CHAIRMAN CORRIGAN. What did you say the two main factors were that you had in mind?

CHAIRMAN VOLCKER. Well, on the one hand, a feeling about [not] deliberately pushing up interest rates on the one side or deliberately pushing down the exchange rate on the other side. Other factors obviously can enter in, but if important factors intervene we would have a consultation.

MR. MELZER. Is there any feeling that if we moved to $300 million, that would show through and could possibly be construed as an easing in the degree of reserve restraint coming out of this meeting?

As far as the foreign exchange market goes, I think that would not be a particularly timely conclusion.

CHAIRMAN VOLCKER. My assumption is no. But I would think we would express this as unchanged, given what's been happening recently within--

MR. GUFFEY. But the market wouldn't see that for another six weeks.

CHAIRMAN VOLCKER. Well, it's a relevant question. Maybe I'm wrong, but I was going on the presumption that they wouldn't see it at all, given that we've had a couple of periods when we've been below it. That is my interpretation of an unchanged posture; or that would be perfectly consistent, anyway, with an unchanged posture.

MR. BLACK. That's an awfully good question. Could we ask Peter and Steve what they think about it?

MR. STERNLIGHT. I think there has been enough variation from period to period that there wouldn't be that much notice taken if we were centering around the $300 million.

MR. JOHNSON. That's my point. Given what we've been doing, some people could even interpret that as a tighter policy.

MR. AXILROD. I don't think it would be interpreted that way at all, Governor Johnson. Conditions may [unintelligible] the market to react and they don't, as Peter said. But I would--

CHAIRMAN VOLCKER. Well, I set it forward with a feeling that it is unchanged. I don't think the market would interpret it [differently], but I'm not--

MR. STERN. Assuming the funds rate stayed in the 7-3/4 to 8 percent area and didn't do anything that would lead the market--

CHAIRMAN VOLCKER. It seems to me that the funds rate, at times at least, has been surprisingly high considering the borrowing. If we got a different relationship somehow and [market participants] got it in their heads that--. The funds rate in the very short run is half psychology anyway; it is where they think it should be. So I can't rule out that if we did this, the funds rate might settle down in the lower range; but it hasn't so far.

MR. AXILROD. It might be useful to note, Mr. Chairman, that the funds rate, which had averaged 8 percent in November and 8-1/4 percent in December, since mid-January has averaged on the weekly numbers 7.94, 7.87, and 7.83 percent. And up until very recently it has been at 7-3/4 percent. So most of the time, in a sense, it has tracked down since the last meeting.

CHAIRMAN VOLCKER. Well, just in terms of Mr. Melzer's question, at the last meeting we said we were easing a tiny bit. I think what could be happening and has happened--if somebody wanted to look at it through a magnifying glass--is consistent with that in terms of the funds rate. But my interpretation of what we're saying is that we would not be saying that this time.

MR. MELZER. If that's the judgment of the impact it would have, it probably wouldn't be perceived that way. It's something you're totally sensitive to, so that's satisfactory as far as I'm concerned.

CHAIRMAN VOLCKER. Do I hear objections?

VICE CHAIRMAN CORRIGAN. I would just make one point. It gets me into the zone of nervousness, I'll tell you that! The point I would make is this: I think there is a danger that even if the Japanese, for example, were to lower their discount rate again and through a process of events we were to end up lowering ours, the net result of that could very well be greater pressure on the dollar, even though the spread in some sense wouldn't be any different than it is today. And that, in the short run, is the principal focus of my being in the zone of nervousness. But I can--

CHAIRMAN VOLCKER. Well, I share that nervousness. Maybe there should be more comment in the short run. One comment on that external point: Everybody loves to sit around waiting for us to change our discount rate before they change theirs. If you look at Japan in particular--there was some mention of this yesterday--they're going to have an exceptionally favorable inflation rate this year and so are the Germans. From an already good record, they have two big influences working in the same direction: the exchange rate and the oil price. I forget just what the short-term Japanese rates are; they're 5-1/2 percent aren't they, Ted?

MR. TRUMAN. I think they're a little higher than that.

