Meeting of the Federal Open Market Committee

March 28-29, 1983

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., beginning on Monday, March 28, 1983, at 3:00 p.m. and continuing on Tuesday, March 29, 1983, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Gramley
Mr. Guffey
Mr. Keehn
Mr. Martin
Mr. Morris
Mr. Partee
Mr. Rice
Mr. Roberts
Mrs. Teeters
Mr. Wallich

Messrs. Boehne, Boykin, Corrigan, and Mrs. Horn, Alternate Members of the Federal Open Market Committee

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

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

Messrs. Balbach, R. Davis, T. Davis, Eisenmenger, Ettin, Prell, Scheld, Siegman, 1/ and Zeisel, Associate Economists

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

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

1/ Attended Monday session only.

Mr. Coyne, Assistant to the Board of Governors
Mr. Gemmill, Senior Associate Director, Division of International Finance, Board of Governors
Mr. Kohn, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Lindsey, Deputy Associate Director, Division of Research and Statistics, Board of Governors
Mr. Promisel, 1/ Associate Director, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Sims, Executive Vice President, Federal Reserve Bank of San Francisco

Messrs. Burns, J. Davis, Keran, Koch, Mullineaux, and Stern, Senior Vice Presidents, Federal Reserve Banks of Dallas, Cleveland, San Francisco, Atlanta, Philadelphia, and Minneapolis, respectively

Messrs. Broaddus and Soss, Vice Presidents, Federal Reserve Banks of Richmond and New York

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

1/ Attended Tuesday session only.

Transcript of Federal Open Market Committee Meeting of
March 28-29, 1983

March 28, 1983--Afternoon Session

CHAIRMAN VOLCKER. Mr. Cross, do you have anything to say about the foreign currency authorization, the foreign currency directive, or the procedural instructions?

MR. CROSS. No changes are recommended.

CHAIRMAN VOLCKER. And you have no comments?

MR. PARTEE. Would you refresh my memory, Sam? What kind of authority does this gives us on the foreign currency operations?

MR. CROSS. What kind of authority does this give us?

MR. PARTEE. What restrictions exist on our authority to deal in foreign currencies?

MR. CROSS. These are procedural restrictions, which set out limits on how much we can--

MR. PARTEE. And which currencies we can deal in.

MR. CROSS. And the currencies we can deal in.

VICE CHAIRMAN SOLOMON. And the amounts [allowable] within intermeeting periods unless the Foreign Currency Subcommittee moves on something urgent.

MR. PARTEE. We have 14 currencies listed, some of which we've never dealt in, I believe. Is that an exhaustive list of the currencies that we can deal in without Committee action?

MR. CROSS. Yes.

MR. PARTEE. It would take Committee approval to add a currency to that list? Is that right?

MR. CROSS. Yes.

MR. TRUMAN. The Authorization would have to be changed.

MR. PARTEE. The Authorization would have to be changed. And likewise the aggregate limit?

MR. CROSS. There is an aggregate limit. Let me check on whether Committee action is required on that. It is required.

MR. TRUMAN. Well, except in exigent [circumstances].

MR. CROSS. It is required, but a change can be approved by the Subcommittee, which would be subsequently taken to the Committee [for ratification].

VICE CHAIRMAN SOLOMON. But normally the Subcommittee doesn't act unless there's a time bind, and even then I think a proposed change is frequently referred to the whole Committee.

MR. PARTEE. I was questioned recently by a Congressional Committee on this, in the environment of discussing the possibilities of bailouts of foreign countries. And I reassured them that we weren't going to bail out any foreign countries through the operations of the Federal Open Market Committee. So, I wanted to be sure that there wasn't anything here that really would permit us suddenly to move in and buy the Yugoslavian currency or the Chilean currency or even the Brazilian currency--currencies that are not named on our list.

MR. TRUMAN. I think the answer to your question, Governor Partee, is that an addition to that list of 14 currencies has to be authorized by the full Committee. To the extent that the procedural instructions, which relate to the day-to-day operations of the Desk, [address this], there are some provisions such that if the full Committee can't be consulted there's a way of continuing to do business. But I think, as common sense would suggest, that would be only in cases in which we had ongoing operations and not something that we were starting fresh.

MR. PARTEE. And the only Latin American currency we have on the list is the Mexican peso?

MR. CROSS. That's the only one.

MR. GUFFEY. Are we talking about the swap arrangements or the Desk operations?

MR. PARTEE. I'm talking about Desk operations in foreign currencies.

MR. GUFFEY. Okay.

MR. PARTEE. Although the two happen to be the same list right now, I think. It's not exactly coincidental, but it's accidental in the sense that there could be a different list.

MR. GUFFEY. Yes, but on the swap agreements the Desk has to have prior authorization from the Committee to activate a swap.

MR. TRUMAN. No. The procedural instructions call for activation of the swap by the Subcommittee if it's [less than] 15 percent of the arrangement or $200 million. So, as a matter of the Committee's procedures, that's what is called for. In most recent cases that I remember when the foreign country was activating the swap, as a matter of practice, the full Committee has been consulted.

VICE CHAIRMAN SOLOMON. Anyway, [despite] what Ted said, Chuck is exactly right: You don't have to worry about it.

MR. PARTEE. I just wanted to probe a little for the record to see whether I got general agreement from people here that there's nothing to worry about. I think it's true also, Roger, that among the problem countries the only one we have a swap line with is Mexico.

CHAIRMAN VOLCKER. In which one of these [documents] does the overall limit appear?

MS. TEETERS. Agenda item 4a: Authorization for Foreign Currency Operations.

CHAIRMAN VOLCKER. It's in the Authorization. Have all the sublimits on particular currencies disappeared?

MR. TRUMAN. On holdings, Mr. Chairman, the last time around on that the Committee maintained the overall limit of $8 billion.

CHAIRMAN VOLCKER. $8 billion. Yes, but I don't see the sublimits.

MR. TRUMAN. We have not made those limits public.

SPEAKER(?). Even to the Committee?

CHAIRMAN VOLCKER. Where are those sublimits?

MR. TRUMAN. They are not in these documents.

CHAIRMAN VOLCKER. They're not anyplace?

MR. TRUMAN. They aren't in the documents that were circulated to the Committee.

CHAIRMAN VOLCKER. Where are they?

MR. TRUMAN. They were determined in a decision by the Committee the last time this was reviewed, which I think was last May.

CHAIRMAN VOLCKER. But we do have an outstanding decision that controls individual currencies?

MR. TRUMAN. Yes.

MR. BERNARD. Yes. There are so-called informal limits and the total is $4-1/4 billion.

MR. TRUMAN. It's $5 billion, actually.

CHAIRMAN VOLCKER. Mr. Bernard.

MR. BERNARD. My list may be a little out of date. When the informal limit was $4-1/4 billion, at any rate, [the breakdown] was $2-3/4 billion in German marks, $1 billion in Japanese yen, and $500 million in all other currencies. I don't know if that $4-1/4 billion was increased or not.

MR. TRUMAN. I think it was increased to $5 billion the last time.

MR. CROSS. It was increased to $5 billion last year and the German mark portion of that was increased to $3-1/2 billion. Now we are getting close to that $3-1/2 billion limit. We do not expect to need it within the next few weeks, but we are not that far away from the limit and we continue to earn interest on these marks, so it is a matter of time before we may need to change that limit.

CHAIRMAN VOLCKER. How far are we from the yen limit?

MR. TRUMAN. $502 million.

MR. CROSS. We're under [no] pressure on the yen limit.

MS. TEETERS. We're holding these--

CHAIRMAN VOLCKER. We're $502 million away from the limit?

MR. TRUMAN. There is the limit in the Authorization, though, for an overall open position of $8 billion, which the Committee set. And that is what appears here in paragraph 1(d) in the Authorization. The Committee has chosen to set limits on balances in these currencies informally in the way in which Norm and I together with Sam have described. That limit is $5 billion, with the sublimits of $3.5 billion in marks, $1 billion in yen, and $500 million in all other currencies. In the case of the yen, we hold roughly $500 million in yen balances and, therefore, there's $500 million to go.

MR. PARTEE. Well, the only reason these would be working up is because of earnings.

MR. CROSS. Yes, interest earnings.

MR. PARTEE. I must say that in reviewing the material this came to my attention and I don't recall it ever being discussed by the Committee. One could have presumed that when we received the earnings on our foreign investments we would liquidate the earnings--that is, convert them into dollars. But instead, apparently we have never converted any of these earnings to dollars; we leave them in the foreign currencies. Is there some reason for that, Sam?

VICE CHAIRMAN SOLOMON. I don't think it makes sense to be buying dollars at a time when we're all worried about there being such a strong appreciation of the dollar, Chuck. I think that was the only reason.

MR. PARTEE. [I suppose] that's the only reason, because I see no reason in principle that we wouldn't want to convert the earnings to dollar form.

MS. TEETERS. Do these limits include the holdings that we have for repaying the Carter bonds?

CHAIRMAN VOLCKER. The Treasury has those.

MR. CROSS. They're put in and then taken back out.

MR. TRUMAN. No, these are not the currencies that are held against Carter bonds.

MS. TEETERS. So, those holdings are in addition to what we hold in--

MR. CROSS. The currencies you are talking about are the currencies held by the Treasury. The currencies that we hold under warehousing [agreements] are in addition.

MR. PARTEE. [That has] come way down.

CHAIRMAN VOLCKER. Do I have a motion on these?

MR. CROSS. Well, Mr. Chairman, let me say that since we're getting close to the limit on [marks] and the Committee has had this chance to discuss it, you may want to consider whether to raise it.

CHAIRMAN VOLCKER. Let's wait until we get to your part on the [agenda].

MR. PARTEE. I want further discussion before I'm prepared to vote.

MR. MARTIN. Move approval of item 4(a).

MR. PARTEE. All right, I second.

CHAIRMAN VOLCKER. Objections? In the absence of any objections, they're all approved. On Treasury warehousing, [we received] a memorandum from Mr. Truman. This is something we review every year. The staff's recommendation is that it be agreed to for another year. The Treasury is still warehousing a lot, I guess.

MR. TRUMAN. Mr. Chairman, the remainder being warehoused is entirely in marks and it's just under $1.1 billion. The timing of that warehousing agreement is such that it will be used to pay off remaining Carter notes--Governor Teeters, this is where the Carter notes come in--in May and June.

MR. CROSS. May and July.

MR. TRUMAN. May and July of this year. And then we would have no more [foreign currency holdings] actively warehoused with the Treasury. On the other hand, it seemed to us and the Treasury, given their activities in other currencies--ones we'd just as soon not hold --and the fact that they do hold a certain amount of marks and Swiss francs and yen in addition to what they've already warehoused, that to the extent the Exchange Stabilization Fund might get into a liquidity bind it made sense to maintain this facility for that purpose.

VICE CHAIRMAN SOLOMON. I'd certainly like to argue in favor of it. I see no reason for discontinuing it; it's an important help to the liquidity of the ESF. The Treasury would have had some very serious problems from time to time if it had been operating without the warehousing fallback.

CHAIRMAN VOLCKER. Would you like to make a motion?

VICE CHAIRMAN SOLOMON. I would move that it be extended for another year.

MR. MARTIN. Second.

MR. PARTEE. What happens here with the earnings?

MR. TRUMAN. We keep the earnings.

MR. PARTEE. In foreign currency form?

CHAIRMAN VOLCKER. Well, it's Treasury earnings.

MR. TRUMAN. No.

CHAIRMAN VOLCKER. They are the Treasury's foreign currencies, aren't they?

MR. TRUMAN. It's the Treasury's foreign currency but the--

MR. PARTEE. I think we pay--

MR. TRUMAN. The warehousing takes the form of a spot sale and a forward purchase, flat. So, they sell us 100 marks and we sell them back 100 marks, except that the 100 marks have earned some interest in the meantime.

CHAIRMAN VOLCKER. Which we put in our regular--

MR. TRUMAN. We keep it in our balances.

MR. PARTEE. As marks?

MR. TRUMAN. As marks.

MR. PARTEE. And we then perhaps pay them off in dollars?

MR. TRUMAN. No, we pay them off in marks.

MR. PARTEE. It accumulates in marks on their side too, so we're neutral so far as the foreign exchange risk is concerned on the earnings.

MR. TRUMAN. No, we take the earnings into our portfolio. The principal is where the--

VICE CHAIRMAN SOLOMON. The Treasury bears the foreign exchange risk.

CHAIRMAN VOLCKER. On the principal, as far as--

MR. PARTEE. So much [unintelligible] exchange is coming--

CHAIRMAN VOLCKER. The explanation, as I understand it, is that we just take the earnings into our portfolio and add them to our balances in foreign currencies.

MR. ROBERTS. So, forget the exchange rate risk.

CHAIRMAN VOLCKER. Forget the exchange risk on the principal.

MR. MARTIN. There's a risk on the earnings but not on the principal.

MR. RICE. These earnings come from investments in mark-denominated securities?

MR. TRUMAN. Well, among other things, yes.

MR. PARTEE. We're not talking about weak currencies here?

MR. TRUMAN. No. Again, the only currencies that the System Account could hold would be the 14 that are on that list.

MR. PARTEE. Even for the Treasury?

MR. TRUMAN. Even for the Treasury, except by a separate authorization of the Committee. In contrast to other operations the Treasury has with us, like the SDR monetization, this is not an automatic facility. It's at our discretion as to whether we agree about the liquidity conditions or the circumstances. If we deem that the circumstances so deserve, they can activate the facility. So, we have to agree to the circumstances.

MR. RICE. Do we manage the investment?

MR. TRUMAN. We manage it; we have some for the Treasury anyhow. It's through the Treasury account at the New York Bank that we would manage the investments.

MR. WALLICH. Is the holding of a foreign currency resulting from interest receipts defined as intervention or is the nonholding--that is, the disposing of that--defined as intervention in your report? You know what I mean.

MR. TRUMAN. As I remember, the report is agnostic or somewhat ambivalent on this point [as is] the U.S. government itself. I was amused to hear President Solomon's response to that because I think when he was once [wearing] another hat he argued--and we did too--that interest on dollars that foreigners accumulate should be put into the markets. Now, I think you can argue the economics of the issue on either side. Likewise, the question of whether it's intervention can be argued on either side. My purist colleagues would say that that is indeed intervention since the interest changes the net asset position in foreign currencies.

MR. PARTEE. We take the interest in foreign currency form and it then flows through to the earnings of the Federal Reserve System.

MR. TRUMAN. Right.

MR. PARTEE. We then pay the earnings of the Federal Reserve System in dollars to the Treasury.

MR. TRUMAN. Right.

MR. PARTEE. As I see it, in some sense the quality of the Federal Reserve's balance sheet deteriorates.

MR. TRUMAN. You might look at it just as that we've diversified further.

CHAIRMAN VOLCKER. Are there any objections? Not hearing any objections, it's renewed. We now have the Authorization for Domestic Open Market Operations, agenda item 6. We have a recommendation from Mr. Sternlight to increase from $3 to $4 billion the intermeeting limit on changes in System Account holdings. He had a memorandum. Do you have anything further to say, Mr Sternlight?

MR. STERNLIGHT. I'd just remind the Committee that the last change in that standard authorization was made in 1974, when the Committee raised it from $2 to $3 billion. I think the recommendation is logical. It seems to me, with longer intervals between meetings and larger dollar volume changes in the typical factors affecting reserves, such as seasonal currency flows, that a change is in order. And I think this proposed change would reduce the frequency of occasions for going back to the Committee for intermeeting changes of the leeway but would still call the Committee's attention to really large needs for change. In the past two years, for example, there were 8 occasions when we came to the Committee for a change in the leeway. Had the leeway been $4 rather than $3 billion, there would have been just 3, rather than 8, such occasions.

CHAIRMAN VOLCKER. This is still low enough so that there will be some occasions for a check upon your operations.

MR. STERNLIGHT. I would expect so, Mr. Chairman.

CHAIRMAN VOLCKER. Do I have a motion?

MR. RICE. Moved.

MS. TEETERS. Second.

CHAIRMAN VOLCKER. Any further discussion? Do I hear any objections? The limit is raised from $3 to $4 billion. Now, item 6(b) is a recommendation to delete section 2 of the Authorization pertaining to direct lending to the U.S. Treasury. We also have a memorandum on that from Mr. Bernard. Are you going to say something?

MR. BERNARD. I have nothing really to add, Mr. Chairman, beyond underscoring the fact that--

CHAIRMAN VOLCKER. It's against the law.

MR. BERNARD. That's right. And there are no prospects for renewal [of that authorization] that we know about.

CHAIRMAN VOLCKER. As it now stands, we provide for an authorization to do something that's against the law. I think that's--

MR. FORD. That's too frank!

VICE CHAIRMAN SOLOMON. If there were an unexpected cash problem in the Treasury, then in practice that night we would honor overdrafts, I gather. But they would be expected then to do a cash management bill and get the cash in before close of business the next night?

CHAIRMAN VOLCKER. I don't know that we've been that precise about it. I think if they're stuck and they overdraw their account, we're stuck. But I guess we'd get after them.

MR. AXILROD. Yes, but we do have a ruling from a lawyer who says that that overdraft is not lending to the Treasury but is performing a normal banking function.

VICE CHAIRMAN SOLOMON. Okay, if they can't--

CHAIRMAN VOLCKER. A normal banking function in this day of lax banking practices!

MR. MORRIS. Was that Burt Lance who wrote that?

MR. MARTIN. [Unintelligible] everybody overdrawing?

MR. FORD. Burt Lance is going to be relieved to hear this!

VICE CHAIRMAN SOLOMON. Steve, but what happens if we honor the overdraft and the next morning they issue a cash management bill but they can't settle it until the next day? Are we permitted under the lawyer's ruling to give an overdraft the second night?

MR. AXILROD. I think they would have to extend their ruling a bit [beyond] one day. I don't know that they would--

MR. STERNLIGHT. Well, I don't see why under present procedures they wouldn't be able to settle a cash management bill the same day. If I can just elaborate on this first point: This ruling from a lawyer sounds very open ended, but it has to be judged an inadvertent overdraft--something that arose despite prudent and proper planning.

MR. BLACK. Did you have to try more than one lawyer?

MR. GUFFEY. Do we get the discount rate plus 2 percent on that overdraft?

MR. STERNLIGHT. I don't know if there's any interest provision.

CHAIRMAN VOLCKER. We better get this changed. If it [unintelligible] Patman [unintelligible]--

MR. PARTEE. It seems strange that this [legal authority] ended in [1981].

CHAIRMAN VOLCKER. Do I hear a motion?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection we will approve the deletion. Next is a recommendation from Messrs. Axilrod and Sternlight to renew the authorization to conduct RP transactions in bankers acceptances. I don't know which one of you wants to address that; I understand we also have a memorandum on that.

MR. AXILROD. Mr. Sternlight.

MR. STERNLIGHT. I think I speak for both Mr. Axilrod and myself when I say I see this as a fairly close judgment call. The activity is of some use in implementing reserve objectives, although it's not really so critical that we could not get on without it. At the same time, we see the financial risks of continuing the activity as fairly low. By doing RPs only in paper regarded as "prime" by the market and engaging only in short-term transactions with reputable dealers who are obliged to buy the paper back in a few days, the System incurs little risk in our view. Perhaps a more likely source of difficulty, though, is the possibility that we would be presented with paper that we had some reason to question. It could be awkward to turn down a name that had previously been regarded as prime, lest that very refusal escalate the questions being raised.

If we were not now involved in doing RPs in BAs, I don't think I would suggest getting into the activity even if it did help us somewhat in meeting reserve objectives. At the same time, given that we are occasionally involved, one must weigh the impact of withdrawal at a time when confidence in the national and worldwide banking system is still fairly tender--though less so than last summer and fall. Withdrawal could be taken as a sign of lack of confidence in the banking system and not merely a judgment that the activity was not essential in meeting reserve objectives or showing support to the BA market. On balance--acknowledging that it's a narrow rather than an overwhelming balance--I'd favor retaining the authorization and so recommend to the Committee. It should be recognized, though, that under a continued authorization, it may well be deemed expedient under certain circumstances to continue accepting names that may be starting to come under some question, lest our refusal aggravate doubtful situations.

