

Meeting of the Federal Open Market Committee

October 21, 1980

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, October 21, 1980, at 9:30 a.m.

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

Messrs. Balles, Baughman, Mayo, and Timlen, Alternate Members of the Federal Open Market Committee

Messrs. Black, Corrigan, and Ford, Presidents of the Federal Reserve Banks of Richmond, Minneapolis, and Atlanta, respectively

Mr. Altmann, Secretary
Mr. Bernard, Assistant Secretary
Mr. Petersen, General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Mannion, Assistant General Counsel
Mr. Axilrod, Economist
Mr. Holmes, Adviser for Market Operations

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

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

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

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Mr. Coyne, Assistant to the Board of Governors
Mr. Prell, Associate Director, Division of Research
and Statistics, Board of Governors
Mr. Smith 1/, Assistant Director, Division of Inter-
national Finance, Board of Governors
Mr. Beck, Senior Economist, Banking Section, Division
of Research and Statistics, Board of Governors
Mr. Morton 1/, Economist, Financial Markets Section,
Division of International Finance, Board of
Governors
Mrs. Steele, Economist, Open Market Secretariat,
Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat,
Board of Governors

Mr. Smoot, First Vice President, Federal Reserve
Bank of Philadelphia

Messrs. Brandt, Burns, Danforth, Parthemos, and
Scheld, Senior Vice Presidents, Federal Reserve
Banks of Atlanta, Dallas, Minneapolis, Richmond,
and Chicago, respectively

Messrs. Bisignano, Mullineaux and Sloan, Vice
Presidents, Federal Reserve Banks of San
Francisco, Philadelphia, and Chicago, respec-
tively

Mr. Levin, Manager, Securities Department, Federal

1/ Left the meeting prior to the action to amend paragraph 1(a) of the
Authorization for Domestic Open Market Operations.

Transcript of Federal Open Market Committee Meeting of
October 21, 1980

SPEAKER(?). Mr. Chairman, I move that the minutes be approved.

CHAIRMAN VOLCKER. Without objection. Mr. Pardee.

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

CHAIRMAN VOLCKER. Questions?

MR. MORRIS. Scott, if they don't like either the dollar or the deutschmark, where are they going to go?

MR. PARDEE. Sterling, gold.

MR. MORRIS. That much in sterling?

MR. PARDEE. A lot has gone into sterling, into Swiss francs, and particularly into yen. The Swiss franc has advanced in the last few days against the mark.

MR. WALLICH. Do you see any systematic move to diversify out of D-marks or is this footloose money that moves around all the time?

MR. PARDEE. It's probably in between. There are footloose funds, but what we're hearing--we don't have a real term for it--one might call reverse diversification.

CHAIRMAN VOLCKER. Diversification?

MR. PARDEE. Shifts of funds out of the German instruments and the dollar. [It may involve] OPEC, a central bank, a noncentral bank. It's on the margin that these people operate. They're getting so much money each month, they decide which way they're going to move it; or when there are maturities, they move the money at that time.

MS. TEETERS. But the increased pressure on the mark is something that has just developed in the past week, isn't it? Why this week, instead of before? Most of the factors that would be pressing the mark have been there for quite some time.

MR. PARDEE. I know. That is one of the questions that even some of the seasoned traders are asking: Why now and not two months ago when all these factors emerged? It's a coalescence of things. In some ways it reflects the post-electoral situation. In Germany it was important for the Bundesbank to maintain high interest rates through the election because the whole idea was that they were fighting inflation. Now that the election is over and they're looking at very slow growth and other domestic problems, the market may feel that the Bundesbank may ease up at this stage. Also, some comments were made during the IMF-World Bank meeting that afterwards rattled around the press pages for several days suggesting that President [Pohl] was talking in terms of lowering interest rates. He had not said that but that's the way the press played it after a while. So there had been these expectations. And by the time the Bundesbank did act, no one was listening. It's one of these bearish situations where anything

positive for the currency is ignored. We've seen it so many times on our side; we know all of the symptoms. But as I say, it's essentially a bearish market. It could pass. They may have some good numbers coming up. If their economy does slow, then their current account will improve.

VICE CHAIRMAN SOLOMON. Another way of putting it is that we're seeing a market reaction to a much more sensible and balanced German policy. There used to be an impression that more than any other single objective the objective of German policy was a strong and appreciating Deutschemark. People are seeing now a Bundesbank policy, pushed by the government as well, toward an easier domestic monetary policy even with a large current deficit and even though the mark tends to be toward the lower end of the EMS. I think the Germans ought to be congratulated for following a more balanced and less single-minded policy. It certainly is helpful in terms of world stability as well as in terms of the U.S. dollar. Do you agree, Mr. Chairman?

CHAIRMAN VOLCKER. Not fully. Governor Rice.

MR. RICE. I just wanted to inquire whether there has been any official German reaction that has been noticed in the market.

MR. PARDEE. Official reaction?

MR. RICE. Yes, any official reaction. Do they seem to be panicking in the government or are they, as Mr. Solomon suggested, playing it cool, so to speak?

MR. PARDEE. On the outside they are playing it very cool because it's hard for them to know what else to do. They are very concerned. Of course, we have helped them a great deal; we are buying these marks in very close consultation with them. And our two central banks are coordinating their intervention very closely. So, we haven't had a panicky situation in the exchange market. In the way they handled the rollover of one of these provisions of liquidity they did move the interest rate up a little to warn the market that they aren't caught in a fixed interest rate situation where they can only go in one way. But it's a very uncomfortable situation. In fact there have been crazy rumors in the market. One was that they were going to put on capital controls. There's no way [a government] can answer that sort of rumor when it comes out. It can't deny that it's going to put on capital controls because then everybody will say: Aha, they're denying they're going to put on capital controls; therefore, they're going to do it. Yesterday there was a rumor that Russia had invaded Poland. It hadn't happened, but it added to some of the flavor of sales of marks. So there is, as you put it, outward cool. But they are quite concerned about the situation.

CHAIRMAN VOLCKER. I saw something in the paper yesterday or the day before that the head of the German Federation of Business or something said they ought to devalue. That's the first time I've seen anything like that, I think.

MR. PARDEE. We are seeing the type of traditional strains within the European monetary system that we frequently saw in the earlier "snake." That is, the mark is declining and pulling other

strong currencies within the band down, like the French franc and the Dutch guilder. In the past when someone left the snake or there was a change in par values, the whole thing snapped back giving profits to everybody on both sides. So, if the pressure continues to build, we could run into one of these classical speculative sprees that we have had in the past, this time with the mark on the bottom.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. I just wanted to ask Scott about a very interesting development I noticed. As I recall from the reports, Scott, for the first time since 1971 you've made some outright purchases in the forward market. I was just wondering if in your view that kind of intervention in the forward market has any more stabilizing influence on exchange rates than outright purchases in the spot market?

MR. PARDEE. Well, in fact it's quite the contrary. This is an operation for the Treasury. We're doing it as quietly as we possibly can. We've only talked with a very few people in the market. The objective is to see if we can acquire more marks [through] a few people who have good corporate customers. When the corporation calls in and says it has some forward marks to offer, then the trader can offer them to us. The Treasury, of course, has its own maturities to consider on the Carter notes. So the forward marks in addition to what we're buying spot are simply placed with the Treasury for that purpose. We're doing it as quietly as we can and on the idea that it would have less impact than intervention in the spot market. There's a great deal of flexibility in the forward market and it doesn't have the same influence. We're doing it also as quietly as we can because our experience in the past is that once the forward market gets active and finds us there, then we can do billions without blinking an eye. So it's a very, very dangerous operation. But the Treasury wanted it and they're getting it.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I'd like to point to a broader matter. I [will try to] be very brief. We may be facing a situation we had early this year [when] the dollar was very strong--this time not so much because our interest rates are rising as they did at that time but because the mark is weak. And we may find ourselves either having the dollar go up or with a possibility of accumulating a fair amount of D-marks. Now, last time we operated so as to allow the dollar to run up pretty far; it came down again. We had a very pronounced upward and downward trip which did no particular good. We didn't accumulate or gather in for repayment a very large amount, although we did do some but over time. We didn't pay all [our mark indebtedness] off and we could have done so at that time. Now the question really is: If similar conditions develop, and there's no assurance that they will, should we follow the same strategy or should we follow a different strategy? That is, should we lean harder against the wind, which in this case would mean not just to gather in [marks] to pay off debt but to accumulate some reserves which might be split with the Treasury or be all for the Treasury or all for us. There's a problem of risk in financing to be considered. But I believe we should think ahead a little and not just leave it to the developments of the day.

MR. SCHULTZ. But we're coming up pretty close to the limit right now. We do we have left--a hundred and what?

MR. PARDEE. There's \$160 million left under the limit on marks. We've already purchased \$55 million worth of marks this morning and we would under the--

CHAIRMAN VOLCKER. Well, we in the government are no way near being in this position. The Treasury is \$2 billion in debt, as Scott said. And they would like to cover their debt so there's \$2 billion to go. They have a few problems in terms of the rate of speed with which they accumulate balances, because of cash problems, which raises a question of whether we can put some element of flexibility in here.

I disagree with you on the value of letting [the dollar] go up earlier. It may be that the reason why the dollar didn't go down further was that the market had seen that they lost some money when it was going the other way. That doesn't mean that we've got to do it that way again. But I don't think one can say that that was meaningless. You can argue about whether it's disconcerting to have it go up--

VICE CHAIRMAN SOLOMON. But I would agree with the implication of Henry's point. I think this time there ought to be more emphasis on accumulating deutschmarks and building Treasury balances. And then if it goes that far, we could always raise the limit here and not let the rate go as much as we did last time, Paul.

CHAIRMAN VOLCKER. Well, that's a different question. I don't know how much influence we have on the rate anyway.

MR. PARTEE. But both of your comments imply that you know what the rate ought to be--that you think the rate has gotten too high and that it's going to come back down again. Now, do you know that with that degree of certainty?

MR. WALLICH. No. We wouldn't be forcing it back down. It's just that as it goes up we would accumulate some D-marks. And if it doesn't come back down, which is highly possible, then we would have built up some reserves and we would have slowed down the movement, which I think is desirable in any event.

MR. PARTEE. Well, if it's a fast movement, I will agree.

VICE CHAIRMAN SOLOMON. Well, Chuck, the only answer I can give you is that I think we know a little more about what is a desirable--to use a dirty word--target range than we do about monetary aggregates and interest rates.

MR. PARTEE. I'm not so sure we do.

CHAIRMAN VOLCKER. That doesn't pin it down very much!

VICE CHAIRMAN SOLOMON. The Germans are running at an inflation rate of 5 percent or less and we're running at 10 percent or whatever rate you want to call it. Eventually there will be a reversal of this movement. I do not think that we get points--we ought to let the dollar rise sufficiently so that traders do not tend

to be bearish on the dollar. They can be caught off guard. But on the other hand, unnecessary volatility on the up side which one knows is going to get reversed later is not helpful. It goes beyond the point of keeping the traders off balance. And I think we have shown in the last couple of years that a more activist policy in regard to the exchange markets is a useful policy. So we don't have to have an exact sense of what an equilibrium rate is to know that at some point we want to limit the volatility on the up side and take advantage [of opportunities] to restore balances.

MR. PARTEE. My only point, Tony, is that I can remember sitting here not too long ago and hearing that if the rate dropped below 2, the end of the world would be at hand. Well, we're not even back to 2. I agree that it slips with time and perhaps what was 2 then ought to be 1.90 now because of the differential in inflation rates. But it requires some care, I think, not to accumulate large balances that in fact turn out to be, as on the down side, a resistance to the tide that really can't be resisted and then results in a large ultimate loss for the central bank.

MR. PARDEE. It doesn't matter how much reserves you have; [what matters is] the determination that you're going to use them and the market's confidence that you're prepared to back your policies. You can have an infinite amount of reserves--

CHAIRMAN VOLCKER. Well, let's take this up in a little more orderly way. We have to ratify the transactions since the meeting on September 16. Do I have a motion?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection, we shall approve them. You have no recommendation with respect to the swap lines, I take it, because we're out and the French [drawing] is not maturing.

MR. PARDEE. Right.

CHAIRMAN VOLCKER. We have this question of changes in the terms of the swap agreements on which we have a memorandum. Just by way of background, the Committee agreed to this in principle. I don't think it requires a formal action. In 1978 there was no formal action, was there?

MR. ALTMANN. No, not on these issues.

CHAIRMAN VOLCKER. It was, in effect, an authorization for negotiation. You have a memorandum describing this again. It basically comes to the conclusion that we probably would have been better off financially [if the proposed changes had been in effect] in the past. Nobody can promise that [will be true] in the future, certainly not on any individual operations. We have had some further discussions with the Treasury. The situation the last time [we considered this question] was that the Treasury had agreed in principle, too, but didn't want to do it at that particular time when we were becoming very active again [in foreign exchange markets] and there was a question of raising an issue which may have been a

complicating factor at that point. The Treasury is agreeable to changing. They have at least one swap that should be parallel in the Exchange Stabilization Fund, and they would consult with Congress about that. And they are prepared to do so if we agree in principle. I don't think we have to take any formal action now other than understand that this [change in swap line terms] is going forward if we want it to. Then we would formally agree, I take it, when the swaps come before us in a renegotiated form. Is that correct?

MR. ALTMANN. No, the authorization says that the Committee should consider and approve changes in terms. What we've done in the past is to have the Committee vote to authorize the Manager to conduct the negotiations toward that particular end.

MR. PARDEE. That's right. I would have a hard time coming to you in November with a whole series of new swap arrangements for you to approve once again if I hadn't had a chance to negotiate these particular items.

CHAIRMAN VOLCKER. There's no question that you have to have the authority to negotiate. I just don't know how formal the action has to be. I don't think we should go ahead unless we're going to approve this when it comes before us. That's what I want to find out.

MR. ALTMANN. What we've done each year, usually in November, is to approve the renewal of the swap agreements as far as the individual currencies, central banks, the amounts, and the 12-month terms. But any other changes in terms have been in the form of an authorization to the Manager to negotiate terms without our being very specific in the Minutes of Actions as to what those terms and conditions were.

CHAIRMAN VOLCKER. Well, I think you may be saying the same thing I did in different words. I don't want to be very specific.

MR. ALTMANN. I'm only saying that there has been a vote.

CHAIRMAN VOLCKER. I don't know whether the Congress is going to approve and I don't know that I want a formal vote at this point. But I certainly want the opinion of the Committee as to whether they're going to approve this [proposal] formally next month, if that's when it comes up, if this is renegotiated. Is that thought to be a good idea?

VICE CHAIRMAN SOLOMON. Okay. Why don't we see if there's any objection to it?

CHAIRMAN VOLCKER. That's what I am asking.

VICE CHAIRMAN SOLOMON. I think it makes a lot of sense to do this. I assume that you will touch base with the Treasury and that you will [negotiate] on behalf of both the Federal Reserve and the Treasury--that's my understanding with the Treasury--unless Treasury voices [a contrary view].

CHAIRMAN VOLCKER. Well, I don't know about that. Somebody will--

MR. WALLICH. The situation has become more and more disagreeable as our interest rates rise above German rates and we pay our interest rate for borrowing in D-marks. They pay the D-mark rate. Now, the expected gain and loss--I fundamentally agree with Tony that over time inflation will have its way on exchange rates--in the short run, of course, is very unpredictable. So one can't be sure that the surrender of the profit and loss sharing will have the "expected effect." But that just means that one focuses on the gain in interest from switching to the D-mark rate instead of the dollar interest rate.

MR. PARTEE. It's really a very complicated question, isn't it? I was impressed by the memo, which did indicate clearly that we would have been ahead if we had run it the other way. But it depends on the presumption that the strong currency will have the lower interest rate. Now, that's not true in the case of sterling where the interest rate is higher than elsewhere and the currency is stronger. Do we know that it will always be true of the mark?

CHAIRMAN VOLCKER. No.

MR. WALLICH. Well, there is a--

MR. PARTEE. Do we know that our interest rates will always be high? It just seems to me that the relationship is complicated. That's the only thing I'm saying. And I don't fully understand it, because I think it probably involves a question of meshing of monetary policy worldwide, or at least among the major countries. I don't think they'll agree to that.

