Meeting of the Federal Open Market Committee

January 30-31, 1984

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, January 30, 1984, at 2:00 p.m., and continuing on Tuesday, January 31, 1984, 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. Balles, Black, and Forrestal, Presidents of the Federal Reserve Banks of San Francisco, Richmond, and Atlanta, respectively

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

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

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

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1/ Attended Monday session and Tuesday session after action to establish long-run ranges.

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Kohn,1/ Deputy Staff Director, Office of Staff Director for Monetary and Financial Policy, Board of Governors
Mr. Gemmill,1/ Senior Associate Director, Division of International Finance, Board of Governors
Mr. Lindsey,1/ Associate Director, Division of Research and Statistics, Board of Governors
Messrs. Freund 2/ and Madigan,2/ Economists, Division of Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Fousek,1/ Executive Vice President, Federal Reserve Bank of New York

Messrs. Burns,1/ J. Davis,1/ Keran,1/ Koch,1/ Mullineaux,1/ Parthemos,1/ and Stern,1/ Senior Vice Presidents, Federal Reserve Banks of Dallas, Cleveland, San Francisco, Atlanta Philadelphia, Richmond, and Minneapolis, respectively

Mr. Meek,1/ Vice President and Monetary Adviser, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
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January 30, 1984--Afternoon Session

CHAIRMAN VOLCKER. The meeting can come to order with the approval of the minutes, if somebody would like to move that.

MR. MARTIN. So moved.

MR. PARTEE. Second.

CHAIRMAN VOLCKER. Without objection, we will do that. I want to change the agenda order here a bit and have Mr. Cross and Mr. Sternlight report first, after we discuss this confidentiality item on the agenda. Then we'll go to the long-term ranges with the staff report and the discussion. I would not anticipate that that will come to a conclusion this afternoon, but I would hope that we will be prepared to reach a conclusion, as nearly as one can forecast, when we assemble tomorrow. Given this confidentiality problem--and maybe out of an excess of caution--I think perhaps we could have an executive session first thing tomorrow morning while we complete that discussion and then resume with the short-term targets.

Meanwhile, let me discuss this confidentiality issue. Everybody has received a copy of the GAO report, which in general came to no conclusion with regard to who did the leaking. I think the GAO also came to the conclusion that procedures were somewhat more casual on the Hill than in the Federal Reserve. And the unspoken conclusion from that I will leave unspoken. Maybe one should speak in terms of probabilities. But obviously, they did call attention to weaknesses in our own procedures, too. I don't think the key to this lies in procedures but rather in personal integrity and morale. Those are really the key. But I think it is incumbent upon us to review our procedures and satisfy ourselves that they are reasonable and reasonably tight and also that people know what they are. The latter was particularly the criticism that GAO pointed out. [Our rules regarding confidentiality] have been lying around for a long time without review and there was, to say the least, some confusion about them.

The way I would like to proceed is to do nothing further at this meeting but to appoint a committee that I would hope--maybe overly optimistically but not necessarily--could report by the next meeting and if not then, by the following meeting. But let's see if they can review the procedures and present some recommendations and proposals to us at the next meeting. In thinking about who might be appropriately on that committee, and taking some account of geography and distribution among the presidents and the Board, it seems to me reasonable, if they all agree and if the Committee doesn't point out any great objections, that Mr. Solomon might chair the committee--and the New York Reserve Bank, of course, has a particular problem--and Mr. Partee might represent the Board and Mr. Black, in effect, the other presidents. I would have the committee work with a staff group. I left the names of staff I had in mind on my desk; I hope I can recall them. I thought Mr. Axilrod might serve as Chairman of the [staff] committee; Mr. Oltman could provide some legal perspective and some practical perspective from New York; Mr. Coyne with his particular responsibilities could also serve on the staff group; and Mr. Bernard could act as Secretary to it. That doesn't mean that anybody else who has an idea--either on the staff or the Committee--should not participate. I would hope that the staff would consult with other staff and that the committee might be [open] to suggestions or comments from any member of the Committee or from other Presidents and that we could proceed on that basis.

VICE CHAIRMAN SOLOMON. We'll be deeply honored.

CHAIRMAN VOLCKER. If anything goes wrong, we'll point to the Solomon guidelines in the future. Let me turn to Mr. Cross.

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

MR. MORRIS. Mr. Chairman, I have a feeling that the exchange market for the dollar is exhibiting all the characteristics of the top of a bull market and that when the turn does come it could be precipitous; the market could very well overshoot on the down side. I understand the constraints placed on us by Treasury policy positions, but it seems to me that this would be a good time for us to begin stockpiling currencies to use if and when we get the kind of decline in the dollar that I feel is on the way.

VICE CHAIRMAN SOLOMON. Instead of stockpiling, the Treasury is de-stockpiling. It was a very unusual thing that they did, paying half of the United States' quota--the gold tranche of the quota--in yen and deutschmarks. But they wanted to reduce their war chest.

CHAIRMAN VOLCKER. Your point has been made on a number of occasions. I think we're getting into a very difficult situation here where we're getting totally locked into a big capital inflow from abroad which so far has come very easily--too easily--with the dollar up. But when that mood changes, we will have problems because there is no way we can get out of dependence on our capital inflow from a balance of payments standpoint or from a budgetary deficit standpoint. The capital inflow this year will run to more than 2 percent of the GNP, I guess. So, the total net savings runs to something like 7 or 8 percent in the United States and about 25 percent of that is being supplemented by foreign capital inflows.

MR. MORRIS. But for precisely that reason it may take a very sharp decline in the dollar to maintain the inflows.

CHAIRMAN VOLCKER. I don't disagree with you.

MR. PARTEE. It's hard to say where equilibrium might be.

CHAIRMAN VOLCKER. We have a wonderful specter of the dollar plunging and interest rates rising at the same time! In some sense the crowding out is now crowding in--or rather, drawing in--foreign capital. If it [stops] drawing in, we will have a problem. I think that is at the heart of our budgetary deficit policy problem.

VICE CHAIRMAN SOLOMON. Until the dollar reaches extremely weak levels, we're not likely to get any really meaningful central bank cooperation on major intervention. So, Frank, the only reservation I have to increasing the war chest of foreign currencies, which as you know I have always been in favor of--and we did follow [that approach] until this Administration came in--is that even that war chest is going to be of very limited value unless we get very strong cooperation by other central banks. And we would not get that in the first stages of a--

CHAIRMAN VOLCKER. I'm not sure we would want it in the first stages, but all that remains to be seen. But even then, I wouldn't have too much faith in intervention when we're relying on $80 billion of capital inflows. Intervention of $5 billion or even $10 billion is a small fraction of the total.

MR. WALLICH. Well, there is the fact that interest rates would be going up. That is, foreigners would be [buying] bonds, so there is a sustaining element. Inflation--

MR. MORRIS. Yes, but if the market perceives a 20 percent drop in the dollar, a small movement in interest rates is not going to stop it.

MR. WALLICH. Inflation is low and it's not going to rise very much as a result of this movement; it will rise some. So, I don't think one can take this as a foregone conclusion. It's a risk.

CHAIRMAN VOLCKER. I would have had somewhat similar feelings a year ago, though less strongly, and it hasn't happened yet. It may not happen in 1984. But I think it is not a sustainable long-run position to have the United States borrowing a larger and larger fraction of its GNP from abroad. It's not sustainable on protectionist grounds either, or on industrial grounds. But I find it difficult to predict when the turning point may come.

MR. PARTEE. We've been predicting it for a year and a half.

CHAIRMAN VOLCKER. That's right. But the fact is that we started--and we're inclined to forget this--from a very strong, relatively balanced, payments position and we had a current account surplus, or a roughly balanced current account, two years ago. Well, two years ago [the deficit] was $14 billion or so and last year it was $30 billion and three years ago [the current account] was in surplus or in balance. [The deficit] wasn't all that big for the whole of last year by today's standards, but as it gets bigger we have to get more and more capital every quarter.

VICE CHAIRMAN SOLOMON. But everything will work the wrong way when it starts, because as interest rates rise foreigners will get out of the bond market and the stock market, even more so given their expectations on the dollar. We'll get a combined reversal of the inflows. I agree with Frank that [the exchange value of the dollar] has been so high for such a long period of time that when it turns the probability is that there will be a very substantial move downward.

MR. CORRIGAN. The mere fact that that is now being widely talked about, not just in financial circles but in business circles in general, tends to reinforce the view that when it goes, it could really go.

CHAIRMAN VOLCKER. It has been talked about a lot and it hasn't happened, which suggests that maybe the market is fairly resistant for the moment, but--

MR. WALLICH. The market sees all this as much as we do and for some curious reason doesn't respond. I think they anticipate two possibilities. One is that we will put our [fiscal] house in order. Then the budget deficit would go down and the United States would become a more dependable place to keep one's money. The other possibility is that we won't put our house in order. Then the opposite of these things would happen. Nevertheless, interest rates would be high, so the dollar might not come down very much. I can't believe we are going to continue on with $100 billion in capital imports for very long; that I understand.

VICE CHAIRMAN SOLOMON. And I take it that may very well be why it's going to be a long period of time yet--maybe half a year, a year, or even longer--before this turn comes.

CHAIRMAN VOLCKER. Do you have this in your presentation, Mr. Truman? We'll get off this depressing subject for the moment.

MR. PARTEE. Would you explain the Jamaican--?

MR. CROSS. That was an arrangement the ESF made with the Jamaican authorities. It has not been announced and I was just informing the Committee of it. It ties in with a move by which the Jamaicans would have an IMF program and it's a kind of bridge financing looking toward that.

SPEAKER(?). Didn't you call it a swap?

MR. CROSS. Yes.

MR. RICE. It's not a Federal Reserve [swap]?

MR. CROSS. No. What I said is that we have done this for the Treasury. It's totally an ESF arrangement. I only noted it for your information.

CHAIRMAN VOLCKER. If there are no other comments, we need to ratify the transactions.

VICE CHAIRMAN SOLOMON. So moved.

MR. MARTIN. Second.

CHAIRMAN VOLCKER. Without objection.

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

MR. BOEHNE. Peter, I noticed that the net change in outright holdings for all of 1983 was about twice as big as in the two previous years. Is there a reason for that?

MR. STERNLIGHT. Currency. The outright change was an increase of about $16 billion, and a big rise in currency in circulation was the main factor. Currency was up something like $14 billion when I last looked. There was some decline in our foreign currency holdings over the course of the year, which would have been another reason for the outright increase. But that currency increase is the chief thing that comes to mind.

CHAIRMAN VOLCKER. No other comments? If not, we have to ratify the transactions.

VICE CHAIRMAN SOLOMON. So moved.

MS. TEETERS. Second.

CHAIRMAN VOLCKER. Without objection, we will turn to Mr. Kichline.

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

CHAIRMAN VOLCKER. Can someone explain to me the chart in the upper left hand corner on households?

MR. PRELL. That indexes the dollar volume of borrowing relative to personal income at 100 in any trough and plots the movements from there. The shaded area shows the range of experience in the earlier--

CHAIRMAN VOLCKER. How does that differ from the chart immediately below it, except that it is indexed?

MR. PRELL. That is the outstanding debt relative to personal income. This is the level of indebtedness. The other is the flow of borrowing scaled by disposable income; one is the flow and one is the stock.

CHAIRMAN VOLCKER. Well, if the top one is changing, the bottom one ought to be changing too, right?

MR. PRELL. No. If debt is growing at the same pace as income, which is what the bottom panel shows, you would have an upward movement as shown in the top panel.

CHAIRMAN VOLCKER. I'm not sure why, but I won't pursue it anymore.

MR. PRELL. Well, let me restate it: The volume of borrowing has grown relative to GNP, but the [percent] increase in debt has been the same as the [percent] increase in income.

CHAIRMAN VOLCKER. Does anybody else need any enlightenment?

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I have a question. I don't know whether it's appropriate now or later, but one of the problems that I have with the forecast is that it doesn't seem to be compatible with the M2 assumption. Would you prefer to defer that question until later on?

CHAIRMAN VOLCKER. Mr. Axilrod says yes. We will defer it, meaning that he will effectively answer it in his presentation. But we can have his presentation now if it's more desirable.

MR. AXILROD. Well, I'm not sure my presentation deals directly with it, since I go even in the opposite direction to President Morris' question. But it will certainly come up, either as a question now or as a question after my presentation.

CHAIRMAN VOLCKER. Well, I don't know what people prefer. I think we ought to discuss the economic outlook. Do we want to do that against the background of your presentation? Go ahead and give your presentation.

VICE CHAIRMAN SOLOMON. Before you do that, let me ask a simple question. I see that mortgage loan delinquencies did not really come down in 1983 and are running at very high rates. Why hasn't this big wave of prosperity since 1982 reduced mortgage loan delinquencies?

MR. PRELL. Well, as you can see, that line has edged off very slightly. If one looks back at 1975, one can see also that it was a while before that rate dropped very substantially. Clearly, there has been, and even now still is, a great deal of unemployment, and that could be a factor holding the rate up. And there may have been some problems among people who had short-term loans that they got earlier at low rates which they have had to renew at higher rates than perhaps they could handle. We don't have any information suggesting that that has been a major problem, but that's a special feature in the current period.

MR. MARTIN. May I speak to your question?

VICE CHAIRMAN SOLOMON. Yes, go ahead.

MR. MARTIN. To take the analysis of the housing financial situation out to the margin, I note that data on the losses from foreclosures in residential property last year, including the fourth quarter of last year, indeed [support] Mr. Prell's premise. For example, the mortgage insurance industry, which could be accused of insuring some of the submarginal and certainly a lot of the marginal residential credit, is now experiencing losses from foreclosure at about 3-1/2 times their historical level. That industry historically has had a ratio of losses to premium of about 20 percent and now has a loss ratio to premium of 90 percent. So, at the margin, there is considerable difficulty in the mortgage market.

VICE CHAIRMAN SOLOMON. Is this mostly in the industrial states--the heavy smokestack industry?