CHAIRMAN VOLCKER. Well, if anything, a little higher than that. Their real rate--

MR. TRUMAN. They're a touch above 6 percent.

CHAIRMAN VOLCKER. Okay. Their real interest rate--depending on the importance you attach to that in the short run--is something like 6 percent. It's much higher than ours; the German rates I guess are less striking, but nonetheless--

MR. TRUMAN. They are 4-1/2 percent.

CHAIRMAN VOLCKER. There is one country, Japan, with its growth prospects really pretty dead, particularly against the Japanese potential, and another country with an unemployment of 9 percent, both of which have higher real interest rates than we do. You sit around and say: Why don't they move?

MR. RICE. I don't quite understand what Jerry was saying. Are you saying we should be firming up a bit for you to stay comfortable?

VICE CHAIRMAN CORRIGAN. No, no. The discussion, as I heard it--I don't know what the numbers will end up being--was in the context that we were talking about a borrowing target of $200 to $400 million or $250 to $350 million with an initial level of $300 million.

MR. RICE. Presumably, that's no change.

VICE CHAIRMAN CORRIGAN. Well,--

CHAIRMAN VOLCKER. That depends.

VICE CHAIRMAN CORRIGAN. I guess I will accept that. But I'm on the nervous side because my druthers would have been to tilt a little the other way, but I can't make a federal case out of it. In other words, I would try to aim more toward hitting the borrowing target that has been in the path all along.

CHAIRMAN VOLCKER. And what I would say, just as an observation, is that if we aim pretty religiously at $350 million, that would de facto be a little tightening from where we are. That's saying the same thing in the opposite way. It's in a pretty narrow range.

MR. MARTIN. Mr. Chairman, it seems to me you've expressed well two of the factors that we must consider in this short-run goal setting and that is the rather overworked [unintelligible] projection of the change in the price of oil and the known change in exchange rates. But I would hope that the impact of the change in the price of oil would predate the impact of the exchange rate changes because of the contracts, the business relationships, the investment and distribution systems and all the rest of it. And, therefore, I would hope that we would have a window here--to use another overworked cliche; it's cliche day at the Board--for a brief time to move the fed funds rate down by moving the borrowing rate. We should take advantage of it.

CHAIRMAN VOLCKER. Well, let me just look at the language here. What we'd be saying is "maintain." And we would use whatever these numbers are for M2 and M3: "6 to 7 percent, respectively, while the growth of M1 is expected to be at an annual rate of"--what do we say, about 7 percent?

MR. FORRESTAL. About 7 percent, right.

CHAIRMAN VOLCKER. We've come to Mr. Black's "would" and "might."

MR. BLACK. I thought I deserved equal time since Pres had made that charge of asymmetry.

CHAIRMAN VOLCKER. We had it asymmetrical toward the easing side last time. Do you want to make it symmetrical?

MR. BOYKIN. I would.

MR. MARTIN. No.

MR. BLACK. I favor symmetry.

CHAIRMAN VOLCKER. Suppose we made it symmetrical by using might in both circumstances? Would that suggest that neither one is all that [likely]?

MR. KEEHN. Yes.

MR. JOHNSON. That's a posture of [unintelligible].

SPEAKER(?). Take what you can get.

MR. BLACK. It's better than what we had--let's put it that way.

CHAIRMAN VOLCKER. The federal funds rate is still in the middle of that range of 6 to 10 percent. What it would say is: maintain; 6 to 7 percent; might and might; and 6 to 10 percent.

MR. GUFFEY. What's the understanding on borrowing?

CHAIRMAN VOLCKER. Well, $300 million, however you want to express it: $300 million plus or minus; $250 to $350 million; I don't care. It all amounts to the same thing, I think.

MR. GUFFEY. $250 to $350 million?

CHAIRMAN VOLCKER. Express it any way you want.

MS. SEGER. You predict that that would keep the fed funds rate in the same neighborhood as it has been. Am I reading you correctly? Is that close--

MR. STERNLIGHT. Well, in the recent period it has been averaging about 7-7/8 percent; I think something centering around the $300 million ought to give us something like 7-3/4 percent or maybe a hair over that.