CHAIRMAN VOLCKER. Theoretically.

MR. WALLICH. At the very abstract level, there is reason to think that the difference in interest rates equals the expected exchange rate change, because why would anybody hold a currency if he can make 3 percent more in another currency unless he fears that he loses at least 3 percent going in?

MR. PARTEE. Because the inflation rate must be another--

MR. WALLICH. That means inflation is part of the basic [calculation]. Inflation differentials tend to equal interest rate differentials and inflation differentials also tend to equal expected exchange rate movements. If you can swallow these abstractions, which are tremendous ifs, then you'd have a very neat pattern where the return on every currency is--

MR. PARTEE. Equal.

MR. WALLICH. Exactly.

MR. PARTEE. Well, I understand.

CHAIRMAN VOLCKER. Theoretically.

MR. MORRIS. I don't think the issue ought to be decided on the question of whether we make more money one way or the other. It seems to me that the terms of the present system reflect a period when we were reluctant interveners in the market. Now that situation has

changed, and, quite apart from the dollars, it no longer seems appropriate for us to proceed with this kind of system.

CHAIRMAN VOLCKER. Well, there are various considerations. Theoretically we ought to be a little better off. That theory is not going to be borne out in practice all the time. But there are these other considerations in that [the proposed terms] look more symmetrical--in fact are more symmetrical--and the foreign countries want us to do it that way. I take it in the case of sterling that they've always refused to do it the other way anyway. In that particular instance, we just haven't done any [swaps] with sterling. We don't anticipate any, but it could happen. And it could happen that sometimes we will do it when we get stuck on the interest rate. When this interest rate was originally negotiated in the early '60s I'm sure that the U.S. presumption was that U.S. interest rates would always be lower than the foreign rates. But that was a somewhat different world. It hasn't been borne out in recent years, anyway. But it could happen again.

MR. PARTEE. Yes, in the past we always assumed we would have a lower rate. We now seem to be assuming that the Germans will always have a lower rate.

CHAIRMAN VOLCKER. We can't forecast that. The experience shows that the theory has been more or less borne out recently. But I'm not going to stake my life on that in the future. There are going to be instances where it doesn't work out, I'm sure, as there were in the past. Mr. Mayo.

MR. MAYO. I would favor going ahead with this, Mr. Chairman. I have just two points. The loss and gain business doesn't make it any harder for us to explain this to a busy Congress under the new system than under the old. As far as I'm concerned, we shouldn't worry about the losses and gains except on general principle. And I find Henry's equation and the equation in effect that's in the memo easier to understand than our own equation on domestic monetary policy. So, I would favor going ahead with this. I think it's the right course.

CHAIRMAN VOLCKER. Is that the general view?

SPEAKERS(?). Yes.

CHAIRMAN VOLCKER. I just want to make sure because if we go ahead now we may run into some problems in the next month, more internally than externally, I suspect. But what we'll look toward is negotiating it that way. Would we [ordinarily] have approved these in November or December?

MR. PARDEE. In November, because the first renewals are in early December. So we have to act between now and November.

CHAIRMAN VOLCKER. What we are saying, without objection as I understand it, is that we would go ahead and negotiate to this end assuming that we don't run into some roadblock here or abroad, though more likely here. I don't think we will, but I can't be sure. Now we have this remaining question--I don't think we have to debate the whole problem at this stage--of how much in foreign currency balances

we want to hold or should properly hold over time. I do think there's a case [for some accumulation of balances]. I say that because the Treasury is so far in debt that there is quite a bit of absorptive capacity in the United States government for the next month or two anyway. But there is a problem with the Treasury's management of its cash. Just how that is going to be worked out, I don't know. We are going to have some discussions with them, and I think it might be helpful to have some more flexibility in holding D-marks anyway. That is the area in which the Treasury is short and eventually they are going to want to cover this \$2 billion at least. As I understand this, we're operating on a rather informal understanding now in this area. The present limit, which was informally agreed to quite a while ago, is not in an authorization; it is not in any written directive.

MS. TEETERS. Is the problem that the Treasury wants us to warehouse the marks?

CHAIRMAN VOLCKER. Well, if it's warehousing, it doesn't come within this limit. If that's the way it is worked out, there is going to be no problem for the time being. They may just do more forwards and I suppose theoretically we could swap-out some of this spot stuff and buy it back forward for the Treasury. We can just hold some for a while until they're ready to take it. There are several options; I just don't know the answer to it. But I would propose that it doesn't hurt to have enough flexibility to go to, say, \$1 billion during this period while we're working this out. The more general question can be discussed in the fullness of time, but I don't think we have to discuss it right now.

MR. GUFFEY. Don't we have in place warehousing agreements with the Treasury where they permit us to accumulate mark balances?

CHAIRMAN VOLCKER. Yes. Well, it's not that they permit us; we permit them and we'll take them back. That's one of the considerations we'll be looking at--whether they want to do it that way. There are several ways this might be worked out, all of which have pluses and minuses from the Treasury's standpoint. They have a debt-ceiling problem, too, among other things. And I don't think they can be seen warehousing currencies with us in indefinite amounts to avoid a debt-ceiling problem. There are a number of considerations that bear upon this. I would simply suggest--I don't think it's out of keeping with our long-term needs--that going up to \$1 billion, which does not strike me as very excessive considering the amounts by which we have gone into debt on the other side, would give us some flexibility.

MS. TEETERS. The current limits are what--\$1 billion of all currencies except the yen and \$1 billion of yen? And then there is a \$500 million limit on any currency within the overall \$1 billion limit. Is that correct?

CHAIRMAN VOLCKER. Other than yen.

MS. TEETERS. Other than yen. And you're suggesting that we go up to \$1 billion on the D-mark alone?

MR. PARTEE. How about the aggregate?

MS. TEETERS. What about the aggregate, yes?

CHAIRMAN VOLCKER. I suppose we'd have to put that at \$1-1/2 billion, say.

MR. PARTEE. Make that \$1-1/2 billion?

CHAIRMAN VOLCKER. That would leave us where we are except [to allow] another \$500 million on the D-mark.

MR. WALLICH. You're making a very modest proposal.

CHAIRMAN VOLCKER. This is just a holding action to give us a little flexibility at the moment, that's all.

MR. GRAMLEY. Is it likely to be enough to last us until next month?

CHAIRMAN VOLCKER. Well, it might not be. I'm perfectly happy to go higher if the Committee wants to. And if it's not high enough and we run into a problem, we can come back [to the Committee].

MR. GRAMLEY. Maybe we can get some understanding from the Treasury on warehousing. It would be to our advantage to encourage the Germans to continue to follow a more relaxed policy, as Tony has been talking about. Given the developments in the world economy, we can't afford to have Germany go back to a very tough monetary policy.

CHAIRMAN VOLCKER. I only suggest \$500 million to give us a little maneuvering room; I would come back if I thought that created a great problem. The basic philosophy that is being expressed I agree with. I just don't think it's necessary to make it a very high limit right at the moment. It probably isn't necessary operationally.

MR. WALLICH. Well, it gives the impression that \$500 million is a lot of money in this particular game, whereas actually if the market should be weak for the D-mark we could use up a good part of that in a day.

VICE CHAIRMAN SOLOMON. Could we authorize now on an interim basis a move up to, say, \$1-1/2 billion in D-marks?

CHAIRMAN VOLCKER. We can if you want to.

VICE CHAIRMAN SOLOMON. It seems to me that the--

CHAIRMAN VOLCKER. I do think we'll try to work something out with the Treasury so that they are, in effect, taking the first \$2 billion. So I think we have more room. But if that isn't easy to work out, that's when we will run into the problem.

VICE CHAIRMAN SOLOMON. It is possible that one of the options that could finally prove most satisfactory to the Treasury and ourselves in regard to their cash problem [would] also involve charging this against our own balances. It would be useful to have a higher limit on DM holdings because [that is] one of the options, although it is not likely [to be needed]. Warehousing doesn't require it. It seems to me that if there's no opposition within the Committee

it just makes sense to put ourselves in a position where we do have some extra margin. And an interim authorization to hold up to \$1-1/2 billion in DM seems to make some sense.

MR. PARTEE. I'd be more comfortable with \$1 billion myself; I feel uncertain about it.

CHAIRMAN VOLCKER. I have no problem going up to \$1-1/2 billion. I personally have no problem with going higher in a long-run context. But I think that raises other questions.

MR. GRAMLEY. What about an arrangement whereby we grant up to \$1-1/2 billion, but the extra \$1 billion is not used unless we feel fairly certain that arrangements can be worked out with the Treasury, however we work it up. That would give us the additional freedom and still meet Governor Partee's concerns.

CHAIRMAN VOLCKER. Well, I just don't know. I suggest \$500 million in the knowledge that we can always come back to the Committee if we need more. The way you worded it makes it sound a little more restrictive--that the presumption is we won't come back. But I guess we're [talking] nuances here. I'm perfectly happy to add \$1-1/2 billion, if that's the way you want to go. I'm perfectly happy to go with \$1 billion with a footnote that if the Treasury for some reason can't [finance more marks] very readily and we run into the kind of problem you're talking about, we may well want to come back and indicate that we want more than the \$1 billion.

MS. TEETERS. What has been the size of your D-mark purchases recently?

MR. PARDEE. Yesterday we bought \$200 million equivalent of marks. On other days we've bought \$10 million. The amount varies depending on the pressure. Today we've already done some \$85 million.

MR. PARTEE. You bought \$200 [million] for our own account yesterday, Scott?

MR. PARDEE. To be split between the Federal Reserve and the Treasury. We're splitting it down the middle all the way, except there are certain transactions that the Bundesbank insists the Federal Reserve take rather than the Treasury. But basically we're splitting it.

VICE CHAIRMAN SOLOMON. I don't think it's important whether it's \$1 billion or \$1-1/2 billion. Since Chuck feels so strongly about it, let's keep it at \$1 billion.

MR. PARTEE. Well, I don't feel too badly as long as it's on a consolidated basis, so to speak, and we're not holding a significant cash balance. But I always get concerned because of the parallel, let's say, with buying [unintelligible].

CHAIRMAN VOLCKER. Why don't we go to \$500 million more now but with the understanding that if we run into a problem, we'll be back to the Committee.

VICE CHAIRMAN SOLOMON. We can go up to \$1 billion.

MR. PARTEE. We can go up and ask the Germans--

MS. TEETERS. I take it the overall limit is \$1-1/2 billion.

MR. ALTMANN. It's \$1 billion in any one currency and \$1-1/2 billion overall excluding the yen.

CHAIRMAN VOLCKER. Well, \$1 billion just in the mark is all we're talking about at the moment.

MR. PARDEE. I don't want to buy \$1 billion in Swiss francs.

CHAIRMAN VOLCKER. If we run into a problem, we'll just be back [to the Committee] with a written communication.

I think that's all on the international side. We can consider at some point the more general issue of whether these limits are too restraining or not. Do we have an overall limit? We're left with a limit, I discover, [in the formal authorization] of \$8 billion, which seems a little inconsistent with our open position. We can only have \$1 billion on the up side but we can apparently have \$7 or \$8 billion on the down side. But we may--

SPEAKER(?). I think there's something asymmetrical about this.

CHAIRMAN VOLCKER. We may want to look at that, but I think we can do it when we review the whole authorization early next year.

MR. PARTEE. The notion is that we defend the dollar harder than we defend the mark.

VICE CHAIRMAN SOLOMON. The psychology of this [unintelligible].

CHAIRMAN VOLCKER. Okay. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Questions or comments?

MR. PARTEE. What is your estimate of the reserve release that we are facing in early November, Peter? How big is it?

MR. STERNLIGHT. The drop in required reserves is on the order of \$3 to \$3-1/2 [billion]. There's also, depending on what we do with definitions, a large increase in excess reserves. Of course, we don't expect to offset that raw figure for excess reserves. In fact we are still having staff discussions on that.

MR. PARTEE. My point was simply that your request for expanded authority is roughly related to the size of the release that you may have to be doing.

MR. STERNLIGHT. That's right.

MS. TEETERS. Is that from member banks or from nonmember banks coming in or is it net?

MR. STERNLIGHT. The \$3 to \$3-1/2 [billion] would be a net of the phase down [in required reserves] for member banks and the first phasing in for nonmembers.

MR. ROOS. Peter, I'm a little confused. Page 2 of the Bluebook shows a dramatic increase in August and September both in total reserves and in the monetary base. Both skyrocketed, in effect, which should normally signal a massive increase in growth of the aggregates. When you at the Desk see this type of thing happening, do you take steps to compensate for that? In other words, first of all, what caused the 16 and 22.9 percent monthly increases in total reserves and the 15 and 10 percent increases in the base? What [unintelligible] the Desk operation, or couldn't you take steps to drain--

MR. STERNLIGHT. We were following our nonborrowed path during those periods. For the most recent period, as I mentioned, we will be coming out very close to the path on the nonborrowed reserves. Total reserves are running above path essentially because of the strong growth in the aggregates. We have not accommodated that increase. The banks have been obliged to get those additional reserves from the discount window. And in the course of seeking those reserves, they've had to bid up the funds rate; and we have had the interest rate increases that I mentioned. We did take some further [tightening] action during the period, as I mentioned. As we saw the total reserve path running at \$400 or \$500 million above the path, we acted to reduce the nonborrowed path by \$200 million midway through the period. That had a reinforcing effect on bolstering the need for borrowings and stepping up the pressure on the banking system.

MR. ROOS. When you observe a significant increase in bank lending, which obviously requires the availability of reserves, do you accommodate that? In other words, do you make those reserves available to the banks? Or sometimes if a bank decides to increase its lending and knows it is going to have to pay the piper two weeks later or a week later on this lagged reserve accounting, do the banks just assume that they can make these loans and price them because the good old Fed will come along and provide the reserves to enable them to meet their reserve requirements at a later date? Or do we sometimes say: Look, you guys can't have it both ways. You're increasing your loans and it's going to cost you more money in the federal funds market.

MR. STERNLIGHT. I think it's essentially the latter, President Roos, because by sticking with our nonborrowed reserve path for the period we are saying we are going to provide nonborrowed reserves in line with the path and the additional reserves will have to be obtained at the discount window. And banks are subject to those pressures that emerge when there has been a persistent sizable borrowing.

MR. ROOS. What is the relationship between the nonborrowed reserve path and total reserves? We obviously agree that total reserves and the monetary base grew too quickly in August and September, right?

MR. STERNLIGHT. Yes.

MR. ROOS. So, couldn't you have done something to avoid that explosive growth?

MR. STERNLIGHT. Well, as I said, by sticking with the nonborrowed path, pressure emerges on the banking system; and we did accelerate that pressure somewhat by reducing the nonborrowed path. We could have gone still further with that. We conformed with what has been about the norm in such behavior, which is to reduce the nonborrowed path by roughly half of the overrun on total reserves.

MR. ROOS. So it's a matter of degree, really?

MR. STERNLIGHT. I think so.

MR. ROOS. But we don't really stick to them.

MR. STERNLIGHT. The pressure could have been increased a little further, with of course an impact on interest rates.

MR. ROOS. That's the bottom line, right.

MR. AXILROD. But without necessarily any impact on total reserves in the period you are talking about. That is, the impact on total reserves and the base might well have come later. And it might have been considered, conceivably, to be a lot greater than you would have wanted later. It's really very difficult to judge. I doubt that the banks would respond instantly to an increase in the funds rate of another 1/2 point or 1 point. They will respond, but perhaps not instantly. The response may come later when the money supply might otherwise have been being reduced, so we have to judge that also.

MR. MORRIS. Well, if you have developed a convention that you only offset half of the overshoot in total reserves by a reduction in the nonborrowed path, what is the rationale for that convention?