MR. MARTIN. No. I don't have a map of the United States in my mind, Tony, but it's very widespread. It includes California, with the so-called creative financing, and it includes overcommitting in the Southwest as well as the smokestack states.

CHAIRMAN VOLCKER. Baldwin United got in just at the right time!

MR. PARTEE. Let me ask the staff who look at the domestic side of the economy whether they were aware that the implication of the international projection is for the residual rate of price increase to go down as 1984 and 1985 transpire. It seems rather inconsistent with what you have for unit labor costs, which don't go down, and GDBP prices, which don't go down. Yet the working through of this I take it by Ted's people on the international side is that once you take the international effect out, you must have a decline in the rate of inflation. Do you want to comment on that, Jim?

MR. KICHLINE. We're talking about the CPI, not the deflator, in our forecast.

MR. PARTEE. Is that the CPI?

MR. KICHLINE. Yes. The CPI in our forecast runs a good deal above the deflator. So, in part, what we're looking at is the difference between the measures of GNP prices versus the measures of consumer prices. I think that's the bulk of it. Our CPI forecast for 1984, for example, is around 5-1/4 percent, which is .6 to .7 more than the deflator. But you're right: A good deal of the impact of the dollar does show through; it's not a minor feature. We are of the mind that, indeed, 1984 unemployment rates are still high enough to be exerting some degree of downward pressure on wages and compensation domestically. Aside from the dollar problem, we think there is downward pressure, but it erodes over time. And by the end of 1985 the downward pressure on the wage side is virtually nonexistent in the sense that we think an unemployment rate of 7 percent is near the top end of what is "full employment."

MR. TRUMAN. Part of the point here is that the dollar's earlier rise brings forward some of the price pressures in the wage/price dynamics that we would get later. So, therefore, just the fact that you have those price pressures tends arithmetically to hold down some of the prices in the short run and removal of that gives you somewhat of an uptick. That's why, at least measured off the consumer price index, you get that tilting up.

MR. PARTEE. The other thought I had as I looked at this particular chart is that I don't see much delay in the price effect of the alternative projection--that is, the one where you have the dollar falling to a hundred by the fourth quarter of 1984. It seems as if the maximum first difference price effect appears almost at the same time. I thought there was supposed to be a lag of 6 months or so.

MR. TRUMAN. There is a lag before you get the total impact. Well over half of the impact is seen as an instantaneous adjustment or in the first four quarters. The total impact would go out further; more than three quarters to 80 percent of it would occur by the end of two years.

MR. PARTEE. So we're looking at the increment, and the increment is at its maximum in the early quarters; then the increment falls off but the total effect continues to accumulate.

MR. TRUMAN. That's right. That's partly shown in this lower panel. You can barely see it, but there is a little pushing together and the dollar stays up as the impact wears off.

MS. TEETERS. Ted, I'm a little surprised in your foreign projection that the continued very moderate growth of the industrial countries doesn't do anything for them on prices. Is there some reason that they get very little impact on prices?

MR. TRUMAN. There are two factors. First of all we're averaging. For the low inflation countries we have basically the same kind of phenomenon that we have for the United States--that as the economy picks up, you get some upward pressure on prices moderated by the fact that on our full projection their exchange rates are appreciating. So, for the forecast period you get about a 1/2 percent rise in the year-over-year inflation rate for Germany and Japan and Switzerland and countries like that. That is combined with some further downward pressure for Italy and France and Belgium where inflation has been above average and they still are following more austere policies in general.

VICE CHAIRMAN SOLOMON. How much of the assumed fall in the exchange value of the dollar over the projection period is correlated with that 1/2 point rise?

MR. TRUMAN. The difference is between the level and the rate of change. The 1/2 percent "bonus" that I referred to in the middle panel of that chart corresponds to a 1-1/2 percent change in the level, given the 10 percent decline in the dollar over a period of time. The reason you get a fairly constant contribution is that the difference between those two lines in the upper chart is about the same. There is a rather constant process; every year in this three-year period we got about a 10 to 15 percent appreciation of the dollar. So, the first-year effect, the second-year effect, and the third-year effect are all coming in together; once one faded out another one came together. So you get about 1/2 percent a year of the three-year effect.

VICE CHAIRMAN SOLOMON. You're crediting me with a more subtle question than I asked.

MR. BALLES. It probably was a good answer. What was the question?

VICE CHAIRMAN SOLOMON. Given the fact that we're moving into a period of much more utilization of capacity, the falling exchange value of the dollar in time will have much more of an inflationary impact than it otherwise would. Now, if I understood you--maybe I didn't catch it earlier--you are projecting that over the 1984-85 period there will be a 1/2 point higher rise in inflation due to the fall in the dollar, ceteris paribus. Is that right?

MR. TRUMAN. Yes, about that.

VICE CHAIRMAN SOLOMON. And how much of a fall in the trade-weighted value is that?

MR. TRUMAN. The depreciation is 17 percent over eight quarters--two years.

MR. WALLICH. The 1/2 percent is inflation or level of prices?

MR. TRUMAN. Inflation. The answer to the question, Governor Wallich--

CHAIRMAN VOLCKER. Somehow this chart of yours on inflation abroad seems somewhat improbable to me too. If we have that kind of decline in the dollar, all these countries are benefitting from a 25 percent [decline] in the price of oil--and you still show no improvement in their consumer price indexes.

MR. WALLICH. The dollar price of oil may rise.

CHAIRMAN VOLCKER. Well, he didn't assume that.

MR. TRUMAN. That's right. It is true that when we've done these kinds of experiments, for the foreign countries there is a larger impact per unit exchange rate change than in the United States largely because of the dollar oil price effect. That suggests, at least in the forecast, that the pickup in demand is correspondingly higher to hold the prices down.

CHAIRMAN VOLCKER. But you have unemployment rising, I thought you said.

MR. TRUMAN. Well, rather stable.

CHAIRMAN VOLCKER. Stable. All right.

MR. TRUMAN. On an historical basis unemployment would be rising because if you believe, as most people still do, that potential is rising at something like 3 percent abroad and they don't get there it should be rising. On the other hand, they had been growing at less than that rate in 1983 and in some of the faster-growing countries the unemployment rate has come down. That may reflect different changes in work sharing and that kind of thing going on in the labor market. That's why I hedged my projection about what will be happening on unemployment.

VICE CHAIRMAN SOLOMON. For our labor force in 1985, as I remember the chart, you are projecting an increase only a shade more than 1 percent.

MR. ZEISEL. That's about right, if I remember correctly. No, it's about 2 percent.

VICE CHAIRMAN SOLOMON. You have about a 1 percent increase in the participation rate as I read it.

MR. ZEISEL. I'm sorry, that's right. We have a 1 percent increase in participation--about a 1 percent increase in population.

MR. PARTEE. That's 2 percent!

MR. KEEHN. I have a question on capital expenditures. Maybe it's a question of the scale, but capacity utilization in the period doesn't go back to the '79 level yet the capital expenditure line appears to be going up fairly steeply. Are you pretty confident about that real business fixed investment [projection]?

MR. ZEISEL. Well, we've had a very, very substantial increase in business fixed investment recently. In fact, it has been in the phenomenal range and we don't expect that to continue. We think that some of the increases that have occurred over the last few months are a surge in one-time activity. But there is a very widespread, and we think very fundamental, increase in expenditures. And what we have projected is a fairly strong recovery by historical standards. The assumption is that a number of factors have operated to reduce the relative cost of capital--the stock market rise, tax law changes for accelerated depreciation, and so on--and apparently have laid the basis for a considerable recovery in capital outlays. We have it moderating through 1985.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I was going to ask a question on the same subject, as a matter of fact, but with a little different slant, Jerry. The anecdotal evidence from some of our directors, which of course isn't definitive, has been pretty constant in recent months. When I quiz them about the capital spending outlook they say that there still are great inhibitions--the high cost of money, in particular--to spending on long-lived assets. I was wondering whether you have any breakdown in the fixed investment data between the equipment side and the plant side. The impression I'm getting, which may or may not be accurate, is that a good deal of this surge in spending has been on computer and business equipment and so forth rather than on basic new capacity, which requires additional buildings and plants. Do you have any breakdown on that series?

MR. ZEISEL. Well, we certainly have data on the composition in broad terms. Over the last couple of quarters, the third and fourth quarters of this past year, producers durable equipment rose by annual rates of 22 percent and 28 percent respectively. During the same periods the outlays for structures were [up] about 10 percent, which is fairly strong. The outlays were rather concentrated in public utilities; commercial activities have not been so strong. In terms of further detail, we have some shipments and orders figures that show fairly strong growth in heavy non-electrical machinery, communications equipment and--of all strange things--farming equipment; but the growth is fairly widely distributed.

MR. PRELL. Plant construction is not a whole lot of dollars in the investment total. We think our forecast is consistent with a rate of increase in that kind of spending of maybe 4 to 5 percent over the forecast horizon, which is not very substantial.

MR. BALLES. That's very interesting. The bulk of the increase is going to be on the so-called equipment side, then?

MR. ZEISEL. For producers durable equipment we have projected increases in the 12 to 15 percent range for 1984 and in the 6 to 8 percent range for 1985.

VICE CHAIRMAN SOLOMON. Let me ask you a general question. I assume that there is no change in the projection of revenues and expenditures--that there is no new action on the deficit. Is that correct?

MR. KICHLINE. We have some small changes but nothing of major size.

VICE CHAIRMAN SOLOMON. Now, maybe I should be smarter and understand this, but what conclusions do you come to about the so-called "crowding out"? What is the impact later in '84 and in '85 on medium- and long-term interest rates? Would you just take that as a given coming out of monetary policy?

MR. KICHLINE. No. We think it's there now in a variety of ways, one of which is that interest rates tend to be higher than one might otherwise--

VICE CHAIRMAN SOLOMON. Well, I know that, but that could change from the present situation.

MR. KICHLINE. Well, as we go on we do not have in this forecast any growth in housing; it begins to taper off in 1985. Second, we have a slowing in the rate of increase of durable consumer purchases, which we think are credit sensitive. So, that is slowing and business fixed investment itself is slowing over time, and a related factor is the massive current account deficit that we have. So in a variety of ways it's sprinkled throughout the projection.

VICE CHAIRMAN SOLOMON. But if I remember correctly you have only a very modest rise in mortgage rates over the remainder of the projection period.

MR. KICHLINE. That's right.

VICE CHAIRMAN SOLOMON. How do you get an assumption that the rise will be that modest? Is that a conclusion arrived at independently or is that taken from Steve [Axilrod] or something?

MR. KICHLINE. We think that all of this is integrated; we try to focus on what interest rates are consistent with a given monetary policy. But I must say that I've been humbled over the years in forecasting interest rates--other things as well, but interest rates in particular. So, we think it is consistent but I would not be prepared to live or die by this mortgage rate forecast. One of the issues, of course, is whether the pressures build up sufficiently so that we get far away from the kind of picture we have forecast, which is one of moderating growth, inflation picking up, and interest rates tending to rise, but we don't hit a point where things really take off or the economy collapses because of pressures. That is one of the issues, it seems to me. It's not so much a near-term issue, but as one looks ahead in this forecast there are things that are out of whack--one is the deficit and another is the international side. And one could easily think of an alternative view in which those pressures build much more substantially and are reflected in events, perhaps not in 1984 but in 1985.

CHAIRMAN VOLCKER. I detected a bit of a struggle in Mr. Prell's explaining how the government is going to be financed and in Mr. Truman's explaining how the balance of payments is going to be financed. But he has the great advantage of a statistical discrepancy.

MR. TRUMAN. Well, Mr. Prell has that too, as a matter of fact. To answer Mr. Solomon's question: These forecasts are more consistent than they ever have been in the past.

VICE CHAIRMAN SOLOMON. Even in 1985 when unemployment gets down to 7 percent, housing is still relatively stable, business investment is strong, the deficit isn't reduced, and you have an extremely modest rise in interest rates.

MR. PRELL. Well, I think Mr. Axilrod in all likelihood will be saying something, at least implicitly, about velocity behavior in terms of our short-term rates. We think the short-term interest rate picture that we have is consistent with the monetary assumptions and the GNP pattern we have [forecast]. And the long-term rate picture that goes with that we also think is consistent. We believe the pieces fit together in a plausible, rational way.

CHAIRMAN VOLCKER. I think Mr. Forrestal is going to explain it to us.

MR. FORRESTAL. I have no statistical variance. I'm just going to stay with interest rates for a minute and try to relate that to the depreciation of the dollar. If I understood you correctly, you're projecting a roughly 17 percent decline in the value of the dollar from mid-1984 on but at the same time you're projecting a budget deficit of about $184 or $185 billion. If you assume that interest rates are going to stay in relatively the same position as a result of the deficit, do I understand correctly that you're attributing the decline of the dollar almost solely to the trade balance and current account deficit? Is that analysis correct?

MR. TRUMAN. Interest rates do go up a bit, as I mentioned and as Jim mentioned in his assumptions. In some sense, in the general equilibrium nature of this whole forecast, that is associated with the decline of the dollar, which helps to push up nominal demand in this period.

MR. FORRESTAL. Well, if you assume that the dollar is strong principally because of high interest rates and that interest rates are going to remain at a high level because of the deficit, then I'm not sure why you're projecting the decline of the dollar except because of the current account deficit.

CHAIRMAN VOLCKER. I think that's a very good question.

MR. GUFFEY. Wishful thinking.

MR. TRUMAN. That is one of the reasons I presented the two alternatives in the bottom part of that chart. One has the dollar continuing to go up; the other one is a scenario in which it is falling out of bed. Our view is that eventually $100 billion current account deficits are going to be generating more in the way of net claims on the United States and [the question is whether] the rest of the world, with safe haven factors and so forth and so on, would willingly want to hold [such claims] at unchanged to say nothing of rising exchange rates; and that would produce an adjustment [in dollar exchange rates]. In fact, a number of foreign countries--I point to Germany as an example--have too long and to their dismay, I think, assumed that their currency was always going to rise and, therefore, built into the price projections a kind of inflation bonus. Eventually some portion of that inflation bonus has to be repaid, and I think that's the essence of the story. Whether it will be of this magnitude--a 17 percent decline--and over this forecast period [is uncertain]. Although we continue to forecast it, I obviously am modest about its probability, given the [experience of] the last 18 months.