CHAIRMAN VOLCKER. I have great doubt myself whether we should continue this for a more underlying reason than anyone mentioned: I think the bankers acceptance market has developed far beyond what was technically thought of as a bankers acceptance in the year [Congress] put in the Federal Reserve Act that we can deal in bankers acceptances. And I'm not sure we want to give this kind of official endorsement to the market anymore. I don't feel strongly that it should be done now. I think there's something to the point that withdrawal at the moment would raise questions in a rather tender situation in the market internationally. So, I don't feel strongly about that. But I do think we probably ought to take an early opportunity to get out.

MR. GRAMLEY. How often do we engage in RPs in the BA market? Is this once a week, once a month? Is it with the kind of frequency that if we were out for any significant length of time there would be commentary on it?

MR. STERNLIGHT. We normally do it in conjunction with doing RPs on behalf of the System. When we have some temporary reserves to inject, we have the choice of whether to engage in RPs on behalf of the System or to just pass through to the market some of the foreign account temporary investment orders. It is done largely on the basis of the size of the need we have to put reserves into the market. If it's a fairly sizable need or we're going to do multi-day RPs, then we do them on behalf of the System and we normally do them on acceptances as well as Treasury and agency securities. I would say it works out on an average to be a few times, maybe two or three times, a month.

MS. HORN. Would it be noticed if you did it half as much in the future as you do now? Would that be commented on?

MR. STERNLIGHT. It would be noticed if we did fail to include acceptances when we were doing RPs on behalf of the System. If we reverted to just leaning more often on passing through the customer RPs and less often on our own RPs--a modest change in that direction--I don't think it would attract great attention.

MR. PARTEE. I want to agree with the Chairman. We have had just a massive increase in the issuance of acceptances relative to the capital of the banks, which would be an occasion for saying: All right, if this is going to be such a big market, it can operate on its own without our doing RPs in it. In addition, we have the problem, which is not quite yet disposed of, of the risk participation acceptance. Now, that'll depend on the Board's definitions of terms, if I understand the matter correctly, and the Board has not yet defined the terms on risk participation. But it makes it at least possible, depending on what the Board does, that we can have an awful lot of acceptances out with a bank's name with the indirect guarantee of secondary banks. And I think we might get in a situation where, although we wouldn't ordinarily have any problem with the bank--let's just take for example Chase Manhattan--that if there were three times that many acceptances circulating with Chase's name because they have participated out with banks like that one in Oklahoma City and others, the risk might indeed begin to cause us trouble. So, I can see the possibility of an embarrassment, looking ahead, particularly with this risk participation question.

MR. ROBERTS. Isn't the practical consequence, though, that under those circumstances the bank would come to the discount window and give us the same asset and we would accept it for discounting and we would still have the asset?

MR. PARTEE. That might well be, but in that case we have the administrative possibilities of counseling with them that we don't have when they do an acceptance in the RP market.

MR. ROBERTS. It seems to me that, psychologically, it's a poor time to [make a] break. At the moment it's still a high quality asset and it gives us flexibility. I'd be for retaining the flexibility.

VICE CHAIRMAN SOLOMON. I'm for retaining it for the time being but it's not clear to me, aside from waiting until there's much more confidence in the banking system, [when and how to get out]. If you were requested, Peter, to figure out a scenario to get out of this within a year, what kind of strategy and what kind of rationale would you adopt, assuming you knew you had a very healthy period of time in which to work your way out of it?

MR. STERNLIGHT. Well, I'd probably suggest just announcing a future date beyond which we would cease that activity.

VICE CHAIRMAN SOLOMON. What explanation would you give--that the market had developed enough that it didn't need this?

MR. STERNLIGHT. Well, I'd say that the market has matured to the point that it doesn't warrant any vestige of Federal Reserve participation in it as a supporting arm and that it's of such modest usefulness in open market operations that that reason for staying with the activity has distinctly diminished. And to provide an adjustment period for the market, we can announce a date X months ahead beyond which we would not do it. I don't see a way to phase it out in step-by-step procedures.

VICE CHAIRMAN SOLOMON. If we gave a substantial delay--I don't mean a time limit of one month but, let's say, 6 or 9 or 12 months--do you think there would also be some market feeling that we were leery of this stuff?

MR. STERNLIGHT. There might be.

VICE CHAIRMAN SOLOMON. Even with such a long time?

MR. STERNLIGHT. I suspect that there would. I don't know; it's hard to say.

CHAIRMAN VOLCKER. My main concern is not that I'm leery of them but that they are not what they purport to be. They're no longer self-liquidating pieces of paper. Well, I am perfectly [willing] to put this off, given the surrounding circumstances. I think we ought to come back to it in 6 months or so as one way of dealing with it.

MS. TEETERS. Couldn't we also recommend that we decrease our activity in them rather gradually over time?

CHAIRMAN VOLCKER. Well, as Peter says, there are limitations on what we can do without calling attention to it. I suppose we could just buy fewer when the Desk normally would go in. I don't know how we would lean in that direction, I guess.

MR. MARTIN. Peter, about the comment on page 9 with regard to the two firms that are not on the regular government securities dealer roster: Is it feasible to drop those two off?

MR. STERNLIGHT. Well, we've been thinking about that, as the memorandum noted. My inclination is that as long as we're satisfied, as we have been, with the financial strength and so forth of those firms, I don't think I'd recommend discontinuing activity with them. But I think we would be very reluctant at this point to take up with any new firms that were active only in acceptances and not in the whole range of government securities.

CHAIRMAN VOLCKER. Does our presence in the market contribute at all to the quality of this instrument any longer, in terms of what we will accept and not accept?

MR. STERNLIGHT. I'd say it's a pretty small factor.

CHAIRMAN VOLCKER. That's the only reason I can see for staying in it--if we exerted some discipline in the market. But I don't think we do.

MR. PARTEE. I think you're right, Paul, that we ought to review the matter maybe in 90 days or 4 months or so. The Board is now positioned to make this definitional determination because I sent a letter out on that a few days ago. So, I'd favor a temporary extension and a review of the matter.

CHAIRMAN VOLCKER. I don't think we need a motion, if I understand this correctly. It can just stand as it is but we will make note of the fact that we ought to review this, let's say, no later than September.

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. We need to approve the minutes.

MS. TEETERS. So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objections. We'll now go to foreign currency operations.

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

Mr. Chairman, I would also like to get back to the question of the possible increase in the limits on the currencies we hold. The present limit is now $5 billion overall of which $3-1/2 billion represents maximum holdings of German marks. We are now at about $3.450 billion marks--in other words, $50 million below the DM limit. We're not going to run against that limit immediately, but with the continued receipt of interest earnings it would be appropriate to provide some additional room for these earnings to accumulate. I would like to recommend that the Committee consider an increase from $5 billion to $5-1/2 billion for the overall limit and an increase from $3-1/2 billion to $4 billion for the DM portion.

CHAIRMAN VOLCKER. Let me raise the question of ratifying the previous transactions, just to get that out of the way. Do I hear a motion?

MR. MARTIN. So moved.

MS. TEETERS. Second.

CHAIRMAN VOLCKER. Without objection. On the first point that Mr. Cross raised--renewing the Mexican swap drawings--have we a motion?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. That includes the second [renewals], I suppose. Without objection that will be approved. Now, let me add to what Mr. Cross said. I think there is some possibility here with the weakening of the mark and a potential weakening of the yen--there's considerable nervousness about the level of the yen and has been for some time--of more willingness perhaps to intervene should that weaken further. I think we have a $500 million limit on the yen.

MR. CROSS. We have $500 million left under [the $1 billion informal limit.]

CHAIRMAN VOLCKER. That may be enough, but I'd throw that question into the pot too.

MS. TEETERS. Well, the limit on the yen is $1 billion and we have $500 million left.

MR. CROSS. Right.

CHAIRMAN VOLCKER. I don't think we have much leeway in either of these currencies. Obviously, we have very little in the mark. I think the yen is the more likely candidate for early intervention simply because [the Japanese] would not be surprised if [it did weaken]. I know they want to use their money; they don't use it because they're afraid of renewing the pressures on the yen. And it's possible that we might want to intervene, if they did, if the yen in fact did weaken.

MR. PARTEE. Intervene to hold it up? Is that the idea?

CHAIRMAN VOLCKER. To prevent it from weakening.

MR. PARTEE. Don't we want a weaker yen? Isn't that our national objective?

MR. TRUMAN. No, we want a stronger yen.

MR. PARTEE. We want a stronger yen. All right. I got it reversed.

CHAIRMAN VOLCKER. This always gets confusing. It's weaker in number. We would like a yen that had a smaller number attached to it. So, I think this is a relevant question. I didn't realize we were as close to the limit as we are in terms of marks but it's potentially relevant with respect to the yen as well.

VICE CHAIRMAN SOLOMON. It still doesn't make any sense to me to take the marks that we get as interest and turn around and sell them. Therefore, I don't see why it's relevant to his proposal, which is to raise the limit in order to accommodate the interest that we'll be getting in marks.

CHAIRMAN VOLCKER. Because we have to raise it. We get the interest and it raises our holdings in marks and begins to threaten this limit.

MR. CROSS. We're only $50 million below.

CHAIRMAN VOLCKER. So, we don't have much more interest to be earned without raising the limit or selling them in the market.

VICE CHAIRMAN SOLOMON. All right. And I'm saying that we ought to raise the limit because it doesn't make any sense to sell them.

CHAIRMAN VOLCKER. We're in agreement, I guess.

MS. TEETERS. How much interest do we earn on the marks?

MR. CROSS. We get about $25 or $30 million a month.

MR. FORD. Mr. Chairman, I would suggest: Let's sell marks and buy yen. Really, that would solve it.

CHAIRMAN VOLCKER. I understand the yen part but I'm not sure I understand the mark part. That's been pretty weak too.

MR. CROSS. The mark has been quite weak recently.

CHAIRMAN VOLCKER. We haven't got a currency to sell, I'm afraid.

VICE CHAIRMAN SOLOMON. Excepting dollars.

MR. CROSS. Dollars.

MS. TEETERS. How much of other currencies do we hold?

MR. TRUMAN. The total is $300 million and something, and most of that is in Swiss francs.

MR. MORRIS. Has there been any change since Reagan [came into office]?

CHAIRMAN VOLCKER. We have the best one can hold relative to the dollar. They haven't been any good but I don't know of any better.

VICE CHAIRMAN SOLOMON. There has been no change. Aside from repaying the Carter bonds, there has been no change, virtually, in the combined Treasury and Federal Reserve holdings of foreign currencies since the new Administration came in.

CHAIRMAN VOLCKER. We had a little intervention, I think.

MR. MORRIS. What I meant was: Do you sense any change in the Treasury's stand on intervention?

CHAIRMAN VOLCKER. Yes.

VICE CHAIRMAN SOLOMON. We've seen signs of flexibility but haven't seen the flexibility.

CHAIRMAN VOLCKER. Well, there hasn't been a real clear reason to [intervene] in recent months. But there was intervention last fall at some point.

MR. TRUMAN. October was the last time.

MR. RICE. A very small amount.

CHAIRMAN VOLCKER. It was not very large.

MR. TRUMAN. Governor Teeters, we hold at purchase price, which is what these balances are carried at, $296 million of Swiss francs and only about $20 million in currencies other than Swiss francs. I don't have [a list of] all the others but it's only about $20 million.

MR. CROSS. The others are very tiny balances of several currencies. Holdings of Canadian dollars, I think, are very modest.

MR. MARTIN. Are there specific staff recommendations on the mark and the yen?

CHAIRMAN VOLCKER. Well, we have one on the mark and I threw the yen into the pot at this point, which is obviously less pressing since we have a $500 million leeway. I don't feel strongly about it except it's not inconceivable that we may run into conditions where we would want to change that.

MR. ROBERTS. Is there no limit on our actions? We can do whatever is our judgment?

CHAIRMAN VOLCKER. There's no legal limit.

MR. ROBERTS. No legal limit on anything.

MS. TEETERS. There would still be the $8 billion overall limit.

CHAIRMAN VOLCKER. That's right. But this is all within the $8 billion, which is in our formal authorization.

MR. GUFFEY. Absent some change of policy by the Treasury, though, we're not going to use that $500 million on the yen, are we? We're not going to do it unilaterally?

CHAIRMAN VOLCKER. Not at this stage, no. I don't think it's particularly a matter of Treasury policy, if I can distinguish the two. They are ready to do it, if it is weakening.

MR. WALLICH. But it seems to me sensible to provide for that in case they give us a little leeway.

VICE CHAIRMAN SOLOMON. I don't know what that means, Paul. Today for example, the deutschemark started at 2.42, didn't it, Sam? And now it's down to what--about 2.39?

MR. CROSS. No.

VICE CHAIRMAN SOLOMON. I mean up to 2.39.

MR. CROSS. It has changed over the course of the day. There have been a number of days when these exchange rates have moved by, say, 1 percent. The mark got down to over 2.43 today. It closed at 2.42-1/4 on Friday. The dollar in terms of DM got down below 2.43

again. There have been a substantial number of occasions where the DM has moved a couple of pfennigs or even more and the yen has moved by a comparable amount. So, a 1 percent movement in these rates is by no means unusual. And there have been a lot of periods when there have been substantially higher pressures. Throughout this period there has been a considerable amount of volatility in these rates and a considerable amount of nervousness and unsettlement.

VICE CHAIRMAN SOLOMON. Under what circumstances would you encourage the foreign exchange Desk, Mr. Chairman, to make to you and the Treasury a recommendation that intervention seems appropriate to us? Earlier we made that recommendation a few times when there had been a very substantial weakening in a key foreign currency and the Treasury would then say: Well, let's wait a while and watch. And so the opportunity would be missed. [Their] reaction might have been that if there's a further weakening, yes, we'll do something. But by then there had already been a 1 percent or a 1/2 percent move and then there wasn't any further weakening.

CHAIRMAN VOLCKER. That has been the story of our life recently. It moves and we're ready and then it moves the other way.

VICE CHAIRMAN SOLOMON. But it would seem to me that we could have a prior understanding and a presumption that, if it were to move more than, say, 1/2 point in 3 hours or more than a point in 4 or 5 hours or overnight, we wouldn't wait for a further significant weakening--that only a few basis points move after that would be sufficient to trigger it.

CHAIRMAN VOLCKER. We have a long history of trying to reduce it to arithmetic and I'm not sure at this stage that we can.

MR. PARTEE. We don't know in advance what kind of news would have brought that about. We wouldn't know what the news is.

CHAIRMAN VOLCKER. In any event, we have a recommendation for $500 million, which I would support. I think the yen is more problematical. We could do $250 million as a gesture or we could do nothing now and wait and see what is needed.

MS. TEETERS. How long will the $500 million last you? It doesn't sound as if it would be a whole year even.

MR. CROSS. It would not be a large amount if our policy were one in which there were more intervention; $500 million is not a large amount if we're intervening with very much activity.

CHAIRMAN VOLCKER. Certainly, it can last you. I don't think we're going to become that aggressive all of a sudden. It presumably will last you for a few days at the very least.

MR. CROSS. Oh, yes. And that would be time enough to convene the Subcommittee.

MR. TRUMAN. As a matter of procedure, normally in recent years when we have intervened, the proceeds have been shared with the Treasury in any case. The limit on actual intervention is twice that much.

VICE CHAIRMAN SOLOMON. I move that we increase the limit on the deutschemark but not on the yen. Are you ready for a motion?

CHAIRMAN VOLCKER. I don't think we need a motion. This is done by an understanding.

MR. BERNARD. It's not a vote, no.

CHAIRMAN VOLCKER. Unless I hear some objections, we will assume that we have another $500 million on the mark.

SPEAKER(?). Therefore, the total is--.

MR. PARTEE. This is all within the $8 billion.

CHAIRMAN VOLCKER. All within the $8 billion.

MR. CROSS. All within the $8 billion.

MR. CORRIGAN. The total informal limit would go to $5.5 billion.

MR. PARTEE. That would be enough for quite a few months' interest, wouldn't it?

MR. CROSS. Yes, it would.

SPEAKER(?). That's around $30 million a month.

MR. CROSS. It would carry us for several months.

CHAIRMAN VOLCKER. I don't know how you feel about the yen. Let me suggest the $250 million increase in order to test your acquiesence for a little more intervention if the occasion arises.

MR. GUFFEY. Well, if that's the purpose of your discussion, I join you.

MR. MARTIN. It isn't much intervention; I would certainly support that.

MR. ROBERTS. Why would we want to intervene? Do we know better than the market what the rate ought to be?

CHAIRMAN VOLCKER. At times.

MR. WALLICH. Yes.

MR. PARTEE(?) I doubt that.

MR. FORD. We like to think that, but I think we know [better]. Didn't you say you tried the arithmetic on this a lot of times and you could never figure out a formula for intervention?

CHAIRMAN VOLCKER. I could never figure out a formula for whether it should be 1 percent more or less in a day. I have no doubt at all in my own mind that the yen at 270, or wherever the heck it got to a few months ago, was too low and was greatly damaging to our interest and theirs. I have no hesitation at all in pronouncing that. I thought so at the time and I think so now.

MR. PARTEE. But what we are talking about is disorderly conditions, isn't that right? We're not talking about trying to set a yen/dollar relationship; we're talking about smoothing a movement in the market so that we could--

CHAIRMAN VOLCKER. The only contingency I see now is that the yen might weaken appreciably, contrary to the desires of the Japanese government and contrary to the desires of our own government as a policy matter.

MR. WALLICH. And in the process that would create problems of protectionism and a larger current account deficit for us.

CHAIRMAN VOLCKER. Let me hasten to say that I don't think we're going to cure the basic problem by a little intervention. But it's a gesture.

VICE CHAIRMAN SOLOMON. [If you are] testing the tone of the Committee's thinking, obviously, I would be in favor of raising it. But I didn't think that $250 million had very much meaning. There is a real need to move on the deutschemark because we're getting near the limit with the interest earnings.

CHAIRMAN VOLCKER. Although $250 million is not all that much, Mr. Truman is correct that what we're basically talking about in terms of intervention is $1-1/2 billion of leeway and that is more than I suspect we will need in any short period of time.

MR. PARTEE. Am I right in thinking that we have $500 million leeway now?

MR. TRUMAN. Yes, I think that's what the Chairman's arithmetic was. The $500 million plus [$250] million is $750 million and times two it's $1-1/2 billion.

MR. PARTEE. How do we get times two?

SEVERAL. Treasury.

MR. PARTEE. That's a lot of intervention.

VICE CHAIRMAN SOLOMON. There have been times when the Fed has intervened without the Treasury, but it has been more common--

CHAIRMAN VOLCKER. Well, the Treasury might not want to intervene just because they're worried about their own cash position. That's the only--. It's quite possible at some point along the line here. Well, what is the overwhelming sentiment one way or another?

MR. PARTEE. I would prefer not to until we can review the whole question of intervention at the international level, which I think is going on, if I understand it. Am I right in thinking that there is still such a study?

CHAIRMAN VOLCKER. Yes. There is still such a study, which will be discussed in Williamsburg. What I'm saying is not apart from that in the sense that that's part of the background. But it could well arise before Williamsburg--like tomorrow.

MR. TRUMAN. The study, as far as the studiers are concerned, has been completed. Our lords and masters have not had a [unintelligible]. It is actually going to be at the end of April that they are going to have a meeting on the subject.

CHAIRMAN VOLCKER. It has not yet been considered by the governments.

MR. PARTEE. Well, my thought was that I didn't get a clear answer to [my question on] this disorderly market test. It sounds as if maybe we're changing the test some on why we would intervene, in which case it seems to me we really ought to consider what the issues are and to what extent it ought to be the Federal Reserve and to what extent the government ought to be directly the intervener [under] a different policy. I just don't feel very comfortable with it.

MR. WALLICH. You know, we have a directive--

MR. PARTEE. We haven't discussed this at all. It hasn't come up in months and now it suddenly is coming up and I'm just not prepared to support it.

CHAIRMAN VOLCKER. Well, we've done a little intervening off and on--

MR. PARTEE. $5 million.