MR. AXILROD. I don't know [that it's a] convention. There's always an option of adjusting the discount rate or the nonborrowed path. I don't remember exactly when the discount rate went up, but I think it was in this period. So that's an additional factor; that is, I viewed that as an alternative to further downward adjustment in the nonborrowed path. That's [equivalent to] taking another \$200 to \$300 million off the nonborrowed path. So I would say [the adjustment] went pretty far. Otherwise, you're left with a rule--I don't know what the rule would be--that every time total reserves are above where the original path was, we lower nonborrowed. The amount of lowering in the nonborrowed path we have to do really isn't equal to the [drop in] total reserves. It would have to be one heck of a lot more--billions more--because banks are going to borrow more. So we'd have to lower nonborrowed even more to offset the increase in borrowing to get any drop in total. And to do it within a month is very difficult; it would require very substantial drops in nonborrowed reserves. So, inevitably, we get into the question of either letting nature take its course or trying to figure how much speed we can give to the process given the lags.

MR. MORRIS. So you come out with 50/50 [as your rule].

MR. AXILROD. When Governor Partee was head of research, in all uncertain things he laid down the dictum 50/50.

MR. MAYO. It's all Chuck's fault!

CHAIRMAN VOLCKER. Well, we don't know. This gets into some very serious problems, as Steve suggested. If we had pressed down very hard and pushed, I don't know where the federal funds rate would have gone but the evidence seems to be that we get very little impact on the money supply in the short run. But we might get a helluva big impact two months from now and then you would say: My word the money supply is declining 8 percent and we have to push way the other way. So if we let the federal funds rate go to zero--I'm exaggerating a bit--we still won't get much impact [in the very short run]; we'd get that impact two months later. Now, if one wanted to be nasty and critical of the Federal Reserve, one would say we reacted or pressed too hard in February and March when money supply growth was high. The result was a very [weak] money supply in April and May. And we pressed much too hard against the decline in the money supply in April and May with the result that it went up [rapidly] in August and September. Now, I think there are other things operating, but to the extent that these lags are operating that's the dilemma we get into.

MR. PARTEE. Yes, we get whipsawed. As long as we assume there's a lag--

CHAIRMAN VOLCKER. If there's a lag of that sort, we can get whipsawed. That's very easily--

VICE CHAIRMAN SOLOMON. I know there's no exact answer, but what are the best estimates of the length of the lag?

CHAIRMAN VOLCKER. Well, we are working on that again. It's probably premature to say anything, and we probably won't get a good answer when we get it. So, what do you say?

MR. SCHULTZ. The lags are shorter than they used to be.

MR. AXILROD. They have gotten shorter. On both our quarterly model and monthly model the lags are quite a lot shorter than they were a few years ago when we first started [looking into] this. On the monthly model, to the degree there's a response in money demand to interest rates, the elasticity is a little over 10 percent. On our current estimates of the model, fifty percent of the impact comes in about two months. It's pretty fast.

MR. MAYO. That isn't Chuck's 50 percent.

MR. AXILROD. No, no.

MR. PARTEE. It used to be five months--50 percent in five months.

MR. AXILROD. It's down at least to three months. Our quarterly model, which has been re-estimated very recently but only with data through '74 because using data after '74 we couldn't get a fit that was worth talking about, the elasticities are variable. There is one for the bill rate and one for the [unintelligible]

savings rate. If you add them up--pretend they're additive--it's something like 10 percent again. It says that within a quarter we get 60 percent of the response, depending on how things go. And after one quarter we get three-fourths of the response. That's much faster than we had when we started estimating these things. That means that if we have done a little here, we will begin to get some movement shortly thereafter. I don't think this is too inconsistent with the kind of behavior we have had this year, but we are working on [an analysis of] it. But our latest view is that the lags are a lot shorter than they used to be.

VICE CHAIRMAN SOLOMON. But that's based on pre-1974 data?

MR. AXILROD. For the quarterly model. But for the monthly model that's estimated with more up-to-date data.

MR. PARTEE. We ought to recognize that we could still have this whipsawing with a lot of two-month cycles.

CHAIRMAN VOLCKER. It only takes a 2- to 3-month lag. We don't assume a very long lag, but we have to assume there isn't much instantaneous [effect].

MR. GRAMLEY. It isn't just a matter of lags. It's also a matter of the size of the elasticities and what's happening to transactions demand for money as a consequence of changes in GNP. The worst possible implication of thinking through this lag business is that if we have both significant lags and a very low interest elasticity of demand for money, when we try to push the money stock in the direction that's counter to the direction in which transactions demand is going, we don't get a response right away. It may push interest rates to a point where the response comes through the effect on the economy later on, in which case we could end up chasing our tail more or less perpetually. And that's a possibility I think we have to look at very carefully. I've asked the staff to begin looking at this, but it's much more [than lags]; it's a complicated process.

MR. PARTEE. You change demand [for money] by changing the spending that it's related to.

MR. GRAMLEY. Right.

MR. SCHULTZ. If one carries that to the extreme, the amplitudes of the swings get higher.

MR. GRAMLEY. They could get worse, yes.

MR. BAUGHMAN. Doesn't even the short-term adjustment we are talking about have to come through interest rates? That is, banks individually presumably are not responding to what we are doing in terms of total reserves or total nonborrowed reserves. I'll put it as a question. Shouldn't we assume that whatever adjustment we get from our actions that impact on money stock growth has to come through the interest rate circuit? It doesn't come directly through the manipulation of reserves.

CHAIRMAN VOLCKER. I'll ask you the question back again. You don't have to resolve what mechanism it goes through; [the question

is] how can you get the restraint on the money supply and on bank activity without having an impact on interest rates?

MR. BAUGHMAN. I don't think you can; therefore, I don't think we are talking about two separate things. In other words, the effects on the economy are through the interest rate and the effects on money stock are through the manipulation of reserves. It seems to me that they are both through the interest rate and that should be recognized. To me the lag aspect of the reserve part of the mechanism is not too important; if we focus on it, it seems to me that we are exaggerating its importance.

CHAIRMAN VOLCKER. We are not talking about the lag in the reserve requirement. This is the lag between interest rates or whatever other mechanism and the change in the money supply.

MR. BAUGHMAN. That's where the focus needs to be. And that brings to the surface again this idea that if one is going to focus pretty closely on the aggregates and accepts the desirability of stability in the movement of the aggregates, then one just has to accept a lot of flexibility in interest rates in the short term.

CHAIRMAN VOLCKER. But that doesn't follow; that's the problem.

MR. BAUGHMAN. And if we don't go that route, then it seems to me we come back to the old problem we had--which we apparently didn't handle too well--namely, our ability to project what level of interest rates will give us what we want in some other measure.

CHAIRMAN VOLCKER. That problem we surely have had. But I don't think one can simply say that the answer is that we ought to be less concerned about interest rates. Indeed, it may be--I just present this as an hypothesis--that our lack of concern over interest rates is what produced the fluctuations in the money supply this year. Now, I think many other things are going on, but one cannot reject the hypothesis.

MR. BAUGHMAN. Did you say project or reject?

CHAIRMAN VOLCKER. I cannot reject that proposition on the basis of what I know now.

MR. PARTEE. It might have been a factor.

CHAIRMAN VOLCKER. I don't think it's the whole thing--I'm speaking somewhat theoretically--but it may have entered into it to some degree. By letting interest rates fluctuate so much, we may have helped to generate the fluctuations in the money supply.

MR. WALLICH. In one sense I think that is almost certain because we helped to change income. That's Lyle's case. We have changed income by letting interest rates fall so sharply; we probably contributed to the recovery. It changed income again. So that mechanism has been in play. Now on your mechanism, the lag in money demand to interest rates, I just don't know about the evidence. We used to say it was six months to get the full effect, wasn't it?

MR. AXILROD. Yes; it's a lot shorter now.

MR. WALLICH. And you've shortened it now considerably.

MR. PARTEE. It used to be that in five months we'd get half of it.

MR. ROOS. This is a subject that is part of the overall study?

CHAIRMAN VOLCKER. Indeed it is.

MR. SCHULTZ. We have another problem. The communications problem is terrible. There are enormous numbers of people out there who believe that the money supply is controlled by some magic wand. And there are an awful lot of people who say: Look, if you guys would just hold down the money supply, then interest rates wouldn't go so high. I just sort of look at them and my eyeballs twirl a bit, because it's very difficult to figure out how they intend for us to do that. So, we really have a serious communications problem we are going to have to address.

CHAIRMAN VOLCKER. And we're left--there's no escape at the moment--with having to rely on some judgment as to how to express this formula for how far to put down the nonborrowed reserves when the aggregates begin running high. The mechanism isn't a perfect one, that's for sure. But I don't know of any statistical formula that resolves it at this point.

VICE CHAIRMAN SOLOMON. Following up on what Fred said, I think we're in a major quandary because I think the way the country interpreted our October 6th announcement was that we were going to pay a price in terms of volatility of interest rates but the implication was that there would be much more stability in the growth of the money supply. We have seen at least in a year like this--and possibly, although I hope not, even in a year when the underlying economy is not quite as volatile--that we don't have that kind of control for the reasons we were talking about. So I think we built up expectations that we can't meet now. And there's also an impression increasingly getting around that it's not so much a lack of political will or resolution by the Fed but that the Fed basically doesn't have the ability to control the money supply, which is your point. But, Fred, if we stress too much that we can't control the money supply in the short run, it can give a very undesirable impression of the Federal Reserve's [impotence] among those in the public and in the business and even the financial community who are naive about [the extent of] our ability to control the money supply.

MR. ROOS. Tony, in defense in those of us who believe that we do have the ability to do it, in the study we are undertaking I would hate to close our minds to that possibility and reach the conclusion that the money supply cannot be controlled better than it has been. It's only fair to stay open-minded on this. Hopefully, the research that Steve and his people are doing might indicate that perhaps the way we went about controlling the growth of the money supply was not the most effective means of doing it. In other words, I wouldn't buy the fact that it can't be done. I'm not sure that we

did it in the most effective way. But we could argue this issue endlessly. This is what is being studied, correct?

MR. AXILROD. Yes, it's one of the things for sure. There are several, but that is certainly a key issue.

MR. ROOS. There are a lot of people in the markets who feel that we announced we were going to do this and then we reestablished our practice of flirting with [controlling] interest rates, so we really only [went part way] in this process, not the whole way.

VICE CHAIRMAN SOLOMON. That's the whole point, Larry. There has been a supposition that if we are willing to let interest rates go without any limit whatsoever, we can achieve more control over the money supply. I think the results--plus the analytical discussion we have had in miniature this morning, with our discussion of the lags and other things--have shown that one can't draw that conclusion.

CHAIRMAN VOLCKER. Well, one can't draw it right now. But it is obviously on the agenda. I don't mean to exaggerate this but I think the main reason the money supply has been fluctuating is that the real economy has been fluctuating. That may be partly due to our policies but I--

MR. PARTEE. I think one has to have time periods in mind, what we are talking about is a relatively short interval of a few months and we are having great difficulty controlling the money supply in a short interval. But I think the record is pretty good on the longer run.

MR. MAYO. That's just what I was going to say, too, Chuck. Let's turn it around the other way. Yes, it can be done--it has been done--if one is willing to look through the second quarter and the third quarter and at the broader record. The subject of our study is, can it be done better? And if so, we want to find out how. But we still have to stress the successful side of this if only to keep up our credibility and our confidence. Credibility has two sides.

CHAIRMAN VOLCKER. John Balles.

MR. BALLEES. In listening to this discussion, Mr. Chairman, a question did occur to me that I wanted to ask Steve. As you recall, a year ago when we got into this new plan, we all anticipated a need to adjust the discount rate with great frequency. To our considerable surprise, at least to most of us, that turned out not to be true for quite some time. In looking back on the experience since June, when we had this big surge [in money growth]--actually now June through October--do you have any feeling, Steve, that had we been more flexible on the discount rate we might have headed off some of the net overshoot in total reserves? I gather that what has really gone on is that the multiplier has worked out pretty well but we've come in with more reserves after the fact than had been planned before the fact; and most of that was accounted for by a higher level of borrowing than was in the plan at the start when we projected the nonborrowed reserve path. What good would it have done, if you have a view, to have manipulated the discount rate more in this period?

MR. AXILROD. Well, I'll just give a tentative response, because we are doing research in that area and the results of that research, particularly with the relation of the lags to what happened to money, would be critical in one's appraisal. I don't view it myself, President Balles, as a discount rate question. I see it more as a question [relating to the level] of the federal funds rate or the constellation of short-term rates. So I would transpose your question to be: If the discount rate had been raised earlier, would it have put more pressure on the funds rate earlier and, therefore, damped money growth in January and February of this year? I don't think it's a question of discouraging borrowing but of discouraging bank [lending] activity and the public's demand for money. And that's not a question of the discount rate per se, but a question of the level of short-term rates. My tentative view is that one would have raised the discount rate to higher levels only if one came to the judgment that other short rates ought to have been higher. If one were content with the level of short rates that emerged, I don't see any need to have adjusted the discount rate from what was done. On a more technical basis, there is some validity [to that concept], and I think the surcharge is a step in that direction. There is somewhat of a slippage in that; one can't be sure, as we saw this time. We might get a lot of borrowings early on when we're expecting [only] a little, and we might get little when we are expecting a lot. There are uncertainties in the relationship between market rates and nonborrowed reserves as a result. Those are rather short-run slippages and probably a more structured discount rate system, which the surcharge was, might help to give a little more certainty in the relationship between borrowing and the funds rate. So we may get more certainty in the response. But that's a technical thing and not a question of the overall level of the discount rate. I think the question is what overall level of short rates the Committee is willing to see and tolerate.

CHAIRMAN VOLCKER. Let me just remind you that we had a perfect practical example this time of raising the discount rate between meetings, which did not affect the margin between the discount rate and market rates at all. It just raised the level of market rates. So we were left with an even larger discrepancy, so to speak, between market rates and the discount rate by the time [the adjustment] was finished. That is what one would expect to happen if the level of borrowings, which we control, remains the same or goes up.

MR. BAUGHMAN. I was going to make this remark later, but it may fit better now in view of the discussion. It seems to me that another thing that falls out of this recent experience is the possibility that we need to move in the direction of relatively more weight on, or attention to, the broader concepts of money. There are institutional changes taking place and, I gather, an increased amount of speculative activity flowing from the rising concern about inflation in the economy and an increasing tendency to shorten commitments. I thought that was captured very well in the paragraph in part I of the Greenbook that begins at the bottom of page 14 and concludes on the top of page 15 on how funds are flowing between the categories we include in M-1A, M-1B, and M2. It seems to me that we are seeing relatively more stability in the broader [M2] measure, and that measure is one which is more and more becoming a closer

approximation of what people view as money or something they can use as money. We may be exaggerating the importance of achieving targets in a fairly stable way on [the basis of] an unduly narrow concept of money or what people are looking at when they behave in a way that we think has a relationship to money.

CHAIRMAN VOLCKER. Well, I'll just make one more comment in connection with what you said [and then I think we ought to move on.] My impression is--it has to be confirmed by a little more statistical analysis--that basically all countries have much more instability in M1 than in M3 or M2 or whatever [broader measure] they look at. And some of this stability we hear reported in foreign countries is because they concentrate on the broader aggregates. If one looks at their M1, it doesn't look a lot better than ours, although ours looks pretty bad this year relative to any experience [unintelligible].

MR. BAUGHMAN. This has the further link in terms of what items we attach reserve requirements to. It seems to me that book needs to be kept open to the extent we can keep it open.

CHAIRMAN VOLCKER. We have to ratify the transactions.

MR. ALTMANN. And his [leeway] recommendation.

CHAIRMAN VOLCKER. Oh, yes.

MR. STERNLIGHT. I'm not confident that I need the added leeway--

CHAIRMAN VOLCKER. Let's take up the ratification first. Without objection the transactions are ratified. Now we'll take up the \$4 billion [leeway], which seems reasonable under the circumstances. Would somebody like to move that?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection, you have a \$4 billion [intermeeting] limit. Mr. Zeisel.

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

CHAIRMAN VOLCKER. You're overjoyous. Let me ask a question on the short run, the very short run. We had a pretty good increase [in economic activity] apparently in August and September. If we had a monthly GNP number, it would probably be going up--I don't know--at maybe a 5 percent rate or more in those two months. And July was the low point. So September must have been substantially higher than July. To get only a 1 percent increase in GNP in the fourth quarter, are you assuming a decline if you plotted this monthly in November and December?

MR. ZEISEL. We haven't plotted it monthly, Mr. Chairman, but it does imply some contraction in activity toward the end of the year, in November and December, seasonally adjusted.