MR. WALLICH. Well, the current account implications of that decline in the dollar come mostly in 1985 and after, so the interest rate implications of that--at least as far as the financing of capital needs is concerned--also come at that time, although movements in the security markets of course might make them come at any time.

MR. TRUMAN. Everybody has his own technique, but the way I tend to think about it is more to have interest rates coming out of the rise in nominal GNP--higher prices and at least for a while higher GNP coming from more exports and lower imports in real terms. And that pushes up the interest rates rather than the actual foreign sales of securities, which would tend to bring that pressure forward in time more than what you're talking about.

MR. WALLICH. If throughout 1984 the crowding out goes about half against the balance of payments and the other half against domestic investment, that's one reason why interest rates don't seem to have to rise.

VICE CHAIRMAN SOLOMON. Is that Wallich's rule--the ratio is one to one?

MR. WALLICH. Well, if you have a current account deficit of $100 billion and a budget deficit of $200 billion--which produces, let's say, $200 billion worth of crowding out--half of it goes against the foreign sector, hurting exports and import-competing industries. The other half goes against investment, hurting housing and so forth.

MR. PARTEE. That's assuming that the current account would be zero in the absence of the federal deficit. I'm not so sure.

MR. TRUMAN. If you look at the structural deficit, Governor Wallich, the change shown on the first chart is about the same size--at least for the calendar year [or the] fiscal year--as the change in the current account deficit. And in that sense in fact all of it is going into the foreign sector.

MR. GRAMLEY. Are we supposed to be having our regular go around now or is that going to be later? If we don't talk now, do we forever hold our peace?

CHAIRMAN VOLCKER. The ground rule is that you can talk about the economy now. If people don't want to talk anymore about the economy now, we will have a break.

MR. GRAMLEY. Well, I have a couple of comments I want to make on the price forecast. I think there is very considerable danger that prices are going to go up more than the staff is forecasting over the next couple of years, and I think so for several reasons. One is that I am more optimistic on growth--or pessimistic, as the case may be. I don't want to chop that one up, but I noted Ted's comment--and [I did so] with approval or otherwise I wouldn't be mentioning it--that when net exports go down as they have recently, one shouldn't regard that as a sign of weakness in the economy but as a sign of strength. It's a consequence of the fact that the domestic economy is growing very rapidly. We have a lot of fiscal stimulus and high interest rates. If you apply that to the fourth quarter and take into account the fact that the rise in inventory investment in the fourth quarter was very small, that more than explains why we had a slowdown in [economic] growth. Indeed, if you take the private domestic final purchases--they went up more in the fourth quarter than they did in the third--my hunch is that we're going to have a stronger economy in the first half than the staff is forecasting. I think the underlying dynamics are stronger than the 4-1/2 to 4-3/4 percent growth rate projected for the first half. And I think that is going to be building up pressures on prices as time goes on. Second, I think we have to reckon with the possibility that the turn-up in the labor force participation rate that the staff is forecasting may or may not happen. And if it doesn't happen and we have somewhat stronger growth to boot, we're going to have a much bigger drop in the unemployment rate in the course of 1984. Third, to go back to what Governor Partee was saying, I don't understand the consistency of the staff forecast in regard to prices. The staff is kind enough to give me all kinds of details when I ask for them and I--

MR. CORRIGAN. They are used to it!

MR. GRAMLEY. Well, they are very good about that. The fixed weight deflators for private domestic final purchases, excluding food and energy--and that's about the most trouble-free index you can look at--goes up 4.4 percent over the four quarters of '83, 5 percent in '84, and 5.6 percent in '85. But if you take out the half point bonus that Ted has been talking about for the appreciation of the dollar in '83 and take out two-tenths for the depreciation in '84 and eight-tenths in '85--and I think that's the right calculation--you get a deflator that's just flat. It goes nowhere. And it goes nowhere despite the fact that we have both higher food prices and higher compensation per hour. Now, if there have been a few miscalculations on that side that have favored lower prices and if we get more growth and if we get this flat participation rate, the potential is there--I'm not sure it's going to happen, but the potential is there--for a worse inflation outlook. [It could mean] 1-1/2 percentage points or maybe 2 percentage points by 1985 on the inflation rate, and that's something I think we ought to--

CHAIRMAN VOLCKER. Let me ask you a question on the business outlook. You say final private domestic demands are high and rising.

MR. GRAMLEY. Not rising. Well, they rose from the third quarter to the fourth quarter.

CHAIRMAN VOLCKER. Well, let's say they remain high, or however you want to qualify it, and the GNP doesn't rise all that much because imports are going up so rapidly. How long can that last?

MR. GRAMLEY. Well, not forever, that's for sure. Something is going to happen. But the fact is that a $9 billion drop in net exports in 1972 dollars at an annual rate is most unlikely to continue in the first half of this year. This would be a lot greater deterioration in the trade balance than what the staff is forecasting. And if what happens is that we get a somewhat smaller decline in net exports and a somewhat larger increase in inventories and continuation of fairly strong private domestic financial purchases, we're going to get a growth rate, I think, in the 5 to 6 percent range during the first half of this year. And that is going to be trouble for us, particularly if we continue to get slow growth in the labor force.

CHAIRMAN VOLCKER. How big an increase do you have in this concept Mr. Gramley is using for the first half of the year?

MR. KICHLINE. 5 percent in the first quarter and 4-1/2 percent in the second quarter.

CHAIRMAN VOLCKER. What was it in the third and fourth quarters of last year?

MR. KICHLINE. 5-1/2 percent in the third and 8 percent in the fourth.

CHAIRMAN VOLCKER. The rates are 5-1/2, 8, 5, and 4-1/2 percent. You still have a big increase in imports in the first half of the year; it's magically going to level out in the second half.

MR. PARTEE. Well, it could be even larger, it seems to me. As I've said, in addition to consumer demand, which is fueling imports now, we have the probability of a speed-up in inventory accumulation. It may well be stronger, as Lyle thinks, and that's going to feed disproportionately into imports. I must say that I sense a certain fragility in the forecast, the same as Lyle does. I'm not so sure I would say the first half will be that much stronger, but I think the odds would favor a gradually accelerating price rise, particularly in 1985. And with a sharp drop in the value of the dollar--say, perhaps 25 percent in the latter part of '84 or early '85--why, we would have more of a price rise. Because of that, we also would have problems financing the deficit, higher interest rates, and reduced domestic demand. So, as I see it, the odds are that 1985 will have more inflation, less real growth, and higher interest rates than the staff is forecasting.

MR. BOEHNE. One question we haven't talked about is how much inflation we're likely to get before this cycle is over. If we're ever going to get back to price stability, we have to keep ratcheting down the peaks of inflation from cycle to cycle. As I look at this, all expansions come to an end because of some excesses somewhere. We've pointed out a couple--the [budget] deficit and the trade balance--and there may be others. But it seems to me that the two excesses that we have our telescopes on are the kind that are likely to push up interest rates fairly sharply once they go. And we have a recovery, it seems to me, that is operating near a margin of interest rates that could turn the whole recovery soft fairly easily. We see that in the mortgage market. I think we see it in automobiles and in the consumer sector generally and in business equipment. By the end of 1985 this recovery will be three years old and as we get into 1986 it will be four years old. The question is: Will the excesses trigger a recession before inflation jumps up above the previous peak? And it seems to me that that's not likely to happen--in other words, that inflation in this cycle is not likely to accelerate beyond [its peak in] the previous cycle.

CHAIRMAN VOLCKER. Because you have the happy prospect of another recession!

MR. BOEHNE. That's right. Speaking realistically, it seems that we have the kind of cycle that will likely run itself out within the context of inflation continuing to ratchet down. You can view that as good or bad. But if you look at inflation in a cyclical context, inflation is not likely to get away from us in this particular cycle.

CHAIRMAN VOLCKER. Are there any other general points people want to make now? Mr. Corrigan.

MR. CORRIGAN. I think the predicament we have has actually gotten worse even though the business statistics at the end of 1983 in some sense look a little better. In the near term, and by that I mean the first half of this year, my forecast is almost identical to the staff's. The problem is that I'm not sure I believe either one of them. The risks continue to be on the side of a stronger economy and more inflation--not by a lot, but I think that's the direction. The irony is that an economy that is better in the short run is likely to be worse in the long run. And what we have been talking about on the international side brings that home very forcefully. On the inflation front, for example--even aside from Governor Partee's point--the staff's forecast basically assumes that profit margins are exactly flat. As I detect things out there, I still see a lot of pressure on the part of businessmen trying to widen those margins in any way they can. And that's one of the reasons why I just wonder whether the kind of assumptions that historically are reasonable about the implications of a declining dollar for the inflation rate are really in the ballpark. It seems to me that we may have a situation right now where the indirect effects of the exchange rate and the import issue on domestic inflation are greater than the direct effects. In other words, it's not just the question of the price level of an imported good coming into this country as much as it is the way in which those imported goods are affecting the behavior of domestic manufacturers, wholesalers, and retailers in terms of what kinds of pricing they think they can get away with. So, I'm inclined to think that if the dollar did in fact come off--whether by 17 or 25 percent or whatever--the impact on the domestic price level could be larger than that contemplated by Mr. Truman's exercise, even though it's a quite reasonable expectation from an historical perspective.

On the whole credit flow question, I see the complication at this point growing out of the international side and the deficit in combination. That seems to me problematic and then some. I find it difficult to conceive that we can easily get $45 billion in capital inflows in 1984. I don't know what we would ever do if we had a negative statistical discrepancy. That's another story. More generally, even if we could get those capital inflows, I have a very difficult time squaring the circle as it were in terms of the overall credit flow analysis that Mr. Prell went through in the context of the kind of interest rate outlook that's associated with the staff forecast, absent a reduction in the deficit in 1984. Personally, I don't think the so-called crowding out issue in the context of the current international situation is an '85 problem; I think it's an '84 problem and then some. So, again, while one can feel a little better looking at the very recent statistics--as I do and I think we all do--the overall situation that we face has become a little more problematic, if anything, from my perspective.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I would like to join those who have been warning that the interest rate projections may be on the low side, even with regard to 1984. Upward pressures on rates may find their way out even by mid-1984--not in the clash between private and public financing, which I think obviously has occurred and will occur, but between financing the international trade deficit and financing the enormous [budget] deficits. Deficits in 1984 of $189 billion or $195 billion--take a number--will give us an interest rate situation, given these other assumptions in the forecast, that may catch us sooner rather than later.

I look at the curves depicted in the charts here on the level of housing starts and the line in the diagram depicting business fixed investment. I can't reconcile that to my expectation of interest rates rising sooner than projected here. The housing curve, I believe, is unrealistic. Housing doesn't reach equilibrium; housing is either rising or falling. With increased interest rates, I don't think the level of housing in this projection can be achieved. I'm not even sure it can be sustained with today's interest rates because much of the first-time home buyer segment has been used up and now we do not have the strength in trade-up purchases that has been typical. We have mortgage payers unable to handle their financing in part because the builder points that kept their interest payments down are running out. And, with an increase in interest rates in mid-1984, the adjustable rate mortgages will be adjusting upward. That will increase the foreclosure rate--a depressing element on the housing market.

As far as business fixed investment is concerned, I think we see here that the easy kinds of investments have been made. Business firms that did have some cash and could finance themselves to easily modernize the plant or the office building have done that. In a rather remote way it's [comparable] to the first-time home buyer, as these people attempt to match the hurdle rates that their boards of directors are going to require of them with what they have to pay in the stock market. I would suggest to you that the broad [stock price] measures have decreased since midyear. We aren't talking about financing 30 firms whose stocks go into the DOW. We're talking about financing a thousand firms whose stocks are represented by the broad measures of the New York and American [Stock Exchanges] and the NASDAQ; and those broad measures have declined, not increased. Add to that higher interest rates on raising credit and I think you get a flatter curve than the business fixed investment curve here. So, it seems to me that those are two factors that mitigate against what some of our colleagues have indicated here might be a much stronger recovery in 1984. I join those who feel that we certainly will have a cumulative impact of the various imbalances by 1985. It seems to me that we have a considerable downside risk right now in 1984, and it arises from the difficulty of financing the enormous mega deficit and the mega trade balance deficiency.

MR. BOEHNE. I would like to piggyback on something that Pres said. I've been talking to thrift people in the Philadelphia area and they have been trying to figure out the best way to market these variable rate mortgages. I don't know how widespread it is, but a fellow was telling me the other day--and I've heard it several times--that the variable rate mortgages will sell with more points up front and a lower variable rate. I have forgotten the numbers precisely but this fellow was telling me that they had something like a 10.9 percent rate with 3 points and that wasn't going, so he changed it to 4 points and dropped the initial rate to 9.9 percent and they're going like hotcakes. Everybody knows that after a year, with no change in interest rates, the variable rate is going to pop back up. And if that also happens to hit the rising--

SPEAKER(?). It's a temporary agreement.

MR. BOEHNE. Yes, that's a temporary agreement, but it is more marketable.

VICE CHAIRMAN SOLOMON. They don't limit the amount of the interest rate movement each year?

MR. BOEHNE. Well, [that varies]. But they certainly can accommodate a 1- or 2-point change after one year. This came up in the context of a [discussion with a] large retailer in Philadelphia. That's the same kind of technique that has been used in retailing for years, but it's an interesting development--that people would rather have more points up front knowing that the rate is going to pop up in a year. I don't know how widespread the practice is but these were some fairly conservative thrift bankers I was talking to, and they were nearly gleeful with the discovery that they had found this marketing element. It may very well have a bigger impact than we think. I believe that was your point, Pres, but I was surprised to find this.