CHAIRMAN VOLCKER. --and we were prepared to do more if the markets moved the other way.

MR. PARTEE. We've been doing an awful lot of $5 and $10 million amounts with a $500 million leeway.

CHAIRMAN VOLCKER. We have been prepared to do considerably more than that upon occasion, if the market ran the other way--nothing very big. But this directive, I think, was the same when we did a lot more.

MR. WALLICH. And it is always directed against countering disorder, so you're--

MR. PARTEE. Except I was uncomfortable about it before, and now we've not done anything for a couple of years to speak of and I'm still uncomfortable about it. I am just not prepared to support it today, that's all.

MS. TEETERS. You're prepared to support the mark increase, though?

MR. PARTEE. Well, that seems to be because of the interest that came in. Although, again, I have some doubts about it.

VICE CHAIRMAN SOLOMON. What you're saying is that you'd prefer a full-dress debate on this one.

MR. PARTEE. I think we ought to have an issue paper and have a discussion here in the Committee.

CHAIRMAN VOLCKER. Well, I hope you're not suggesting that we would not intervene, assuming the Treasury was in agreement, on occasions that we decided met the criteria that have been existing for some years.

MR. PARTEE. Well, I didn't even think I had the latitude to suggest that because there's $500 million of leeway.

CHAIRMAN VOLCKER. I take it that wording has been there since 1976 when we were going through a great game of intervention from active to inactive to moderately active to moderately inactive.

MR. PARTEE. Yes, there's not very much--

VICE CHAIRMAN SOLOMON. We had a full-dress debate on this in 1980 and we continued the policies that we had been following jointly --the Treasury and the Fed--in terms of trying to slow the appreciation of the dollar. And we got up to $8 or $9 billion in foreign currency holdings by the time the current Administration came in and [intervention] was brought to an abrupt halt. Even though there had been some incidental comments on that at various meetings, I guess we haven't had a full-dress discussion. In deference to Chuck's view, why not schedule one for the next meeting? That will be after Williamsburg; it will be after your G-Five Ministers of Finance meeting, Paul.

MR. TRUMAN. Yes.

CHAIRMAN VOLCKER. I don't know when that is.

VICE CHAIRMAN SOLOMON. It will be after that. That would be a logical time, then, to have a discussion here. In the meantime, we can just move on the deutschemark limit.

MR. PARTEE. If we're going to be talking about doing something considerably larger here, which seems to be in the wind, I'm interested in the question of how much we could reasonably do without using these foreign currencies to collateralize Federal Reserve notes. That's an ancillary issue that I'd like to have investigated because there must be some limit. We've collateralized, as it happens, our currency with foreign currency something like 138 times. And that needs to be examined too so that we know what we're getting into if we considerably expand our effort in this sphere.

CHAIRMAN VOLCKER. I do not want to suggest at this particular time that I see anything I would consider really large in terms of affecting the overall [composition] of our asset portfolio in any significant way. Have we concluded that we have ample leeway for the yen for the time being? If we have to change it later, we'll bring it up. We will change the mark. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Comments or questions? You uncovered an overpowering interest--

VICE CHAIRMAN SOLOMON. I have a premature question. If the fed funds rate continues at around 8-3/4 percent, am I correct in assuming that it's rather unlikely that the prime rate would move up but that if it were to go to 9 percent the prime is likely to move?

MR. STERNLIGHT. Well, as I mentioned, that spread between the prime rate and the rate on CDs or other things that I think the prime tends to take its cue from has gotten relatively narrow. I think it's at the point that would very likely call for a move. Obviously, as the funds rate moves up and other short-term rates move up, at some point a prime rate move would very likely be kicked off. I think the whole set of public policy considerations that banks will look at will play a role here. I'm just guessing, but if funds got up to around 9 percent or somewhere in that area--maybe more toward 9-1/4 or 9-1/2 percent--there probably would be very strong pressures for the prime rate to move.

MR. PARTEE. It's above 9 percent really, Peter, that you would be concerned that the pressures could be [strong]?

MR. STERNLIGHT. Yes.

CHAIRMAN VOLCKER. Where is the CD rate now?

MR. STERNLIGHT. The CD rates are now 9 to 9-1/8 percent--something in that area.

MR. GUFFEY. They may be in a danger zone right now.

SPEAKER(?) That's before reserve adjustments.

CHAIRMAN VOLCKER. We haven't got much for them.

MR. BOEHNE. On the decision, Peter, to err on the side of providing fewer rather than more reserves when there has been some closeness in that decision: Was that related to a conscious decision to react to the strong aggregates or was it more technical than that?

MR. STERNLIGHT. I think that was part of the background. I'd say this came about just in the day-to-day implementation when we had discussions on our morning conference calls or with senior Board staff. I don't know whether Mr. Axilrod wants to add any comments on that.

CHAIRMAN VOLCKER. I will speak for myself to the extent that I was involved. Yes, because of a stronger business picture and strong aggregates [I had the view that] if we were going to make a mistake, it'd be better to make it on that side than the other side. Also, I think in terms of free reserves we were overshooting on the liberal side earlier--inadvertently, but there it was. We need a motion to ratify the transactions.

MR. PARTEE. So moved.

CHAIRMAN VOLCKER. Approved without objection. I didn't want to cut off any discussion, but I didn't hear any. Let's turn to the staff report on the economic situation. Mr. Zeisel.

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

CHAIRMAN VOLCKER. Well, the staff has presented you with a nice smooth middle-of-the-road forecast, I suppose.

MR. ZEISEL. The smoothness is the nature of forecasting, Mr. Chairman.

CHAIRMAN VOLCKER. I think that's probably right--most forecasts anyway. I'd be interested to explore who has something sharply different than a nice smooth, even, business forecast in either direction.

MR. FORD. For the remainder of '83 or are you talking about next year too?

CHAIRMAN VOLCKER. Whatever you want to talk about.

MR. ROBERTS. I have a question, just out of curiosity. The change in final sales was predicated upon a big swing in CCC. How big was that and is that based on something unusual? Has that happened before?

CHAIRMAN VOLCKER. Mr. Zeisel, would you like to respond to that?

MR. ZEISEL. CCC has had a tendency in the last 3 years approximately to rise very, very sharply toward year-end, much more rapidly than it had historically. And that's one of the problems in the sense that if it had been going on long enough it would be in the seasonals and it would be damped. But as it stands, we have tended to get these huge payouts in the fourth quarter and then a smaller rate of payout in the first quarter for the last couple of years, and this has tended to distort the numbers. This will be less of a factor next year. But for the time being, it really does distort.

MR. ROBERTS. Would it be fair, therefore, to conclude that final sales weren't really as strong in the fourth quarter and aren't as weak in the first quarter?

MR. ZEISEL. They've been running about 3 to 3-1/4 percent in both quarters. So, it's fairly moderate. It suggests that--

CHAIRMAN VOLCKER. Do you mean final sales have been running 3 to 3-1/4 percent leaving out this factor?

MR. ZEISEL. Leaving out CCC.

MS. TEETERS. What about the next quarter?

MR. ZEISEL. Leaving in other components of government, however--just taking out CCC.

MS. TEETERS. But didn't you say this morning that there were some influences on that final sales number from net exports also?

MR. ZEISEL. Oh, there are.

MR. TRUMAN. Not between the two quarters, though.

MR. ZEISEL. Well, it changes the pattern. If you exclude net exports, you'd get a slightly larger deceleration, but it doesn't change the fundamental picture. Excuse me, final sales excluding net exports were about 4 percent in the fourth quarter and about 3-1/4 percent in the first. So, it's in the same ballpark, I suppose.

CHAIRMAN VOLCKER. I think you're right [that] it is clearly a distorting factor in trying to trace final sales. Any other questions or broader comments?

MS. TEETERS. At this point you have just the month of January on inventories, don't you? So, you really have no feel yet for what February and March are doing on inventory liquidation.

MR. ZEISEL. No, we don't really. This is a forecast and it's a forecast based upon the fact that the inventory level in real terms has been reduced to at least, or actually below, pre-recession levels; it's extremely low. The inventory/sales ratios have been brought down considerably. There are indications in some very key sectors, such as automobiles and steel, that the end of liquidation is at hand and they're beginning to build a little. And these factors are sufficient to indicate that we've just about run the course on our inventory liquidation. We have some liquidation actually in the total continuing for the next several months, but the rate of liquidation decelerates considerably and by the end of the second quarter is no longer a factor.

VICE CHAIRMAN SOLOMON. What assumptions with regard to the trade deficit and the current account deficit underlie your projection?

MR. TRUMAN. We are assuming that the trade deficit this year, Mr. Solomon, will be on the order of $35 billion dollars.

VICE CHAIRMAN SOLOMON. That's the current account.

MR. TRUMAN. Excuse me. The current account is $35 billion and the trade deficit--that's a wrong number here--is about $65 billion. They are rising by $20 billion approximately next year.

VICE CHAIRMAN SOLOMON. Both?

MR. TRUMAN. Both.

VICE CHAIRMAN SOLOMON. The only way that you factor the extent of recovery abroad into your domestic projection is through the trade account?

MR. TRUMAN. I'm not sure what else you would have in mind.

VICE CHAIRMAN SOLOMON. Well, I'm not sure myself. I was just wondering.

MR. TRUMAN. As far as GNP, that's largely it--well, the exchange rate too, and prices. Price is more generally in international trade prices.

MR. ZEISEL. Well, the exchange rate too.

CHAIRMAN VOLCKER. What are other people forecasting for the trade balance?

MR. TRUMAN. Most outside forecasts, although there are some in the range that we're in, tend to be in the $20 billion range for the current account. I misspoke again, excuse me. The [trade] account forecasts tend to be in the $20 billion range. There are some that are as high as ours.

CHAIRMAN VOLCKER. I think it's fair to say--you can correct me if I'm wrong--that your depressed outlook for the current [account] has not been matched by developments so far. You were predicting a bigger deficit than materialized in the fourth quarter and potentially in the first quarter?

MR. TRUMAN. Well, the fourth quarter in fact was a $24 billion current account deficit; we had forecast somewhat higher, I think, but not more than $2 or $3 billion dollars higher than that for the fourth quarter.

CHAIRMAN VOLCKER. It was $34 billion in the fourth quarter?

MR. TRUMAN. It was $24 billion in the fourth quarter of last year, at an annual rate. At one point we had forecast somewhat higher--I think $25 or $26 billion--for the fourth quarter of last year. The figure that came out was a bit lower. What came out was a little higher than even we had forecast at the last meeting.

MR. KEEHN. Could I ask about capital goods? I think you indicated that as we get further into recovery you expect an improvement. But with the level of capacity utilization where it is currently, when would you expect this to occur? Is it an '83 event or are you thinking about later?

MR. ZEISEL. It's an '83 event. Breaking it down into equipment versus construction--that's important because they are really in different phases--we expect a recovery in purchases of business equipment to start very shortly, within the next quarter roughly. Looking back at past relationships between purchases of business equipment and production, there tends to be something like a one-quarter lag there. Typically, it starts with purchases of trucks, cars, office equipment--off-the-shelf kinds of items. But we have a rather moderate turnaround occurring. On the nonresidential construction end of things, we expect weakness to continue throughout '83 and then relative stability in '84.

CHAIRMAN VOLCKER. Do the figures show weakness currently in commercial building--not the new orders figures, the actual expenditure figures? Are they coming down?

MR. ZEISEL. Well, there was a one-month jump in January--

CHAIRMAN VOLCKER. Up?

MR. ZEISEL. Up. But the vacancy rates on commercial buildings have been rising and are quite high. And we feel that there's a fairly long digestion time involved, given--

CHAIRMAN VOLCKER. There's no evidence yet in the actual spending figures of a downturn?

MR. ZEISEL. Well, the January spending figure was up.

CHAIRMAN VOLCKER. Yes, it was up. Were there any previous months that were down appreciably?

MR. ZEISEL. There was a flattening out, an indication that they were weakening. But there was not a sharp decline, no.

CHAIRMAN VOLCKER. How would you change this forecast if the tax cut were rescinded or if there were another more or less equivalent tax increase before the end of the year?

MR. ZEISEL. I think the initial response might well be in consumer expenditures, in terms of the effect on disposable income, [which might tend] to damp the growth somewhat. The longer-term response is, of course, a function of changes in attitudes and market perceptions of the implications of these changes. I think they would be positive over the longer run, but I do think the first response would be to slow down the recovery somewhat.

CHAIRMAN VOLCKER. Stop the recovery?

MR. ZEISEL. Well, that would depend on how large--

MR. TRUMAN. [If the] third stage is dropped.

MR. ZEISEL. Oh, the third stage alone. No, I don't think so. The third stage is not really that big. As it stands now we're talking about something in the neighborhood of a net effect of about $30 billion at an annual rate for Q3 from that alone. I don't think that would undermine the growth momentum overly.

MS. TEETERS. The jobs bill that just passed will show up where--in state and local purchases?

MR. ZEISEL. That would be mostly in the form of transfers and, therefore, will show up in state and local purchases.

MS. TEETERS. And is the new increase in the gas tax devoted exclusively, as in the past, to highway construction?

MR. ZEISEL. Well, that gets a bit obscure; I think there is a promise that a good deal of it is so dedicated, but I don't know if all of it is.

MR. PARTEE. Mass transit takes some of it.

MR. ZEISEL. Mass transit, yes. It's not a big item in any event. Wait a minute. No, I'm sorry that's the bill that's [unintelligible]; the jobs bill is not so big.

MS. TEETERS. But between the two of them it's $10 billion.

MR. ZEISEL. The jobs bill is $4.6 billion over a 3-year period; it reaches a maximum in 1984 of about $3 billion of expenditures.

MR. BOEHNE. How sensitive is your forecast to interest rates? The underlying assumption, I gather, is about constant or perhaps a slightly downward drift in rates. How much of a backup in rates do you think this forecast could stand before the cumulative momentum would be affected seriously?

MR. ZEISEL. That's an interesting question. We don't have a very vigorous forecast and it's already in a sense damped by historically high interest rates, particularly in real terms, whatever that means. Further movement in that direction could well have a significant effect on attitudes; it depends on the degree, I think. It's one of those extremely difficult questions to answer because business attitudes are likely to be very sensitive at this time.

MR. BOEHNE. Well, just an observation on that: There clearly is a recovery and attitudes are clearly improved, but it's more because people have seen business go downhill or be completely stalled for so long that even a modest lift from the very deep hole that they're in makes them feel a good bit better. But I think this increased optimism is very sensitive to interest rates. It seems to me that it wouldn't take much of a backup before this optimism could turn around rather sharply and even turn to some pessimism.

MR. PARTEE. There's nothing mild, Ed, about the increase in residential construction and the turnover of used properties, both of which have increased much more sharply than we would have expected--[more than in] previous recoveries, I think the staff has said. It might be that that would be shut off by a point rise in interest rates. I don't know. But that has been a very strong recovery to this point.

MR. ROBERTS. Of course, that's financed by long-term money. The best way to hold that rate down is to avoid changing inflationary expectations and that gets to our discussion, I'm sure, of the rate of increase in money. Mr. Chairman, I'd like to go back, if I may, to a point you were making about the July tax cut. An area I'm curious about is what is happening at the state and local level with regard to tax increases. I keep reading that state after state is raising taxes because of deficits, so I guess a big deficit there is changing to a lower deficit, which is going to take something out of the spending stream. Have we any figures on that from the staff?

MR. PRELL. I don't think we have. There is a cumulative tax increase of note going on. It's probably several billion dollars this year in total, which doesn't loom large necessarily against the kind of tax cut that's going to occur at the federal level, but it is substantial. Clearly, many state governments have run through all of the surplus funds they had and are having a drain in spending as well as an increase in their taxes, so that we're getting an unusually weak cyclical contribution from the state and local sector in this forecast.

MR. CORRIGAN. The state and local [situation] is even worse than the numbers suggest because, for example, a large number of states don't even have their state pension plans anywhere near fully funded. They've been living off that to the tune of billions of dollars. And at some point they not only have to raise taxes but one way or another have to replenish those pension arrangements, and I would imagine for the 50 states as a group we're talking about an enormous sum of money there.

CHAIRMAN VOLCKER. Do we have any overall information about what is going on in state and local government employee compensation trends?

MR. ZEISEL. On wage rates do you mean?

MR. MARTIN. Well, we have some information from the results of the surveys that we do for the setting of compensation levels in the Federal Reserve Banks. In some of those surveys state and local compensation is included.

CHAIRMAN VOLCKER. That's pretty fragmentary.

MR. MARTIN. That's pretty fragmentary, yes.

MR. ZEISEL. The BLS does collect state and local data--with a fair lag, but still the data are available. Unfortunately, I'm not really familiar with what they've been showing recently.

MR. MARTIN. Back on interest rates: I noted in that fairly new survey of commercial bank pricing of their various deposits a 25 basis point backing up in the rate on money market deposit accounts. Is that unexpected? Is there some particular factor that caused that turnaround in the pricing of that instrument?

MR. PRELL. This is news to me, I must confess. It could simply be sampling errors.

CHAIRMAN VOLCKER. What's this--a higher rate on money market accounts?

MR. MARTIN. It's up 25 basis points.

CHAIRMAN VOLCKER. I see that some [depository institutions] in New York are getting more aggressive again. They're paying 9.50 percent.

MR. MARTIN. Why is it a sampling error when it goes up and it's just good information when it goes down?

MR. PRELL. A 25 basis point change might not be something significant in terms of the aggregate.

CHAIRMAN VOLCKER. Well, it seems to be going up according to the newspapers in New York. Is there any sense that it's going up elsewhere?

MR. MARTIN. Yes, the national survey, which is a very large sample stratified by bank size, had a 25 basis point backup. That is the reason I'm questioning it.

MR. PRELL. Is this our survey?

MR. MARTIN. No, the Money Market Monitor, or whatever that new commercial--

MR. BOEHNE. It has it by sections of the country.

MR. MARTIN. It has it by sections of the country. It doesn't look like very hard data but, anyway, it did go up.

MR. MARTIN. You've seen that?

MR. BOEHNE. Yes, I've seen it.

CHAIRMAN VOLCKER. It has pretty good figures.

MR. MARTIN. Yes, it's up 25 points.

MR. PARTEE. It's a rather large sample, as a matter of fact.

MR. MARTIN. It's a large sample.

MR. STERNLIGHT. They're doing it keyed to something like what the money funds pay; that has crept up a bit as market rates have come up.

MR. BOYKIN. We're looking at 7-3/4 percent versus 7-1/4 or 7-1/2 percent a couple of weeks ago. But it's not close to 10 percent.

MR. BOEHNE. For the money market accounts?

MR. BOYKIN. Money market deposit accounts.

CHAIRMAN VOLCKER. But it's up a little.

MR. ZEISEL. The question is--

CHAIRMAN VOLCKER. [Unintelligible.]

MR. PRELL. That would be less than market rates in general.

MR. ZEISEL. Yes, rates in the market have been moving up.

MR. BOYKIN. Either that or I'm in the wrong bank.

CHAIRMAN VOLCKER. Well, who has a case they want to make for a markedly different business forecast?

MR. CORRIGAN. I won't make the case, but--

CHAIRMAN VOLCKER. Oh, wait minute. Mr Guffey was ahead of you.

MR. GUFFEY. Well, I'm not sure I'm going to respond to that; I don't want to make a markedly different case. I just would like to observe perhaps the obvious that has already been touched on. What we have seen and have described as a recovery is largely driven by the two interest-sensitive sectors of our economy, autos and housing. And to the extent that interest rates move up appreciably from this level, that quite likely could kill off the recovery. In other words, the recovery that's being projected is very fragile. I just note that one of the comments made concerning the outlook was that [the staff] expects business spending on equipment and exports to increase to sustain this recovery, and each of those areas is as fragile or as uncertain as anything we can tie it to. I really think this is a very fragile recovery. There's no question of recovery, but [in] autos and housing it's the rundown of inventories that has made the numbers look pretty good in the last 2 months or perhaps 3 months. That can go away pretty quickly with any increase in rates--maybe even to the levels that we're now experiencing. The reported increase in the fed funds rate, for example, and the upward pressure that may exert--the prime could go up--could be very devastating in my view to this recovery.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I'm not about to make the case myself but I will at least report that at our board of directors meeting last week I think I can fairly say that our directors were more bullish than they have been at any point since I've been at the Bank.