MS. TEETERS. Your housing starts alone would do that, wouldn't they? Aren't your housing starts trending downward?

MR. ZEISEL. We assume that housing starts will drop off rather sharply.

CHAIRMAN VOLCKER. Well, starts will drop off, but the [drop in] activity lags.

MR. ZEISEL. Activity and spending continue for a while, and that's why we get as much increase as we do in GNP. We are assuming very little growth in personal consumption expenditures--actually none--for the fourth quarter. We don't assume any substantial increase in employment or income during that period. The saving rate has already dropped in the third quarter; we don't expect any further decline in that, or nothing major. So that's the major element. We also won't be getting the kind of help from the foreign trade sector that we have had.

CHAIRMAN VOLCKER. Let me put it this way: If your forecast for GNP is right, does it imply a decline in industrial production in November and December?

MR. ZEISEL. It probably would by December because we come into the fourth quarter at a rising slope, so I think we have to get some [decline].

MR. PARTEE. But, Jerry, your industrial production was a lot weaker in the third quarter than GNP. And, therefore, there could be a rise in industrial production compared to GNP in the fourth quarter.

MR. ZEISEL. I would think industrial production would not be as weak. That's right. Industrial production was down about 2-1/2 percent in the third quarter--about 10 percent at an annual rate. And I would think we'd begin to get some pickup from that toward the end of this quarter and so we'd come into the fourth quarter at a higher level and that would hold pretty well. We are not anticipating the continued strength in spending for automobiles and other consumer durable goods that we were getting. Basically, that's the sector showing weakness.

CHAIRMAN VOLCKER. Maybe we will go on to you, Steve, and then have a general [discussion].

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

CHAIRMAN VOLCKER. Why don't we deal with any immediate questions that arise and then have a coffee break.

MR. SCHULTZ. Steve, we may have made an error at midyear in not changing the M-1B target ranges. Do you think it makes any sense at this time to consider the possibility of making a downward change in the target range for M-1A and an upward change for M-1B for this year? Or are we already too far through the year so that we are unlikely to get any positive effects from that kind of action and might get considerable negative effects?

MR. AXILROD. I would say the effects of that probably would be negative because I perceive difficulty already in the public's understanding of the increase in the M-1B range [described] in the appendix to the Chairman's letter in February, having to do with the 1981 targets. I've heard people interpret that as an increase in monetary growth and an easier policy when it was explained that that meant a tighter policy. So I think an effort at this point to do that for 1980 would probably be nonproductive.

VICE CHAIRMAN SOLOMON. You mean because of the misestimation of NOW accounts?

CHAIRMAN VOLCKER. Yes.

MR. ROOS. I would caution, Mr. Chairman, against our believing that we can move in an admirable fashion from M-1B, which certainly has been the primary focus for our attention in recent months, to M-1A just because we are running into trouble with M-1B. I don't think we can fool the financial markets. At Frank Morris's recent conference, which was attended by a lot of individuals from the financial markets, there was pretty strong allusion to the fact that the Fed has several different definitions for the aggregates just so it can conveniently use the one that seems to be working best for the moment. I don't think we can get away with it. I was a little concerned, actually, about what I sensed as a primary emphasis on M-1A in the Bluebook this time whereas [previously] we have talked about M-1B. I don't think we can switch the tiller, or whatever we are using as the directing mechanism, at will and not confuse this Committee as well as the financial markets generally.

MR. WALLICH. I'm not sure that we have been using M-1B primarily and not M-1A, but I do think there are weighty reasons why we should downgrade M-1A. There are substantial shifts into NOW and ATS accounts. The indications that we get from M-1A are clearly biased. So I would say that in the future we should look more at M-1B. There are some [financial flows] coming into M-1B that are not coming out of M-1A.

CHAIRMAN VOLCKER. The same thing that distorts M-1A distorts M-1B. I don't see how we can escape that.

MR. PARTEE. I think the reason we said they should have equal weight, which I believe is what we have said in recent months, Larry, is precisely because we recognize a downward bias in M-1A and an upward bias in M-1B. And so we said we'd give them equal weight.

CHAIRMAN VOLCKER. I don't think we have ever to my knowledge made a decision to deemphasize M2. Operationally, when the staff make up the paths and so forth, they are looking at M1 because that's what [depository institutions] hold reserves against. And that tends to color the conversation. But in an analytic sense, in setting the targets for the year I wasn't that conscious of downgrading M2.

MR. MORRIS. Mr. Chairman, I hope we will keep this in mind when we set guidelines for next year. Because if you think we have problems with the gap between M-1A and M-1B this year, next year--

CHAIRMAN VOLCKER. Next year we may face the possibility that neither M-1A nor M-1B makes sense for the first six months of the year.

MR. MORRIS. That's correct.

CHAIRMAN VOLCKER. That may be healthy. It's not just a question of looking at one or the other. We know they are both biased, but by some unknown amount.

MS. TEETERS. Steve, in the Bluebook you gave us the interest rates associated with alternative A. Do you have the ones that are associated with alternative B?

MR. AXILROD. For alternative B, through this year we would expect a funds rate roughly around the recent level of 12-1/2 percent, virtually no change. Over the course of next year we still expect rates to rise. Maybe Mike has those figures with him.

MR. PRELL. We haven't put down a set of numbers. Because of this very short time period, the differences in money stock expansion are minimal and we'd end up the latter part of next year presumably at roughly the same rate.

MS. TEETERS. But the near-term rates would be lower, is that right?

MR. PRELL. That's the presumption we have with more generous monetary expansion.

MR. AXILROD. Next year it gets to be a question of the feedback of that on GNP and inflation.

CHAIRMAN VOLCKER. If there are no more questions or clarifications, let's have a coffee break.

MR. WINN. Could I make one comment, Paul, before the break? We pay a lot of attention to the shortcomings of our quantity measures. Are we paying enough attention to the shortcomings of some of the national aggregate measures that we are trying to [deal] with? I don't have a feel as to whether the underground economy is more or less than it used to be. But I'm becoming more and more skeptical of some of these national figures that we are using in some of these other areas.

CHAIRMAN VOLCKER. I have an uneasy feeling that our national economic statistics in general are not getting any better. They're probably worse, but I don't know what to do about it.

MR. WINN. That's my feeling. So I'm wondering, in terms of what we are trying to do to the national figures, if we are really keying [our actions] to the real changes that are taking place.

CHAIRMAN VOLCKER. Any other clarification questions? Let's have our coffee break.

[Coffee break]

CHAIRMAN VOLCKER. Presumably the clarifications have been taken care of. We can go around the table and see what you think about the business picture. And perhaps you can give some general comments on our own posture and then we'll look at the decision more carefully. But let's be a little general right now.

MS. TEETERS. I looked back over the numbers and I'm impressed with several things. Practically every indicator of real output is below last year. We talk about the increases in housing starts in the past two months, but housing starts are 25 percent below last year. Industrial production is down a large amount. Employment is flat because the labor force didn't grow very much. New orders are down and consumption is down. Every indicator is below what it was last year. If one looks at [developments in] a little longer context instead of just what happened in the last two months, we've created a rather severe recession at this point. The numbers that are up, unfortunately, are prices. Both producer prices and consumer prices are up 11 percent. And within [those measures] are energy prices, which in the producer price index are up something like 36 percent and in consumer price index somewhat over 20 percent. If one looks at the money numbers, they have been quite reasonable over the past year. They're just about where we would want them to be and I think it makes one wonder. I don't think this is a surprising outcome. If you tighten monetary policy, the first impact is on real output. We have had very little impact on prices. We've had relatively well behaved monetary aggregates, but it does raise in my mind the question of where we go from here. I'm quite worried that we'll put too much emphasis on trying to get [monetary growth from] the fourth quarter 1979 to the fourth quarter 1980 at some predetermined level. Those are pretty arbitrary dates to pick to say that we're going to hit the midpoints [of our target ranges].

What also strikes me is that we're not very good in [estimating the] relationships. From the fourth quarter of '79 to September '80, we're off the midpoint on M-1A by .35, on M-1B by 1.65, and on M2 by 2.2 percentage points, all plus. We're off M3 by minus 1.2 and bank credit by minus 1 percentage point. No way are we going to get all of them on the midpoint by the fourth quarter of this year. So it seems to me that we should pick which one we're going to try to keep within bounds. I don't think we have any hope of getting M2 within [its range.] We can come close on M-1B, but not completely within. And when we come down to the fourth-quarter-over-fourth-quarter projections, there's not a lot of difference where we end up if we choose "A" or "B." The rate for [alternative A] is 4-1/2 percent and alternative B gets us maybe two-tenths of a percentage point above that. But alternative A does produce an extra 1 percentage point on the federal funds rate. What we obtain by running the funds rate up by 1 point isn't a great deal in terms of obtaining our objectives for the year, fourth quarter over fourth quarter. I would caution against focusing too sharply on trying to hit something exactly in the fourth quarter of calendar year 1980. We may not have a double-dip [recession], but I think there's a great danger that we will have a totally flat economy if we pursue our [monetary growth] objectives too strongly.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, looking over the economy sector by sector, I don't see much fundamental strength in the short run. So I wouldn't be surprised to see one quarter between now and the spring that might come in with negative growth. What happens beyond then I think depends on whether or not we have any discernible success in dealing with inflation. We [in Richmond] have been expecting less inflation and more real growth than the Board staff over most of this recent period because we thought it likely that the aggregates would come in significantly lower than they have. Since they've come in higher than we thought, and in view of the deteriorating budgetary prospects, we've come closer and closer to what the Board staff has been projecting in the way of inflation and less on real economic growth. But my feeling still is that we're probably going to have a little less inflation and a little more real economic growth than the staff has projected.

So far as the overall policy posture is concerned, I think it's imperative that we do what we can to hit these long-run targets on M-1A and M-1B, although I think we can tolerate some overshoot on M2. But if only M-1A comes in within the target ranges, then I doubt --no matter how much we justify it by the rapid growth in other kinds of transaction balances--that we'll stand much chance of maintaining any credibility. Also, I would say that the recent rise in interest rates we've had might be due largely to the public's perception of a deteriorating budgetary situation, more than just an expanded demand for money. There's also a feeling, given the rapid growth in the aggregates, that we will have to react to that.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I'm inclined to the view that the real economy may be a tad or so stronger over the next quarter or two but nothing dramatic. Beyond that, it's very hard to see with any clarity. I think where we are on inflation will have a lot to do with the longer-run performance of the economy. There are big uncertainties about fiscal and other economic policies as they will be enunciated by the new Administration. The question of consumer resistance to these high car prices is an area of uncertainty and it's one that could work against us. I am not as sanguine as many people seem to be about the oil price situation either. I don't claim any particular expertise but the more I look at the information coming out of the Middle East, the more I think it could turn into a very negative factor by sometime in 1981. On the financial side, I don't know to what extent the Ninth District is representative; it probably isn't. But I can say this: There is intense advertising and pushing by commercial banks on ATS types of business to try to get a leg up on the thrifts, which is compatible with what Steve was saying about this departure between M-1B and M-1A. I think it is very real. It's moving a lot faster than we thought it would, and I think we can have some impact in terms of trying to explain it in a coherent way, particularly if we start to do it sooner rather than later.

Broadly speaking, on policy I lean toward "A." But in the current situation I think a more important consideration than "A" or "B" is the point that Steve made on how we might want to shape the language in the directive so that whatever we come out with is couched in terms of an upper limit. Therefore, if we continue to get the

overruns that we've had in the last eight or ten weeks, we can respond to that more quickly.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, as I look at the state of the economy, it seems to me that we have a lot of unpaid bills accumulated. We've been through five years of expansion with a lot of inflation and other distortions and hardly any of that has been paid off--corrected or expiated, if you will. We've had no reduction in inflation. We've had no significant restoration of consumer demand. The consumer has been overbought because of inflation and is coming around slowly. We've had no restructuring of balance sheets. It's hard to believe that after five years of expansion the distortions could be corrected, so to speak, in one quarter of recession. Now, we didn't expect that kind of short recession. We may have it. The forecast that we have--and it has changed quite significantly from last time--seems to say that we have more GNP now and we'll get less GNP next year. At the end of next year we'll have about the same level of unemployment and GNP as we would have had if we had traced an alternative path with the recession continuing through 1980 and then a more rapid recovery. I'm not sure whether this new path is as adequate in terms of corrections as the previous one because we seem to be treating as a gain the rise in the [third] quarter and maybe in the fourth quarter as something to be defended by our monetary policies. We can't latch onto that. I think we have a bigger correction, unfortunately, to go through. We may be dragging it through 1981 with an almost zero rate of growth. That is why I conclude that we have to accept a degree of financial discipline. There just is no interest rate level that is both noninflationary and pleasant to live with in terms of the demand effects that it has. If we're going to go to interest rate levels--and I always think of interest rates as being established of course by money supply targets--so if we go to money supply targets to produce interest rates that will make the present situation livable and pleasant and make for expansion, I think we're building in more inflation for the future. We're moving from an uncorrected base. My inclination, therefore, continues to be to lean on the hard side of the aggregates.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, I can't quarrel with the staff's projection. I suppose I still lean, if at all, toward the view that the economy may be a little weaker rather than stronger and that we may have a little more unemployment and a little more inflation than the staff forecasts. Even with that, although I have never been a great advocate of monetary targets, I find I am thankful that we have several targets and ranges rather than spot targets for one or two aggregates. The latter assumed a performance measurement device that is far more risky than any of the FREPS measures that we fiddle with in the Federal Reserve System in terms of the individual bank performances. I find that we do have a public credibility problem when the heads of the two [Congressional] banking committees plus quite a few other people have embraced the idea, simplistically, that target setting and target achievement are the be all and end all on inflation control by the Federal Reserve System. Even though I don't believe that that's the way to measure our performance, I acknowledge the fact that [such a view] is there. And I still feel that we will

have a better chance of [achieving] credibility through the end of this year by leaning toward "A" rather than "B" to give a little better insurance that we will remain within the aggregate targets. Despite my agreement with Nancy on the interpretation of many of these things, I must respectfully disagree on the emphasis I think we have to place to keep the balance of factors in proper perspective. I would lean toward the more restraining position even though the differences may be slight. We're being measured. From a purely theoretical approach, I think we're being measured unfairly by any of these things. But I'm just old fashioned on that particular subject. I recognize that we are being measured in many different ways, not just by the Administration or the Congress but by the market.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, in looking back over this past year, it seems to me that the real product of our new operating procedure has been pretty good. I think we turned the economy around much sooner than we would have under the old system. If we had been managing interest rates, the expansion probably would have gone until July and we would now be in a recession of the magnitude of the one in 1974-75. And the unemployment rate at the end of the year would be substantially higher than it's going to be. I think the resilience of the economy that we're seeing now reflects two things. One is the fact that we did turn interest rate policy around so sharply. But secondly, I think the economy shows signs of being able to live with higher interest rates than was the case in the past. Nonetheless, I don't think any of us can have much confidence in the forecasts for the next couple of quarters because we've never been in a situation where we have come out of recession with interest rates at current levels. So, I don't think there's anything our econometric models can tell us, based on history, as to how the economy is likely to perform in the next few quarters. I find that there's tremendous skepticism about the Federal Reserve in the financial community. They are watching us like hawks. We clearly need, not only for the financial community but the business community, to get expectations working for us instead of against us. And that's why I am supporting alternative A today. Having made the commitments we have made, I don't think we can end the year and tell the public that everything else was higher, but M-1A was within the bounds and we declare that a victory. I don't think that kind of victory is going to fly. And since we don't know much about how the economy will behave coming out of a recession with high interest rates--and I talked to Lyle about this at the coffee break--we may find that in order to stay within our guidelines that we would have to produce absurdly high short-term money rates. If that's the case, then it seems to me that we've got to change the guidelines. But as long as we don't change the guidelines, I think our credibility requires that we stay within them. That's all I have to say.

CHAIRMAN VOLCKER. I'm not sure I fully understand what you mean by guidelines.

MR. MORRIS. I'm talking about monetary growth guidelines.

CHAIRMAN VOLCKER. Do you mean for the longer run?