MR. WALLICH. I think the fundamental fact in the outlook is that we have a $200 billion deficit. Now, we would take back, so to speak, $100 billion of that by sending the money abroad. That leaves us with $100 billion of net stimulus; and to get a weak economy we really have to argue that that much stimulus is not adequate to keep the economy growing. That seems to me like saying that the economy is inherently very recessionary, that the expansion or impulses for investment incentives and so on are very small. I really don't find that plausible. After all, high interest rates and the high current account deficit are the result of the expansion that we're getting from the deficit; they're not independent factors that are cutting into the expansion.

MR. PARTEE. If I might, I would like to ask Governor Wallich something. You have a declining domestic stimulus, don't you? That is, using your terms of reference, you have $60 billion of financing abroad and $140 billion stimulus [last] year and in 1984 you have $100 billion financing abroad and $100 billion stimulus. Doesn't it decline, and wouldn't that give you a reduced stimulus?

MR. WALLICH. Well, since the structural component of the deficit is rising and the cyclical component is falling and by the time you get to full employment it's all structural, I would think--although I haven't studied this--that in terms of the full employment budget deficit we are increasing the stimulus.

CHAIRMAN VOLCKER. You have a bigger full employment trade deficit too.

MR. PARTEE. Yes, it's hard to do the arithmetic.

VICE CHAIRMAN SOLOMON. It sounds to me that in the scenario that most of us tend to think is more likely than not--if not in '84 at least in '85--of rising interest rates combined with a falling dollar and rising inflation, that we won't get a tapering off of the cycle but a very quick turnaround. Then 1986 might be a period of distinctly negative growth or recession rather than a tapering off. That seems to me more likely, given this set of imbalances we're talking about basically coming to a head.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. As I look at these projections, Mr. Chairman, I think that the risk is probably on the up side in terms of higher inflation and growth than projected. I think the staff's projections are very reasonable. The only point of departure I have is on the inflation number, which I think will be higher. Some of the reasons have already been stated, so I'll skip over those but one of the major factors is the effect of the structural deficit plus the projected decline of the dollar. I must say, though, that I have some question about whether that really is going to happen in 1984. But one point that hasn't been mentioned and that I take into account somewhat is the monetary stimulus that we had in late '82 through the spring of '83. I realize those numbers have just been revised downward a little but, as I read the Bluebook, the numbers indicate a revision upward for the last couple of months. So, I think that stimulus is still working its way into the economy. For those reasons I think we might very well get higher growth and higher inflation than the staff projects.

CHAIRMAN VOLCKER. I think this is the time to have a cup of coffee.

[Coffee break]

CHAIRMAN VOLCKER. Mr. Axilrod will tell us how to resolve this.

MR. AXILROD. Mr. Chairman, at the end of my prepared remarks, I would like to make a few unprepared comments that relate to the issue President Morris raised. I interpreted him as saying that he thinks M2 ought to be higher for this GNP and, if anything, my prepared comments go somewhat in the opposite direction, although not necessarily for this GNP but for interpreting M2. [Statement--see Appendix.]

I would add, Mr. Chairman, partly in response to President Morris' question, that there may be a certain amount of uncertainty with regard to the velocity of M2. In the second year of the expansion following the cyclical troughs of 1961, 1970, and 1975 the M2 velocity declined, which would argue that for a 9 percent GNP growth M2 ought to grow more like 10 or 11 percent. We have an M2 expansion less than the GNP growth [for 1984], though not as much less as shift adjusted M2 grew in 1983. I think that ought to be interpreted against the actual behavior of interest rates and ceiling rates in the earlier recoveries of 1961, 1970, and 1975. In the second year of the expansion after the 1961 trough the ceiling rate was raised from 3 to 3-1/2 percent. So, despite some little rise in [market] interest rates continuing on into the second year, the spread remained favorable to deposits in M2, and money continued to shift into those deposits. In 1970, in the second year of expansion the ceiling rate remained around 4-1/2 percent but interest rates tended to edge off in the early part of that second year and not rise very much thereafter and the spread again remained favorable and in fact became more favorable in the first two quarters of the second year. So, again, I think it was the structural reason affecting that. Following the 1975 trough, the second year was a period when interest rates began declining and by the end of that second year during which the system continued an expansive policy, market rates fell below Regulation Q ceiling rates, which again jazzed up M2 and led to a drop in velocity. So, now, with M2 having very little of ceiling rates in it and a policy of edging down money growth to restrain price increases, we believe that the M2 we have forecast is reasonably consistent with those objectives, with a slight caveat--that to exert additional restraint in a somewhat mechanical sense it ought to be 8-1/2 percent or even a point lower.

CHAIRMAN VOLCKER. I see you all have absorbed all that.

MR. MORRIS. If I may comment, since I raised the issue of M2 ranges and the same thing also applies to M3 ranges: Since 1960, in the second year of an expansion the rates of growth of both M2 and M3 averaged 2-1/2 percentage points higher than the nominal GNP, which is to say velocity declined by 2-1/2 percent. We're showing targets here for M2 and M3 that are at or below the nominal GNP. Now, I am not saying that Steve is wrong; he may be right. But if he is right, I'm just saying that these ranges represent a marked departure from the historical [pattern]. This does suggest to me the fundamental issue that the character of both M1 and M2 have so changed that we cannot have any confidence in our ability to forecast the velocity of either one of them. And I would extend that now to M3. I've already seen the First National Bank of Boston at the end of the year make a decision--in a situation where the holding company capital was pretty strong but the lead bank capital was a little submarginal--to move loans out to their subsidiary banks to improve the lead bank capital ratio. I think what is likely to happen, if we get into a tight money market and strong loan demand, is that we're going to see a repetition of what we saw in 1969. The banks are going to start moving the loans off their books entirely. That will mean they will keep the risk but plant the paper in the market someplace, in which case M3 will no longer be a sensible indicator for monetary policy. If we really don't have a good basis for knowing whether M2 velocity should be minus 1/2 or plus 2-1/2 percent--if the range of uncertainty is that big--it raises serious questions in my mind as to whether these aggregates are sensible tools for targeting monetary policy.

CHAIRMAN VOLCKER. I might just interject that if you notice that phenomenon going on in an important way, you might have a little counseling session at those banks about how we might look at their capital ratios.

MR. PARTEE. Frank, those subsidiary banks had to finance that loan purchase didn't they?

MR. MORRIS. Well, they had subsidiary banks whose capital position was okay.

MR. WALLICH. But they have to be consolidated.

MR. MORRIS. Well, sure. They have to [unintelligible].

CHAIRMAN VOLCKER. They have to take it off the balance sheet.

MR. PARTEE. I think Frank's second point was much better: that they will tend to put this out in the market.

MR. MORRIS. Yes. Shifting the loans among the subsidiaries doesn't affect M3. I just pointed that out to note that the process has already started. The first stage is that they move it to the subsidiary; the second stage is that they move it out of the bank's balance sheet entirely.

VICE CHAIRMAN SOLOMON. And keep the risk. It gives them recourse on the paper.

MR. MORRIS. Yes. That's what they did in '69.

CHAIRMAN VOLCKER. One vote for no targets.

MR. GRAMLEY. We're starting off well!

MR. PARTEE. Well, that's the same way we started off before.

MR. MORRIS. Could I change that to read no M1, M2, or M3 targets?

CHAIRMAN VOLCKER. You want that debt target?

MR. MORRIS. Yes.

CHAIRMAN VOLCKER. Well, I tell you: That's very strange. Since you raised that subject, the chart [we saw] earlier indicates that past patterns of debt [in relation to GNP] are not being observed, rather strikingly, and I wonder what the implications are. I haven't been able to figure it out but the debt aggregate is off the pattern anyway. Who else would like to [comment]?

MR. CORRIGAN. Just a question to Steve: Did you make any allowance in M3 in particular for those net capital flows at the banks?

MR. AXILROD. Yes. I can't find that piece of paper offhand but there is an assumption of large capital inflows, on the order of $30 billion, at the banks in '84. That's more than in--

MR. CORRIGAN. Basically all in M3?

MR. AXILROD. Well, that's the assumption--that what comes through the branches so to speak that isn't in CDs issued here would [not] get into M3. It comes in as a liability to a branch. If a foreigner invests directly here into a CD, it will get into M3. But if it's invested in a Eurodollar abroad and then it comes in as a liability to a branch, it won't get into M3.

CHAIRMAN VOLCKER. A technical question from Mr. Partee.

MR. PARTEE. Let's assume, Steve, that Frank is partly right and the velocity wants to go [down] rather than [up]. So you would have a situation where M2 is 10 percent relative to the same nominal GNP we're expecting and we have a 9 percent limit on our range. How do we go about getting M2 down in the range?

MR. AXILROD. You raise interest rates.

MR. PARTEE. What if we have elasticity of rate setting by the institutions? Can't they just meet that--

MR. AXILROD. Well, our work suggests that there is some interest elasticity to M2 demand although less than M1 now. Secondly, of course, it comes out of income. At some point income has to adjust.

MR. PARTEE. Well, the GNP will go up less rapidly.

MR. MORRIS. But would you really want to raise interest rates if the nominal GNP was coming in at the 9 percent that you forecast?

MR. AXILROD. I don't mean to sound editorial but in many of those periods when we had this negative velocity you are mentioning--such as in '72 and '76 and '70--the M2 growth you had to get was 12 and 13 percent and that was followed by substantial price pressure. Now, whether those upward price pressures came from the M2 with a lag or came from the associated M1 with a lag, we could discuss; but I think that's the problem you get into. It isn't so much what you do this year but what the lagged effects of what you do this year happen to be.

MR. BOEHNE. Do you find yourself in a somewhat absurd position of controlling GNP to control M2?

SPEAKER(?). Yes, but you end up doing it through interest rates.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Well, we might as well go from one extreme to another here, from Morris to Balles. I would like to speak to the desirability of restoring M1 as one of the aggregates we target--possibly going back to the old equal weight we used to have for M1 and M2. I'll be brief about this because my reasons for recommending this haven't really changed since last fall when I circulated a paper to all of you comparing the performance of M1 and M2. Very briefly, and perhaps over-simplified, the conclusions I drew were that the demand for M1 has remained surprisingly stable through this recent period of financial deregulation, whereas the demand for M2 as a matter of fact has become progressively more unstable. It's true, of course, with respect to M1 that we had this very sharp and unexpected decline--a very surprising decline--in its velocity in '82 and even early '83. In our analysis that decline was not caused by a shift in the demand function for M1 but was a direct outcome of the decline in inflation and the corresponding and later decline in interest rates. So we have had an increase in money demanded because interest rates were down and the opportunity costs of holding money were lower. I think a significant piece of evidence that this was not a shift in the demand function for money but a move along a curve was that the velocity of the [broader] monetary aggregates also declined in 1982. I don't think that would have happened if the problem had been solely one of instability in the demand function for M1.

Another thing that I would like to point out is that the variability of M1 velocity to which Steve referred indirectly is actually a bit less than the variability of M2 velocity. Our staff, using the figures in Steve's excellent memorandum of January 23, compared the standard deviations of one to another and found that the standard deviations of the annual growth rates of M1 were actually a little less than was the case for M2. So it's all well and good and proper to point out, as Steve has done in his usual thorough way, that there are residual problems remaining with M1. A good part of it now consists of Super NOW accounts that may have some interest elasticity. On the other hand, what are the alternatives? Looking at the alternatives, two things clearly stand out to me. One is that M2 really has lost any meaningful relationship to future income. That is to say, M2 in recent years has grown at a steady 8 to 9 percent rate a year whether we had a strong, booming economy or whether we had a deep recession. We never could have anticipated either one of those two from the growth rates of M2 that preceded it. Though I wouldn't put all my bets on M1 by any means, I do think, given the point that Steve made about the velocity of M1 now seeming to have turned in an upward direction even if moderately, that the sharp inflow of funds into Super NOWs has tapered off and we have a fairly stable slow growth rate there. So, I would recommend restoring M1 to about equal weight and I would subscribe further to the point that Steve made that if we are going to restore M1, we probably should consider reducing the width of the range to 3 percentage points. That would mean something like 4-1/2 to 7-1/2 percent, giving it the same midpoint, if you wish, as alternative II.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, if Frank Morris is on one end and John Balles is on the other, perhaps I can think of little old reasonable me as being right in the middle. I'm probably more bullish on the economy than most people here and I'm at least as concerned about the inflationary aspects of what may happen this year and next as others are. But I don't think there is any need to deviate from the alternative II targets, which are consistent with the staff's forecast. If we could get a 9 percent nominal GNP, we would be in reasonably good shape. So if these target ranges are consistent with that--and I have no strong reason for thinking they're not--that's what we ought to start with. In any event, if things work out more along the lines of a stronger economy and somewhat more price pressures, it seems to me that growth ranges that are as low as 4 percent for M1 or 6-1/2 percent for M2 or 6 percent for M3 give us all the room for monetary restraint we could possibly want. So, I like alternative II as it stands. I don't want to put more emphasis on M1 this year. I think that would be a very, very bad idea in a year in which I think we're going to need an awful lot of flexibility for monetary policy. And I think we've had more flexibility since we adopted the broader aggregates as our principal targets in October of 1982. I don't deny that we may be getting back to a situation in which velocity is following historical patterns, but I don't think that in and of itself is sufficient cause for elevating M1 to the principal target. If we get into a situation in which the dollar begins to fall like a stone and interest rates begin to rise and we find ourselves thinking we have to be constrained by an M1 target in the way we were during the period before 1982, I think we're going to be in big trouble.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I favor giving more weight to M1. I think there is some presumption that it is regaining a stable relationship. Now, with more of it being subject to interest, I think its velocity is likely to rise less than it used to. In other words, instead of having a 3 percent advantage in velocity gains relative to M2 and M3, it might have a 1-1/2 or 2 percent relative advantage. As far as its interest elasticity is concerned, I recognize that it is important. It seems to me that that depends on how market oriented NOW and Super NOW accounts become. If NOWs remain at a fixed rate, then they will be highly interest elastic because the opportunity costs of holding NOWs as compared to the cost of market instruments will be important. If there are market oriented rates on M1 predominantly--they all have different components--then I would think that indeed the interest elasticity will diminish and one ends up controlling the aggregate by controlling GNP. Nevertheless, that is [done] through interest rates. I think M1 is the one aggregate that has some plausibility of having a causal effect with respect to GNP whereas for M2 and M3 and debt it seems to me the causation runs more from GNP to the aggregate. As for the choice among these ranges, it may seem inconsistent having said that I think the velocity of M1 is likely to increase less than in the past, nevertheless, I lean in the direction of alternative I. And I would prefer widening the range there on the down side so that the range would read 3 to 7 percent. I wouldn't be greatly concerned if M1 were running on the high side of that range. Also, I hope that going to contemporaneous reserves does not mean that we are going back to some form of immediate automaticity--doing what Lyle Gramley implied, where as soon as M1 overshoots we immediately rush after it to capture it. I think the kind of approach that other central banks use to control the aggregates--bringing them back on track over a period of a quarter or two--is feasible and less disruptive. With those specifications, I would also say that M2 could possibly be reduced on the lower end; but I feel less strongly about that and would leave it stand the way it is in alternative I. Thank you, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I would like to jump on the Balles bandwagon and make a plea for greater emphasis on M1 for the following reasons, some of which are perhaps repetitious of things that have been said: the revised money numbers imply that M1 velocity has been more stable than we previously believed; the Bluebook suggests that M1 velocity is expected to behave pretty normally throughout 1984; and the Axilrod memorandum that John Balles referred to also suggests that M1 velocity is expected to behave normally not only in 1984 but in the future as well. Also, the research that we've looked at in our bank suggests that M1 demand was not nearly as unstable as perhaps we thought it was and that the relationship to GNP does seem to be pretty well established, whereas on the other side it seems to us that M2's relationship with GNP is not all that secure at the moment. The other factor in my thinking is that we did say in our recent directives that we would place more weight on M1 as soon as velocity assumed a more predictable pattern and, as I have indicated, I think that has happened. Also, given that the implementation of CRR in a couple of days was for the purpose of more efficiently controlling M1, I ask the rhetorical question, I guess: Hasn't the time arrived--now rather than later--to place more weight on M1?