CHAIRMAN VOLCKER. That's not a--

SPEAKER(?). 2-1/2 years.

MR. BLACK. It's been pretty bad the whole time you've been there.

MR. CORRIGAN. Clearly, their comments [conveyed] a tremendously different atmosphere. Some of that does reflect what Mr. Boehne spoke about--just the fact that it was so bad that if things begin to look at all better it sounds a lot better than that. But I think housing has an awful lot to do with it. The thinness of inventories in the retail sector in particular is something that people cite, and to some extent there's a little glimmer of hope in the agricultural sector because livestock prices are a little better and people are feeling a lot better because of the PIC program, even though it's recognized that that's not going to mean much until well down the road. The other thing that is more or less compatible with that is that a significant body of my colleagues in my research department also take the view that the economy is in fact a lot stronger than some of the numbers now suggest at current interest rates. I think they pretty much take the view that if long-term interest rates in particular were to go up at all, the fragility that Mr. Guffey speaks of could be manifested in a hurry. But in the framework of current long-term interest rates, a number of those people are really quite bullish. I myself have not quite bought into all of that yet, but I do think in the framework of roughly the current level of rates that the prospects for the economy performing along the lines of the staff's forecast or maybe even a little above it are quite good. But, again, I certainly would agree that any number of things could unravel that in a hurry.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I don't know that I would want to argue that my own thinking is radically different from that of the staff's, but I think the time has come when we have to wonder whether or not this recovery might not be gathering more steam than we've realized up to this point. I can make a case for a significantly higher rate of increase in GNP, I think, along lines like this. If we look back at the past two quarters, in the fourth quarter to the first quarter we see an increase of private final purchases on the order of 3-1/2 percent at an annual rate--a little less in the first than in the fourth quarter--and this is just in the process of going into recovery. That's what we are getting before we have the effects of the tax cut hitting in the second half of the year and before we have the beginnings of a pickup in business fixed investment, which we all expect to happen at some point or other. Now, the staff forecast doesn't have a sustaining of the recent pace of advance in private final purchases, partly because it's expected that we're going to get a big drop in net exports in real terms and also because residential construction is not going to contribute as much as it has in the recent past. The staff may be right. But there is a tendency, I think, for final sales to gain momentum as a recovery proceeds; and that could happen again.

The second fact is that I'm very, very much uncertain about what we ought to be forecasting for inventory acceleration during the course of this year. When I talk to people out in the field they tell me: Boy, those shelves are just bare so that if you get a dollar's worth of orders at the consumer level it just goes right back through to an order for a manufactured good because there's nothing [on the shelf] to sell. In fact, if you look at the statistics, you'll find that in real terms we've had the biggest drop absolutely in inventories in this recession than in any since 1949. And that tends to confirm the bareness of the shelves argument that we hear from qualitative comments. We don't have what I would consider a normative ratio of inventory investment to GNP in real terms until we get out to about the end or the middle of 1984, when we get inventory investment up to about 1 percent of GNP. It could happen sooner than that. We could easily get an increase of as much as 1 percentage point in real terms above what the staff is forecasting at present levels of interest rates for 1983. If that happened, the momentum is going to build still further. I don't know whether this is really going to happen or not, but my guess would be--and we talked about this at the Board meeting this morning--that the risks at this juncture are more on the high side than they are on the low side of our staff forecast.

MR. MORRIS. Mr. Chairman, I think it's a little too early to have any convictions as to how strong this expansion is going to be. We have two sets of numbers, January and February. The January numbers at face value looked very good, but probably the seasonal factors made them look better than they were. The February numbers in general were quite disappointing. If we're talking about triggering order books, they weren't triggered in February; the orders numbers in

February were really quite disappointing. Again, that may reflect the fact that the January numbers were inflated. But certainly, the range of numbers for February on retail sales, on personal income, and on new orders would have to be viewed as on the disappointing side. I think we need another month of data to shake this out; I'd like to see a little more of that inadequate inventory phenomenon showing through in the orders. It's not there yet.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. It seems to me that fragility is almost inherent in this kind of expansion and one should not be too surprised to see that. The sectors that can move up at a time like this typically are interest-sensitive; that is, housing and automobiles typically start up at this time since they've become very much a matter of interest rates. So, to find that those are the areas that have been moving the economy more strongly than others is not surprising. It doesn't seem to me to suggest that it is fragile in any sense other than that other previous expansions have been fragile. If we had all the other factors moving right now--if consumption were moving forward on a broad base, if we weren't losing from exports, and if inventories were turning around strongly--we would have a very booming situation and that wouldn't be conducive to sustainability. So I think as far as we've gone, with rather limited impulses, we've done quite well. We should be concerned about the possibility of excess [spending] as well as the possibility that it might weaken. I don't think fragility is a particular warning at this time.

MR. MORRIS. Certainly, Henry, in terms of the financial structure, we have a greater fragility than we've ever had before. That is one area, and a very important area, where we have more vulnerability built into the system than we've had before.

MR. GRAMLEY. Are you talking about the thrifts or the international situation?

MR. MORRIS. I'm talking about the quality of debt, domestic and international. If we do abort this recovery, I think we would end up with financial strains of a sort that we would find very difficult to handle.

CHAIRMAN VOLCKER. I might just assert, on that point, that I don't think the international strains are getting any less and they are a little more disguised. They will get worse. Basically, there are more countries unable to pay--I'm looking for a polite term. And the ones that have been attempting adjustment for some period of time --I think with the exception potentially of Mexico which has now been hit by the oil situation--have not yet shown a turnaround. There is no confidence returning to that picture in a basic sense. Mr. Black.

MR. BLACK. Mr. Chairman, I always feel very uncomfortable when I make a forecast on anything. This whole Committee ought to feel uncomfortable because I think if you look at our Humphrey-Hawkins testimonies, most of the time the majority has been wrong. There is usually somebody who is right each time, but--

CHAIRMAN VOLCKER. You managed to get right outside the range a good part of the time.

MR. BLACK. --the one who is right usually differs from meeting to meeting.

MR. PARTEE. That's the trouble.

MR. BLACK. That's right. And that's why I feel very uncomfortable. I hasten to add that that is why I have less and less sympathy for discretionary monetary policy too, but that's another issue. But I'm very much in sympathy with the points that Lyle made; my guess would be that this is going to be front-end loaded a little more than the staff has projected. It does follow a deep recession, and historically deep recessions usually have been followed by relatively fast recoveries. We've also put out a lot of liquidity in the economy. It's also at this stage historically that most people have underpredicted the amount of economic growth. And I think the swing toward optimism, though certainly it may well be fragile, has been the most abrupt swing that I can remember. It may be because people were so fearful it wouldn't come at all, but it seems to me to have been more abrupt than it has been in the past. I think businesses are unusually lean now and if we do get any kind of pickup, profits ought to rise more rapidly than most people think and again ought to help the outlook. So, my guess would be that growth is going to be a little faster. Like Lyle, I think the error may be on the side of [the staff forecast] being slightly lower than what really will occur.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I can even report a better attitude on the part of the Chicago directors at our meeting about 10 days ago. They were more positive in their outlook than they've been since I've been there, and it's really a very surprising change. A lot of it comes from the agricultural side through the PIC program, in which the participation is becoming very heavy. I think that has changed the attitude in the agricultural sector very dramatically.

CHAIRMAN VOLCKER. A little inflation makes people feel better!

MR. KEEHN. In fact, whereas our original guess was that the PIC program wouldn't have any effect [until] 1984, we now have the feeling that we will see some effect from PIC this year. On the cautionary side, though, it may be darkest before the dawn but the people I talked to still say that the capital goods side is very, very sick and they don't see any near-term outlook for an improvement. That is why I asked the question about capital goods. On the inflation side, I have just a word of caution there: We are beginning to see increases in prices of some of the basic commodities like steel and nonferrous building materials. It's not so much that the prices themselves are going up, but the discounts that had been offered very broadly as we were going through a difficult period are beginning to be eliminated. So, I think we can expect to see some increase on the price front as we get into this recovery.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I want to make a case for the staff forecast as a good working premise for the Committee. I think it's possible, as

Lyle suggests, that we could have a little stronger recovery, probably led by housing. That could give us maybe a half point or even a point more in the real GNP increase, but it's still certainly well within manageable territory. But I also am impressed that it could be a little weaker than the staff forecast because the financial fragility is really pretty deep and it could affect our export numbers if in fact the Latin Americans buy very little from us in the course of this next year. It also could affect, more adversely than the staff has forecast, the commercial construction projection because I do think there's a very serious overbuilding problem occurring, particularly in office buildings, but to some extent in shopping center and hotel/motel complexes and things of that sort too. Now, the thing about office buildings and big commercial centers that they share in common with foreign situations is that they involve an awful lot of debt; and in both cases an awful lot of the debt is held by banks. It seems to me that we may have a very conservative lending attitude on the part of financial institutions for more forthcoming deals for the next year or so and that could hold back the recovery some. So, I could see the outcome being below the staff projection by as much as a point and I can see it being above the staff projection by as much as a point. Therefore, I think the staff projection is a good working document.

CHAIRMAN VOLCKER. How much are our exports to Mexico down percentage wise in the past year?

MR. TRUMAN. Oh, it's more than 100 percent.

CHAIRMAN VOLCKER. It can't be down more than 100 percent.

MR. TRUMAN. It depends on which number I use as a base. Exports to Mexico in the fourth quarter of last year were at an annual rate of $6.8 billion dollars and in the fourth quarter of 1981 they were at an annual rate of $17.6 billion. So it's more than $10 billion.

CHAIRMAN VOLCKER. Two-thirds.

MR. TRUMAN. More than one-half.

MR. PARTEE. That's a lot.

CHAIRMAN VOLCKER. Well, I was talking to a Mexican central banker and I was beginning to think I didn't hear him correctly. He said their exports in the first quarter were 15 percent of what they were a year ago.

MR. TRUMAN. That is possible, yes.

MS. TEETERS. Exports or imports?

CHAIRMAN VOLCKER. Imports. I'm sorry.

CHAIRMAN VOLCKER. I began thinking afterwards that he had said 50 but maybe he did say 15.

MR. BLACK. Is that from us, Mr. Chairman, or all imports?

CHAIRMAN VOLCKER. It's their total imports, but they get a big--

MR. TRUMAN. I was thinking that probably the right number is 50 percent of the imports of a year ago. The first quarter a year ago our exports to Mexico were $15 billion. So, something on the order of $7-1/2 billion at annual rate is probably right.

CHAIRMAN VOLCKER. That says, though, that it went up from [the fourth quarter].

MR. TRUMAN. Slightly.

CHAIRMAN VOLCKER. It's not possible, I wouldn't think.

MR. TRUMAN. Well, the fourth quarter had October, November, and December in it. I'm almost surprised that they were in [unintelligible] in the fourth quarter of last year.

SPEAKER(?). Financed?

MR. TRUMAN. We financed $700 million in that quarter; half of it would have been CCC-related in the fourth quarter of last year.

MS. TEETERS. What about other South American countries, Ted?

MR. TRUMAN. I don't have that with me here as such, but for other developing countries our exports dropped by $3 billion on the same fourth quarter-to-fourth quarter basis.

MR. CORRIGAN. How many billion?

MR. TRUMAN. $3 billion.

CHAIRMAN VOLCKER. I don't think any of them have tightened up the way Mexico has in this time period. That may still lie ahead but they haven't done it yet.

MR. TRUMAN. Exports to Mexico were essentially financially constrained; they weren't letting in anything in that period.

CHAIRMAN VOLCKER. They weren't in the first quarter either.

MR. TRUMAN. They probably were somewhat more in the first quarter than they were in the fourth quarter.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. I'm not surprised at the numerous positive comments in the Redbook or those that we've been sharing with each other. As far as the businessman's attitude is concerned, I think we need to separate his or her little burst of optimism here from the probabilities of their obtaining the results they're talking about. Partly their attitudes are those of survivors. And as survivors they're looking at ways to increase their market share over the competition and they have good probabilities of doing that. I think we may be discounting a little in the forecast the shape of the curve that we have reviewed with regard to profitability. The increase in profitability projected a few quarters from now and for next year is very great indeed and that, of course, not only affects the external financing of the business sector but gets good old Keynesian animal spirits going again. And once the profits begin to come rolling in with some modest recovery, with the middle management cutbacks and the layoffs and so forth that have trimmed some of these organizations down, you get a positive effect on inventories, you finally get a positive effect on the computer-related or so-called tech kind of purchases in the equipment area. But I think we have to keep our eye on the probability of these attitudes not materializing. In housing, I am at a point of eating my words. I was hopeful that the mortgage lending institutions of our world, particularly the thrift institutions, finally would have learned something and as the MMDAs came in they would not put virtually all of it out in fixed rate long-term mortgages. I eat those words. I admit being overly influenced by the representatives we have on the Thrift Institutions Advisory Council; those people aren't doing that, but it looks as if everybody else is. And it's a small advisory group.

MR. PARTEE. I even wonder about them sometimes.

MR. MARTIN. So here comes this flood of fixed rate long-term funds. It meets the demand of the first time home buyers. They are influenced by an improvement in their tax position and are willing to undertake these obligations. The thrift institutions are not paying off the Home Loan Banks, as we found out today. They've made real progress; they've gone from $65 billion in debt there to $62 billion! Given the flood of funds coming in, they likewise have not paid off their friendly commercial bank. So, they're carrying that credit. They didn't do that with the money market deposit funds either. On the other hand, I separate the positive implications of home buyers from the probability that it will occur in the future. Namely, these are people who despite the after tax implications of income tax [savings] are sensitive to the interest rate. These are small young families in which two people are working. They can wait if the interest rates move up some; they'll simply postpone the purchase and we could have a good deal of that impetus disappear. So, again, I separate the positive nature of profitability and equipment purchases around the corner from home-buying--in terms of the sensitivity these areas have to the interest rate.

CHAIRMAN VOLCKER. One aspect that Governor Martin did not mention, except by implication, is that unfortunately the savings and loans have gotten themselves more and more sensitive to changes in interest rates on the liability side of the balance sheet and they are even less in a position to take an increase in interest rates now than they were before.

MR. MARTIN. That's right.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, we have revised our own forecast up just slightly. We tend to line up much as Governor Gramley and Mr. Black did. On balance, I rather like Governor Partee's position that the staff forecast presents a pretty good working document. We do have developments in our District that are causing some concern--certainly the energy situation and the implication that has for our banks down there. This past week most of our major bank holding companies have been making their public announcements about decreased earnings and increases in loan loss reserves. And unemployment picked up in February from 8.2 to 8.8 percent, which by our standards at least seems awfully high. In Houston, where nothing can go wrong, unemployment went from 9.1 up to 9.7 percent in February.

MR. MARTIN. Those people are all from Michigan!

MR. BOYKIN. That doesn't sound too high by national standards, but if you remember it was just half that a year ago. I was told last week that in Houston there are 30 million square feet of office space in commercial real estate construction that either is completed or is in the process of starting. I'm also told by one of the large developers that an estimated 65 percent of the office space in Houston is energy-related in some way. So, with what is happening in energy, that raises a question. We have an overbuilt situation in Dallas for commercial office buildings. We just started a 70-story building last week to cure that! The people in the energy business who feel that they're in it to stay, and we find fewer of those, say that stability in price is probably more important than the actual price level--that is, within a reasonable [range] of, say, somewhere between $25 and $29 per barrel. They would not get overly upset if it just stabilized, because [the instability] causes them difficulties in doing their planning. We know that the supervisory and regulatory groups are quite concerned about energy portfolios. There are some special [examinations] going on, as I understand it, in the major energy-lending banks just to take a look at the energy portfolio. So, being that close to what is a drag [on the economy] tends to color my thinking somewhat. But we still have some positives in areas that have already been mentioned, such as housing. On balance, for the economy as a whole I feel relatively optimistic that growth will be somewhere in the 4 to 5 percent range. That sounds reasonable.

CHAIRMAN VOLCKER. On the [energy industry] forecast, can you be more specific? Suppose the energy price stayed close to where it is now. Would the number of rigs hold up? Would you continue to get the current amount of drilling?

MR. BOYKIN. I don't think we would, Mr. Chairman. I would not anticipate a great deal of added activity. There are those engaged in that business who say that we will probably see drilling pick up again in the latter half of the year. Some of it is for tax purposes if for no other reason. I was talking to a pipe supplier to the energy business who says he basically is not doing anything but in talking to the majors--and these are the people he supplies primarily --they tell him just to hold still and that come summer and on into the rest of the year they have their budgets planned and they will spend that; he will get the orders. At that same meeting there was an independent oil man who has a pretty big business and he said that is the difference between the independents and the majors. The independents are not going to be going in.

CHAIRMAN VOLCKER. It's a lot cheaper to drill now, isn't it?

MR. BOYKIN. Oh, yes.

CHAIRMAN VOLCKER. It must be more cheap to drill than the reduction in the oil price.

MR. BOYKIN. It is; it's a lot cheaper to drill. But also the price is lower and there are a lot of rigs laid over. There is a question of whether one wants to wear that rig out right now on relatively cheap oil because some think that this may turn around next year. So, they're hedging their bet and figure they are better off keeping the rig down rather than pulling it up and wearing it out.

MS. TEETERS. It's cheaper to drill because the interest rates are down?

MR. BOYKIN. Yes. The cost of labor and all of the cost components are substantially--

MR. CORRIGAN. The cost of the rigs?

MR. BOYKIN. Yes, you can get a rig at a really cheap price. I might even have one or two before too long!

CHAIRMAN VOLCKER. If you don't have one now, you soon will. Mr. Ford.

MR. FORD. My next door neighbor is one of those independents who is a millionaire a number of times over. He told me there has never been a better time to buy rigs and leases--that right now is the time to get in. I always wondered--

CHAIRMAN VOLCKER. Is he buying them?

MR. FORD. He's doing it.

MR. BOYKIN. If I could just tack on, Bill, I got a report from one of our major banks that they are seriously putting a group together to bring up some REITs in the not too distant future.

MR. FORD. What's that--a rig equity investment trust?

MR. BOYKIN. Not in rigs, but in office buildings--they believe that there are some really good deals out there.

MR. FORD. Mr. Chairman, on the general economic outlook that we've been talking about, I come down on the side of Lyle Gramley and Preston Martin. When you look at the major sectors of the economy, the only thing I see to worry about is the one that has been noted; export growth is likely to be weak for the reasons we're all aware of, namely, that the buyers abroad are financially strapped and can't afford to buy. But if you take all the other sectors of the economy, in government spending, for example, the surge is just starting to hit in our part of the country and spending is going to come down like manna from heaven as far as the military buildup and the other sectors of government are concerned. It looks as if federal spending is just starting to surge through as a stimulant to the economy. I agree that there will be a sharp inventory turnaround; there almost has to be. All of the businessmen I've talked with in our area are saying that the [inventory] pipelines are dry. The orders are starting to pick up in our area. It's also showing up, as was noted, in sensitive commodity prices; virtually everything except oil and precious metals is surging. The BLS 22 commodity spot market index has been up 14 weeks in a row. Scrap steel, lumber, aluminum, wheat, corn, soy bean, cattle, cotton--everything--is going up and going up fast, which is a further indicator that the pipelines are rather dry as prices get bid up.

The big thing that we have to watch for, though, which will determine which of these polar forecasts is right, is exactly what the consumer does. When you look at the consumer's potential, the consumer really hasn't hit the market at all and he's in excellent condition to do it. The only thing that consumers are buying is new homes; and there's a little more resale house business. We haven't yet seen it feed through to the related industries in the consumer durables sector other than autos. I think that's bound to come with the employment picture brightening; the consumer's balance sheet certainly allows it. Then there is the profits surge that allows business to finance the inventory buildup. So, when you go through the different sectors--and the internal arguments we have at the Atlanta Fed have been on how vigorous and how quickly the surge is coming and so far I'm ahead--I think it's going to be a vigorous spring and summer for us. And I'm worried about what will happen at the end of the year and early next year--whether it's sustainable, given what we're doing with the monetary aggregates while this deficit spending is going on. I'm worried that we'll have a vigorous recovery and a drop through the floor about a year from now or maybe sooner. That's where I come out on it. I'm not worried about the next few months. I think we're going to be--

CHAIRMAN VOLCKER. Where does this drop through the floor come from against that background?