MR. MORRIS. Yes. If we find in the fourth quarter, to take an extreme case, that we need a federal funds rate of 20 percent to

get the money supply growth within our ranges, then we will either have to change the ranges, which I think is the only way that we can handle it without losing credibility in the marketplace--

CHAIRMAN VOLCKER. For this year?

MR. MORRIS. [Unintelligible] as they do. We either change the ranges or--though I don't think we have this option--say we can't stay within the guidelines that we've established.

CHAIRMAN VOLCKER. That may be the fact. But I'm not sure we can do anything at this point to affect that.

MR. MORRIS. Well, if we were to decide that we can't stay within the M-1B targets--

CHAIRMAN VOLCKER. We can decide that. I'm just saying that what happens in the next two months may be very little influenced by what we do [today]--whether it's up or down or on the target--because it's in the cake.

VICE CHAIRMAN SOLOMON. But that doesn't remove the need to make a decision.

CHAIRMAN VOLCKER. No, but that decision may influence more what happens beyond [that time horizon] than what happens within the next two months.

MR. MORRIS. But if we are going to try to stay within the guidelines, we would have to move monetary policy in a direction that is consistent with trying to get inside the guidelines. To me the adoption of alternative B would be [tantamount] to telling the public that we've given up on the guidelines.

CHAIRMAN VOLCKER. Why?

MR. MORRIS. Because we would be telling the Manager to follow a reserve course which is only going to show a prospect of bringing M-1A within the guidelines. And it seems to me that is equivalent to abandonment.

MR. PARTEE. M-1A is well within the guidelines.

MR. MORRIS. I know, but that will be the only one.

MR. PARTEE. And M-1B will be outside regardless of which alternative we take.

SPEAKER(?). M-1B [comes out] right at the top on "A."

SPEAKER(?). And right at the edge on "B."

MR. PARTEE. Well, look at the chart. In fact, on average "A" and "B" are within the guidelines.

CHAIRMAN VOLCKER. I question how clearly the market can perceive that. Governor Gramley.

MR. GRAMLEY. You characterized the staff forecast as a gloomy one, Mr. Chairman, and I think that's right. Indeed, I think the outlook is probably even a little gloomier in the sense that the risks in the forecast are mainly on the down side. The staff's forecast assumes a shift in the money demand function, which may or may not happen. I have my doubts about it. It assumes that the saving rate is going to decline by half a percentage point; that may happen, but I have some doubts as to whether consumers are going to spend that aggressively. It assumes that businesses are going to want to increase the ratio of inventories to sales moderately in a period in which final sales growth is extremely weak--and in fact declining outside the personal consumption area--and interest rates are very high indeed. I conclude from this that if interest rates go up significantly further from what the staff has forecast, that we're going to convert growth of 1/2 percent into a recession. I think 1/2 percent growth--to respond to Governor Wallich's comments--is appropriate; I don't find that an unacceptable outcome. In my view a recession is not going to give us any help in our fight against inflation. I don't think the first recession, the recession of '80, did any good. I doubt that another sharp recession would do any good. I think you are quite correct, Mr. Chairman, insofar as the fourth quarter of the year is concerned, that we're probably going to see more real growth this quarter than was forecast. That doesn't give me any comfort. On the contrary it gives me additional worries, because I think we may find that the demand for money is growing even more strongly than the staff has forecast and that interest rates will have to go up a long, long way to get [growth of the aggregates] within the ranges of either alternative A or B. And then we will set the stage for another downturn. What I want to do at this point is not to overreact because I believe there is a very real possibility that what you say is correct: That we may be caught in a cycle in which the very way we're trying to operate is producing these fluctuations in both money and interest rates and [thus] in the economy.

I want to call to the Committee's attention, too, what has been happening to the components of M2 that are not in M-1A or M-1B. It's quite dramatic. We had an M2 growth rate in the third quarter overall of 15-1/2 percent; that's the quarterly average. But during the course of the quarter, these deposits have shown an annual growth rate of 22-1/2 percent in July, 13 percent in August, and 7 percent in September and October. There has been a dramatic deceleration; and those deposits are four times the size of the deposits that are in M-1A and M-1B. And that's something we ought to take into account in thinking about how hard we try to achieve those targets for M-1A and M-1B in the near future. So, I'm leaning toward the easier alternative.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Mr. Chairman, I have several comments. First, with respect to the forecast, it seems to me that it's based on the internalities of our economy rather than the externalities. I don't know how to recalculate it, but it seems to me we have oil problems and military problems. [If one is] just conscious of what we're shipping overseas at the moment, one can't miss the kinds of activities that are going on, and they are going to have a delayed effect. Second, if one looks at the figures and then takes a small sample--and I realize the danger of samples, but try to go to a

shopping center some weekend. You can't find a place to park. If you go in, you can't believe the prices they're charging. And people are all saying: Well, the price is only going to get higher; we better buy it now. And when you add to that what I see in the agricultural area, with foreign demand springing from China and Russia and other places, the inflation pressure is very real to a whole host of people. So the saving rate decline wouldn't surprise me a lot, given what we see people doing. It seems to me that somehow that [inflation] expectation has to be halted. And if the externalities get out of hand on us, which we really haven't factored in [to the forecast], we will have an explosive situation on that side of the coin that we haven't thought about too much. Consequently, I lean rather strongly to the feeling that with all the publicity that has been given to our activities we at least have to do our best to perform because there are not many areas in which people have much confidence these days. Going back to my college days where A was a good mark, I guess I'd strive for an A+. I'd not be too aggressive, but it seems to me that we really have to lean against the [tide] this time.

CHAIRMAN VOLCKER. Grading standards have been relaxed.

MR. PARTEE. As a matter of fact they've been reversed.

MR. SCHULTZ. I had heard that.

MR. MORRIS. Well, that's why we don't have a C alternative!

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I agree in general with the staff projection. The only point on which I have some reservation--I wouldn't say disagreement--is that the staff does not attach much weight to the possibility that consumers may continue to try to defend their current living standards and spend at a level which continues to reduce the saving rate. We have misjudged the behavior of consumers before and we may do so again. I'm not saying this has a high probability of happening because I recognize that the saving rate is at a low historical level, but it could happen. And consumers have demonstrated a marked reluctance to accept lower real living standards. I agree with much of what Governor Gramley said [except] in this one respect--that is, a difference regarding the likelihood of continued high levels of consumer expenditures.

Now, from a credibility standpoint, I think it's very important to end the year with the aggregates close to the target ranges that we've established. I emphasize "close to" because I think nothing we're likely to do today will bring all of the aggregates within the target ranges. I mean "close to" in the sense that M-1A will be well within and M2 may be near the upper end of its target range, with M3 and bank credit, of course, being within the ranges. I believe either of the alternatives presented to us will bring us very close to the target ranges at the end of the year. I don't think it makes a great deal of difference, so far as our credibility is concerned, whether we get the monetary outcome under alternative A or the monetary outcome under alternative B. The significant difference between alternatives A and B is the likely influence on interest rates. Following alternative A, we're almost certain to get upward pressure on interest rates in the months ahead. We will get upward

pressure on interest rates in 1981 under either alternative. But under alternative B we're likely to get little, if any, upward pressure on interest rates for the remainder of the year and possibly the first month or two of 1981. Interest rates are already at high levels. As was pointed out by Frank Morris, compared to other recoveries they're at extremely high levels. And at this point they are also positive in real terms. We have positive real interest rates. I see Governor Wallich disagrees with me but--

MR. WALLICH. After tax.

MR. RICE. So the danger is that by selecting alternative A we run the risk that interest rates will have the effect of eliminating even the possibility of that 1/2 percent growth that is projected for 1981. I don't think we ought to do that and, therefore, I lean toward alternative B.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, briefly I'll make comments in three areas. One, on the local situation, we get reports of very high levels of activity across the border between the United States and Mexico. Apparently that's still strengthening in just about all aspects, and it's presumed that both the legal and illegal traffic is moving apace. Oil and gas activity, as you probably all know, is continuing to boom. And prices of both the rights to make holes in the earth and of the equipment to do so are up sharply and continuing to rise rapidly, reflecting the views of the people who engage in that activity. An illustration of the kinds of distortion which government programs can inject into an activity, with which we are all familiar, can be observed in the agricultural sector at the present time. We are having very low production on land which has [been subject to] bad weather this past summer; nevertheless, with the high prices, it would still be economic to harvest the crop in that the market price would cover more than the harvesting cost. But if the crop is declared a complete failure and not harvested at all, [farmers] will receive a bit more income than they would if they went through the harvesting operation. So we have some reduction in [potential farm] production because the government disaster payments exceed the market value of the product.

With respect to the general economic projections, I am less comfortable with them this time than I usually am. If my recollection is correct, the current staff projections are about the same as those I reported when we had our round-up last July or August. And I can assure you that there is no basis for drawing any comfort in having an economic projection which is the same as the one that I may have made. With respect to progress on the economic and inflation fronts, as some of you know I have held the view for two, three years, that we're not going to handle this problem unless we develop some kind of machinery for direct interference, particularly in the wage market. And it was of interest to me that a locally domiciled airline, which is struggling with a problem currently, has under serious negotiations with its employees the possibility of a 10 percent pay cut. While I wouldn't expect to see that sort of thing spread generally through the economy, it seems to me that we've got to find some machinery for beginning to get those kinds of questions raised.

CHAIRMAN VOLCKER. That's the best news I've heard in a long time, Ernie. I didn't know that. The last wage settlement I heard of down in your part of the country was a 60 percent increase for three years front-loaded.

MR. PARTEE. Was that Reserve Bank employees?

CHAIRMAN VOLCKER. It was in the energy-related area.

MR. BAUGHMAN. With respect to monetary policy, it seems to me that the Committee should go with alternative A. And bearing on the comments with respect to our communications with the public on monetary policy, it seems to me that we might buy a little in that area if we were to adopt the procedure of routinely moving the funds rate range at a meeting so that it centers on the current funds rate, as compared with leaving a specified range stand for a long period with market developments at times making it bump against the bottom of the range and at other times making it nudge against the top. And I would not see such a change in what we report as necessarily providing any restraint on what we actually decide with respect to shaping and implementing policy. That's all I have to say.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, Mr. Chairman, I don't know that I have anything to contribute on the economic outlook. I am not surprised at the projection. As I view it, we have more or less established a governor on the economy with our monetary aggregate ambitions and the credit and interest rate implications that fall out. And if we have a governor that limits the speed to 55 miles per hour for spending, well, we are not going to have more than 55 miles per hour spending. The question of how much head wind there is in the form of inflation is something that we all argue. I think wage costs, food costs, and energy costs are pretty intractable and we'll have as much or close to as much inflation as the staff projects. But one could be more optimistic on that, as Bob is. However, the fact of the matter is that if we get a little more housing, then we get a little less something else in the existing environment, assuming we hold to our assertions about monetary growth rates over the period.

I do have a much stronger feeling about the shorter-run specification of policy. I asked Steve where alternative C was because it seemed to me that alternative A was totally out of the ball park so one really needs to choose between alternative B, which [calls for only 3-1/2 percent M-1A growth], and an alternative C which is easier. The reason I say that is that I just don't think that one can say to the economy at large--not the financial people or the monetarists but to the economy at large--that we are seeking, [as in alternative A], a 1-1/4 percent rate of growth in money supply over a 3-month period in which we expect to have some continuation of economic recovery. That just isn't the kind of number that one seeks, and it's way lower than anything I've seen. And 4 percent on M-1B is a very low rate, too, for the next three months. To get us down more comfortably within the ranges, as alternative A would do, really implies in the short run a policy which wouldn't be understood and which could very likely result in a second downturn, or at least increase its probability. I think it will occur anyhow, but that will increase its probability. We faced a situation similar to this a year

ago. We were running high in our target ranges. In fact, it looked as if we weren't going to be within the target ranges. So what we did was to specify, as Steve suggested at the end of his briefing [today] I think, that we would accept a rather moderate number or "somewhat less." And I think that's the way we ought to specify our alternatives this time in terms of the 3-month [specifications].

Going off from alternative B I find tolerable: The notion of seeking a 4 percent rate of growth in M-1A or somewhat less, a 6 percent rate of growth in M-1B or somewhat less, and a 7-1/2 percent rate of growth in M2 or somewhat less. I think we can take a little chance on M2 because, as Lyle pointed out, we have been getting quite a lot of [slowing] in that rate of growth through the summer and early fall. I do think that we need to be even-handed about this and that we need to recognize that our mistakes always occur not because we are [slightly] off from modest numbers, but because we are way off from modest numbers. And, therefore, I think the funds rate range should be raised to 9 to 15 percent, which is in keeping with Ernie's thought that we should center our range around where the rate is, and the midpoint of 9 to 15 would be 12. And I think we need to recognize the possibility that if we have enough demand, we'll have to move against it and the funds rate could indeed need to move up considerably because monetary growth is above [our specification]. But I just can't accept the idea of saying to the public that we seek a monetary growth rate of 1 percent over the 3-month period.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With respect to the staff's forecast of the outlook for economic activity, the only real divergence I have is that I would suggest that the fourth quarter might be a bit stronger than they are projecting. In turning to the financial side, it seems to me equally that the Bluebook's forecast of moderate demand for money in the fourth quarter may be a bit optimistic. Taking those two things together would suggest that we will find considerably higher interest rates necessary to hit either "A" or "B." And it comes to my mind that the Fed's credibility may be more suspect now than virtually any time in the future because we are the only one out there that the public is looking to for any comfort that prices will come down some time in the future. Thus, with the prospect of difficult times ahead, I don't think we should shirk the responsibility. It seems to me that the nation would be well served if we made a fairly strong public comment and commitment that inflation is the number one problem. And we can do that in my judgment only by adopting a policy at this meeting that is at least no more expansive than "A." Let me suggest that if we adopt "B," for example, we would be saying to the markets and the public--maybe 30 days from now to be sure when they look at the record--that the Fed gave up in November the opportunity to come within the stated ranges. And I think that would be very unfortunate. I would focus on at least alternative A. I think we are going to have difficulty hitting either [unintelligible]; it does imply higher interest rates. There has been some comment about the 1980 recession and the fact that we got no price improvement as a result of that recession. I'd like to point out again that it was a very short recession. I don't think one could expect any price [improvement]. If we now shy away in monetary policy from the risk of having a recession or a double-dip, I think we are avoiding our responsibilities for the future. Lastly, if we adopt "B"

or something to the right of "B," I think we would be making our task for 1981 impossible in the sense of trying to hit the targets we have already announced. As a result, I would like to take the bite now rather than some time later.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I think that credibility is important not just because we like to use the word and like the ring of it, but because without credibility in what we have announced we are going to do, we are going to have high interest rates. In other words, inflationary expectations [might be rekindled] because of the loss of credibility in our October program and we'd have high interest rates and inflation. Now, let's go back just a second to October of last year. We adopted a policy at that time, based on a recognition that inflation was generally at a much higher than tolerable rate in the view of the American people as well as in the view of the Federal Reserve. We recognized then that in order ultimately to bring down inflation with the tools available to us we would try to reduce the rate of money growth gradually over a period of four or five years until it was brought down to maybe a 2 or 3 percent rate. And that, in turn, we felt--and we announced--would have an effect in reducing inflation. At that time in 1979 money was growing at about 7 percent per year. We announced that our target for this year was 4 to 6-1/2 percent, with some hope [that it would come in near the] midpoint at maybe 5 to 5-1/2 percent. That was accepted with satisfaction by the Congress as well as the public. We have not succeeded. Even with the most restrictive policy from now until the end of the year, we will not succeed in bringing that growth rate down much below the top of our range, or to approximately 6-1/2 percent. Actually, M-1B, which I think is a good aggregate to use, has grown in the third quarter of this year at about a 13-1/2 percent rate. According to the projections on page 6 of the Bluebook, under alternative A or B the staff expects something like a 9 to 10 percent rate of growth in M-1B for the fourth quarter.