Having said that, I turn to the alternatives in the Bluebook and what I would prefer. First, let me say that as I look at setting long-range targets, I think that we are probably looking at objectives of price stability, some credibility for the Federal Reserve--that is, setting targets that are obtainable and not out of reach and that we don't change all the time--and thirdly, I guess, a gradual decline of the monetary targets over time. With those objectives in mind, I come out pretty close to alternative II, although because of what I said about M1 I would be more inclined to reduce the upper end of the M1 range to 7-1/2 percent and raise the lower end to 4-1/2 percent, thus making the range 4-1/2 to 7-1/2 percent. I'm not as concerned about M2 but I would keep it in mind for reasons stated in the Bluebook and I would move the range for M2 to 6 to 9 percent rather than 6-1/2 to 9-1/2 percent. But I think alternative II is consistent with the staff's projections and where we ought to be going as the Committee.

CHAIRMAN VOLCKER. Let me just interject: Beauty may be in the eye of the beholder, but I don't see any normality about the velocity of M1 ex post. We have had some increases--much less than the normal cyclical increases and well delayed in the cycle. Now, this may all be consistent with a presumption that M1 may be getting more normal in the future but you can't prove it by what has happened, I think, through the fourth quarter. Mr. Solomon.

VICE CHAIRMAN SOLOMON. Do those who are saying that M1 should be reinstated as a target mean by that that we should return to the automatic feedback on the nonborrowed reserve path that we had before, with all the volatility in the short-run [interest rate] movements? Or do we get to the Henry Wallich view--and I want to ask Henry what he means by this in practice or whether it is just symbolism. Since you said you're opposed to that kind of automaticity but you want to give more importance to M1, by that do you mean we should target it rather than have it as a monitoring range for the fourth-quarter-over-fourth-quarter period? And if so, what does that really mean then?

MR. WALLICH. I meant to say that if we're driven off path, we shouldn't rush after it by sharp changes in the volume of borrowing and, therefore the funds rate, in order to bring it back on track but we should do it gradually the way we did in a way early last year. Interest rates were allowed to go up 1 percent maybe and that contributed to bringing M1 back on track and not overshooting. I don't know how influential this move in interest rates was, but it seems to me that that was about the right way of managing M1.

VICE CHAIRMAN SOLOMON. So, if I understand you, Henry, you would continue with intermeeting directives that are written in terms of more or less restraint rather than returning to the language of the earlier intermeeting directives?

MR. WALLICH. I would be reconciled to that. Of course, that really means funds rate management. It's what we did before 1979. We would have a little more flexibility and we wouldn't intervene in the securities market in order to peg, or almost peg, the funds rate or hold it between narrow limits. We would intervene in order to supply or drain reserves regardless of whether the rate is at a particular point. And it seems to me that that is a pretty good form of management provided it is guided by looking at M1. And if M1 gets away from us continuously and for a long period of time, then it seems clear that the interest rate and the borrowing level that we established weren't the right ones.

VICE CHAIRMAN SOLOMON. Well, of course, I have much less difficulty with that approach because what you're really saying is that we allow significant movements in M1 to influence our management of the fed funds rate gradually over a period of time.

CHAIRMAN VOLCKER. Manage our reserve position.

VICE CHAIRMAN SOLOMON. Well, in managing our reserve position we're guided by the fed funds rate.

CHAIRMAN VOLCKER. Who is?

VICE CHAIRMAN SOLOMON. It shows the accuracy of our reserve calculations, right?

CHAIRMAN VOLCKER. Seldom.

VICE CHAIRMAN SOLOMON. Anyway, on the alternatives, even though alternative II strikes me as acceptable, I think there is some case for reducing M2 to 6 to 9 percent rather than 6-1/2 to 9-1/2 percent. But that's probably a quibble. At first, I was in favor of moving the M1 monitoring range to 4 to 7 percent, but I think that detracts from the de-emphasis that I, like Lyle Gramley, continue to prefer. So, I would stick with alternative II with the suggestion that M2 be cut 1/2 point both on the top and bottom.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. In general, I think the case for trying to preserve as much flexibility as we can in 1984 is overwhelming. Therefore, regardless of what we do with the targets themselves, I hope that we as a Committee would be even more willing to look through them to the GNP, the inflation rate, exchange rates, and so on, even though we probably don't want to do that in any more direct way publicly. On the question of M1 as a target or a monitoring range, I'd want to keep it as a monitoring range. Look at the revisions. Forget about velocity, just look at the numbers themselves. Steve, if I read the appendix right, the growth rate for the second half of the year was revised up from 5-1/2 percent by 1-1/2 percentage points. In five of the last six months I think the revisions have raised the monthly growth rate in M1 by 3 percentage points or more. I just have a great deal of trouble hanging my hat on a statistical series with those kinds of properties, particularly since it's my hunch that at least for the first half of 1984, M1 is going to be more noisy because of contemporaneous reserve accounting and the [trickiness] involved, if nothing else, in applying seasonal factors for weeks that end on Monday when they used to end on Wednesday.

VICE CHAIRMAN SOLOMON. Is it seasonal or is it revision due to the benchmark mostly?

MR. CORRIGAN. The ones I'm talking about here are a combination of benchmarks and seasonals, but most of the changes come from seasonals. But when we go into 1984, looking prospectively with CRR, I think it's going to be a noisier series anyway. In addition to that, seasonal factors are going to have to be different in nature because they reflect a week that ends on a different day. So, I would keep M1 as a monitoring range. Generally, I'd be comfortable with the alternative II specifications, although I do have a preference even with M1 as a monitoring range for going to 4 to 7 percent or 3 to 7 percent--it wouldn't matter to me either way--just because I think the lower range might give us a little more flexibility in the event we were faced with a situation in which we thought we had to firm up a bit. So, I could go with alternative II for M2, M3, and debt. And I'd favor alternative I for M1 and would keep M1 in a monitoring status for at least the foreseeable future.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Well, in line with the long-run plan of reducing ranges over time, I could go along with either alternative I or alternative II. If alternative I had the kind of flavor that Henry talked about--or really anything that goes along with more or less a 6 percent path for M1--I would find that satisfactory. I suppose that states my position in one sense on M1: I'd like to raise M1 in importance for reasons that have already been stated. I'd take it seriously and I'd particularly take long-run nominal GNP seriously. But on the way to taking M1 seriously, I'd stop short of any kind of automaticity. That approach has been outlined by several people. My reasons are very much in line with the reasons that Jerry just mentioned and that Lyle mentioned earlier. This is a time when we need a great deal of flexibility in how we interpret [the aggregates] and how we interpret what is happening in the economy. The economic forecast we've just listened to is based on some very strong assumptions. And the economy is very sensitive to those assumptions, not the least of which are the velocity assumption and all the international assumptions and the assumptions on the deficit as well. So, I would argue for alternative I or II, with M1 moved up in importance but, at least within the Committee, for maintaining our flexibility as we might be dealing with any of a wide variety of situations that we haven't yet been able to forecast.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I'd like first of all to ask a question, perhaps directed at Steve. I notice that your seasonal adjustments and benchmark revisions bring the growth rate of M1 for the last 6 months of 1983 to 7.2 percent. But I also note that using the experimental model that you have been tracking over the past year would drop M1 growth from 5.5 percent to 5.3 percent.

MR. AXILROD. We haven't rerun the experimental model yet, so I'm not sure what that will show. It is being checked.

MR. GUFFEY. Well, my point is that there's some uncertainty as to the seasonals with respect to our confidence level that M1 grew from the base period at 7.2 percent. Would that be a correct statement?

MR. AXILROD. Yes, except with a caveat: that I don't know what the experimental model will show when that is rerun. We simply haven't had the time.

CHAIRMAN VOLCKER. The experimental model would show a little more rapid growth rate, if the seasonals did not change, because of the benchmark I suppose.

MR. AXILROD. Yes, the benchmark itself does some raising--

MR. PARTEE. Well, it would, certainly.

MR. GUFFEY. By 1/2 percent or so.

MR. AXILROD. Yes.

MR. GUFFEY. My only point in asking is that I'm uncertain what the growth rate of M1 has been over the last 6 months, which only adds to the concerns that I have. There are lots of uncertainties, not the least of which is the strength in the economy that we may experience in the first half of 1984 and through the year. And that is coupled with concern about the implementation of CRR and what will come about this week and for the period ahead. I would just note in that regard that the last real big bust that we had in the money supply numbers was at a time when Manufacturers Hanover chose to change its reserve accounting computer program. We missed by a very large amount and it took a while to figure out what caused it. Now we have some 10,000 banks or so that are going to be dealing with CRR.

Having said all that, I want to climb on the band wagon or the wagon that Lyle is leading to say that flexibility is perhaps the most important aspect of policy in the next 6 months as far as I'm concerned. As a result, I would not elevate M1 to a target but rather would maintain it as a monitoring range. With regard to the alternatives, I would select alternative II in the Bluebook with the modification of moving the M2 range down another 1/2 point to a 6 to 9 percent range. And if we maintained M1 as a monitoring range rather than a target, I would not object to seeing the M1 range moved down another 1/2 point to 4-1/2 to 7-1/2 percent, which is about half-way between the alternative I and II ranges for that particular aggregate.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I think there's a good bit to what Frank said. I have a lot of doubts about the aggregates. But probably my Midwestern upbringing leads me to where Lyle is, somewhere in the middle. I think we do need the targets, but I would put a great deal of emphasis on the need for judgment in the use of these targets. And I would judge them in the context of what happens to the real sector and credit conditions. I think there is a need for flexibility both because of the lack of dependability of the aggregates and also the uncertainties in the economy. As for M1, I would keep it as a monitoring range. There's probably some case for giving it a little more weight within a monitoring status; there's some evidence that it is beginning at least to move in a direction of behaving itself a little better. But I think the evidence is far from conclusive that it has. I could live either with keeping [its weight] about where it was last year or moving it up a little within a monitoring status, but I don't think there's a case for giving it equal status. Maybe moving it from double probation to single probation might be a good way to [describe it]. I would go with alternative II in the long-range alternatives. The goal for monetary policy [over the] next year ought to be keeping the recovery going. I think the recovery is too young to abort within the context of making cyclical progress against inflation. And, that being my objective, I would not chop off a point or two at the tops of any of these ranges. It seems to me that we may very well need that room at the top and I think we have plenty of room at the bottom. So, I would keep it as it is in alternative II in the Bluebook.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. Well, Mr. Chairman, I'm a little confused by the financial legerdemain of these benchmark and seasonal revisions. But, as I look at them, it appears to me that we have more growth in money than we [thought we] had before but we still have a rather precipitous decline in the second half of last year from the first half--from 12 percent to 7 percent. And that concerns me in terms of the near-term outlook for the economy. I think we have enough momentum to carry us through the first quarter, but we could very likely see some leveling temporarily in the second quarter. Therefore, I would want to see moderate growth in money for the year as a whole. I think the time clearly has come to reinstate the primacy of M1 in our policy directives since it is really the only thing we control and since it has the demonstrated relationship to predicting the economy. I think that CRR coming along gives us a golden opportunity to improve our control over M1. While obviously there's a transitional period to go through, we ought to use this new tool as soon as possible and be willing to see the funds rate fluctuate if that's necessary to control the growth rate of money--which is really the important thing to do. We have made a major move on inflation and it has been at the expense of great pain and misery; and it would be a terrible disaster if we missed the opportunity now to try to continue that improvement. And I think the way to continue that improvement is to tighten the ranges that we apply to the monetary aggregates, particularly M1, and to reduce monetary growth. Therefore, I would be in favor of a 4 to 7 percent range and approximately 6 percent growth in money, which I believe is somewhere between alternative II and alternative III.