MR. FORD. I think what is going to happen is that when we do raise the rates, and I think we are going to raise the rates within a year for the reasons others have given, we're going to put the economy back in the tank. And it will come when we finally pay for all the monetary expansion that has been going on. We are going to have to pay for what we're doing now; we can't put off the day of reckoning forever. We can put it off for another 6 to 9 months and then we will pay. One way or another--

CHAIRMAN VOLCKER. What do you mean we will pay?

MR. FORD. We will pay when all this borrowing in the private sector that has to come in order to continue the expansion much beyond a few months comes into conflict with government [borrowing]. Then we are going to have to blow the whistle on it. And when we do, we're going to drive up rates and put the economy back down.

MR. PARTEE. You really do have a different pattern, Bill.

MR. FORD. Yes, I see a vigorous recovery.

MR. PARTEE. You have a pretty aggressive recovery and then a turn.

MR. FORD. Another surge and then a drop-off.

MR. ROBERTS(?). He has a boom/bust.

MR. FORD. That's my forecast: boom/bust.

CHAIRMAN VOLCKER. Because private credit demands are colliding with government credit demands?

MR. FORD. Yes. So far it has been rather moderate as far as the private sector tapping the market. But it has to come, don't you think?

CHAIRMAN VOLCKER. Well, I can see that very clearly. I don't see the connection quite so clearly with the money supply. It seems to me you said we'd avoid this by getting a much lower private credit expansion now.

SPEAKER(?). Get if off now.

SPEAKER(?). Have a lower economy now.

MR. PARTEE. Have no boom.

CHAIRMAN VOLCKER. I don't--

MR. FORD. What I'm suggesting is that the thing to do is to think in terms of moderating a boom now so that we don't have to come down as heavily about 9 months to a year from now.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. I have just a couple of comments. Our staff has consistently been optimistic and is looking for about a 5 percent fourth-quarter real growth and we think that the first quarter is probably running ahead of expectations in terms of the numbers that will come out. I went around to all my branches recently, as part of an introductory thing, and I met with the boards and heard their summaries of what they thought about the economy. I would say in reference to what someone said earlier that they're not euphoric at all. If anything, it's a reluctant optimism; but there's definitely unanimity of optimism. In the wood products area, for example, one fellow was cautioning about interpreting the February seasonally adjusted number and yet he concluded that [business is] really booming and prices are up 60 percent from the bottom. He said his lumber prices are still below his costs, but that with the sharply rising prices we had to look out in terms of what that would do to housing. But there was a reluctant optimism--

CHAIRMAN VOLCKER. That was lumber you said was up?

MR. ROBERTS. Lumber was up 60 percent since October.

MR. PARTEE. Lumber or some [wood] products?

CHAIRMAN VOLCKER. The figures don't show that generally, but they're up sharply; there's no question.

MR. ROBERTS. This chap heads the

and he said prices had really taken off and he was getting similar reports from people on the West Coast.

CHAIRMAN VOLCKER. They have gone up sharply in price.

MR. ROBERTS. My attitude is colored a little by the fact that I just contracted to buy a house in the weak St. Louis market where I found the seller is very, very firm and the price is not weak at all. Housing is very strong. has a large consumer oriented company--shoes and recreational products and so on --and he said he's seeing expansion in unit sales across the country for the first time; the expansion is concealed a little by the lower prices. But he really is doing better than when he had higher prices and the units weren't moving. So, all in all--

CHAIRMAN VOLCKER. Now he can convince a few other people of that!

MR. ROBERTS. I might add that his profits are up very substantially with this type of development, so it's very constructive. All in all, there is pretty solid and widespread optimism but nothing in terms of a soaring economy.

VICE CHAIRMAN SOLOMON. What is your staff projecting in regard to inflation?

MR. ROBERTS. On inflation I believe we had 5 percent. My own feeling is that we're probably overestimating inflation. With the good control over compensation per manhour, the good productivity figures, I think a low increase in prices is in the bag for '83. I'm more concerned about '84 in terms of this sharp buildup in liquidity.

CHAIRMAN VOLCKER. I have run through my list. Does anybody else want to say anything? I think at this stage we might as well wait and begin with Mr. Axilrod first thing tomorrow morning. How long do you plan to talk, Mr. Axilrod? If people want to stay 5 minutes and get this introduction tonight, I'm at your--

MR. FORD. He said 10 minutes.

CHAIRMAN VOLCKER. Would you rather stay or go?

MR. PARTEE. How about doing half of it?

SPEAKER(?). Can't do it.

MR. GRAMLEY. To facilitate discussion, I think it's better if it is fresh in our minds.

CHAIRMAN VOLCKER. Okay. You'd rather have it fresh in your minds than think about it. That shows you something, Mr. Axilrod.

[Meeting recessed]

March 29, 1983--Morning Session

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

CHAIRMAN VOLCKER. [Unintelligible] given a lot of room. Who would like to comment?

MR. RICE. Mr. Chairman?

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. I'd first like to compliment Steve on what I think was an unusually clear analysis of the kinds of issues we face. The policy preference course today seems to depend more than usually on how one sees the current performance of the economy and how one sees the economy developing in the near term. If one sees the economy as fragile and the economic recovery as vulnerable and much weaker than usual--and, of course, sees the inflation rate very low and, therefore, not a major concern--one obviously then would be pushed in the direction of alternative A and perhaps even a further relaxation. On the other hand, if one sees that the economy is strengthening rapidly and indeed appears to have a boom momentum and there is a strong fear of the uncertainties of inflation, then obviously one might be pushed in the direction of alternative C or even more restraint. I would agree with Governor Partee's statement yesterday in support of the staff analysis and the staff forecast, which he found to be in the middle. And I would agree when he says that over the rest of the year the real GNP could come in 1 percent higher or 1 percent lower. But the staff forecast is in the middle.

I would agree also with Frank Morris when he says that we need more data and a little more time before we can be confident about the nature of this recovery. Readily accepting that inventories are lean, that shelves are bare, and that defense spending is strong and rising, it seems to me that one must make some heroic assumptions with regard to consumer expenditures and consumers' willingness to take on debt in large quantities, given the level of real interest rates. Also [it takes] some expansive assumptions with respect to residential construction in order to see that the economy is recovering strongly and in danger of causing a boom. I think the worry that the economy is strengthening too quickly would ignore what is best [not] minimized. There are drags on the economy at the present time: the drag effects of capital spending and the probable composition of that spending when it turns around and begins to expand, and the drag effects of state and local expenditures as well. While I would agree, as I said, that we need more time and more data to feel confident about the nature of the recovery, at this point I'm persuaded that the economy still needs nurturing and at the very least does not need any restraining influence resulting from a more restrictive monetary policy. Now, I would agree that there may have been considerable stimulation in the sense that the underlying rate of growth of the aggregates may well have been very strong. But I think that we have to see stimulation in relative terms, and we have to see that stimulation in a situation when real interest rates are negative [and] not quite as sensitive as stimulation in the context of highly positive real rates of interest. So, I would come out in favor of a position somewhat between alternative A and alternative B--that is, somewhat of a holding position until the economic picture becomes clear. And instead of sending up interest rates, I would tend to err slightly on the side of a downward [nudge]. I think that's what the outlook calls for at the present time.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I think that a strong case can be made for continuing with a money market directive for the time being. I'm not sure but that it'd be premature to return to targeting even M2 and M3 in the short run of the intermeeting period. With a money market directive we could implement an extremely modest tightening, which I think would be indicated under the situation for reasons Emmett talked about; I doubt that we would respond in a mechanistic way to the short-run targets. So, therefore, we could achieve the same substantive effect anyway with a money market directive. I'm not saying that there won't be a point when we would want to return to targeting the aggregates, but at the moment I have an instinct, and I think that's all I can actually call it, that a strong case could be made that it's somewhat premature to do so. It could put us back in that situation we were in earlier. I'm a little concerned about the market impression of our going in that direction. Paul made one casual remark in one sentence in answering a question about M1 growth, namely that it was looking strong, and the market very strongly overreacted and people were looking at M1 for quite a few weeks. If they see us now moving back to monetary aggregates targeting, then I think they might draw more conclusions from that than would be justified. I don't think that they would recognize the heavy degree of judgmental decision components that I assume will go into our policy moves. Even though it may make some sense to target M2 and M3 --although I think M3 would be more reliable for the next period and we might consider just targeting M3 for this short period while we're still seeing the substantial movement of funds going on--I still think a case can be made for a money market directive being continued.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I think that Steve has posed the issue very correctly. We have the evidence of a very strong monetary expansion. On the other side is a high real interest rate. Which of the two is what really drives the economy? Now, if I were to follow through the monetary implications of the recent monetary upsurge, I would have to say that the monetarist view is that half a year later the real sector would begin to move strongly. If that were to be the case, then we'd see something stirring now and certainly have very strong second and third quarters, which we don't seem to expect, and a couple of years later prices would begin to expand. This is an empirical finding. There is no logical reason why that should happen unless over two years we reach a level of unemployment at which prices do begin to react to a continued monetary expansion. So, the analysis of what this bulge in the money supply is likely to do does not seem to me to be very plausible at the present time. We don't see the real sector effect before us now. And the price effect farther down the road would occur, it seems to me, if by that time unemployment had come down to an inflationary level. But that is not very likely, even over two years. So the bulge in the money supply to me seems to be less persuasive as a predictor of what is going to happen than is the level of real interest rates. The level of real interest rates does seem to be high. It may not be as high as present indexes indicate. I think people like to think of long-term inflation as well above 5 percent, maybe 6 or maybe 7 percent. That seems to be the findings of the Bache-Prudential survey. So, real rates may not be as high as they seem on the basis of present indexes, but they are still substantial. And that, I think, is what dominates the situation and is giving us probably a moderate recovery.

Why it is that we're experiencing these great increases in the aggregates is something I don't understand. [I don't know] why the model predicts so differently what shifts may be taking place. But it doesn't seem to me to be the kind of thing that is likely to generate the usual future consequences of high money growth. So, I don't see an immediate need to bring down the growth of the aggregates sharply to within their ranges. On the other hand, I like the idea of going back to a money supply target even though I recognize we can do exactly the same thing with an interest rate target. We can have a money supply target if we qualify the money supply target adequately. The way the [staff's draft wording] is formulated in the square brackets does seem to qualify the money supply targets in a very complete form. That is to say: If we undershoot, resist that; if we overshoot, let it run. One could not be more accommodative than I interpret that formulation. But I would prefer going back to the aggregates because I feel very uneasy with interest rate pegging just on general principles. It has been an unfortunate thing in the past. Tony may have confidence that we can shift gears in a timely way--and I take it that that's your ultimate intention--but interest rate targeting has had a bad history. It will not look good in the record and is I think in the long run surely inflationary. So, I'd rather get away from it as soon as I can.

CHAIRMAN VOLCKER. [Unintelligible] I'm not sure. At least you can make a plausible explanation, which Steve touched upon, as to what is going on in the broader aggregates. I'm not sure you can in the narrow ones. But it's a fairly straightforward story, if I understand it and if the figures are right, which they may not be. If the credit figure is as low as the estimators now think it is, and that's subject to considerable uncertainty, we have no great credit expansion; this figure is about in line with nominal GNP, which is what one would expect.

MR. AXILROD. It seems to be.

CHAIRMAN VOLCKER. What we have is a lot more intermediation through depository institutions when they are aggressively paying higher rates relative to credit market instruments, which is I guess what one would expect of that. The amount of deposit growth among individuals is very large in the first quarter and the amount of credit market instrument growth is very small relative to what it has been; that's consistent at least with different pricing. Now, that doesn't explain M1, but it's a reasonably consistent story for M2 and M3, to the extent that M3 is high at all.

MR. AXILROD. For the depository institutions, we don't put the money funds in there, so--

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I think you put the right slant on it just now, Paul. It's a situation where the broader the aggregate the less egregious the situation looks; that's the result. But apparently total bank credit is well within--in fact, slightly below--the range we've specified and well within expectations or even on the weak side so far, if the figures are at all right. Growth of M3 shown here on page 2 of the Bluebook for the fourth to the first quarter is 9.8 percent; for the fourth quarter to March it is 9.7 percent. And [that's about] the way it has been running for some considerable period of time. M2 is very large because of the shifts to MMDAs principally, I think, but there could be a little more underlying strength in there. M1 is impossible to explain. M1 is just extraordinarily strong and has been for a considerable amount of time. And rather than trailing off, it got stronger in February and March. That's the one, of course, that the market is beginning to look at, even though we haven't targeted it as one of our principal variables. And that's the one that gives us all kinds of difficulty. I don't know; it may be that one component after all now pays 5-1/4 percent--the NOW accounts. That's about 3 points below the market but 3 points on an after-tax basis is not much and might lead people to keep excess liquidity in NOW accounts. The other component, Super NOWs, is presumably right on the market if one allows for the cost of handling the transactions activity in an account. And there is no reason at all, assuming that you have a reasonable deal and need some money for transactions, not to keep your money there rather than in the market. Perhaps that's much of the explanation. I might remind the Committee that this is also a very volatile series and that we sometimes have periods of very large increases and then we have periods of small increases or declines. It may be that we're getting here some kind of a bump in this and that it subsequently will have a low rate of growth. In fact, I'm inclined to think that's what is going to happen. So, I guess I agree with Emmett: I don't see anything in the economy nor in the credit picture nor in the inflation picture to lead one to say that we need to react with great alarm because of these aggregates. And, therefore, we should not do so. I don't think it's a time to return [to the old operating technique]. I don't quite understand this discussion of money market versus aggregates. After all, we do target the aggregates. If we stop targeting them, we've got to tell Congress we are going to stop targeting them.

VICE CHAIRMAN SOLOMON. We didn't target them at the last meeting in terms of the short-run targeting.

MR. PARTEE. Yes, but we specified target rates of growth for M2 and M3, bank credit and--

CHAIRMAN VOLCKER. Only indirectly in the last [directive].

MR. PARTEE. I don't think we should say we're going to stop targeting these things. On the other hand, I don't agree with Henry that we ought to run our policy on the basis of a presumed path relative to targets. I think we ought to continue to do about what we've been doing because I don't think, Henry, that we should change back to proximate targeting on the aggregates when we still have this inexplicable decline in velocity. It seems to me that as soon as we can see something in terms of a move to a more normative relationship, then we ought to return strictly to monetary targeting, but not now. We have no more reason now than we had last time or in the fourth quarter, since we're still getting sizable declines in velocity by all evidence. I don't think that we have to go back to the nonborrowed reserve path targeting that we had before; rather we ought to stay with the presumption of a net reserve--

CHAIRMAN VOLCKER. Let me try to develop the semantics--

MR. PARTEE. No, I got a little confused there.

CHAIRMAN VOLCKER. --in an acceptable manner. We have two alternatives here. There obviously are more alternatives, but we have two in front of us, which some of the comments have been directed to. I don't think the first alternative has no targets in it but they are depressed a bit. It says "paths implied by the long-term ranges;" it has some coloration of a short-term mechanistic following of the targets, I think. But the only reference to targeting is to the longer-range paths. The second one is set out in more traditional quarterly targets. But I don't read that as necessarily implying as much as you were suggesting, Chuck, that it is necessarily returning to the operating technique [of recent years]. And I'm not sure Henry was suggesting that.

MR. WALLICH. That's right. We have flexibility.

CHAIRMAN VOLCKER. I think these do reflect to some extent different degrees of emphasis, but I--

MR. PARTEE. Well, I misunderstood Henry. I wanted to argue against returning to the operating technique.

CHAIRMAN VOLCKER. Well, that's a substantive issue. But I don't read alternative II as necessarily implying that. Nor does alternative I imply that we don't look at the targets at all.

MR. PARTEE. I see. Well, I come out that we ought to hold about where we are again for a period, until we can get some of Frank's new numbers and get some sense of what is occurring and perhaps understand the aggregates a little better than we do now. So, I don't feel that because of market sensitivity we are justified in pushing rates down. I think that would cause considerable alarm at this point. Nor do I think we ought to return to the old operating technique. I guess that's about alternative B.

CHAIRMAN VOLCKER. I'm anxious to get to Mr. Morris' new numbers. I don't know what they are.

MR. PARTEE. I meant new monthly numbers. He said we didn't have enough information yet to know where the economy is.

MR. RICE. The numbers that will come out next month.

CHAIRMAN VOLCKER. Oh, okay. I thought I was missing something again! Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, let me start by making a couple of observations about M1, because I do think in the eyes of the financial markets that M1 is the aggregate that is causing the most problems in terms of expectations right now. We've done a little look behind some of the numbers and I must say it leads me to the view that the shifting phenomenon as it relates to Super NOW accounts in particular is having an impact that I think at this point clearly works in the direction of overstating M1. We looked at a sample of about 20 banks outside of the Twin Cities in terms of what is going on with Super NOW accounts, and it's rather revealing because we find that the average balance in household Super NOW accounts runs in the range of $15,000 to $20,000, which is 3 or 4 times the balance in conventional NOW accounts. In addition, we have found a number of instances that involve very, very sizable Super NOW account balances--balances associated with institutions, state and local governments, hospitals, and so on. This is a very limited sample, of course, but in some cases we have seen average balances in individual institutions as high as several hundred thousand dollars in Super NOW accounts. And we're led to believe from some limited discussions that those balances, in particular, were not M1 balances before. Both of those phenomena, to the extent that they represent anything close to a pattern--and obviously I can't draw that conclusion from 20 banks--do suggest to me that the measured growth of M1 may be more affected than perhaps we've been thinking. I'm not saying this is right analytically, but if you assume that the difference in the average balance size in the Super NOW household account as opposed to a conventional NOW account, is a proxy for the additional savings component that's reflected in these NOW accounts and you make any kind of adjustment for the measured growth rate in M1 over the first quarter for that, it's not very hard to find yourself looking at a situation where shift-adjusted growth in M1 is in fact within the ranges that we're talking about for the year. But again, that is highly speculative and based on a very limited sample. In any event, I am persuaded from this limited exercise that we may have more of a problem in terms of what M1 is really doing than perhaps we have recognized up until now. Obviously, to the extent that is right, it could have quite a bearing in terms of market psychology itself.

Just one other quick point on money: I mentioned yesterday in the context of some of our directors' comments about the economy being pretty strong that one of the very interesting things that they reported was a tremendous increase in the use of currency for financing retail transactions in size--not toothpaste transactions, but fairly sizable transactions being paid for with the currency of the realm. Surprisingly, one person brought it up and several others immediately said that they--

CHAIRMAN VOLCKER. These were bankers?

MR. PARTEE. The trade people?

MR. CORRIGAN. It was both bankers and trade people, as I recall. But it was interesting because once one person mentioned it several others chimed right in and said that they had seen exactly the same thing.

CHAIRMAN VOLCKER. Did they have an explanation for that?

MR. CORRIGAN. Nope.

MS. TEETERS. Currency or checks, Jerry?

MR. CORRIGAN. Currency.

CHAIRMAN VOLCKER. Let me just interject here, for anybody who has not been observing the figures, that we have three months in a row of very high currency growth figures. I think if you go back 20 years you can't find another three months like this. It seems to be quite general and nobody has an explanation.

MR. CORRIGAN. I was really astonished by these comments. As I said, they were seeing currency being used to pay for retail transactions of size. Again, I'm not talking about a tube of toothpaste or a can of peas.

VICE CHAIRMAN SOLOMON. Have we ever gotten down how much currency is going to Latin American countries?

CHAIRMAN VOLCKER. We've looked to see whether there is anything unusual for which we have any specific evidence. They tell me we have no evidence. Now, that doesn't tell us how many Latin Americans may be holding money in the United States in a safe deposit vault, but we haven't any evidence of it flowing in. Maybe it is, but we have no evidence. It's a very surprising development. I don't know why it would go in that direction; I can understand Latin Americans buying dollars, but we haven't any specific evidence of that. I don't know why they should be doing what Mr. Corrigan says. All I know is that the [currency growth] figures show a big bulge.