Now, I am assuming that we don't want to abandon totally what we said we were going to do, which was to bring down the rate of money growth gradually from 7 percent in 1979 to 6 percent, let's say, in 1980, which would in turn imply 5 percent money growth in 1981. But if we go from a 13-1/2 percent third-quarter rate to a 9 to 10 percent fourth-quarter rate and go to Congress and say we are going to shoot for a 5 percent rate of money growth in 1981, the only way we will be able to achieve that is by drastically reducing the rate of money expansion starting in 1981 from the rate of growth in the last six months of this year. That will most assuredly cause a serious recession. We've either got to bite this bullet now [or later]. I don't like to use the word "politics" but I would rather dish out the bad medicine after the elections this year when everybody--or at least half of the people--is in a euphoric mood for a couple of months than wait until 1981 and face up to this very difficult task, which will not be accepted by the general public too favorably. Therefore, I would [favor] neither alternative A nor alternative B--and I'm not a monetarist freak when I say this--because I think both of them imply [monetary] growth that is too fast. I would suggest that M-1B growth, and I'm only going to speak of M-1B, from September to December not exceed 2 percent. I would suggest that the growth from the third quarter to the fourth quarter in M-1B be 6-1/2 percent instead of the

9 to 10 percent figure that's shown here. I would suggest that the range for the federal funds be increased to have a top of 16 percent, because unquestionably this is going to drive up the federal funds rate for at least a short period of time. If we don't do this, we are going to have to face up to it next year when I think the facing up to it will be even more difficult. If we don't do this, we are going to have high interest rates as inflationary expectations continue. I think it's a very critical time for our credibility, and that's my recipe.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. First, I have just a very brief comment on the business outlook. On the West Coast we have had little evidence of recession except for the housing industry and auto purchases and so on. Given that this is the year of really cruel dilemmas, I was particularly interested in the views of two of our branch chairmen who happen to run big lumber companies and another head office chairman who is a big operator in the construction business. Obviously, they have a direct interest in not seeing mortgage rates get so high that they cut off their own businesses. We had a pretty extensive discussion of what the alternatives and the problems are. Interestingly enough, all three of these guys came out expressing the view that we are really faced with a dreadful set of choices: Either we price people out of the housing market temporarily through higher interest rates or, even worse, price them out of the market for the longer run through inflation. And if their diagnosis is correct, they are willing to suffer the slings and arrows of outrageous fortune as it were by seeing mortgage rates go up at the present time, hopefully on a temporary basis, to get inflation under control.

As far as the immediate economic outlook is concerned, our staff forecast doesn't differ too much from the Board staff's except that we expect somewhat more growth in the months immediately ahead. All of us were surprised by the bounceback in real GNP in the third quarter; we underestimated that, and I'm hoping we may see somewhat more GNP growth in the fourth quarter. But the differences between our staff views and those of the Board staff are not all that great. I am getting increasingly concerned that the economy has been subject to some exogenous shocks that have the effect of increasing inflation expectations--such things as the Middle East war and the talk coming from both parties about big tax cuts either before, or probably more likely, after the election. As people think about the implications of that in terms of bigger budget deficits, I think that has had the effect of increasing inflation expectations. My real fear is that if we should have a significant overshoot in our targets for this year, we ourselves will become a source of rising inflation expectations.

Now, looking back over the year as a whole, I think we've had until recently at least a pretty credible record. That is to say the shortfall in money in the spring was one which we offset--in my view quite properly, and I was in favor of doing it--by efforts to catch up. And through August I felt pretty comfortable about that because by August we had caught up and were roughly back in the middle of our ranges for the various Ms. I'm quite concerned, though, about what has happened in September and October and whether we're building to an overshoot that we aren't planning on but which may occur in any event. At the last meeting I called attention to the fact that it is very

troublesome, I'm sure, from the staff's point of view that for each of the months June, July, and August they initially had substantially underestimated how much monetary growth there was going to be. I have that same fear now about October. We have now had three estimates of October monetary growth, and each one has been higher than the preceding one. And I fear that before the month is over we may have another outcome like September, in which case there won't be any hope of our coming even close to the upper end of our ranges. So, given recent economic developments that portend some rebound from the recession, which is the good news, and given the persistence of the bad news that there has been almost no measurable progress on inflation, I'd be inclined to tilt more toward combatting the latter problem and would move toward alternative A. Indeed, I think there is some merit in the [unintelligible] inflation that some people have spoken of. So if there were an "A plus," that would be my choice.

CHAIRMAN VOLCKER. Mr. Smoot.

MR. SMOOT. Thank you. I'll be brief. Anecdotally, though I heard your story about the shopping centers, Willis, my barber assured me yesterday that people are getting fewer haircuts in reaction to inflation. I said it was just because I'm getting bald!

I think as a group we have been somewhat surprised by the strength in the economy and that has been reflected in the unexpected strength in the aggregates. The Bluebook provides policy alternatives that are somewhat accommodative to those surprise events by proposing two alternatives, both being less restrictive than the path chosen by this Committee last month. I think that's correct; [if not], then I retract that. My impression looking at "A" is that we picked [a growth rate of] something less than the top of the M-1B range last month. I raise the point to question whether we are trying to lead or follow here. And I would certainly urge that we attempt to lead, although I bear in mind the problems with monetary policy attempting to do it all by itself. With regard to the forecast, the Greenbook is more pessimistic than we would be on the economy and somewhat more pessimistic than other forecasts we have seen. This would cause me to be somewhat concerned about our present view of the future and our reaction to it. Further, if we are entering some kind of recovery, I suspect that we have tended in the past to underestimate the growth of the economy in the early stages of recovery; and I throw that out as a reason for being somewhat concerned. Given that, I would urge at a minimum alternative A, accepting the risk of higher interest rates. On the issue of credibility, I think it's important that we do all we can to meet the M-1B target in the sense of staying within the range. I think changing the ranges because of technical factors, which was suggested today as an alternative, would be a mistake. We tend to accept what is given to us in the form of a lower M-1A but we're not happy with or [don't] tend to accept M-1B when it drifts out of its range. So I would urge alternative A at a minimum.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. On the business outlook we don't have much to add. My staff is exuberant about the fact that they have done better for the last two or three quarters forecasting the aggregate economic variables, and they are saying that the quarter we are in now may be a little stronger than the Board staff's forecast. In the Southeast we

are finding a very mixed economic picture and some of the same concerns that others around the table have expressed about what we might do to housing and whether or not new car sales will really go up and all that. But the new things that I would like to add to the discussion that has occurred around the table so far involve not just how our policy would be viewed by the public but how the public and the financial community will perceive the government's overall policy actions. And what is happening on the fiscal front concerns me as much as what we are doing. Irrespective of the outcome of the election, if I read it right, we are going to continue to see above range spending in the federal government; every revision of the level of the federal deficit has been sharply up in recent months. We are now looking at estimates for the deficit during this fiscal year of perhaps \$50 to \$80 billion, after closing out last year somewhere in the \$60 to \$70 billion range, without considering off-budget spending. So on the fiscal side, if we ask what we will be looking at six months from now, regardless of the outcome of the election, it appears to me that both sides are coming out with tax cuts. [So] that applies to the outlook of the Board [staff] for the fiscal deficit irrespective of the outcome of the forthcoming election. That has to be considered.

Everyone has mentioned that the outlook for shocks is particularly scary right now, with a major war going on in the Middle East. So we are vulnerable there to inflationary pressures hitting us again. And that brings us down to what we should do against this background of vulnerability to shocks and the fiscal outlook. My feeling is that we have to be very concerned not to go through these wild gyrations of monetary aggregate growth. I wouldn't want to advocate that we sharply contract [such growth] in an effort to get it way down in the middle of the range because that will just encourage another round of [unintelligible] that we will settle up with monetary policy. Rather I do think we have to temper our approach at this time to try to hit--your commitment Paul, you were the one who said it last October--these targets. We can't ignore the fact that regardless of what we say and how we interpret the different variables to the public, they are going to make their own reading on it. What they are going to say is that either we did it or we didn't. In that connection, I feel somewhat like Mr. Mayo: Whether or not we are happy about these things, the fact is that we are going to be measured by them. So we may as well try to play to win, whether or not we like the rules of the game. The only element that I would add [relates to] the letter you sent to us concerning how the public would interpret hearing that we are reconsidering our operating procedures. If you throw that into the pot, I think you are very right to be worried about how it would be interpreted, especially if we miss the aggregates. So with all of that taken together, I come out on the "A" side, with a lot of concern that we are not going to win either way we go on this. But "A" seems to be the one that gives us a chance at least to maintain some element of our credibility on the October 6, 1979 plan you announced.

CHAIRMAN VOLCKER. Well, we have a couple of quarters that haven't been heard from. I don't know whether they want to be heard from or whether we should proceed.

MR. SCHULTZ. Well, I had hoped that the discussion was going to help me some, but so far it hasn't! We are in a terrible dilemma

and I would like to vote for "none of the above," but I don't have any good alternatives to offer you.

CHAIRMAN VOLCKER. You are permitted to be silent at this stage.

MR. SCHULTZ. You know that silence is not my nature!

CHAIRMAN VOLCKER. I'm not saying permanently. I said "at this stage."

MR. SCHULTZ. We have credibility problems on one side and on the other side we have interest rates that I think are beginning to bite. I'm not sure how much we can do about monetary growth over the next couple of months. As the Chairman says, [the outcome for this year] is probably already in the cake. And although I think the [economy's] momentum is rather strong and this fourth quarter might be a little better, [the economy] is very fragile; and if we run interest rates up too much, I see a real possibility that we will slip into another downturn. I don't think that would be very helpful nor is it the kind of policy we want to carry out. It seems to me that stability is pretty important but I hate to be slavishly chained to any kind of special numbers. So I really am having a very difficult time. I would like to talk in such a way as to keep our credibility, which leads me to "A." And I'd like to act in such a way that we don't let interest rates go up too high, which is equally problematical. So, we have a very difficult decision to make today and I don't have a very good answer at this point.

CHAIRMAN VOLCKER. Thank you, Governor. Does he speak for you, Mr. Solomon?

VICE CHAIRMAN SOLOMON. Yes. But let me follow up on what Fred said at the end. It seems to me that we ought to go for the targets of alternative A but we ought to put the borrowing level close to that of alternative B. I would suggest \$1.3 billion. That can always be reviewed later, but with a \$1.3 billion [initial] borrowing assumption presumably we would not get any significant upward pressure on the fed funds rate if the other projections are correct. Now, both alternatives may be completely unrealistic and we may just be swept over by this situation. Taking these funds rate assumptions that are consistent with the aggregates, it seems to me that we may pay some enormous costs if a month from now when the minutes of this meeting are published they show we targeted alternative B [growth rates] for September to December, which clearly indicate mathematically that we have given up on M-1B. Its growth would come in at 7 percent fourth quarter-over-fourth quarter, with the upper end of our range being 6-1/2 percent. I think the public would not understand that. At the same time, we are in this dilemma, and any significant rise in interest rates right now would cause some proverbial problems to the economy. So my instinct is basically the same as Fred's, and I would reach toward a combination as I indicated.

CHAIRMAN VOLCKER. Well, let me make a few comments. We certainly have some difference of opinion, which may not be fully resolvable, but a certain number of truths keep repeating themselves to me. Some have been mentioned and some may not have been. These truths seem to me self evident. They may not seem self evident to

everybody else around the table so I will repeat them. I think we have to recognize, first of all, that there is a certain artificiality in talking about these targets, however much the market is preoccupied with them and however much we are preoccupied with them. We talk about our credibility and that's important. But credibility over time has to bear some relation to what is possible and what is desirable. And these targets were not exactly written in heaven. They were written by fallible people. And there are a lot of uncertainties in the economy and a lot of changes occurring in it. I'd love to meet these targets, but it is not absolutely the be all and end all of existence.

Tony speaks about the public not understanding if we have--by some complicated arithmetic, which I'm not sure they are capable of doing very well--[numbers that are] inconsistent by a half percent of meeting the target. My judgment is that they will understand one hell of a lot less if we broke our back to meet the target in the fourth quarter at the expense of a decline in the money supply by a rather sizable amount in the first quarter. We'd be sitting here with people saying: Why did we have interest rates so high in the fourth quarter and now we are running way below the target in the first quarter and interest rates are tumbling and we are in the midst of another recession. I wouldn't like [it] either. I'd like to meet the targets and not have the first-quarter experience. All I know, looking at the past year, is that it isn't quite so simple to meet a target in any particular quarter and that an undue effort to meet a target in a particular quarter, however important the target may be, isn't the only thing that's important. There are some substantive problems that I don't think we can completely solve by saying this is what we said, or more specifically, this is what I said 12 months ago. I think we have to recognize--whether it's good strategy or bad strategy to change the targets at this point and I would not at all suggest that we change the targets officially--Steve's point about the targets for M-1A and M-1B, which is that they are wrong. They are internally inconsistent. That is the fact of the matter, which cannot be evaded. And in any public explanation of monetary policy and how we have met these targets in the past year, I will say that because it happens to be true. The M-1B [range for the year] is too low relative to [that for] M-1A. We thought there was going to be a 1/2 percentage point difference; there's a 2 percentage point difference. What we don't know is how much of that should come out of M-1A and how much should be added on to M-1B. But we know roughly that the M-1A target is too high. If the central tendency of what we were aiming at a year ago is right, the M-1A target is too high and the M-1B target is too low. It's an arithmetic fact. We said they were going to be different by 1/2 point and they are different by 2 percentage points.

As a number of people have said, forecasts are uncertain. And we have not had a good forecast of the money supply, and I say this with no criticism whatsoever. We haven't had an accurate forecast of the money supply on a monthly basis or a quarterly basis. We haven't had--really nobody has--an accurate forecast of the economy on a quarterly basis. When we sit here and guess about what will happen to the money supply, a great deal depends on the relative optimism of the staff regarding the business forecast, which I think does imply at least a slight downturn in November or December. That may or may not develop. A lot of people have suggested that there's a chance [GNP growth] is going to be a little higher than the staff

estimate--that's my own instinct--just from momentum. I'm not talking about anything big. And if we look at the direction of the errors in the money supply estimates, well, maybe they are going to change. There's a good chance the money supply is going to come in higher than the staff estimate. But that's a gut instinct and not anything more than that because basically it's a very uncertain proposition.

If you look at the forecast for next year, I have the instinct that it's improbable that the economy will be quite as stable as the staff suggests. But if I had to choose between whether it's going to be stronger or weaker, I would be very uncertain. I well understand why the staff ended up with a forecast of stability. Indeed, whether it's going to be stronger or weaker depends a lot upon what we are going to do this month, next month, or whenever. In that sense, the decision we make today is very important. Unfortunately, the hard fact of the matter is that the decision we make today isn't going to have much to do with what the money supply does between now and next month or between now and the end of the year. I don't think we have any experience that suggests the direction in which we try to move things is terribly significant in the very short run. But it may be very significant 2, 3, or 4 months from now. I just don't think we can change that. That's the way the economy is built. We face a situation, given the October estimate--which should have a little validity but which has been moving up, as John Balles says--in which October is already higher than either of these paths. And to get down to "A" we'd have to have [an actual] decline, in M-1A anyway, from here on out. Whether that's achievable or not, I don't know. It depends in part upon whether the economy turns around as the staff suggests it will.

The next point I would make is that I think the instability in interest rates has become a problem. It has become a problem in terms of real economic activity--I'm trying to abstract a little from the level of interest rates over a period of time--because the mere instability of interest rates, to some considerable degree, I think, affects the housing industry and perhaps the car industry and other areas of planning. If we could manage things so that in general we both followed the targets and had less instability of interest rates we would be better off, obviously. How to do that is the question.

I would repeat the point about lags that I made earlier. There are limits to the effort that has to be made, given the relative inelasticity of money supply in the short run, to change the trend over the next 2 months if the expense of that is changing the trend in months 3 and 4 by a much bigger amount in a direction we don't want to see it go. And we don't know. We don't know those relationships very well. I think we have to recognize that we're working in an area here involving some ignorance. The difference between "A" and "B"--and here is where the artificiality of some of this comes into play--is almost negligible in terms of the actual reserve path exercise. We are talking about a 2 percent difference in the growth path over the period to the next meeting, when we will look at them again anyway. That amounts to \$60 million worth of reserves, which in the first place is within our range of error and is much smaller than adjustments that we tend to make in the path between meetings in any event. So in that sense, if we just focus on those targets and we expected that what we are going to do here is the only thing that influences our actions, the difference between those targets we are

talking about is trivial. I don't think our decisions are trivial because they affect more than next month; and we ought to bear in mind what the effect is likely to be not only next month or this quarter, but next quarter and make some judgment on those grounds.