CHAIRMAN VOLCKER. Alternative II and alternative III?

MR. PARTEE. Are you talking about the long run?

MR. ROBERTS. Alternatives B and C, I'm sorry.

MR. PARTEE. You're talking about the short run.

MR. RICE. You mean alternatives I and II.

MR. BLACK. You're looking at the short-run [alternatives], Ted.

MR. RICE. I know he is, but he has been talking about the money supply.

MR. PARTEE. I think you meant between I and II.

MR. ROBERTS. Okay.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I want to agree with Lyle and Henry, if that's possible. In agreement with Lyle, I think that a 9 percent nominal GNP increase for the year would be about right, and I break it down roughly as half price and half real. If it runs substantially above that in either real or price or both, it ought to be stepped on; and if it runs substantially below that, it ought to be given a little care and feeding. So the question is: What aggregates would be consistent with that kind of an economic performance? Now, I want to agree with Henry in the sense that I do believe that M1 has had a pretty reasonable record recently and I can't see anything superior about M2. So, I think M1 should be reestablished as one of our targets but not given primacy. I wouldn't agree with Ted on that, but I'd have it as one of our targets. But we ought to avoid the automaticity that we used from the fourth quarter of '79 to some time in '82. I think that experience indicated that, because of the lags in adjustments in the demand for money and changes in conditions, we really did overshoot on the up side and the down side in that experiment. We need to treat it more gently, along the lines that Tony was talking about [rather than] along the lines that we did in 1979. So, I would put it back very much as it has been done in the alternative directive language the staff proposed.

Now, what targets? I don't think we really have a clear view as to what kind of velocity performance to expect in M1 in the coming period. I'm inclined to agree with Henry that it probably will be less of a rise than in the past because of the inclusion of Super NOWs in that category. So I would be reluctant to see us narrow that range of 4 to 8 percent that we have in alternative II. Chances are that growth for the year probably will come in at 6 or 6-1/2 percent, if what I expect to occur in velocity does occur. But there's just too much risk that velocity won't show that much strength as the year goes on. I wouldn't reduce the M2 range from 6-1/2 to 9-1/2 percent because I'm somewhat sensitive to Frank's comment that velocity may not go down for M2 in the year to come. Now, it may be that it was a statistical error that led us to adopt 6-1/2 to 9-1/2 percent before; but having made that statistical error publicly, and having had it accepted, I see no reason not to take the benefit of it and leave it as we did when we talked about ranges for this period initially last July. It gives us just a little more room. For M3 I think 6 to 9 percent is probably okay because in addition to M3 financing there will be borrowing abroad that will give us a little more lift in total institutional credit than the 6 to 9 percent seems to imply. So, I would urge that we reestablish M1 as a co-equal in targeting; that we think in terms of supporting something like a 9 percent nominal GNP increase fourth quarter to fourth quarter; and that we use the ranges specified on page 5 for alternative II as an indication of what we think will be consistent with that.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I would agree pretty much with Lyle and Tony, and with some exceptions with Henry and Chuck. We really should give ourselves--as has been said many times--as much flexibility as possible. One of my reasons is that I think the international scene is not going to be like any of the alternative [scenarios] that have been presented. And we will need everything we can have in order to cope with that because I don't think we know what is going to happen out there and what the interrelationships are going to be. I would disagree with Chuck and Henry in that I don't think M1 should be elevated at all. I think M1 is an indication that we have found the wrong interest rates. I feel very strongly that the relationship with monetary policy to gross national product is through the interest rates and not through the Ms and that any change in the rate of growth of the Ms is an indication that we found the wrong interest rate. There are other indications that we found the wrong interest rate as well: whether inflation is going too fast, or business fixed investment is going through the roof, or inventories are out of whack, or a lot of other things. So, I tend to look through the Ms to what is going on in the world out there rather than at the rate of growth. I do not discount them entirely but I give them a fairly low [weight] as they are only one of many indicators of what is happening. I would state that we need to keep [an approach] where we can change interest rates when we think it's necessary. I don't want to go back to pinpointing them. I would follow the procedures that we have used in the last year, moving them gradually in response to changes in economic developments.

Given that background, I come down for alternative II. I think that we want to continue the recovery. We need to figure out as we move into the year what the appropriate rates are to do that without choking it off. And this seems to me to give us a lot of flexibility. Also, I would adopt the attitude that if it goes wrong, I'm willing to change the ranges. I just don't think the ranges are all that important that they should restrict us as a corset would to some dictate of policy.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, initially I was inclined to support giving more weight to M1 as a nod to the tendency of its velocity to move toward normality. But I was talked out of it pretty much by Steve and by Lyle. Steve reminded me, although he shouldn't have had to do that, that if interest rates turn out to be significantly different from the outlook for them at the moment, we really don't know what will happen to the NOWs and Super NOWs. Therefore, the behavior of M1 and its velocity are much more unreliable than I think we should accept. Given the need to keep the aggregates within our stated ranges, I would not want to give more weight to M1 in the sense of putting it on an equal plane with M2 and M3. I think we should wait a little longer and have more observations or indications of how it's really going to behave before we rehabilitate it and give it equal weight. So, I would keep M1 as a monitoring variable and monitor its performance rather than rehabilitate it as a target.

I also would support alternative II for the reasons that we established those ranges initially. Alternative II does allow for some reduction in the target ranges in the direction of price stability. Also, it seems to me that alternative II provides the best chance of maintaining market conditions pretty much as they are now. Alternatives I and III would risk significant changes in interest rates and I would not like to see that happen over the foreseeable future. I think the best chance for maintaining the recovery and a steady expansion is to maintain steady money market conditions at the present time. I would, however, reduce the range for M2 from the 6-1/2 to 9-1/2 percent [shown under alternative II] to 6 to 9 percent, mainly because it would represent an effective 1/2 point reduction, which it does not now. And that would make it more consistent with the reductions in the ranges of the other aggregates.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. It seems to me that one message that comes rather clearly from our discussion is that we have the usual difficulties of forecasting, projecting, and tracking what are in some cases new relationships between and among variables here and that we have an even wider range of probable outcomes around any kind of forecast assumptions this time than is typical. Add to that the difficulty of looking ahead at the interaction among unknown relationships themselves and we're really in terra incognita here. We really don't know when it comes to the elasticity of some components of M1 what the new market situation will be, given changes in exchange rates and given changes in interest rates. We don't know what sort of impact the money fund competitors and the thrift institution competitors will have. That compounds to me the uncertainties of the elasticities. In such a situation, of course, we are subject to the disequilibrium impact of shocks. The Argentines haven't come to the table yet; the Brazilians can come back with demands for concessions; and some kind of disturbance could arise from international credits having to be written down over some period of time. Translate that into what might be required in terms of domestic lending from write-downs of that sort. I only mention this to indicate that we need the flexibility that the Volcker standard would give us. Therefore, I argue for utilizing the bit of additional knowledge we seem to have with regard to velocities in the Humphrey-Hawkins testimony on a verbal basis rather than restoring M1 to the pantheon. I don't believe the markets have ever given up M1. As far as the markets are concerned, I think they project M1 into our targeting. I'm not sure there has ever been very much of a belief in our monitoring it. If we put it back on Olympus, the market will say that is the Federal Reserve's target; the Federal Reserve has no others.

VICE CHAIRMAN SOLOMON. If it's put on a co-equal basis, it will become primary.

MR. MARTIN. If it's co-equal, I think they will read that as primary, Tony. I would stress it a bit more in testimony and in other presentations to the public and that will in effect make it co-equal. I think one must be extremely careful with regard to the handling of M1 for another reason and that is that we are as an organization, after all, a creature of Congress. The Congressional consideration of the monetary aggregates has been one of a heightened degree of skepticism. Therefore, if we aren't sure, why should we subject ourselves to the possible pressure to go to some other kind of perhaps unreachable target such as the unemployment rate? With regard to the alternatives, I would join the majority here with regard to alternative II. I'd leave [the M1 range at] 4 to 8 percent, where it is. My druthers would be to raise it to 4 to 9 percent, but 4 to 8 percent is a signal to the world that we are still aiming toward longer-range disinflation, whereas 4 to 9 percent might give a different signal. I would leave [the M2 range at] 6-1/2 to 9-1/2 percent, right where it is, for reasons of the Volcker standard. I'd like to have all the flexibility we can get there, particularly when we still have a good many unknowns. As I mentioned before, it is the possibility of shocks and unknowns that troubles me about changing that. So, I vote for alternative II as is.

CHAIRMAN VOLCKER. [Unintelligible] 17 good men and 2 [good] women. Mr. Keehn.

MR. KEEHN. Well, if there's any word that's consistent in all of our comments it is the word "flexibility." I concur that we are at a point where we need a maximum amount of flexibility and that we ought to preserve our options as long as we can. I might do it a bit differently: I would raise M1 from a monitoring status, and I would rather deemphasize M2 and M3.

CHAIRMAN VOLCKER. Make them all monitoring ranges? Where is Mr. Morris?

MR. KEEHN. That is a way of saying that I would prefer the [Bluebook] alternative for the directive that accomplishes that but with softer language. We can change the words to shift the emphasis in a way that I would suggest. It just seems to me that if we're working with three [variables] we have more options and more flexibility than if we're working with two. But having said that, I think we certainly are in a period and will continue to be in a period where we're going to want to look through all of this to the underlying economy and to use the flexibility that I hope we will be able to accomplish by choosing this particular alternative. With regard to the specifics, I'd be in favor of alternative II. I'd prefer the broader range, the 4 to 8 percent range, [for M1]. Again, I think it's consistent with a higher level of flexibility. The 6-1/2 to 9-1/2 percent range for M2 is reasonable, but I would be in favor of using M1 to a higher degree than we have, and I'd be in favor of alternative II.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, a while ago Chuck said that he thought he agreed with Henry and Lyle; I might go even further and say that I think I agree with parts of what even more people than that have said. I started off this morning thinking the staff was pretty nearly right on real GNP and the unemployment rate, but then I joined Lyle and his cohorts when I concluded that inflation probably will be building over the 1984 period as a result of the usual cost/price pressures we get in an upswing and also as a result of the delayed impact of the large growth in the money supply that we had earlier. That gets to the question--if indeed that's right about what is going to happen--as to the best way to finance that. I think we have to be concerned about the risk that Ted Roberts outlined--that we might in fact have slowed the aggregates down too fast. But I don't believe we've captured all the seasonal factors in that yet, Ted. I think money market mutual funds and MMDAs were used to take care of Christmas payments instead of demand deposits, and since the buildup of demand deposits that we ordinarily had before Christmas didn't happen we took it out [in the seasonally adjusted numbers]. I think we probably will find out later that that was still understated, despite the upward revisions.

Also, I think we ought to be concerned about what Lyle said about inflationary pressures and the economy looking pretty strong. I think both possibilities are risks for us. So, I would go with alternative I, which I think is broad enough to take care of both of those risks. I like the idea of restoring this balanced proviso in the directive. Since we're not sure which way the aggregates will behave, we ought to be prepared to act if they go one way just as we should be prepared to act if they go another way. And I like Arabic alternative 2 [in the Bluebook] for the long-run portion of the directive, which would restore more emphasis on M1.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I would also put more emphasis on M1, particularly if it were used as Governor Wallich described how he would do that. All of the uncertainties that we have in both the foreign and the domestic situations lead me to fall back on at least what I feel fairly certain about, and that's what the long-run objective should be: price stability. In looking at the various alternatives, alternative I as prescribed in the Bluebook is at least to me more consistent with that than the other two. And I find the rationale used in the Bluebook for explaining alternative I very appealing. From the standpoint of flexibility and judgment, I strongly favor that. I'd favor it even more if it were solely mine! But given the fact that it isn't, it does seem to me that history shows that this Committee has exercised flexibility and judgment as circumstances dictate, so I don't have a great deal of concern that we wouldn't. So, in this uncertain world let's stay with what we've said our primary objective is and that is price stability over time. And if things don't work out under alternative I, we'll do something else.

VICE CHAIRMAN SOLOMON. When you say we exercised judgment, are you referring to good judgment or bad judgment?

MR. BOYKIN. I think it has been pretty darn good.

CHAIRMAN VOLCKER. I'm not sure we have ever said clearly as a Committee that our objective is price stability.

MR. BOYKIN. No.

MR. BLACK. We split evenly on that and you didn't vote, Mr. Chairman.

MR. BOYKIN. What I was saying is that as far as I'm concerned it is the objective.

MR. PARTEE. We don't want to clash with Humphrey-Hawkins on this.

MR. WALLICH. Well, I think we can say that price stability is becoming the orphan of this expansion. We're having a lovely expansion if nothing sensational happens to the dollar. But inflation continues to mount. And the suspicions around this table are that it is going to go up more than projected. That is why I think we ought to lean a little on the side of price stability, recognizing that we're not going to get there, of course.

CHAIRMAN VOLCKER. I don't mind leaning on the side of price stability but I raise my eyebrows a little at your earlier statement when inflation has done better than we projected.

MR. WALLICH. Well, I mean from here on out.

CHAIRMAN VOLCKER. It's a projection. Do you want to add anything to your earlier comments, Mr. Morris?

MR. MORRIS. I thought they were quite comprehensive!

CHAIRMAN VOLCKER. In their way they were, but a little confused--

MS. TEETERS. If you had to pick an alternative, which would it be, Frank?

MR. GRAMLEY. None of the above!

MR. MORRIS. When we talk about the objective of the Committee to move toward price stability, I think the concept of how we do that is important. It seems to me that our objective in this phase of the economic expansion should be to keep the inflation rate from going up above the 4 to 5 percent range, not to try to decelerate the inflation during an economic expansion because I just don't think that's a reasonable objective. But if we can keep it within a 4 to 5 percent range during this expansion, when we come out of the next recession it ought to be in the 2 to 3 percent range. I think that's how we're going to get inflation down. We're deluding ourselves if we think that we can so manage monetary policy that we can have both an expanding economy and a decelerating inflation rate. I don't think in history, at least in the American economic history with which I'm familiar, that that has ever happened.