MR. RICE. Maybe the recovery in the underground economy is stronger than--

CHAIRMAN VOLCKER. A very radical difference.

MR. GRAMLEY. That won't even show up in Frank's statistics.

MR. FORD. Just thinking about it in terms of a priori logic, with real interest rates coming down, I don't see that the cost of holding cash has changed that much in favor of using more cash. So that wouldn't be a [reason].

CHAIRMAN VOLCKER. Well, it's not low relative to what it has been in the past when currency wasn't going up this rapidly.

MR. FORD. One thing we have noticed in Miami is the cash flowing into the Miami branch. We had a big surplus of cash flowing in versus payouts, on the order of a $6 billion differential in '81. I forget [the exact amount]--I wish I had brought the figures--but I did notice in reviewing the [more recent] Miami currency report that we're getting a slower inflow and Miami is less of a net cash generator for our big branch down there. Paul, one possible explanation would be that Venezuela, for example, has just put on exchange controls. France is putting on limits as to how much cash one can carry out and Mexico is putting on limits. I'm just thinking aloud: Could it be that to the extent that dollars show up in these economies through the underground economy, or however they used to remit them back when there was no limit on carrying money in and out of Venezuela, they're stashing more cash down there?

CHAIRMAN VOLCKER. Well, it is conceivable. But we don't find any evidence of real cash shipments down there. You would think it might be tied in with this international financial and economic disturbance, but we just can't find direct evidence for it.

MR. FORD. Yes, but if you buy the fact that the cash has been flowing that way--for example, into Columbia and Venezuela as a result of the black market--the cash was going in and then it would come back and end up in our banks and end up in the Miami branch.

CHAIRMAN VOLCKER. It might be. I don't say you're wrong; I just don't know how to find it directly. That kind of explanation sounds more plausible to me than Mr. Corrigan's, but the other thing is that it seems to be happening all over the country. You read that Federal Reserve notes in all the Federal Reserve Banks are going up. It's a strange phenomenon and I don't know how to approach finding more information. Just in line with Mr. Corrigan's earlier comments, I think it's worth scratching our heads harder and expending some resources in trying to work on what's going on in M1 in general in terms of behavior patterns, particularly Super NOWs.

MR. MORRIS. One idea we had--I don't know that it has any merit or not--is that with the new discounts for cash payment in gasoline stations people are having a tendency to pay in cash rather than using a credit card and may be carrying higher balances than they used to in order to get the discount.

MS. TEETERS. Frank, I have a son who works in a gas station. They net between $20 and $40 a day because people don't pick up their cash discount.

MR. PARTEE. You mean they charge it still?

MS. TEETERS. They are charged the credit price and paying cash and [the attendants] have to figure out what the discount is, and people don't wait to get it.

MR. GUFFEY. I don't know what the credit card growth is, but another possible explanation is that the credit card companies all are charging on a day-of-purchase basis an interest rate something between 18 and 22 percent; that makes the cost of holding cash much less at these current interest rates.

MR. CORRIGAN. If you look at it that way, using cash--

MR. GUFFEY. You're just substituting cash for credit card purchasing.

CHAIRMAN VOLCKER. Well, we're not going to resolve it at the table this morning, but I think we ought to devote some further imagination to trying to figure out what is going on there. But I don't think you were finished, Mr. Corrigan.

MR. CORRIGAN. On policy itself, for reasons that have already been stated, I would come out somewhere along the lines of alternative B in the Bluebook. I do have a preference for the alternative II language in the directive as well, for the reasons cited by both Governor Partee and Governor Wallich. I think they were saying the same thing; if they were, I agree with both of them.

VICE CHAIRMAN SOLOMON. Chuck was saying stay with the existing language.

MR. PARTEE. I thought I was a little closer to Tony, actually, than to Henry.

MR. GRAMLEY. Are you talking about alternative I or II?

MR. CORRIGAN. I'm talking about alternative B in the directive language.

MR. GRAMLEY. Yes, but I mean in terms of alternative [wording].

CHAIRMAN VOLCKER. You're talking about directive II?

MR. BLACK. Alternative II, I think.

MR. CORRIGAN. Yes, right. Well, in the Bluebook it's alternatives I and II and in the draft that was handed out it's alternatives A and B. I'm talking about the second one. The case for staying more or less where we are in policy both tactically and operationally makes a lot of sense to me. The only other point I would add is that, looking out from where we are, it really does strike me that we're approaching a situation where analytically each of these money supply measures is just a horse of a totally different color. I must say I am not at all sure what that is going to mean for the evolution of monetary policy over a long period of time both in terms of operating procedures, definitions, and all the rest. I think the day may be at hand when the Committee and the staff have to start to explore some of these questions on a more fundamental basis because the point will come when we're going to have to have a better mouse trap. And I just don't know what it's going to be at this point.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, we continue to be concerned about the growth of M1. It seems clear to us that the reported growth has not been inflated. Jerry raised some interesting points. If we look at the money market deposit accounts, in our analysis that provides a big offset, which suggests the shift-adjusted figure is really bigger. And Steve's group has suggested that it's probably largely unaffected, which is probably the most reasonable of all because I'm sure they've looked at it much more extensively than the rest of us have. If there has been this upward shift in the demand for money, it seems likely to me that we've pretty well accommodated, if not more than accommodated, the overshoots that we've had. I continue to have a lot of difficulty in understanding why we're placing our main emphasis on M2, which is the aggregate that seems to be most distorted by these new accounts and one over which we have very little control while M1 in contrast is now generally thought to be the one least affected. And it's the one that's most controllable. All the empirical studies to me suggest that M1 has the best past record for predicting inflation and nominal GNP. Of course, that may change; it certainly is a different instrument now. But my feeling would be that the burden of proof ought to be on those who think it's going to change that much, though I realize it certainly can.

So, with these points in mind, I feel very strongly that we ought to move back toward the old operating procedures, as far as we can persuade the Committee to do so, that we were using before last October. And in particular, I think we ought to allow the borrowed reserve target and the federal funds rate to vary in reaction to any overshoots or undershoots above or below the stated path that we have. Now, it might well cause the federal funds rate to rise a little in the short run, but I think it's unlikely that a moderate increase of that sort would seriously undermine the recovery since it seems to me to be pretty firmly [entrenched]. The real issue, as I see it, is that if we fail to act now, we may have to take a lot stronger action later when business confidence and the bond markets may be a lot weaker. And they may be weaker because I think we'll have a revival of the inflationary expectations--even more so than we have now. So, I lean toward the C alternative and, for obvious reasons, prefer the language of alternative II as shown in the Bluebook and alternative B as shown in the handout. I would like to eliminate the wording in that first bracket there; I think that's really unnecessary. And, obviously, I would like equal if not more importance attached to M1.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, Mr. Chairman, we're getting some indications of a divergence of views among the Committee members as to where the economy is going, and I think that's understandable. This is, after all, a recovery that's only just beginning. The evidence on where we're going is still fragmentary. And each of us, I think, tends to seize upon a particular number that tends to support his own view. Not by way of singling out Frank, but Frank for example mentioned that durable goods orders had fallen in February and that was disappointing. I could come back and say, yes, now we only have a 34 percent annual rate of rise in durable goods orders from the fourth quarter to February. You can take either side of this issue and make something of it if you want. I think we ought to recognize that there are a lot of uncertainties and that means to me among other things that we ought to be cautious. Whatever we do we don't want to go back to a situation in which inadvertently we either let interest rates drop a ton or increase a ton. If they move in either direction, we're likely to find ourselves far from where we want to.

The second thing I want to say is that I agree entirely with Jerry Corrigan, not just on M1, but on the Ms generally. I just don't know what they mean. Now, it is true that M1 in the past has proven to be our faithful friend--more predictable in terms of its relationship with GNP and maybe more controllable. I also would want to remind everybody that since the fourth quarter of 1981 the growth of M1 has just baffled us. We've had a movement of velocity we do not understand. In mid to late 1981 and early in 1982 I think we reacted in an overly restrictive direction to the growth of OCDs. We got an economy that was a lot sicker in 1982 as a consequence thereof. To say that somehow these recent increases in M1, despite five quarters of very, very puzzling velocity, are going to generate inflation right around the corner is a very, very dangerous line of thinking. For the moment, I think we ought to try to look at other things. I agree with Bob that we need to start positioning ourselves for where we want to be in the future. I have come to the conclusion that real interest rates may well need to be moved up to keep this recovery from strengthening [too much]. I'm very much impressed by the fact that the cost of capital, if you take into account the rise of stock prices, has dropped a lot. And we've added a half a trillion dollars of wealth. Now, this affects consumption spending, through the cost of capital, as well as the outlook for business fixed investment. But I would want to proceed very slowly and very gradually. I'm inclined, therefore, to think that we ought to go somewhere between "B" and "C." I'm not quite sure what I want by way of initial borrowing, but I wouldn't mind at all if the federal funds rate were nudged up to 9 percent or maybe a little over. As to the alternatives, I don't really care whether we go with I or II. I'd feel a bit more comfortable if we begin moving back in the direction of something other than a strict money market directive. But I can go with either one of those.

CHAIRMAN VOLCKER. Ms. Teeters.

MS. TEETERS. I guess I will counterpoint Lyle. I think it would be a disaster for interest rates to go up. We are at 68-1/2 percent capacity utilization and we have 10.4 percent unemployment. We have just the beginnings--at most three months--of signs of recovery. If we abort it, we will have major problems not only in terms of what it will do to the economy because rising interest rates can only force capacity utilization lower and the unemployment rate higher--I think the economic consequences of starting to tighten from that particular position are too severe--but I think the political consequences are even worse. If you look at the structure of both our domestic and international institutions, again, rising interest rates could be very difficult to cope with and could only exacerbate problems that are out there. I've noticed that we have eleven institutions on extended borrowing. That's the highest number that I remember seeing; it may have been higher at other times.

MR. PARTEE. They are all banks too, aren't they?

MS. TEETERS. Yes, they are all banks. We're going to increase the strains in the economy by increasing interest rates. And, if anything, I think we ought to be aiming to lower them. In fact, I am very much against this. If snugging went on--however that term got into the public press--I am opposed to it. I think the rates, if anything, should have been drifting lower and not higher over the intermeeting period. And [the funds rate] certainly should not have been above the discount rate. I also am cautious. I want more information. We're running on highly seasonally adjusted numbers at this point and sometimes [the final numbers] don't turn out that way. I think we do have a backlog in housing and we're probably catching up on it. But we could destroy any recovery in housing if the mortgage rate goes up above 13 percent again. So, I would be with Emmett. I would like to see the [funds] rate come back down to at least 8-1/2 percent and, if anything, fluctuate between 8 and 8-1/2 percent rather than between 8-1/2 and 9 percent. The real interest rate is extraordinarily high. And I don't think that we can get a sustained recovery, particularly with the high interest rates that we're dealing with at the present time. On the other hand, I realize that there is still a booming federal deficit out there. And I think there is some movement in Congress to do something about it. But if we give up too soon, they won't do it. So, I would like to wait for more information. I certainly am opposed to any increase in rates and would like to see them return to where they were at the time of the last meeting. I would go for "A" or "B" and I don't think the language makes a lot of difference. If I had to be pushed one way or the other, I'd go for alternative I, but I don't think that's what we're operating on, frankly.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I would like eventually to get back to targeting the aggregates and to the previous operating procedures. The way I'd like to do that is in some long-run sense--saying that by year-end we'd like to be at such and such a point relative to the ranges. And I'd like to be able to say that with regard to M1 particularly because of its controllability and its historic relationship with GNP. I'm uncomfortable with the rate of growth in M1. I am interested in pursuing your analysis further, Jerry, but with the information I had coming into the meeting I am uncomfortable with the growth rates in M1. However, two problems I see as being very severe at this meeting are: (1) the velocity problems of M1; and (2) the great uncertainties in the economic outlook. I agree with the staff forecast on the economy but I see a lot of downside risks. Of course, in the Fourth Federal Reserve District we continue to have pretty dreary reports. So, I'm not ready to argue today for a return to the operating techniques that were previously used. I come out for alternative B because of the tremendous uncertainties. I come out for directive language II because I think it's one step toward returning at what I hope would be an early date to the old operating procedures or to some modification of the operating procedures. That would cause, perhaps, a slower adjustment to the long-run paths, but I do see that as very definitely the direction that we need to go and hopefully will be able to go sooner rather than later. I'd like to end with a question to Peter, if I might, with regard to the term structure of interest rates. Could you just elaborate on the remarks you made in a couple of sentences yesterday about short rates versus long rates and so forth? Could you elaborate on how you feel the market might react to, say, a slight increase in the fed funds rate?

MR. STERNLIGHT. What I said yesterday, President Horn, is that I sense a great feeling of uncertainty in the market. As to what kind of reaction there would be, on some occasions I've gotten the sense that the intermediate and longer end of the market would take quite comfortably--in some cases even welcome--a firming in short rates as evidence that the Fed was still actively concerned with inflation and wanting to put a lid on monetary growth. But there also have been other occasions when the whole market has reacted. Last Friday when Kaufman's report came out--and maybe it was a little exaggerated when it hit the ticker--the whole rate structure moved a bit, both short and long rates. In the preceding week there had been a rather different picture, with short rates edging up but nothing at all happening on the longer rates. I think there was a sense among some people who took a somewhat longer, broader view that the higher short rates would not have to impact, even temporarily, on the longer end. So, I'm left in a bit of a quandary on just how the market is reacting.

VICE CHAIRMAN SOLOMON. Isn't there some basis for reconciling the two different reactions in terms of the fact that Kaufman was talking about a very substantial move in short-term rates whereas the earlier impression in the market was that it was just what they called a snugging up--20 to 30 basis points? I think that may account for part of the difference in the reaction in the long end of the markets.

MR. STERNLIGHT. That could be.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I certainly am in agreement that the recovery is in place but I tend to be much more on the cautious side than other people as to just how strong a literal recovery we have. It seems to me that so far the growth has been entirely on the interest sensitive side of the economy and so far it has been uneven. The capital goods sector continues to be very weak and, therefore, at this point I think we just couldn't run the risk of having rates go up significantly. By that I mean that I think the upper end of the fed funds range in alternative C would be unacceptably high. I think we can continue to sustain the recovery if we have fed funds broadly in the area of where they are now, in the 8-1/2 to 8-3/4 percent area or something like that. On the other side, I do think there's an awful lot of noise, and I'm suitably confused by the level of noise in the aggregate numbers. But there is rather compelling evidence that we have been through a period of pretty rapid expansion and I think we have to begin to set the stage to react to that at some point lest we let it get out of control. So, I think we ought to become a little more directed in our language as to what we're going to do. I would be in favor of alternative II. Having said that, though, with regard to the directive under alternative II, I'd leave in both parenthetical expressions. I would be in favor of [the specifications of] alternative B, but I would tend to let the initial borrowing level go up to, say, $300 million, or broadly about where it is now. That seems to me to be an acceptable course given the circumstances.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. It probably will not come as any surprise that I would join those who would not want to see interest rates rise any further. For clarity purposes, because of the statement I made yesterday, I would agree generally with the staff's forecast. Then turning to the percentage chance that it's right or wrong, I think the risk is on the down side rather than on the up side. That's particularly true in view of the experience we've had with two recessions in the last 3 years. I think we would be taking a very great risk if we [slow] this recovery down so that the psychological impact on the public is such as to perhaps push us into another recession. So, I think the risk is on the down side. Thus, I would opt for a policy that would ensure that we would not increase interest rates above the present level. Just as a guide, I would think that anything in the range of 9 percent or over in the federal funds rate increases that risk very measurably and we should not take that risk. I should also say that if you believe in the staff's forecast in the Bluebook, for those who are interested in returning to the targeted ranges of the aggregates that were established for the year as a whole, you will find that alternative B would return both M2 and M3 to within those ranges by midyear. And for M3 I bet it would be before that. I think that's a pretty good track record, considering the uncertainty that we're facing today. With regard to the directive, I would like to move back to the targeting of the aggregates sometime in the future. And I would just observe that what we're doing today is setting policy for the second quarter as a whole and that this directive will not become public until after the next meeting. As a result, it seems to me that alternative II as a directive would be an appropriate policy.

MR. MORRIS. Inappropriate?

MR. GUFFEY. It would be an appropriate policy. I would opt for alternative B--for aggregate targeting and a move to alternative II. I would keep the first parenthetical phrase. To emphasize my feeling about interest rates and that they not move up, I would even opt for a 5 to 9 percent federal funds rate range to ensure that the rate doesn't go above 9 percent, although I don't think that's necessary if there's some reasonable agreement around the table as to what policy should be with respect to interest rates going up. On the point about how the market will react to higher interest rates, it seems to me that the earlier episode in which the market reacted to a little snugging up if you will, in which long rates came down and short rates went up, reestablished the Fed's credibility with regard to inflation. I don't think we ought to do it again. [Laughter] So, I would opt for alternative B with a borrowing level at $200 to $250 million, simply based upon the history of the last 5 weeks of borrowing. A level of $200 million would be acceptable; $250 million would be acceptable. To go above that, I think we would be holding the funds rate in the 8-3/4 percent or above range, and I'd feel uncomfortable about that.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I agree with Roger that the major risk in the present situation is on the down side. It's a risk of possibly aborting the expansion, and the risk of reigniting double-digit inflation is considerably farther down the road. I think the broader aggregates do not confirm the proposition that our current policy is too expansionary. They suggest that it ought to be adequate to a produce a sustained upturn, but they are not indicating an excessively expansionary policy. I've been persuaded by Jim Duesenberry that the very rapid rate of M1 growth can be explained by the very sharp reduction in short-term money rates--that is, the cost of holding money in the form of a NOW account is now relatively low whereas a year or so ago it was extremely high and, therefore--

CHAIRMAN VOLCKER. You say you've been persuaded by Mr. Duesenberry?

MR. MORRIS. Yes.

CHAIRMAN VOLCKER. I have to ask what equation Mr. Duesenberry has; our equation doesn't show it.

MR. MORRIS. Well, I think it does. Doesn't our equation indicate that you would expect that, given the sharp decline in rates? And one other thing--

CHAIRMAN VOLCKER. It goes in that direction, but it just doesn't go above--

MR. AXILROD. It doesn't have as big an effect. If it were to explain what happened, the rate effect would have to be bigger than in fact is built into the equation at the present time.

MR. MORRIS. But I wonder about the equation since it was based on historical relationships. We've never had such a major decline in rates before.

MR. AXILROD. The deficiency in our equations, or the ones that fit through 1974, is rather obvious. The staff experimentally has been dealing with one fit through 1981, which tries to track OCDs separately. So far we haven't been able to get a variable in there that reflects the saving behavior very much. It has a sort of technical assumption that it behaves like a transaction account and I don't think it's working quite right. I have some sympathy for what you're saying. Our equation doesn't quite give that result yet; maybe it should, but it doesn't yet. So, we have to explain this as a demand shift.

MR. MORRIS. Well, so much for M1. I'm still uncomfortable with having an M2 target at this juncture because the second-quarter targets here are based on assumptions as to how rapidly the adjustment to the money market demand account is going to be completed. The assumption may be good or it may not be good. It seems to me that in this period of transition the case for having an M2 target is not very strong any more. It seems to me we'd be better off with simply an M3 target, as Tony has suggested I think. Until we get some further evidence to tell us how strong the expansion is going to be--and we should get that in the next couple of weeks when we get March employment numbers, which ought to be a pretty good indicator--it seems reasonable to hold to the present level of interest rates. But I would agree with Nancy in the sense that I would urge the Manager, when he has to make a choice, to err on the side of a little more ease. Lately we seem to have be erring on the side of a little more restraint, which I don't think is particularly appropriate at this juncture. I would keep the existing directive language. I don't think we're ready yet to move to a strict aggregates targeting approach.