We are going to be controlled by what happens much more than by a difference between "A" and "B." Last month is a perfect example. What happened last month? We had a great argument about whether the money supply should be aligned, in terms of a target, 1 percent higher or lower. Within a week, as I remember, it was clear that the money supply figure was far above either of the targets. And we responded. I don't think the aggressiveness of that response would have been a \$60 million difference--or I suppose in one sense \$30 million--because there was only one difference in opinion. It was washed out in other factors. The fact is that the Committee in general recognized--there was no disagreement, for instance, on the discount rate decision--that [the money supply] was going too high. And within the limits of human judgment we responded. I think it's more than likely that we will face that kind of question again this time.

Now, whether we choose "A" or "B" biases things a bit, but I don't think we ought to be overwhelmed by that particular difference. If I had to guess--and I suppose it's implicit in my remarks here on worrying about what's going to happen--I'd say the danger is that the money supply is going to be too big and the economy is going to be a little stronger. The growth in money is going to be too big regardless of which of those targets we pick or if we choose something in between. Now, we still have to make a judgment about what we are going to do and reach some kind of consensus. In a sense the more relevant issue substantively--not in terms of what somebody reads in the directive a month from now, which I think is highly colored by what happens between now and a month from now--is what our intentions are, or how we bias this in the future. That is only partially influenced by the choice of targets; it is more directly influenced by the level of borrowings we set now and the speed of reaction to what all experience shows is likely to be a change in the money supply estimate, not within a 2 percent range but within a 6 percent or an 8 percent range, either up or down. And that's where we have to make a decision.

I would point out in just technically explaining what has happened to the money supply during this year that we may have had one of the biggest swings in the direction of economic activity in the shortest period of time that we have ever had. From March to July--I'm just guessing and not looking at the quarterly figures--I suppose the GNP was declining at an annual rate of something like 10 percent for four months. It meant nominal GNP was virtually zero, looking at it on a monthly basis. Since then--I don't know what you would guess, Jerry--but I'd say it was going up 7 or 8 percent if one just looked at August and September alone. So, getting into October we had a swing in the course of economic activity at an annual rate of 17 percent. And since that is the major factor that affects the money supply in the short run, with stable interest rates anyway, looked at in that light it isn't totally incomprehensible as to why the money supply went through a swing of 17 or 18 percentage points at an annual rate. Now, I'm abstracting from some very big changes in interest rates, [whose effects involve] some lags, which is the point I think we made to a considerable extent. That's why I think what happens to

the money supply in the very short run is going to be largely governed by an uncertain business outlook as well as by all the random disturbances that enter in, as it always is.

Let's look at where we come out. Right at this point do we want to put considerable additional pressures on the market in the absence of any further evidence that the money supply is off line or do we not? That's the first decision, from my point of view, that has to come out of this meeting. Secondly, I take it for granted that if the money supply is increasing more than, let's say, the "B" path--I'm not suggesting necessarily that we take "B" at this point--but just given the random fluctuations in the money supply, if we get some more upward revisions in the present estimates of the money supply, I would personally presume that we have to react. [The growth in money] is already high; we are already above "B." If [money growth] in the next few weeks comes in still higher than we expect, that is consistent with a reaction--from what most people have said, anyway. In general terms of direction, I assume that there is a consensus on that point. If it comes in low--in that happy circumstance--I'm not sure there is a consensus. But Steve first, and others subsequently, commented on not reacting too fast in an "easing" direction if the money supply comes in low. I don't know whether I can take that as a given of our decision or not. I would personally accept that. And just to pin down the first point I made, I'm not sure I would come out of this meeting with a strong conviction, based upon knowing nothing else about the money supply or the economy or anything else, that we should force a significant change in the money market--in other words force a significant change in the borrowing level. I'm not talking about fine-tuning here, but a really significant change.

Now, I don't know whether there is a consensus on those points or not. Point one is that we don't force a really major change now and I'm not fine-tuning on that. [Point two is] that we certainly react if the money supply comes in above the current estimates that the staff has given us, which are already high compared to any of these [ranges] and that we don't react very fast if it comes in low. I'm speaking now in qualitative terms. If that's more or less an agreed framework--and I just raise that as a question--then we're left with what I see as the more trivial part of the decision, which has some cosmetic importance, more cosmetic importance to some of you than to others. I shouldn't downplay it as cosmetic. I realize it gets into the so-called credibility problem and all the rest. Precisely where we put the forecast for the money supply, which is a figure we're not going to affect very much in the next month anyway, is a question. Nonetheless, we have to put down a number at least in the directive. I suppose after listening to all of this, I'd be perfectly happy to put that number between "A" and "B." So, let me hear your reactions to all of that. And I suppose we need to make the borrowing number a little more concrete to give us some feeling of how fast we should react if the number comes in high--I don't know that it's so much a question of how fast, but how strongly--and the reverse if it comes in low, as to how passive we should be in relieving the borrowing pressure on the market as some have suggested.

MR. GUFFEY. Mr. Chairman, following those comments, I'm attracted to Tony Solomon's proposal that we adopt the A alternative with a borrowing level of about \$1.3 billion. I would also suggest

that we move the federal funds range to 9 to 15 percent, with some caution as we go above 14 percent if that is indicated.

MR. WALLICH. If we do that, aren't we saying "A," but doing "B" in effect? It seems very close to that because--

CHAIRMAN VOLCKER. It's just the opposite of what we did last time.

MR. WALLICH. It's the borrowing level that really influences market conditions and, therefore, eventually money.

MR. GUFFEY. I'm picking up on the Chairman's comment that we not move too quickly early in the period. I guess I've come to the conclusion that in this intermeeting period we are going to move upward with interest rates. It's a question how quickly we do it. And I think we control that through the level of borrowing.

CHAIRMAN VOLCKER. Well, you've come to that conclusion--just to clarify your view--because your instinct is that the money supply is going to come in high.

MR. GUFFEY. I think that's correct.

MR. PARTEE. It's already high relative to "A." Remember, M-1A is what has all the reserves on it. And we already have growth in October that looks to be above the number here. So, I think it just means that the borrowing level will move up from \$1.3 billion to a significantly higher number. And the result will be that [the funds rate] will have to move up in its range. I agree with the 15 percent upper limit for that range; the question will soon be before us of whether 15 percent is too restrictive and whether the discount rate will need to be increased another couple of points and so forth. So it really biases [the outcome]--remember that we are going to be running a path against whatever aggregates we choose--to take "A." It means we are talking about a very tight policy consistent with a significant degree of recession and no recovery.

MR. GRAMLEY. I agree with Chuck. I don't think we can solve this problem by just picking the level of borrowing. If we pick aggregates targets that are likely to be exceeded and the borrowing begins to rise above the level [we chose], then interest rates are going to go way up. And then I think we will be in very great danger of precisely the circumstances Chuck is talking about--generating another recession.

CHAIRMAN VOLCKER. All I mean to say by the difference between "A" and "B" is that the money supply--my own feeling and maybe I'm wrong--is [likely] to come in high; it's unlikely to come in between "A" and "B," just by the law of averages.

MR. GRAMLEY. Yes. But your guess is that it probably will come up to the level of "B" and maybe run over.

CHAIRMAN VOLCKER. That's right.

MR. GRAMLEY. That's what worries me, too. And I think what we ought to try to do is find a strategy. I don't mind if we don't

react on the down side. If the money supply falls a bit short, that's all right. I wouldn't want to react in a downward direction on interest rates. But I certainly don't want to react strongly in the direction of much higher interest rates, if in fact the aggregates run over for a 2-month period. And I think they might.

MS. TEETERS. Isn't the point about lags relevant here? What we do with interest rates over these next couple of months will impact the first quarter. And certainly the forecast for real GNP in the first quarter is weak enough that if we raise interest rates in the next couple of months, we won't [reach] that forecast of real GNP; it will be much weaker than that. So instead of trying to figure out what the money supply is going to be for the next two months, I'd rather look at the first quarter. And I don't think we need a rise in interest rates with the impact going over into the first quarter.

MR. MORRIS. Mr. Chairman, I'd like to speak for the opposite position. In picking \$1.3 billion [in borrowing] you're contemplating that we would start out with about a 12-1/2 percent funds rate. The rate has been there for a month, roughly, despite the fact that the early October money supply numbers have come in very strong, stronger than we expected. It seems to me that what has happened to the money supply in October calls for some response on our part. So I would advocate a level of borrowing compatible with a 13 percent funds rate as a minimum move. We don't have much time left in this year.

CHAIRMAN VOLCKER. That's for sure.

MR. MORRIS. And, therefore, I don't think we should waste a week or two when we have so [few] weeks left to operate.

MR. PARTEE. In terms of quarterly averages, the year is almost over.

MR. WALLICH. If we look at the averages, we have to look not only at what is happening now but what has gone on before. When we look at a 6-month period, the third and fourth quarters, we will have had a very strong rise. I don't think one should say the third quarter is over, we're now looking at the fourth quarter only, and we can't accept a risk of near zero on M-1A. We have to merge the two periods. But I do share the view that we need not focus too closely on what happens between now and the end of the year on the aggregates. We really ought to look further ahead in order to get a reasonable period over which these things evolve. What matters to me mostly is the stance with respect to the real sector in that we have a very inflationary situation. Several people have pointed to possible shocks that we might get from oil and other sources. And we haven't run any of that out. I'm not arguing for a recession, but I think we have to restrain this economy a little longer.

MS. TEETERS. Steve, can you pinpoint a federal funds rate with a level of borrowing?

MR. AXILROD. Well, [the relationship] has been a bit shaky.

CHAIRMAN VOLCKER. "Pinpoint" isn't exactly the word he would use!

MS. TEETERS. But that's what we're talking about--how we do it in--

MR. AXILROD. We have had a level of borrowing in the last two weeks of \$1.1 and \$1.2 billion [respectively], with the funds rate right around 12-5/8 percent. So, I'd say it isn't unreasonable to think of \$1-1/4 billion with a funds rate around 12-1/2 percent. In the previous two weeks we had a much higher level of borrowings and a much lower level of the funds rate. That was around quarter-end. But also in that period very large banks were much heavier borrowers than they have been recently. In the last two weeks of September, large banks borrowed 45 percent of the total borrowing and in the recent two weeks they have borrowed 25 percent of the total borrowing. And when there are large borrowers, I think it takes a little pressure off the funds rate; when they are not [in], it puts some pressure on the funds rate. That's my view in any event. So a lot depends on which banks decide it is their turn to borrow. I would say that a 12-1/2 percent funds rate and \$1-1/4 billion in borrowing isn't unreasonable to think about, but I'm uneasy because I can't quite tell which banks are going to decide to borrow or not to borrow.

MS. TEETERS. But our determining the level of borrowing doesn't automatically determine the funds rate.

MR. AXILROD. Well, that's right, not precisely; but there is certainly a reasonable band. In interpreting the demand for borrowing we certainly interpret the discussion of the Committee as well.

MR. CORRIGAN. Mr. Chairman, I'd like to repeat something I said earlier. I don't think it matters a great deal here in terms of either "A" or "B." When we talk about all the dangers and risks that are out there, what still bothers me is that the biggest danger is that if we get another month or two of money growth rates like the ones we've had over the past three or four months, then all those dangers we're talking about are going to materialize anyway. We're going to have higher interest rates. Indeed, I think we'll have the instabilities of interest rates that you spoke of. We'll go into 1981 on a growth plane in money that will give us a more difficult problem then. I could easily live with "A" or "B," but I personally would like to see the directive couched in terms that forcefully get across the point that if we continue to get this cumulation of errors on the plus side, a [tightening] movement would be [warranted] because if that happens, we're going to have to do it anyway.

CHAIRMAN VOLCKER. Yes, I think that's quite clear.

MR. PARTEE. I don't disagree with that.

CHAIRMAN VOLCKER. It's hard to disagree with that. If we get more indications of this excessive [money] growth, we're going to react.

MR. ROOS. That approach seems totally illogical to me, Mr. Chairman, because we say that there's very little we can do to affect the rate of money growth right now and yet we say if something happens a few weeks from now, then we'll try to do something that will affect it, even though we can't affect it now. I don't think that makes much sense, if I understand what people are saying. If we really want to

do something about controlling the rate of money growth in the long pull, I don't think it's as complex [an undertaking] as we're making it when we talk about borrowings and all of this. We are creating a terribly complex, complicated, and unworkable process of getting from here to there. We're never going to get the job done doing it that way.

MR. MAYO. It isn't a simple world.

MR. GRAMLEY. It seems to me, though, that the issue we're talking about on monetary control is not whether it can be done but over what time period. When one looks at what has been happening to the narrow money supply, it went up 19 percent in August, 12 percent in September, and is projected to rise 4 percent in October. And the two alternatives we have [in the Bluebook] range from growth of minus 1/4 of 1 percent to 3 percent. How dramatic a slowdown could you possibly want? Why do we want to try to force all of the adjustments to what has gone wrong over the whole year 1980 to date into these last two months? It seems to me that we would want to start a course of policy that will bring us moderate growth rates over the next year, the next 18 months, the next two years. I just can't see trying to make up for past mistakes in a two-month period.

MR. ROOS. But, Lyle, hasn't that been where we've missed the boat for almost the last five years? As recovery has begun to occur, haven't we always said: Let's just look in the next 30 or 60 days and let's not rock the boat because we might abort the recovery? Haven't we procrastinated in taking any meaningful action so that in the aggregate what we've tolerated has led to this present recession? I've seen [that happen] ever since I've been on this Committee, whether we were trying to stabilize interest rates or were doing it this way. We always have some fear that something negative is going to happen to the economy. And almost inevitably we've had two [results]: We've been surprised at the resilience of the economy and we've also failed miserably to do anything about inflation.

MR. GRAMLEY. But, Larry, if you remember back just six months ago, the shoe was on the other foot. The money supply was dropping like a rock and you weren't saying let's not worry about it. We're always too much concerned about interest rates being too high and having negative effects on the economy. You were saying let's see how much reserves we can dump in to get money growth this quarter in the immediate future. I think that's one of the reasons we're paying for it now. We just let interest rates drop too far last spring. We got the economy turned around too fast. We should have thought then that we needed to play for the longer pull not for next month or the next quarter. And that's the advice we need now.

VICE CHAIRMAN SOLOMON. You're right; we made that error. In part we made that error not only because of ideology but because of the economic forecast. Nobody expected this early bottoming out of the recession. We may have had a causal impact on the earlier bottoming out of the recession by letting interest rates drop too quickly. I agree with you that we were letting them drop too fast.

MR. MORRIS. Why was that an error if we mitigated the extent of the recession? I don't think it was an error at all.

MR. WALLICH. We aborted the recession.

MS. TEETERS. We're going to abort the recovery, too.

MR. MORRIS. If your objective was a 9 percent unemployment rate, we made an error. But I don't see--

VICE CHAIRMAN SOLOMON. We miscalculated, though. If we had known that the economy would turn up in the third quarter, I don't think we would have pumped in reserves as much as we did.

CHAIRMAN VOLCKER. But suppose you argue that that was just the right course. I think you can also argue that that's why the money supply is rising so fast now. So don't be so worried about it if that was the right course, because now you have to worry about what [the money supply] is going to be in the first quarter.

MR. MORRIS. Well, there's some logic to your [suggestion]; I'm not saying it's completely illogical. But you talked about reacting if the aggregates come in high. I'm saying they have come in high in early October and we have not reacted.

CHAIRMAN VOLCKER. Well, we haven't reacted in the last two weeks. We've had quite a lot of reaction since the last meeting. And I think the first question is: Do we want to react right now? That's a reasonable question. I would say no, but that is the first question to be decided, it seems to me. When I say no, I mean not react dramatically; I think \$1.3 billion or something like that may mean a slightly higher federal funds rate.