CHAIRMAN VOLCKER. 1920.

VICE CHAIRMAN SOLOMON. Farm prices in the late '20s.

MR. MORRIS. Farm prices, but not--

CHAIRMAN VOLCKER. OPEC is going to have to play that role for us. Well, we have a variety of comments. I haven't noticed anybody coming out for alternative III, so that narrows the options. I think we ought to return in the morning and see whether we can dispose of this after mulling on these comments. We are scheduled to reconvene at 9:00 in the morning?

MR. BERNARD. 9:00 a.m.

[Meeting recessed]

January 31, 1984--Morning Session
(Executive Session)

CHAIRMAN VOLCKER. I tried to draft a somewhat different directive, which is being typed. I would judge that the consensus, when we get down to the language, is to give a little more weight to M1 but not full weight. I think everybody is groping for some combination of flexibility and discipline. Those two things are hard to combine. We can combine them in an individual's mind, but it's a little harder to combine them in a directive. But that seems to be the recurrent theme I heard yesterday.

MR. RICE. Everybody is for flexibility.

CHAIRMAN VOLCKER. And everybody is for discipline.

MR. WALLICH. If you get very flexible, somebody will come and push you.

MR. MARTIN. Not if you have a chance.

MR. BLACK. Not if you have flexible discipline. They can't push you but so far.

CHAIRMAN VOLCKER. In terms of numbers, there clearly is a lot of support for just staying about where we were tentatively [in July]. If we wanted to make a little gesture, which is all we are talking about in any of these minor deviations that most people are suggesting, nobody suggested anything more liberal than alternative II but some people said generally they would like one way or another to be a little tighter for either M1 or [M2]. There was not any great consensus for either one of those, but if you added together all the people who thought there should be a little reduction in one or the other, there was some sentiment [in that direction]. In my mind it comes down to taking alternative II to start with. Do we want to reduce the range for either M1 or M2 slightly? It might be going too far, judging from what people said, to reduce both of them. I guess we're talking about a 1/2 point reduction for either of them. There is an argument to reduce M2 if you believe in all the technical analysis.

VICE CHAIRMAN SOLOMON. Psychologically, it makes more sense if we're going to cut 1/2 point to do it on M2 and not M1. First of all, M2 still would be getting greater emphasis than M1 even if we [reinstate some] emphasis on M1. Secondly, if we start using ranges like 4 to 7-1/2 percent, that implies a precision that is [unwarranted for] M1. If we do want to make a tightening gesture, it seems to me that the logic is for making it on M2.

MR. MARTIN. I would certainly support that. After all, we are talking about 4 to 8 percent [for M1 for 1984] versus 5 to 9 percent [for 1983]. Though it might be considered a gesture, we've already made a full percentage point [reduction], which may be a gesture and a half, versus 1/2 point in the [M2 range to] 6-1/2 to 9-1/2 percent.

MR. WALLICH. Well, I'd like you to look at chart 3 [in the Bluebook]. It doesn't say so, but in retrospect it was not a happy move, I think, from the earlier 4 to 8 percent range to the 5 to 9 percent. It proved unnecessary. We're in either range now, and--

CHAIRMAN VOLCKER. What do you mean that we're in either range?

MR. WALLICH. I'm looking at the M1 chart. If you draw a 4 to 8 percent range in there--

CHAIRMAN VOLCKER. For the last year?

MR. BLACK. For the last half of last year; I think it's in chart 3.

MR. WALLICH. [M1] is in there.

CHAIRMAN VOLCKER. I don't know what you mean. That 4 to 8 percent was a tentative range we put down [last July].

MR. PARTEE. He's taking it all the way back.

MR. WALLICH. Well, it's also where we came from. We had 4 to 8 percent--

CHAIRMAN VOLCKER. But we never would have been within that 4 to 8 percent range last year, if that's what you mean.

MR. BLACK. I think he meant just for the last half of the year.

CHAIRMAN VOLCKER. The 4 to 8 percent was for the whole year last year and we were way above it.

MS. HORN. Rebased 4 to 8.

MR. BLACK. A rebased 4 to 8 percent is what he's talking about instead of rebasing to 5 to 9 percent, I believe, Mr. Chairman.

MR. WALLICH. We rebased at that time and I took the same base here. But I don't know that it would come out differently if we went back to the fourth quarter of 1982.

MS. TEETERS. If you go back to the fourth quarter, M1 growth was 10 percent.

MR. WALLICH. Yes, well, that's right.

MS. TEETERS. I have a preference for whole numbers. If we just knock off the halves on the M2 range, it looks like we're not being quite so precise. That's much better than saying we're going to get to a half point--

CHAIRMAN VOLCKER. One has to concede it's a round number.

MR. BLACK. It looks as if it's a mysterious act or something.

MR. RICE. Well, I would prefer to see [any reduction] come out of M2 than M1.

MR. ROBERTS. I'd like to see us tighten the range to something like 4 to 7 percent in consideration of the inauguration of CRR. But I could live with 4 to 8 percent because I think a target of 6 percent is in the right direction, and that's in the middle of that [latter range].

CHAIRMAN VOLCKER. Well, do we have somewhat of a consensus to have the ranges at 4 to 8 percent, 6 to 9 percent, 6 to 9 percent, and I guess 8 to 11 percent [for debt]? I might point out that it bothers me analytically, but I don't know what to do about it, that credit has been growing faster than the GNP in recent years and we just say that's fine and we will continue to have ranges that permit it to grow faster than the GNP. I don't know what the significance of all that is, but I just note it.

MR. WALLICH. It violates Ben Friedman's law.

SPEAKER(?). Yes, but if you compete--

MR. MORRIS. That's only if you're looking upon it as a possible range. If you're looking upon the debt target as the midpoint--

VICE CHAIRMAN SOLOMON. It's a weak credit [measure except] for mergers and acquisitions.

CHAIRMAN VOLCKER. Well, perhaps it would come close to the midpoint, but the staff projections show that its growth will go up. They may be right or wrong. They over-estimated last year, but the current projection--

MR. MORRIS. Well, the debt range could be cut because I think 11 percent is too much.

CHAIRMAN VOLCKER. Well, that's what I say. But the staff has a projection of 10-1/2 percent, if I recall correctly, and that [11 percent] is not much above what they have.

VICE CHAIRMAN SOLOMON. I wasn't being entirely facetious. Just in this proposed Texaco takeover of Getty there was $8 billion of bank credit.

CHAIRMAN VOLCKER. It's all the repayment of equity, which doesn't appear in the debt figures.

MR. MARTIN. Well, some of that financing is paid back [unintelligible]; if it replaces equity, obviously it isn't.

CHAIRMAN VOLCKER. What did debt actually increase by in '83?

MR. AXILROD. Debt was up 10-1/2 percent last year.

CHAIRMAN VOLCKER. What was the nominal GNP?

SPEAKER(?). 10.4 percent.

MR. KICHLINE. 10-1/2 percent.

MR. AXILROD. They both increased exactly the same.

CHAIRMAN VOLCKER. Well, last year we anticipated--I remember this discussion--that debt would increase faster than GNP. It did not. We also are anticipating that it will increase faster than GNP this year, rightly or wrongly.

MR. MORRIS. The normal relationship is that it should increase about 1 percent faster than GNP in the second year of expansion.

CHAIRMAN VOLCKER. Well, if we lower it, we violate the round number.

MR. GRAMLEY. I don't think we gain anything by lowering it. Nobody's expectations are going to be markedly altered if we leave it where it is or lower it. So why not just leave it?

MR. MORRIS. The virtue of leaving it is that we would have something to reduce in the future.

CHAIRMAN VOLCKER. Well, does 4 to 8 percent, 6 to 9 percent, 6 to 9 percent, and 8 to 11 percent capture where we want to be? This may or may not be reflected in what we say in the language, but we are thinking very roughly of M1 somewhere around the middle [of its range]. I say all this with a question mark. What the staff assumes for M2 and M3 is 8 percent and I think their projection for credit is about 10 percent or so.

MR. PARTEE. I think we're rather tight on M2, so we will go over on that one.

CHAIRMAN VOLCKER. Well, let me state it this way. In thinking of testimony I don't want to say we expect to be at the top but if asked why the range wasn't higher I'd say we expect probably to be in the upper half of the range.

MR. PARTEE. Yes, for sure.

CHAIRMAN VOLCKER. Someplace between 7-1/2 to 9 percent is what we expect for M2 and M3 and very tentatively around the middle of the range for M1, but subject to its own [unintelligible]. Well, we have to wait until we get some text to look at. Let me see where the typing stands on the text and have it run through a Xerox machine.

MR. MARTIN. On page [15 of the Bluebook], in paragraph (b), is it appropriate to use language that might put a little more weight on M1 at this stage, Mr. Chairman, or would you rather--?

CHAIRMAN VOLCKER. I just want to defer that.

MR. MARTIN. Until we get the full text?

CHAIRMAN VOLCKER. I don't know that there's anything much the matter with trying to make it a little fuzzier, frankly, as to precisely what weight [we are placing on M1]. It's clearly more; we wouldn't talk about a monitoring range but would express some uncertainty about it.

MR. PARTEE. I'd like to take Frank's suggestion and monitor all three.

MR. MORRIS. That would be a step in the right direction.

MR. RICE. [Unintelligible] the movement of the velocity.

CHAIRMAN VOLCKER. Well, let's see whether we have something we can work from. How are we doing?

MR. BERNARD. Not a lot.

CHAIRMAN VOLCKER. Why?

MR. BERNARD. They are having some problems finding a Xerox machine. Here's the original.

CHAIRMAN VOLCKER. This isn't what I'm talking about at all. I'm talking about the directive that Catherine was typing. Trouble finding a Xerox machine?

MR. MARTIN. There's one right across the hall.

MR. PARTEE. She was typing something. The Xerox machine has been--

MR. GRAMLEY. We have a special Xerox machine in [this corridor] that only the Board Members' secretaries can get to.

MR. MARTIN. It's the building of all word processors, and now we can't--

VICE CHAIRMAN SOLOMON. While we are waiting, is there any way of making the phrase [about international transactions] in the opening sentence somewhat less silly?

CHAIRMAN VOLCKER. I gazed at it and had no conclusion, so I left it. We are always trying.

MR. PARTEE. Certainly [unintelligible].

VICE CHAIRMAN SOLOMON. I'm sure of it. "Any less sustainable"--

MR. PARTEE. "Move back toward a more sustainable"?

MS. TEETERS. Or maybe "improve."

MR. MARTIN. "Avoid a catastrophe."

CHAIRMAN VOLCKER. It would be nice to change that sentence if anybody has a [suggestion].

MR. PARTEE. That was put in several years ago, Tony, and we've never been able to change it since then.

CHAIRMAN VOLCKER. I wasn't able to rewrite the sentence that was given so I just left it. But the assumption is that it's there and it would be--

VICE CHAIRMAN SOLOMON. "Minimize the damage on the international...." No, I mean it; that's what we're trying to do.

MR. ROBERTS. "Accomplish the roll-over of existing debt."

MR. PARTEE. Well, to the extent necessary--

CHAIRMAN VOLCKER. Can you think of a different phrase? I couldn't think of one last night.

MS. TEETERS. Well, we can say "to improve international debt."

MR. WALLICH. That says specifically once the dollar is down--

MS. TEETERS. Well, we often do.

SPEAKER(?). It's not bad at these levels.

CHAIRMAN VOLCKER. It says we're going to do all things.

MR. BOEHNE. How about "and contribute to achieving a sustainable"?

MR. PARTEE. "And contribute to a more sustainable"?

MR. MARTIN. That implies it's sustainable.

MR. PARTEE. Yes, but it implies it now, just barely.

CHAIRMAN VOLCKER. Contribute to an improved pattern? I don't know how we do that.

MR. PARTEE. No, I don't either.

MS. TEETERS. Do you propose just to leave that whole sentence out?

CHAIRMAN VOLCKER. No, I just didn't repeat it here.

MR. WALLICH. But I think "improved" would be a good change.

CHAIRMAN VOLCKER. Why don't we put in "an improved pattern." I just assumed that that sentence would [stand], but that sounds a little less--. At least it recognizes that it isn't very good now.

VICE CHAIRMAN SOLOMON. It's going to get worse.

CHAIRMAN VOLCKER. This [draft that you now have before you] is designed to follow that first sentence. For the ranges we would say 6 to 9 percent, 6 to 9 percent, and 4 to 8 percent. It's only the first two paragraphs. In this second part, I just went on and added the short-run language, which we'll get to later.

MR. KEEHN. What if we left off the phrase after the comma "aggregates, which for the time being would continue to receive more substantial weight"? Doesn't the first part of that sentence give us the flexibility we need?

VICE CHAIRMAN SOLOMON. I would make the opposite suggestion: Delete "for the time being."

MR. ROBERTS. I think Si has a good point.

MR. PARTEE. Well, I would go with Si's suggestion, too, but I think we're quite split on this question. Did you count half [unintelligible]?

CHAIRMAN VOLCKER. Well, another way is to take out the word "more." But I would not protest taking out that whole phrase.

MR. PARTEE. I think the first phrase does capture it.

SPEAKER(?). That's a good sentence.

VICE CHAIRMAN SOLOMON. Well, I guess we're pretty evenly split, but for those of us who would like M1 to be kept as a monitoring range rather than a target, this makes it a target with caveats and it seems to me that that phrase is important. But the markets tend to overreact--we all know that--in terms of the importance it attaches to M1. It's in that context that we have to look at how our language will be received.

CHAIRMAN VOLCKER. Now, just to point out: Technically, it is true that if M1 were in the bottom part of that range--at the midpoint or below--and the economic forecast is correct, velocity growth would not be less than in past periods of expansion. It is [M1 growth in] the upper part of the range that would make [velocity grow] less than in the past.