MS. SEGER. What has been the daily high on the funds rate in the last couple of weeks?

MR. STERNLIGHT. Well, today it happens to be at 8 percent for reasons that are a little obscure right now.

MR. AXILROD. And when the Treasury balance was especially high, it was at 8 percent, too. There were a couple of 8 percents.

MR. ANGELL. Mr. Sternlight, what would happen to the fed funds rate if economic growth came in somewhat weaker?

MR. STERNLIGHT. It would probably work on expectations; as the Chairman said, that's a big part of the daily framework in which the market participants set the funds rate. If they see economic numbers come out that lead them to think that we're going to be more accommodative, even before we do anything there could be a tendency toward a lower funds rate. Beyond that, there is the opportunity in the context of the directive you're writing to make adjustments in the borrowing level. That could have its impact on the funds rate as well.

MR. ANGELL. So, lowered economic conditions, lowered inflationary pressures, provide ample opportunity--

MR. STERNLIGHT. It would work in the direction of a lower funds rate.

MR. ANGELL. And in view of this policy that we're looking at, under those circumstances the members of the Committee would accept the market's sense of adjustments in the fed funds rate and the other rates that might be relevant?

MR. JOHNSON. If we talk only in terms of a borrowing level, those conditions would produce a lower funds rate. Would we say something about the funds rate or would we adjust the borrowing level? It depends on which we emphasize.

CHAIRMAN VOLCKER. There is some flexibility here in adjusting the borrowing level. But I think one would have to put a few other ingredients in here to have confidence in what we would do or what the fed funds rate would do. What are those price figures going to show? What's the exchange rate going to be doing in a couple of months?

MR. ANGELL. Well, I can accommodate to that kind of policy if it would appear that the fed funds rate would be sensitive to market forces, particularly if the oil price decline turns out to be as great or greater than we anticipate. I lack understanding as to how the fed funds rate has remained as stable as it has over the past seven months, given even some wording of a slight change in pressure.

CHAIRMAN VOLCKER. It's anyone's perspective. Considering how little we [have done] in changing things, the federal funds rate--even on a week-to-week basis--just strikes me as being rather volatile. That all [depends on] where one comes from, I guess. We haven't been doing much in changing this and the funds rate has been surprisingly high, considering M1 and these statistical relationships. Sometimes it aggravates you, but basically it hurts you because we're not sitting on it within a 1/4 of a percentage point or an 1/8 of a percentage point the way we used to.

MR. ANGELL. But I haven't seen two-week averages in the 9 percent range nor at 7 percent.

CHAIRMAN VOLCKER. That is correct.

MS. SEGER. We won't see it at 7 percent with the discount rate at 7-1/2 percent.

MR. STERNLIGHT. It did get up almost to 8-3/4 percent in that period when there were a lot of year-end pressures. But the market recognized that as something rather special and they weren't greatly concerned.

MS. SEGER. If you used approximately a $300 million borrowing target but accompanied it with a discount rate cut, what kind of fed funds results would you expect?

MR. STERNLIGHT. By roughly the amount [of the discount rate cut].

CHAIRMAN VOLCKER. Well, I think we're ready to vote. I don't know if anybody wants to pin down whether we're saying $300 million plus or minus or $250 to $350 million or $200 to $400 million. I interpret them as equivalent.

MR. JOHNSON. They're all the same.

CHAIRMAN VOLCKER. I don't detect any policy difference between those ways of expressing it; I don't know if somebody else does. We can discuss it, but on the understanding that those are roughly equivalent maybe we can proceed.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Black	Yes
President Forrestal	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Martin	No
President Parry	Yes
Governor Rice	Yes
Governor Seger	If this precludes a discount rate cut, then I will vote No

CHAIRMAN VOLCKER. I don't think it precludes anything. That's a separate decision.

MS. SEGER. I think I'll still stick with "No."

MR. BERNARD. [Continuing the roll call on the vote]:

Governor Wallich	Yes

CHAIRMAN VOLCKER. All right. I guess the meeting is concluded.

END OF MEETING