CHAIRMAN VOLCKER. We've run out of volunteers. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, I certainly share all of the uncertainties about trying to decipher what information we have. But emotionally, in giving my view of the economic forecast, I tend to agree with Lyle Gramley and Bob Black that somewhere between "B" and "C" is the more appropriate posture to be in. I recognize the risks that have been pointed out, but what we have done over the last several weeks seems appropriate. If I were going to err, I would err a bit on the restraint side at this point. So, "B" or somewhere between "B" and "C" is where I would come out. On the directive, I would go to Roman numeral II or alternative B, primarily as an indication, as Karen would say, that we are trying to move back in that direction.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I would join those who are weighing the downside risks more heavily than pleasant surprises. I do not believe the consumer has returned to the counter, except to the counter in the commercial bank branch to obtain currency! And, therefore, until he or she does return to the retailer's counter, I think the fragility of the financial system, domestic and international, and the flow of bad news that is going to make footprints through the reports of commercial banks--[unintelligible] Mexico, and the report of International Harvester, and the series of bad news that has not yet shown through--are not going to add to the confidence of the consumer or the depositor.

On the other hand, in terms of the operating procedures, I would leave the language alone. There's enough confusion out there in the financial markets for us--in the Chairman's speeches or in the ex post review of directives--to look as though we have deemphasized M2 at this meeting, just as the rate of growth of that aggregate begins to come down. I would not favor--

CHAIRMAN VOLCKER. I'm not sure what you mean by leave the language unchanged; we need more than that.

MR. MARTIN. I would leave the directive language, sir.

CHAIRMAN VOLCKER. Meaning alternative I?

MR. MARTIN. Yes. I would join Governor Wallich in terms of the passthrough, if you will, from large growth rates in M1 and even M2 through the employment effects and prices. I think the good old lead/lag relationship of a year or two from the Ms to prices is highly complicated now because unemployment is not a function of [lax] aggregate demand, but rather reflects very significantly the structural changes in our economy, the more effective international competition, and the changing demographics. I think there are a lot of reasons why the good old correlation is going to have a wider band [of uncertainty] around it now.

On these bases, I think alternative C is too dangerous. I remind the Committee again that the sample of 200 banks shows the MMDA rate actually rising 25 basis points to 8.47 percent on a national basis. There's no geographic difference; it's across the country that there is a firming of rates on that instrument. It's across size classes; it doesn't matter how big or how small the banks are. The sample--admittedly it's only 200--shows a firming of those rates. It shows the Super NOW rate at 7.30 percent. Also, this is occurring simultaneously with the reduction in [the rate on] Merrill Lynch's CMA account, which is a transaction account, of over 50 basis points. Back to the consumer: I don't think the consumer believes that the Social Security system is safe any more. We all have reviewed the technicalities and the funding and assumptions there and have reached one conclusion; I don't think the ordinary consumer believes it. I concede that it might be useful in terms of fiscal policy for us to firm rates further, because in my conversations with a few people in the Congress, both in the Senate and the House, it looks as though there's a good deal of pessimism as to any short-run action by the Congress now that the so-called Social Security restructuring has taken place. It might be useful for us to firm rates and, therefore, put pressure on Congress, but I don't think that's appropriate in terms of the downside risk that is out there; the price is too high on a benefits/costs basis. I would go, therefore, for alternative B and having a good deal of flexibility, which it shows, in the fed funds rate. There may be times when we want to put a little upward pressure on rates, but not such as to threaten this fragile recovery.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. Mr. Chairman, first, I have 3 comments--on distortion, velocity, and real rates. My staff looked at the reference to the Board's survey on the effects of MMDAs, which was reported in The Wall Street Journal, that said 3 percent came from M1 components and 25 percent of the Super NOWS came from nontransaction balances. And taking just nonseasonally adjusted measures, we conclude from that that the effect--if there has been any distortion at all, it's very modest--has been to increase the rate of growth in M1, either measured from July to February or from December to February. I don't think the distortion is significant on M1. Secondly, with respect to velocity, I think a question we ought to ask ourselves is: What is the rapid growth of money having to do with the collapse of velocity and will that be corrected by a slowing in the rate of growth? As to real rates, I think Steve made the point that real rates are a function of what prices people are looking at: historical, current, and prospective. And someone made the point that prospective rates in the minds of the public were still pretty high, so maybe real rates aren't really that high. I don't know what they will turn out to be eventually, but I believe we've had long periods of time when real rates were high and economic recovery and expansion occurred. The 1920s is an example. I've always thought the goal of the System is having sustainable economic expansion without undue inflation. And I think that's what we ought to try to do rather than control interest rates. Interest rates often go down in an economic expansion and it's not unusual that they will fluctuate in the process.

I believe the economic recovery is well under way and is spreading. I saw an excellent indication of confidence in yesterday's paper where I noted that a bankrupt company, Chrysler, in a highly cyclical mature industry, sold $400 million worth of stock. That seems to me to indicate there is some confidence around. I think the big risk is a resumption of inflation. And if we keep money growing at the pace that it's growing now, particularly as measured by M1, we are certain--not in '83 but in '84 and '85--to have excessive price inflation. And if we're really interested in holding interest rates down, the way to do that is to avoid the expansion in money that will lead to higher prices and that will lead to higher mortgage rates and long-term bond rates. So, my view would be that we need to start slowing the growth of the monetary aggregates, particularly M1 since that's the one that's least distorted and most related, with respect to its predictive value, to the economy. I think we have the [growth] rates so high that it would be wrong to jerk them down to a low rate; my view would be that we ought to move gradually to the middle of our 4 to 8 percent [M1] target by the fourth quarter. I would like to see us move to about a 7 percent level for this quarter and come on down gradually from there over the balance of the year. I'd like to see language in the directive showing a return to emphasis on M1. And I think we should, by all means, avoid interest rate targeting or just something called judgment with no standards, because that I think will create a situation in the market that would be the reverse of what we would like to have.

VICE CHAIRMAN SOLOMON. Which alternative would that put you on, "B plus"?

MR. ROBERTS. "A."

MR. PARTEE. You're looking for something around 7 percent?

MR. ROBERTS. Right, but for the quarter.

MR. PARTEE. I'm not sure that does it, but that's March to June at 7-1/2 percent.

VICE CHAIRMAN SOLOMON. Which one would give you 7 percent?

MR. ROBERTS. Well, "A" is indicated at 7-1/2 percent.

CHAIRMAN VOLCKER. You're talking about March to June, I take it, when you say the quarter.

MR. ROBERTS. Yes.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Someone--it may have been Lyle--said that in this kind of environment one can find evidence to support almost any position, and I think that's right. That always happens in periods of uncertainty. People rely on their basic instincts when there is a lot of uncertainty and in this specific situation I think it comes down to how much faith one has in M1--how comfortable one is with judgment overriding the rules that have served us reasonably well. It seems to me that if there ever was a strong case for using judgment in overriding these M1 rules, it's now. All the reasons have been ticked off: the massive redistribution of funds; the almost unprecedented continuous decline in velocity--on the broader aggregates, the broader one goes the less of a problem one sees--the high real costs; and the very moderate recovery. So, it seems to me that judgment leads one rather persuasively for not tightening. On the other hand, there is a great deal of sensitivity in the market. I think that argues for not loosening. So, I fall into the group that comes out for about no change. It does seem to me that the snugging up did prove a point. But I would prefer to see the Desk make these decisions a little more evenhandedly in the coming period and not bias them on the side of tightening up. I would not want to see the funds rate rise to 9 percent. I think a rate somewhere in a range of 8-1/2 to 8-3/4 percent would be satisfactory. On the wording of the directive, I don't have strong feelings between I and II; I could live with either one. I have some preference for alternative I at this point, largely because I think that we're heading into a period where ultimately we're going to have to wean the markets from their devotion to M1. Jerry's comment that we need a new mouse trap is an apt one. I think we're moving into a period when we do need that and I would not want to make that job more difficult. That would lean me toward alternative I.

CHAIRMAN VOLCKER. Mr. Ford.

MR. FORD. I agree with the people who see problems in velocity, but as Mr. Roberts put it, we have to be careful how we interpret what is going on with velocity. In the last 7 months we've had double-digit growth in M1 in every month except January, when it was 9.8 percent. The average is 13 to 14 percent. With regard to velocity, when money is increasing at that rate I don't see how we could expect the economy instantly or in a very short period to expand with a positive velocity on top of that. The point is that just that rapid growth in money itself is driving the velocity down in the near term. And the question is: Will we pay later? Now, being fair to the other side of this argument and looking at the reduced-form models that attempt to predict that, even over a few months or quarters with the normal velocity trend M1 does seem to be overpredicting the growth of the nominal GNP. But I think we have to be awfully careful in assuming that this will go on and especially in overinterpreting the relationship. For instance, in February we had a 21.2 percent growth rate of M1; we have to expect velocity to go down on a current basis when we're expanding the money supply like that.

With regard to the other thing that everyone is so concerned about, namely the shift in the composition of the aggregates, I'd like to make two points. If you just review what we've said at these meetings about distortions, I recall that back in September or October we were saying that we knew we were going to have trouble with M1 because of all savers certificates. There were $50 or $60 billion of those out there and most of them were coming due in October. Therefore, we expected M1 to go up more sharply than usual in October for structural reasons. It came in at 14.2 percent. But most of that money was back in by November, and in November we still had vigorous growth of 13.6 percent in M1. Then we said that when the MMDAs started we expected them to draw money out of M1 and, if anything, to give us some moderation in M1. That did not happen. M1 continued to expand in spite of it. Now we're saying, based on Jerry's argument, that we have yet a third argument about what is happening structurally--namely, that the Super NOWs are more super than we thought and, therefore, this will be a good reason not to be concerned about further double-digit growth in M1. I just think month by month we're coming up with some story explaining what it is. Honestly, I think we are kidding ourselves. If you go to the reserve base to see what we're doing to reserves--and I don't want to be too deferential to St. Louis, but I think it's the right base to use because it takes account of the shift in the composition of deposits--on that basis the reserve base has been going through the roof. And we just keep accommodating all the demands at the window and allowing for reserve expansion that's very rapid.

So, I think the risk is on the side of our paying later for allowing ourselves to be too persuaded by the velocity argument and the composition of deposits argument. The risk is that we will get a return toward normal velocity. It doesn't have to be much when we're talking about these kinds of growth rates of money; any drift back to normal velocity could just boom the economy right out into the stratosphere. So, as concerned as I am about unemployment, housing, the fragility in the international markets, and all the other things we've said, I think we also have to worry about the other side of it. Unlike Mr. Roberts--I don't know how he comes out with exactly this line of reasoning and then comes down on "A"--this brings me to a policy of gradual snugging. I would emphasize what he says: that an abrupt change from where we are now would be disastrous. A gradual snugging is called for and a move back toward [aggregates] targeting is called for. I would come down somewhere in the "B" to "C" range to allow for some gradual snugging. According to what I read in the Bluebook, that wouldn't necessarily imply any dramatic upward change in interest rates, unless we went all the way to "C." And even that only talks about a moderate increase in short rates, the way I read it. So, I'd go for a policy of "B" toward "C," gradually reining in growth and version number II of the statement, which moves back toward using the traditional methods of targeting rather than the pure discretion that we have now. If you look at the changes, we are targeting interest rates so clearly that it's just amazing how steady it is. The standard deviation of the weekly average of the daily fed funds rate has come down by 60 percent since October. It's now down from 1/2 to 3/4 of a percent weekly fluctuation to less than 1/4 percent, so we're just perfect. We're just shooting right at an interest rate target. That's what we're doing. And the market is starting to see that. And I think it's a mistake to go to interest rate targeting, especially in that narrow a band. It's incredible how much we are targeting interest rates. We're back to it; it got us in trouble last time; and we ought to start leading ourselves away from it. That's the argument I would make on where to go from here.

MR. ROBERTS. Steve, a question: These March-to-June rates are annual rates, are they not?

MR. AXILROD. Yes.

MR. ROBERTS. So M1 at 7-1/2 percent is an annual rate of growth during the quarter.

MR. AXILROD. That's right.

MR. ROBERTS. So, that would be dropping from 24 percent in February or from 6 months of growth at 14 or 15 percent, which would be a very substantial decline in the rate of growth.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. I think we have some coffee out there.

[Coffee break]

CHAIRMAN VOLCKER. Well, we've been all over in the various comments. I'm not sure anybody is suggesting anything all that radical, but we've certainly explored every side of the issue. My own feeling is that this is not the time for anything too radical or anything radical at all pending a little [more] evidence, as some people have said, both about the aggregates and about the economy. We have a set of projections; I don't know what weight you put on them--not too much, I guess. The projections for the aggregates look beautiful, but they often look more beautiful than the reality. I just don't know what weight to give them, but if it all came out within the ranges of any of these projections we'd be looking not too bad so far as the aggregates are concerned. It would be interesting to know what will happen on some of the latest economic data. I'm sure it always is interesting, but it may be a little more so than usual. I come away with a rather strong feeling that whatever we do, we probably ought to be meeting again before May 24th. I would plan to have a telephone meeting or something, anyway. Maybe we won't do anything, but at least 3 or 4 weeks from now perhaps we should reexamine the situation against the context of, I presume, not doing anything very striking right now. But if we got a combination, let's say, of high aggregates and a strong economy, maybe we would have to be a little more decisive than anything I have heard discussed this morning. We could have the aggregates coming out as projected and the economy not doing much, and then it would look quite different. So, I would assume that we can meet again before too long, presumably via the telephone.

I do not think we're in any position--and only one or two people suggested it--to go back to a more rigid operating technique right now. I think there are a few more fundamental questions for the future if these aggregates don't straighten themselves out relative to business activity in the coming months. But we're not going to resolve that question this morning. In the preliminary comments we had a perfect split, as near as I can see, between those who like alternative I and alternative II as a matter of presentation. There were about the same number in favor of one as the other, with some straddling in the middle. But if one looks at the central tendency of the comments, assuming we use alternative II--I don't want to foreclose that question [unintelligible]--something like alternative B seems to come closest to the center of gravity. There may be a bit of shading on the up side, depending upon whether you look at the [views of] Committee members or the others. There was a feeling that was not unanimous, nor did everybody comment on it--. To put it in a slightly different form, there was a reluctance to precipitate a general change in interest rates, including the prime rate and everything else. Well, we're on the margin of that right now, I suppose. So, leaving a bit open the question of which way to phrase it in the directive--although I would assume that maybe a little more straightforward way is to use the alternative II formulation--let me suggest, whichever formulation, something like alternative B with the same federal funds rate range that we've been using and, just to throw out a number, a borrowings figure around $250 million.

MS. TEETERS. We had $200 million in the last one, didn't we?

CHAIRMAN VOLCKER. Yes, but in fact we've been running above it. We've been running above that partly because the excess reserves are much larger than I at least was assuming at the time of the last meeting. I assumed that $200 million borrowing level with $300 or $300 plus million excess reserves and implied small free reserves. That's what we were talking about at the last meeting. In fact, we had a higher borrowing level but also a higher free reserve level than I assumed we were talking about. How those two things balance out, I'm not quite sure. I think it's fair to say that in the last few weeks, anyway, we've been a little more concerned about supplying too many reserves rather than supplying too few, particularly given the excess reserves we had earlier in the period. That can be changed, but that's the way I think it's fair to say we were leaning to make the errors--not to aim for errors but to have more assurance against excessive excess reserves than the reverse.

VICE CHAIRMAN SOLOMON. Nancy, the $250 million borrowing assumption is more likely to result in the present 8-3/4 percent [funds rate] than 8-1/2 percent.

MS. TEETERS. That's what I realized. I would much prefer a $175 to $200 million figure in free reserves and then on the basis of that take account of the excess as we're doing it.

CHAIRMAN VOLCKER. $175 to $200 million in free reserves?

MS. TEETERS. No, it would be a negative free reserve figure of $175 to $200 million.

CHAIRMAN VOLCKER. You don't want a negative figure there.

MS. TEETERS. No, I don't want a negative figure.

MR. WALLICH. I don't think we want [to target on] free reserves in principle, whether positive or negative, because they really reach far back into the Federal Reserve's past and are associated with some outstanding misconceptions.

CHAIRMAN VOLCKER. It wasn't too bad of a past: 4 percent real growth and little inflation.

MR. PARTEE. Back in the good old days!

MR. RICE. [I would prefer] whatever level of reserves is consistent with an 8-1/2 percent funds rate.

MS. TEETERS. I take $250 million to be reaffirming an 8-3/4 to 9 percent funds rate and I think that's too tight.

MR. AXILROD. Governor Teeters, if I may: I don't know if Mr. Sternlight agrees or not, but I would assume given our past experience that if $250 million were attained, and assuming excess reserves came in on a somewhat normal track, that it is more likely than not that the funds rate would edge back down from this recent level. It might not get below 8-1/2 percent, but I would think it'd be more likely to be edging to an 8-1/2 to 8-3/4 percent range or somewhere in there. I don't think that would tend to confirm recent experience as much as, say, $300 to $350 million would. Maybe Mr. Sternlight can--

MR. STERNLIGHT. I'd say just about that: that $250 million in borrowing would tend to give you a funds rate of 8-1/2 to 8-3/4 percent.

CHAIRMAN VOLCKER. Well, it depends again on what one looks at. If you look at the last 4 weeks, we had borrowings of $415, $331, $568, and $295 million; we've been above, as I said, all along. But we've also been above on the excess reserve side by an even more substantial margin. So we had significant free reserves during all that period except one week when we made a mistake--we didn't make a mistake but on the last day of the week we had a big shortfall. We had practically zero free reserves last week; they were minus one. It was the week that we had the shortfall [unintelligible].

VICE CHAIRMAN SOLOMON. The only plausible explanation I've heard for the high level of excess reserves is that some banks are being slow to adjust their planning and their operations to take account of the fact that some of their funds, such as the MMDAs, moved to their reserve free situation. And then there have been other changes in reserve requirements. Some banks are slower than others. If that's true, then over a period of time we ought to see a trending downward of this tendency toward large excess reserves.

CHAIRMAN VOLCKER. Well, last week they were just about $300 million, which somehow I have in my mind is normal; it hasn't been very normal recently. If you go back to February, there were a couple of weeks that it was $300 million. Well, how satisfactory or unsatisfactory is that?

MR. PARTEE. Do you want a show of hands, or what?

CHAIRMAN VOLCKER. I don't know whether I want a show of hands just yet. Who has a violent [objection]? We have to figure out the wording of the directive and any modification of the--

MS. TEETERS. Well, I think that $250 million is confirming the snugging. It means that we've added 25 and perhaps 50 basis points to the federal funds rate [and it is] above the discount rate now. I am opposed to that and I think we should be easing slightly.

MR. GRAMLEY. I think that level of borrowing is quite all right. I would note particularly that, although short-term rates are a little higher than they were at the time of the last FOMC meeting, longer-term rates--the important ones--are in fact down. So, I think we've not had any additional tightening in any meaningful sense.

MR. ROBERTS. Is the assumption that, if the borrowing level is maintained at that level and credit demands rise, we simply accommodate them to hold the interest rates and expand reserves?

CHAIRMAN VOLCKER. That depends upon how much they rise. It might be. If the aggregates were running decisively high, obviously, there is some implication that we're going to snug up--to use that term. But we don't use an absolutely mechanical formula to do it. If they were lower, with probably some lapse--if it continued to be confirmed over a few weeks--we would move lower. We would take account of all other evidence we had in that process and, as I said, we will meet again in a month or so. We wouldn't be terribly quick to change but, yes, we would change though not be mechanical about it. We wouldn't change next week because they were high for one week.

MR. MARTIN. But you would avoid a 9 percent funds rate?

CHAIRMAN VOLCKER. Well, you say avoid it. It could come along with this. I don't think it would probably stay there, but again, if we were absolutely at this borrowing number and if we raised it because the aggregates were coming in high and the economy was strong, it would certainly be there. But it might be there for days, or a week or something. I would not think that that would be likely in the short run, but I can't say it absolutely wouldn't happen. I would think more like Steve: that, if anything, it would come down to 8-1/2 percent or a little higher.

MR. WALLICH. Is this your interpretation of the qualifications in alternative II: that is, that somewhat faster monetary growth would be tolerated?