VICE CHAIRMAN SOLOMON. I think one thing we have to bear in mind is that none of us really has any confidence in the forecast. It could come in at that level or it could come in much higher or much lower. Al Wojnilower in New York is saying it's going to be a stronger recovery [than generally forecast]. Other people are talking about the double-dip. The forecasts are all over the lot. Under those circumstances, it seems to me that we have to start off fairly cautiously in terms of not wanting to see any major movement of interest rates. But I do think we have the credibility problem; Paul obviously feels that I may be exaggerating it. But I am concerned about a September-to-December intermediate target that would make us open to the charge that we actually targeted growth fourth quarter-over-fourth quarter that is higher than our target range. It seems to me that in this very unsatisfactory situation there is no good answer and we should compromise because I agree with Paul that the differences between "A" and "B" are not that significant. I think they have a public relations importance. The difference between \$1-1/4 billion and \$1-1/2 billion initial borrowing is not [much] more important than the \$60 million reserve difference between the "A" and "B" [alternatives]. I think there has to be a mix, and I've made a specific suggestion. I don't know what alternative specific suggestions there are.

CHAIRMAN VOLCKER. Let me make a specific suggestion. I don't know if there is any argument about the funds rate; I don't think it's terribly critical. We can change that, but a range of 9 to 15 percent has been suggested by a couple of people. I'll pick up the borrowing at \$1.3 billion--that's Tony's suggestion--which I think

implies a tendency toward a tighter market. It is not a dramatic change, but it tends in that direction. And, just in the interest of achieving a compromise, I'd split [the difference between] "A" and "B." We have to get a majority vote for something. Have I left a variable out? I know the qualitative variable is [how quickly we react]. This wouldn't go in the directive, but the implication is that if we get surprised on the high side--I'll call it a surprise--of the current money supply projections, we're going to be reacting about as soon as we know that [the aberration is] significant.

MR. BLACK. By changing the nonborrowed reserve path or borrowings?

CHAIRMAN VOLCKER. We would permit the level of borrowings to go up automatically in the first instance and would begin thinking about changing the nonborrowed reserve path. If we change that, it's likely to be by an amount that is bigger than the difference between "A" and "B." It always is.

MS. TEETERS. How much higher do you think \$1.3 billion of borrowing would put the funds rate? Somewhere between 12-1/2 and 13 percent?

MR. AXILROD. Again, if large banks suddenly decided to borrow, I'd say it could be [higher]. Ordinarily--

CHAIRMAN VOLCKER. I think the best guess is between 12-1/2 and 13 percent, but it could conceivably go above 13 percent in some weeks depending upon the distribution.

MR. PARTEE. That \$60 million figure you've been using, Paul, that's for one month?

CHAIRMAN VOLCKER. Yes, that's only for one month.

MR. MORRIS. Wouldn't it be a little more scientific, Paul, for the Committee instead of setting a borrowing level--we're not really concerned about the borrowing level per se--to establish an initial funds rate for the period? Why not express it that way?

MR. GRAMLEY. It's not just the initial funds rate. It's the funds rate [unintelligible].

CHAIRMAN VOLCKER. Obviously, all this revolves around some concern, which some people have anyway, about interest rates. But I think we really are saying something different if we set a specific funds rate objective. We just said vaguely between 12-1/2 to 13 percent; it could be above 13 percent in some weeks. That's a little different in terms of the way Peter is going to react. If we say the funds rate should be 12-3/4 percent, he's going to be fiddling around in order to make it 12-3/4 percent or as close to it as he can, I suspect. I think that's a real difference in methods of operation.

MR. SCHULTZ. I don't want to do that.

MR. RICE. If we split [the difference between] "A" and "B," would that imply changing the stated targets?

CHAIRMAN VOLCKER. What targets?

MR. RICE. Monetary growth targets.

CHAIRMAN VOLCKER. For the year?

MR. RICE. Yes.

CHAIRMAN VOLCKER. No, I'm assuming we are not going to announce any change in the targets. But I've already said that I have to testify in three weeks and I assure you that I'm going to say in explanation--what else can I say?--that we had a target that assumed a difference of 1/2 percentage point between M-1A and M-1B and, in fact, it has been running 2 percentage points. After all, they can see that by looking at the chart. We got more inflows to NOW and ATS accounts than we had estimated. Part of that came out of savings or other instruments and part of it, presumably, came out of M-1A. We don't know how much came out of M-1A; we don't know how much came out of other instruments. But the M-1B range is obviously a little low and just on technical grounds--

VICE CHAIRMAN SOLOMON. You're going to say that all these banking structural reforms that I recommended have complicated--

CHAIRMAN VOLCKER. I've already told them that. Now we're giving them a specific example. It doesn't imply anything for policy but it does explain a bit why we're high on M-1A. What it's going to show is that we're high both in the M-1A range and in the M-1B range correctly interpreted. If the money supply comes in high, we're going to be outside the ranges.

MR. GRAMLEY. There isn't any real likelihood that [M-1B] fourth quarter-to-fourth quarter is going to exceed the stated range.

MR. PARTEE. Well, he means adjusted.

CHAIRMAN VOLCKER. No, but if one correctly interpreted it, there's a possibility, I think.

MR. PARTEE. It'll be high in the range. One way to look at it is that we'd be in the upper half of both the M-1A and the M-1B adjusted [ranges].

CHAIRMAN VOLCKER. Well, we'd be very close to--

VICE CHAIRMAN SOLOMON. We should really go back to an average of the two M1 measures.

MR. PARTEE. Well, I think we've always done that.

CHAIRMAN VOLCKER. That's essentially what we are after.

MR. PARTEE. I can't understand what has happened to M-1A. I wasn't aware that Larry, for example, had shifted from M-1A to M-1B until right now. I can only conclude that it's because it's a higher number and that therefore he's really not a monetarist but a deflationist.

MR. ROOS. I just want you guys to know that the Chairman can't starve me into submission!

CHAIRMAN VOLCKER. I will rest on a simple statistical fact that while these targets may be the most wonderful, impregnable things in the world, they are mutually inconsistent.

VICE CHAIRMAN SOLOMON. Yes, in your November testimony, if you are going to hammer that point--

CHAIRMAN VOLCKER. I didn't say "hammer;" I said "say."

VICE CHAIRMAN SOLOMON. I think you're going to have to hammer it in for defense if for no other reason. And maybe you ought to indicate to the [Congressional] Committee that the reformulation of the '81 targets will have to be much more explicit.

CHAIRMAN VOLCKER. I will certainly indicate that. We already tried [not to be explicit] when we announced them preliminarily. But somebody reported to me that that was promptly interpreted as an easing of the M-1B target when we said in three different ways that it wasn't.

MR. SCHULTZ. I hope you will also hammer in or fight against any move to narrow the target ranges. Heaven knows that we ought to have learned that we really don't know that much about the [relationships among the aggregates] at this time.

CHAIRMAN VOLCKER. The general impression that emerges to me is that [growth is] high in these target ranges. Whether we're a little over or just within them, the fact is that on a fourth quarter-to-fourth quarter basis, whatever we say, we're on the high side and not the low side. I also hope that these things don't go wild in the next couple of months and that we don't have to say we missed them all and that they are all out of the ranges.

MR. MORRIS. That's the danger of talking about adjustments. Then we might be in a position where we have missed them all, adjusted, whereas at least this way we have one--

MR. PARTEE. [Unintelligible] M-1A.

MS. TEETERS. We have M3.

MR. PARTEE. And M2 has been showing some life lately.

MR. SCHULTZ. We'll go to L!

MR. PARTEE. Some people think we already have.

CHAIRMAN VOLCKER. If we take the midpoints of the two alternatives, just arithmetically we come out with a 1/8 for M2-- [7-3/8 percent]. So, [rounding for M2] we're talking about 2-1/2, 5, and 7-1/2 percent; or we could make M2 7-1/4 percent if you want to compromise it that way. There isn't much difference between the two M2 figures.

MR. MORRIS. But we'd still have Tony's problem, Paul, that we would be describing a growth path for M-1B that would be outside the upper limits.

CHAIRMAN VOLCKER. Well, technically, people can't tell that because it depends upon the path within the quarter. If somebody assumes it's a straight line, that is right. The proposal that I made, [given] the present M-1B target, would [imply that as] we sat here in October and looked at November we'd be 1/4 percentage point above the range. I don't think there's quite as much importance to that as [there is to the likelihood] that the market is going to attach great importance to the fact that we chose a target that was 6 percent or whatever it is, 6-1/2 percent as opposed to 6-3/4 percent for the year as a whole. I don't think it's the easiest piece of arithmetic in the world, but if that cosmetic is--

MR. GUFFEY. The difference may not be so important today. But as we move into the first quarter of 1981 if we stick with the targets already announced, we're making up not only the reduction that we're proposing for 1981, but the 1/4 or 1/2 percentage point that we missed before. And it just worsens the problem if we're focusing on M-1B, for example.

MR. PARTEE. I don't think that's technically true. It depends on the profile of the months. Now, if you're talking about a decline in the rate of increase so that we don't have that high of a quarterly average--

CHAIRMAN VOLCKER. The fact is that we know the market focuses on M-1B. I think that's unfortunate because M-1B is no better than M-1A. They're both bad. I suppose one answer would be just [for the sake] of debate that we have a target for M-1A that is below the midpoint. I think that's arithmetically right, isn't it?

MR. AXILROD. [Unintelligible] that's right.

CHAIRMAN VOLCKER. The [M-1A] number in "B" is at the midpoint. So if it came in below "B," it would be below the midpoint for M-1A.

MR. AXILROD. These are tenths in all cases.

MS. TEETERS. We're literally arguing over tenths. And that seems ridiculous when we have such a short period of time left.

VICE CHAIRMAN SOLOMON. I agree; I won't argue. I wouldn't dissent from your proposal, Paul. It's sufficiently balanced and it meets the needs.

MR. PARTEE. I would buy it reluctantly, too.

CHAIRMAN VOLCKER. Well, let's [see whether we have a consensus]. Just to repeat: We have 9 to 15 percent for fed funds, a small increase in the borrowing level initially and we have 2-1/2, 5, and 7-1/4 percent, just rounding these numbers, for M-1A, M-1B, and M2.

MR. ALTMANN. And "about"?

CHAIRMAN VOLCKER. In the directive we'd pick up that language that we used a year ago of "or somewhat less."

VICE CHAIRMAN SOLOMON. And you'd move the fed funds range to 9 to 15 percent?

CHAIRMAN VOLCKER. Yes, 9 to 15 percent on the fed funds rate.

MS. TEETERS. With borrowing of about \$1.3 billion.

CHAIRMAN VOLCKER. Initially.

MR. GRAMLEY. How would the Desk react if in fact we get growth in the monetary aggregates a little above the alternative B path or clearly above the alternative A minus that we're talking about here?

MR. STERNLIGHT. If the Committee votes for this, we will have a path that's based on these aggregates, and the nonborrowed path [will be constructed] using that borrowing assumption. If the aggregates come out at "B" or a little above, then presumably the demand for reserves is going to be a little higher than we're targeting and we will just stick with the nonborrowed path, so the implied borrowing level would come out somewhat higher than this.

CHAIRMAN VOLCKER. If it literally came out along the "B" path or a little higher, so long as that persisted the borrowing levels would be edging up. But I would describe it as an edging up rather than a dramatic change. If it came in way above [\$1.3 billion], then we would have a different situation.

MR. BLACK. But you would not lower the nonborrowed target under that?

MR. STERNLIGHT. We have not typically done that unless we're considerably above [the path]. When it was running \$300 or \$400 or \$500 million above last month, yes, we did make adjustments then. But at \$100 million above, we wouldn't be inclined to make such an adjustment.

MR. FORD. There are two other dimensions to what you're discussing on borrowed reserves. One is that on Friday, if the rates don't break this week, I suspect you're going to get a number of Reserve Banks recommending an increase in the discount rate, which would obviously affect the borrowings. The other thing is that we put out a revision in Regulation A.

CHAIRMAN VOLCKER. It won't affect the borrowings.

MR. PARTEE. The borrowings are set.

CHAIRMAN VOLCKER. We'll discuss that later.

MR. FORD. We have a revision of Reg A which, if I've read it right--and depending on how the different discount officers interpret it--calls for a tighter policy in regulating borrowing by the big banks, the issue that Steve just talked about. So we have to [factor]

into our thinking at least whether we're going to raise the discount rate.

CHAIRMAN VOLCKER. I'm not aware of that. But I would interpret a discount rate change as a rather forceful move, which I'm not talking about taking immediately. But we can't exclude it if this really comes in high over the course of the next couple of weeks.

MR. FORD. So you don't think the Board is likely to move [the discount rate] on Friday?

CHAIRMAN VOLCKER. No, not based upon this decision, without a radically different money supply figure or something.

MR. PARTEE. The Board would have to discuss it at its meeting.

CHAIRMAN VOLCKER. That's just a personal remark. Well, unless somebody has a--

MR. SCHULTZ. Let's vote.

CHAIRMAN VOLCKER. --further brainstorm, let me just see tentatively whether, as I take it, this attracts some support given the difficulties. I'm sure it doesn't please anybody perfectly.

MR. PARTEE. It's strictly a live-with kind of thing.

CHAIRMAN VOLCKER. That's right. Under the circumstances, I think "live-with" is about the best we can do until November 18th.

MR. BALLEES. What was your federal funds range, Paul?

CHAIRMAN VOLCKER. Nine to 15 percent, which just raises it a percentage point, doesn't it?

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. Shall we vote?

MR. PARTEE. You wouldn't like to see a show of hands first?

CHAIRMAN VOLCKER. We can see initially with a show of hands. How many of the Committee members find this broadly reasonable?

MR. SCHULTZ. It's the only way we can do it.

CHAIRMAN VOLCKER. I guess I'm forced to ask what else is broadly reasonable.

MR. SCHULTZ. Well, you have enough [votes]. Roger Guffey voted yes. He had a pencil up, but he did have [his hand] up.

CHAIRMAN VOLCKER. My sense is that I do not know of any other approach that's more broadly reasonable, so we might as well vote. I haven't heard any alternative that's likely to attract more support.

MR. SCHULTZ. No, I think under the circumstances you're probably lucky to get 8 votes for anything. It's all smelly; it's all tough. It's just a question of what one is willing to live with. I think that's absolutely right.

MR. WALLICH. Well, I'm less concerned about the money supply targets than about the borrowing level. I said previously that one can do one thing and say the other, and I'm perfectly willing to compromise along those lines. But in terms of the market, I think the interest rate is the crucial thing now.

MR. PARTEE. Well, \$1.3 billion [in borrowing] is above what it has been running.

MR. WALLICH. It's just that I don't believe the present situation is consistent with severely negative real rates after tax. We're going to have an inflationary--

MR. PARTEE. You want higher interest rates. I see.

CHAIRMAN VOLCKER. To get [positive] real rates after tax, Governor Wallich, we'd need a 21 percent long-term bond rate.

MR. WALLICH. Some people don't pay taxes and some people take the standard deduction. So this doesn't go across the board, but there has to be some allowance for taxes.

MR. SCHULTZ. Governor Wallich, I would tell you that if you talk to people out in the business world, there are already some real screams of pain. We are already flagellating them, but I think you want to crucify them.

MR. WALLICH. I think you're looking [at this situation] with an assumption that there is a painless solution.

MR. SCHULTZ. Oh no, no.

MR. WALLICH. And the only painless solution is more inflation.

MR. SCHULTZ. No, I agree that there's no painless solution. But there's already some pain out there.

MR. PARTEE. Henry would argue that they really don't know what pain is yet.

CHAIRMAN VOLCKER. What are you talking about on the borrowing level?

MR. WALLICH. I'd go with alternative A, \$1.5 billion.

CHAIRMAN VOLCKER. That's \$200 million [more]. I don't sense that that proposal is going to have more support than this one. And I think we better vote.

MR. ALTMANN.	
Chairman Volcker	Yes
Vice Chairman Solomon	Yes

Governor Gramley	Yes
President Guffey	Yes
President Morris	No
Governor Partee	Yes
Governor Rice	Yes
President Roos	No
Governor Schultz	Yes
Governor Teeters	Yes
Governor Wallich	No
President Winn	No

It's 8 for and 4 against.

CHAIRMAN VOLCKER. Okay. Do we have a Board meeting now?

SPEAKER(?). Yes, we have lunch and then the Board meeting.

END OF MEETING