CHAIRMAN VOLCKER. Well, that's not really my interpretation of that sentence. I'm not saying that at this point. I don't know what those continuing distortions would be right now. We can always have an unusual demand for liquidity. But I would say, yes, we would expect M2 to run higher than any of these numbers that we're talking about if this new money market deposit account continued to grow at a great rate of speed--significantly beyond what we're projecting now. I think this sentence was carried over from a period when there were more distortions than now and I'm not sure it's quite as--

VICE CHAIRMAN SOLOMON. But I think if you go--

CHAIRMAN VOLCKER. All I would say is that I think we ought to have some qualitative words that suggest we're not following the target mechanically, assuming that we use alternative B.

VICE CHAIRMAN SOLOMON. Maybe you ought to have a show of hands on alternative I versus alternative II because I think alternative I avoids certain of these problems.

CHAIRMAN VOLCKER. I'm afraid the show of hands as to sheer preference would show an even split, unless somebody has changed his mind. I don't know if anybody who has expressed a preference one way or the other feels strongly about it, because I think it's a question of how strongly people feel. If somebody feels strongly about either alternative I or II and wants to reiterate a position or change a position, they ought to say it. Unless people have changed their minds the sheer preference will be 5, 5, and 2.

MR. PARTEE. What you've described sounds a lot more like alternative A than it does alternative B.

VICE CHAIRMAN SOLOMON. Alternative I.

MR. PARTEE. Yes, that's right.

CHAIRMAN VOLCKER. We can blend the two by saying "For the more immediate future"--or in the short run or something--"the Committee seeks to maintain roughly the existing degree of restraint on reserve positions, expecting that would be consistent with...."

MR. PARTEE. Now, that's better. I like it. It's more accurate.

VICE CHAIRMAN SOLOMON. Were you going to say "expecting it would be consistent with the long-range targets"?

CHAIRMAN VOLCKER. No, I was expecting it would be consistent with--and I'd put in--the alternative B [specifications] or whatever.

MR. WALLICH. Well, I could go along with that.

CHAIRMAN VOLCKER. That makes them virtually the same except it puts in the "existing degree of" words. It tells you what restraint there is a little more explicitly.

MR. PARTEE. To me alternative B sounds as if it's being driven by growth of M2 and M3 and alternative A sounds as if it's going on regardless of M1, M2 or M3. This says that we have an expectation. It means we start off with the existing reserve conditions and have an expectation--which may be wrong--that there will be this performance in M2 and M3. And then if we're wrong about the expectation, it seems to me there would be a basis for reconsidering.

CHAIRMAN VOLCKER. That is true.

MR. PARTEE. So, I think the blending is literally a more accurate representation of what is being proposed here.

MR. MARTIN. It avoids getting us committed to annual rates of 9 and 8 percent, respectively.

MR. WALLICH. Whether we committed any--

MR. PARTEE. Committed in the sense that we let it drive the reserves.

MR. WALLICH. We're proposing exceptions to that.

MR. GRAMLEY. One can always reason that even with alternative language, he who seeks may not find.

CHAIRMAN VOLCKER. I don't see anything the matter particularly with saying the existing degree of reserve restraint would be appropriate. "The Committee seeks to maintain the existing degree of restraint"--or roughly the existing degree of restraint or generally maybe--"anticipating that restraint would be consistent with a slowing in the growth of M2 and M3 to annual rates of ____ and ____ percent, respectively. The Committee also anticipates that M1 growth...." It's a rather straightforward blending of the two.

MR. ROBERTS. And would those rates, Paul, be the rates out of alternatives A and B and so on?

CHAIRMAN VOLCKER. Yes. That's what I am tentatively proposing, anyway.

MR. ROBERTS. Yes.

MR. MARTIN. "A" and "B" or--

MR. PARTEE. They'd be 9, 8, and 6 percent, I guess, for "B."

CHAIRMAN VOLCKER. Well, that depends upon what you want to put down, whether it's "B" or some blending of "A" and "B" or some blending of "B" and "C." Other people want some blending of "B" and "C," which seems too low to me. Why do we say "for the more immediate future"?

MR. AXILROD. That had grown out of the previous paragraph, which discusses the long-run targets.

CHAIRMAN VOLCKER. Is that previous paragraph going to be in here?

MR. PARTEE. It's still there.

MR. AXILROD. Yes, it's still there. But I think "in the short run" fits very well also. That had just grown out of the previous language.

CHAIRMAN VOLCKER. I would say: "For the short run the Committee seeks to maintain generally the existing degree of restraint on reserve positions, anticipating...."

MR. PARTEE. Why don't you make that "expecting" so we don't repeat "anticipating"?

CHAIRMAN VOLCKER. Where do we have that?

MR. PARTEE. It's in the next sentence on M1. "The Committee anticipates" is in the next sentence.

CHAIRMAN VOLCKER. Either way.

MR. PARTEE. Oh yes, we could do it either way.

CHAIRMAN VOLCKER. Let's put anticipating in here; anticipating is a little stronger word. "...anticipating that would be consistent with a slowing from March to June in growth of M2 and M3 to annual rates of 9 and 8 percent, respectively" is what "B" says. Then "The Committee expects that M1 growth at an annual rate of about ___ percent would be consistent with its objectives...."

MR. AXILROD. Do you want to use the word "objectives" there?

CHAIRMAN VOLCKER. Then we could leave the next sentence. I'm assuming now that we have the M1 sentence just by changing "anticipates" to "expects."

VICE CHAIRMAN SOLOMON. Why don't we say "The Committee makes a guess...."

MR. PARTEE. The whole thing is a guess.

MR. GRAMLEY. "Speculating wildly, the Committee...."!

MR. MORRIS. Why do we need anything about M1 at all, since we're not using it as a target?

MR. MARTIN. Unbelievable is a 6 percent number!

MR. GRAMLEY. You wouldn't abandon your old friend so completely would you, Frank?

MR. ROBERTS. Since that's the only thing we control, it would be nice to keep it in there.

CHAIRMAN VOLCKER. Well, back to M1: I think it's fair to say, whatever we say, that it has had an influence on our operations. I don't mind it being there. If M1 had been coming in at half the rate that it was in fact coming in, I suspect we would have been easier with some confidence. It's not a very fine judgment, but--

MR. MARTIN. How about 6 to 7-1/2 percent, combining "B" and "A," if we're going to specify M1 at all?

CHAIRMAN VOLCKER. Yes, I would say--

MR. PARTEE. I would make it 6 to 7 percent.

CHAIRMAN VOLCKER. Well, 6 to 7 or 6 to 8 percent is okay. I just don't like the half percents.

MR. MARTIN. But not just 6 percent.

CHAIRMAN VOLCKER. I don't know about it being 6 to 7 or 6 to 8 percent.

MR. MARTIN. 6 to 8.

MS. TEETERS. The wider we can make it, the safer we're going to be.

CHAIRMAN VOLCKER. I'm afraid on any of these things that we have no forecasting record that suggests with any confidence that we're going to come within 2 percent, even. But it makes it sound a little less precise.

MR. WALLICH. 6 to 8 percent is getting a little high.

CHAIRMAN VOLCKER. 6 to 7 percent, I mean.

MR. MARTIN. 6 to 7-1/2 percent is in "A."

CHAIRMAN VOLCKER. The 7-1/2 connotes a precision that--

MR. PARTEE. 5-1/2 to 7-1/2.

MR. MARTIN. I think we should use 6 to 8.

MR. RICE. I second that.

MR. WALLICH. It's more than I like.

MR. MARTIN. You didn't like 7-1/2.

MR. PARTEE. Are you going to leave "about" in? I think I would make it "about 6 to 7 percent."

CHAIRMAN VOLCKER. [About] 6 to 7 percent is all right.

MR. PARTEE. And that gives you 5-1/2 to 7-1/2 percent easily. They're all "about."

CHAIRMAN VOLCKER. And then do we leave in that next sentence on lesser restraint? We probably have to say "in the context of a more appreciable slowing" or "a greater slowing" or something.

MR. PARTEE. It says "a more pronounced slowing."

CHAIRMAN VOLCKER. Yes, "a more pronounced slowing" or "greater" or something. I think that word "appreciable" ought to be changed in there. How about "still more pronounced"?

MS. TEETERS. Well, it hasn't been overwhelming.

CHAIRMAN VOLCKER. No, this is all based upon a projection, I think, at this point.

VICE CHAIRMAN SOLOMON. Or we can say "a further appreciable...."

MS. TEETERS. Are you reading from alternative II?

MR. PARTEE. You're reading from "A," aren't you?

CHAIRMAN VOLCKER. I'm reading the second sentence in alternative I as it's written.

MR. RICE. It's the same as this part; that's in the parenthesis in alternative II.

MR. PARTEE. A narrative sentence.

MR. GRAMLEY. If you take the sentence from alternative II instead, you don't have to worry about it because it says "a more pronounced slowing."

VICE CHAIRMAN SOLOMON. More pronounced than projected.

CHAIRMAN VOLCKER. Well, what about the second part? I rather like leaving the "relative to the paths implied by the long-term ranges." I don't think it has any substance, as opposed to the other wording, but it ties it back to the long-term ranges.

VICE CHAIRMAN SOLOMON. Instead of saying "appreciable slowing" why not take the "more pronounced slowing"?

CHAIRMAN VOLCKER. Well, put "Lesser restraint would be acceptable in the context of more pronounced slowing of growth in the monetary aggregates relative to the paths implied by the long-term ranges." We could put "or indications of a weakening in the pace of economic recovery," as somebody suggested to me at one point.

VICE CHAIRMAN SOLOMON. Very common sense.

MR. PARTEE. We're not going to have much evidence. It will be mixed, and depending on which figure one likes to emphasize--

VICE CHAIRMAN SOLOMON. The more we put in, the more likely we'll be wrong. That's why I don't like short-term targets there associated with operations. We're more likely--

CHAIRMAN VOLCKER. Let me leave aside the borrowing level at the moment.

MS. TEETERS. I'm not sure I know where you are on the language.

CHAIRMAN VOLCKER. Let me just repeat where I am on the language: "For the short run, the Committee seeks to maintain generally the existing degree of restraint on reserve positions, anticipating that would consistent with a slowing from March to June in growth of M2 and M3 to annual rates of about 9 and 8 percent, respectively. The Committee expects that M1 growth at an annual rate of about 6 to 7 percent would be consistent with its objectives for the broader aggregates. Lesser restraint would be acceptable in the context of more pronounced slowing of growth in the monetary aggregates relative to the paths implied by the long-term ranges (taking account of the distortions relating to the introduction of new accounts), or indications of a weakening in the pace of economic recovery." And then the last sentence remains as it is.

MS. TEETERS. Would you read the first sentence over again?

CHAIRMAN VOLCKER. "For the short run the Committee seeks to maintain generally the existing degree of restraint on reserve positions, anticipating that would be consistent with a slowing from March to June in growth of M2 and M3 to annual rates of about 9 and 8 percent, respectively."

MR. GUFFEY. You have discarded the first parenthetical sentence in alternative II and you have tried to incorporate an additional sentence. But wouldn't it be better to keep that first parenthetical sentence simply to maintain flexibility because of the uncertainty we're looking at in the aggregates?

CHAIRMAN VOLCKER. Well, just looking at the structure of this, I think we would have to make the point in the discussion that these projections of 9 and 8 percent, and indeed the M1 projection, assume relatively little distortion--basically none in M1 and whatever we're assuming for M2.

MR. AXILROD. Only about 1 percent.

CHAIRMAN VOLCKER. So, it would be clear that if indeed that assumption were wrong--let's say particularly for M2--and we had some reasonably clear evidence that it was wrong, the 9 percent wouldn't be relevant. It would have to be adjusted; that's implied by the sentence I left in, instead of on the other side. We can make a more complicated sentence by saying that would be consistent with a slowing from March to June in growth of M2 and M3 to these figures and assumes that the distortions aren't going to be very great. We could add a sentence on there.

MR. GUFFEY. That brings it up and highlights the uncertainty and grants to the Committee and to the Desk the flexibility that we may need in this period, which is a full quarter.

MR. PARTEE. Of course, the first thing we're doing, Roger, is specifying the degree of reserve restraint. That's the basic instruction, as I see it, to the Desk. Then it says we expect that that's going to be consistent with those M2 and M3 numbers. But our expectations could wrong. They could be wrong in part because we still haven't allowed for the distortions. So it seems to me that at that point we could say we haven't allowed for the distortions; even though they are high, we're not going to change this direction to the Manager.

MR. GUFFEY. The fact of the matter is that the only real purpose this directive is going to serve is for public consumption. If I understand what the Chairman said earlier, we're not going to change our operating regime in the intermeeting period and I think that's appropriate. This is going to become public on May 25 or some such date. And to the extent that we have done something that deviated from what we think we're doing today and from what we hope will happen in the period ahead, then the flexibility that's built into the statement requires less explanation after it becomes public. That's my only point.

CHAIRMAN VOLCKER. I think you're right about the operating technique in a narrow sense. But I would assume by putting this in the directive that, if these aggregates came in significantly higher without a clear explanation in terms of distortions, the first part of the first sentence might well be overridden.

MR. PARTEE. I think that's right if there is no explanation.

CHAIRMAN VOLCKER. If that amounts to anything, I assume we would have a Committee meeting. But we are expressing a presumption here that with a Committee consultation presumably, if [the growth of the aggregates] were significantly above or at all pronounced, our [general] inclination would be to go in that direction.

MS. TEETERS. Regardless of what is going on elsewhere?

CHAIRMAN VOLCKER. Well, as I say, with a Committee consultation.

VICE CHAIRMAN SOLOMON. Basically you're scrapping the [notion of] unusual demands for liquidity, which gives us complete flexibility on anything. That comes with every possible situation.

CHAIRMAN VOLCKER. I think Chuck is right: that the first part of the sentence is "maintain generally the existing degree of restraint," so we wouldn't change it very much without a consultation. But the whole indication is that we would change with a consultation if growth were appreciably above. It can always be overridden later, but that's the bias on it.

MR. PARTEE. Or appreciably below.

CHAIRMAN VOLCKER. Well, if it's below, we'd need less consultation, I suppose.

MR. PARTEE. Yes, I think that's right: Less consultation if we had some news that it's lower and that the economy is suddenly weakening or something.

CHAIRMAN VOLCKER. That's a much easier decision, I suspect. If it's really low and the economy is low, we're going to move.

MR. WALLICH. I would favor something that points in the direction of consultation rather than automaticity if the case arises.

CHAIRMAN VOLCKER. This does, implicitly, doesn't it?

MR. WALLICH. Yes. That's what it does and why I favor it.

CHAIRMAN VOLCKER. Then we can put some language in the policy record write up. Is this generally acceptable? Do I interpret the silence in that direction? If the language is all right, let's come back to the numbers.

MR. ROBERTS. This language would include the sentence on fed funds at the bottom?

CHAIRMAN VOLCKER. Yes, that's just standard language.

MR. ROBERTS. That would be 6 to 10 percent?

CHAIRMAN VOLCKER. Yes, the clear implication is that it would be 6 to 10 percent. Is that right? Let me check what I assume is the easy number first; 6 to 10 percent is what we've had. But we still have to decide what numbers to put in there for M2 and M3 and for M1 and decide on the borrowing assumption. Basically, if we operated off alternative B, it's going to be 9 and 8 percent and 6 to 7 percent, as we just discussed.

MR. CORRIGAN. Put 6 to 7 percent for M1.

CHAIRMAN VOLCKER. Is that all right? It's 9, 8, and 6 to 7 percent. We're down to the borrowing number.

MR. PARTEE. I find $250 million acceptable.

MR. RICE. I could live with $250 million, but I would prefer to err in the direction 8-1/4 percent rather than 8-3/4 percent on the funds rate.

MS. TEETERS. I would be in the same position.

MR. GRAMLEY. I would go the other direction.

MR. ROBERTS. So would I.

MR. WALLICH. We've been at about $250 million for a long time, so it doesn't hurt much.

MR. RICE. I know, but we've also been pushing 8-3/4 and 8-7/8 percent.

MR. ROBERTS. The problem with $250 million is that unless one makes an assumption that there has been a distortion that's been pushing the growth of the aggregates--and that doesn't appear to be the case with M1--$250 million does not come anywhere near the growth path that we're talking about.

CHAIRMAN VOLCKER. Well, according to the staff projection it does. It's an entirely different question what weight you put on the staff projection. The staff projection says $200 million will come in with that growth path. Let me refine it a bit: If we have to have an assumption, let me presume the assumption is roughly $250 million. But I will tell you, when you're sitting there [and have to make a decision], the mechanical assumption is sometimes not as helpful as it might be because you have to guess where the errors might be or whether you should delay today or go ahead tomorrow. It seems to me the obvious point is that--if we said $250 million, for instance, and it was running a little high--consistent with no consultation or anything else, as these figures come out we'd err on the side of it being a little more than $250 million. If [money] is coming in low, we'd err on the side of it being below $250 million. The "erring on the side of" doesn't say that's where it's going to come out. You can get two errors. But in calculating how the Desk leans to minimize being off course, the Manager leans a bit toward being slightly tighter if the figure is coming in high and slightly lower if it's coming in low. And that's all encompassed by the words "generally maintain the existing degree of restraint."

MR. ROBERTS. But the focus is how they're coming in and not on the level of interest rates per se?

MS. TEETERS. Well, I would like to focus on the level of interest rates per se. I don't want to see them go up. And if we focus on $200 million in borrowing, I think there's less chance that we'll have rising short-term interest rates than falling short-term interest rates.

VICE CHAIRMAN SOLOMON. But in reality I think it is fair to say that the fed funds rate gives us a bit of a clue as to whether our guesses on the reserve situation are erring in one direction or the other. It's one sign of how tight the situation is.

MR. ROBERTS. It's a sign, but also if we accommodate a level regardless--if we keep the borrowings down--we'll provide more money.

CHAIRMAN VOLCKER. We're stuck in the short run with the fact that in implementing this from week-to-week the federal funds rate has a life of its own. It goes where the market expects that it might go. In the space of 3 weeks or something like that we can change that; but if the market is in the mood to fear that it's going to go up, it will go up. And if they're anticipating it will go down, it's going to go down. I would say right now it's in the mood of thinking the risk is that it's going to go up, which is why it's where it is.

MR. ROBERTS. And if the prime moves up here shortly, we probably shouldn't try to prevent the funds rate from moving up a little also.

MR. MARTIN(?). It's your [unintelligible] they'll average.

CHAIRMAN VOLCKER. Well, my modification is that we're somewhere between $200 and $300 million, depending basically on how strong the aggregates are coming in and whatever qualitative evidence we have. That's a relatively big range but, in fact, we've been all around that range in the recent past.

VICE CHAIRMAN SOLOMON. I think $250 million is a reasonable compromise.

MR. GUFFEY. I agree.

MR. GRAMLEY. Me too.

CHAIRMAN VOLCKER. With that kind of gloss I put on it?

SPEAKER(?). You're talking $200 to $300 million; I would support $250 million.

CHAIRMAN VOLCKER. Does anybody else have any comments? In the absence thereof, do we know what we're voting on? If so, we're going to vote. Should I read it again?

MR. WALLICH. I would like to hear at least the previously bracketed sentences.

CHAIRMAN VOLCKER. The previously bracketed sentences? I'm assuming this is a change in alternative I and am working from there. What I have there now, just to repeat that sentence is: "Lesser restraint would be acceptable in the context of more pronounced slowing of growth in the monetary aggregates relative to the paths implied by the long-term ranges (taking account of the distortions relating to the introduction of new accounts), or indications of a weakening in the pace of economic recovery."

MS. TEETERS. Is the economic recovery part within the parentheses?

CHAIRMAN VOLCKER. No.

MS. TEETERS. Okay.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Guffey	Yes
President Keehn	Yes
Governor Martin	Yes
President Morris	Yes
Governor Partee	Yes
Governor Rice	Yes
President Roberts	Yes
Governor Teeters	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. Do we have anything else on the agenda?

MR. BERNARD. Not on the FOMC agenda, no.

CHAIRMAN VOLCKER. I think we would plan in any event to get together in a few weeks by telephone, even if nothing is going on. But certainly, if any pronounced change is in the wind, we would meet in advance of that. So, the Open Market Committee meeting is over.

END OF MEETING