MR. MARTIN. It would be more, would it not? It would be something around the neighborhood of 4 to 5 percent.

CHAIRMAN VOLCKER. Well, I don't know what the average is of past expansions--3 to 4 percent, I guess.

MR. AXILROD. It has been between 2-1/2--

MS. TEETERS. If we get 9 percent nominal GNP, that puts the rate at 2-1/2 percent.

MR. MARTIN. Yes, but not for the first quarter; we start out higher than that. What's our first-quarter nominal [GNP estimate]?

MR. PARTEE. 10 percent.

MR. ROBERTS. It's 10 percent, so it's about 3 percent velocity in the first quarter.

MR. MARTIN. With 10 percent in the first quarter, you could get 5 and 5.

MR. ROBERTS. [Unintelligible] 7 percent money growth for the first quarter.

MR. KICHLINE. We have 10 percent on GNP.

MR. MARTIN. But the Chairman's hypothesis was: Suppose money growth is below the 6 percent [midpoint], at 5 or 4 percent.

MR. ROBERTS. I see, yes.

CHAIRMAN VOLCKER. If it's below the 6 percent, I don't think one can say that velocity would be less than it has been historically.

MR. MARTIN. It's probably more.

CHAIRMAN VOLCKER. Well, I'm not sure. It might be more, say, 5 or 4 percent.

MR. MARTIN. Well, if the staff is forecasting--

MR. PARTEE. Actually, it seems to me that we are assuming putting normative velocity in the range.

MS. TEETERS. Instead of saying "likely" and really meaning that it might be less, why don't we say it might be different because we don't know where it's going to go?

MR. PARTEE. About 3 percent.

VICE CHAIRMAN SOLOMON. How about unpredictable?

MR. PARTEE. "Its velocity as [well as that] for M2 and M3 would remain unpredictable."

MR. CORRIGAN. That's the problem that I have with this language about velocity. The same argument that we're making about the velocity of M1 could easily be applied to M2 as well. I agree with the need to hedge M1 more, for the same reasons I think Tony is suggesting that. But I think logically we have a little problem here in that the hedge that we're creating could easily be said to apply to M2. As a matter of fact, if interest rates are rising, it might apply more to M2.

MR. BOEHNE. Well, the second paragraph--

CHAIRMAN VOLCKER. The second paragraph hedges it all, I'd say.

VICE CHAIRMAN SOLOMON. Would you rather say something about "in light of the changing composition of M1, its erratic behavior"? That's a little too strong, right?

MR. PARTEE. Volatility.

VICE CHAIRMAN SOLOMON. Use "volatility of M1" rather than talk about velocity.

MR. WALLICH. Well, we might have little velocity growth without volatility. And why should we denigrate a good aggregate?

MS. TEETERS. Why don't we say "Its relationship to gross national product may be different than in past periods of expansion." That gets away from the technicalities of velocity; it says what we're really talking about.

MR. CORRIGAN. But we still have the problem that it applies to M2.

MS. TEETERS. I know, but if we just say "different" it is not leaving us open to whether it is going to be less or greater.

MR. GRAMLEY. To some degree, however, the problems with M1 tend to get cancelled out in M2. That is, the staff argues that if interest rates go up, because of the higher interest elasticity demand for M1 now we might get a sharp slowdown of M1. That would not apply to M2 because the nontransaction components will probably continue to grow. So, there would be a less marked movement.

MR. CORRIGAN. There's a wild card in that, though, Lyle, as to how banks would respond.

MR. GRAMLEY. True.

MR. CORRIGAN. My hunch is that in [an environment of] climbing and rising interest rates banks are going to price Super NOWs and MMDAs very, very aggressively. And if they do that, heck, we could have a positive interest elasticity of M2.

VICE CHAIRMAN SOLOMON. What happens to interest elasticity, Steve, if the Congress removes the prohibition of paying interest on demand deposits?

CHAIRMAN VOLCKER. We are assuming that that's not going to happen, and I think we ought to say that. You have now brought it up, and we ought to put in the policy record that this is all based upon an assumption that that's not going to happen during the course of this year.

MR. PARTEE. That will certainly change things.

MR. AXILROD. When that happens, we believe after some time that it would reduce the interest elasticity of M1 with respect to market rates.

MR. GRAMLEY. I have a little problem with the sentence about "taking account of emerging evidence that in the light of the changed composition of M1 its velocity growth over time...." I think we believe that on the basis of theoretical considerations. That is, we think the more elements that bear interest in M1, the higher the income elasticity of demand will be and the less tendency there will be--the more we have Super NOW accounts--for M1 velocity not to slow down as interest rates rise. But that's primarily a theoretical proposition. We really don't have much evidence of that yet.

CHAIRMAN VOLCKER. We can make it a little more neutral by saying "taking account of the possibility that in the light of the changed composition of M1, its relationship to growth in GNP over time might be shifting."

MR. GRAMLEY. Yes, that's better.

CHAIRMAN VOLCKER. We can only shift it in one direction, I'm sorry--

MR. GRAMLEY. Do you want to read that again--the possibility part?

CHAIRMAN VOLCKER. "The possibility that in the light of the changed composition of M1 its relationship to growth in GNP over time might be shifting."

SPEAKER(?). That's good.

CHAIRMAN VOLCKER. We're putting in the nonfinancial debt range here, by the way, of about 8 to 11 percent. Well, the remaining question is: What we do with that part after the comma? Three alternatives: leave it, drop it, or take out the word "more."

MR. MARTIN. In terms of this discussion, I think the wording that you have there is perfectly appropriate. If you recall the amount of time we've spent on M1 and its velocity, its future configuration, and its components, that expresses the sense of the group.

MR. GRAMLEY. A question may arise as to what a reader would interpret "more substantial weight" to mean--more substantial weight than M1 or more substantial weight than they had previously. One could get around that problem, if it is a real one, by simply putting principal weight instead of more substantial weight.

MR. MORRIS. Well, it says "continue to receive," which implies the same weight as in the past.

MR. GRAMLEY. Perhaps there's not a problem.

VICE CHAIRMAN SOLOMON. I don't think there's too much danger, Lyle, for misinterpretation of that.

MR. GRAMLEY. Maybe not.

MR. PARTEE. I think maybe the word "more" should be taken out.

MR. BLACK. It's more weight than what?

MR. GRAMLEY. The "more" is the problem.

MR. PARTEE. Substantial weight.

CHAIRMAN VOLCKER. All right.

MR. KEEHN. By showing M1 below M2 and M3 and by having a sentence in there which deals with the uncertainty of its velocity, it seems to me we are setting the reader up for what is the [unintelligible] fact if we drop the whole phrase. The additional phrase is not necessary.

MR. BOEHNE. That would make sense if we added "in the light of the growth in the other monetary aggregates and economic conditions" or something like that. Then we could have a period.

MR. PARTEE. Well, that's true. In that case, then, in the next paragraph I guess we'd have to drop--

MR. BOEHNE. Oh, I see.

MR. PARTEE. We've already captured part of the next paragraph in the phrase that Paul put in there about interpreting M1. But I think that would be a sensible way of doing it.

MR. KEEHN. Not incidentally, in the third paragraph when we're dealing with the short-term ranges we use M1, M2, and M3 in that order.

MR. PARTEE. M2 and M3 and M1.

MR. KEEHN. M1, M2, and M3.

MR. BLACK. I wish you hadn't brought that up, Si; they may want to change that now!

MR. PARTEE. Yes, I think they will.

MR. BLACK. Change [unintelligible] in there.

CHAIRMAN VOLCKER. And leave out the last few words at the end of the paragraph "as tentatively agreed" and go down on all the others.

MS. HORN. 10 to [unintelligible]?

MR. MORRIS. In the reference to growth in debt, rather than "financial debt" don't you mean "nonfinancial debt"?

CHAIRMAN VOLCKER. Where?

MR. MORRIS. In the last paragraph it says "Growth in financial debt is expected to be within the range established for the year."

CHAIRMAN VOLCKER. Yes, "growth in nonfinancial debt." I'm inclined just to take out the word "more." These things are all very narrow.

MR. GUFFEY. Well, that's just suggesting that if M1 returns to some historical relationship, we would not place as much weight on M2 and M3.

CHAIRMAN VOLCKER. Relatively, yes. It says "for the time being."

MR. GUFFEY. I would prefer to leave "more" in.

VICE CHAIRMAN SOLOMON. Second.

MR. ROBERTS. Take it out.

MR. WALLICH. More than M1 or more than in the past?

MR. PARTEE. That's not clear.

MR. AXILROD. It's lost in here, Mr. Chairman. The language the Committee had adopted before didn't have the word in. It said "In implementing policy, the Committee agreed that substantial weight would continue to be placed on the broader aggregates."

MR. GUFFEY. That's when M1 was described as being only a monitoring range.

CHAIRMAN VOLCKER. You know, we are not going to get it perfect. We cite the other two ranges first--period. Then we say we have a range for M1 and we have to interpret that in the light of these other things, which receive substantial weight. It seems to me that fairly well captures what we're talking about.

VICE CHAIRMAN SOLOMON. What about "principal weight"? Is that any better? It says it more succinctly.

CHAIRMAN VOLCKER. I think it's putting "more" back in.

VICE CHAIRMAN SOLOMON. Right. It's putting it in but in a different way. But we do say "for the time being."

CHAIRMAN VOLCKER. Well, it says "for the time being." It clearly leaves open the possibility that our next step might be--

MR. PARTEE. It says M1 would receive more substantial weight.

CHAIRMAN VOLCKER. That's right. I think the reading of this has to be that we're more tentative about M1 than we are about the other ranges.

VICE CHAIRMAN SOLOMON. Sure, it's hedged all over.

CHAIRMAN VOLCKER. I think that is the way it is whether or not the "more" is in there.

MR. GRAMLEY. If we understand what we're doing, whether that word "more" is in there or not isn't going to make a lot of difference. If we agree that what we're doing is putting principal weight on M2 and M3 and that we will continue basically as we have in the past with a bit more weight to M1, I don't think the inclusion or exclusion of the word "more" is going to rock markets.

CHAIRMAN VOLCKER. I think not. I am sure it's not going to rock markets. But let me restate that what I think we're saying is that we moved M1 out of a purely monitoring status but we are more tentative about it than we are the other ones. We'd be more prepared to change that range if evidence showed it [should be changed]. Or if these other things were in line and M1 were moving peculiarly, we would in that sense put less weight on it. But it has more [weight] than it did before.

MR. MARTIN. That's just what it says.

MR. GRAMLEY. In this phrase about interpreting M1 in the light of growth in the other [aggregates] do we want to say "monetary and credit aggregates"?

CHAIRMAN VOLCKER. I think not. I would argue that the credit aggregate is there but it doesn't have the weight the others have. It has less weight than M1, I guess.

MR. GRAMLEY. The reason I raise this is because in the next paragraph we talk about continuing appraisal of the relationships among the various measures of money and credit.

CHAIRMAN VOLCKER. Right. This next paragraph is general and refers to them all. But the hierarchy here as I see it is still M2 and M3 together, M1 coming up, but with some uncertainty and--

MR. GRAMLEY. With the jockey holding them in!

CHAIRMAN VOLCKER. That's right. And the credit range is an associated range rather than a [principal one]. If no one has any further brilliant suggestions, we're talking basically about the first two paragraphs of this [draft]. But I just anticipated here when I wrote this up that, in contrast to last month's approach which was unbalanced on the restraining side, we would lean a bit to the easing side--that we would be quicker to ease than to tighten.

MR. PARTEE. I thought it was pretty evenhanded. What do you mean? Did you do that by putting in "somewhat greater restraint"?

CHAIRMAN VOLCKER. No. One says we only have somewhat greater restraint if both the aggregates and business expansion were strong. The other says we would ease if the aggregates were weak. I think it is fairly evenhanded, but we don't have to debate that now. Just look at the first two paragraphs. Are we ready to vote?

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Guffey	Yes
President Keehn	Yes
Governor Martin	Yes
President Morris	No
Governor Partee	Yes
Governor Rice	Yes
President Roberts	Yes
Governor Teeters	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. We can have the other [staff] people come in. I don't know what we'll do in the future, but we have a little lapse before announcing [this decision on the long-run ranges] and I think people can know this on a need-to-know basis. I am going to be testifying and we probably will release it either Sunday or Monday.

MR. BOEHNE. You're testifying on Monday?

MS. TEETERS. Tuesday.

CHAIRMAN VOLCKER. No, I am testifying on Tuesday, but we will send the material up by Monday. We'll send it up late on Monday and that's probably the latest we will release it in order to avoid--

MR. PARTEE. We'll release it before you actually present it?

CHAIRMAN VOLCKER. Just a thought: I might do it on Sunday and everybody would get it together on the weekend.

MS. TEETERS. That's a considerable change in the [Congressional] committee's procedures; usually they want to have it released at the time that the committee meeting is held.

CHAIRMAN VOLCKER. Well, I got a letter from Mr. St Germain yesterday, an irritating letter, saying "I direct you to release it immediately." I sent him back a letter telling him it's not his decision to direct us [unintelligible] release. And the Senate committee isn't very happy about--

MR. PARTEE. Which is first this time, Senate or House?

MS. TEETERS. House. It's the Senate's turn but I think it's the House first.

MR. BALLES. Paul, I'd like to suggest that in order to avoid the kind of problems we had last July--or at least as far as my Bank is concerned, I'd just as soon not have a copy of the directive that is sent to New York. In fact, I've already told my economic adviser I do not expect to notify him of what went on here in this meeting today. And I think the rest of you might abide [by that] and do the same thing. If we just kept the directive--

CHAIRMAN VOLCKER. I think that's fair unless somebody has a need to know, and I don't think anybody does except presumably the people in New York who are already here. This is just an excess of caution, but it gives us a defense if something happens between now and--

VICE CHAIRMAN SOLOMON. Because this time if there's a leak, it's squarely going to be on us.

CHAIRMAN VOLCKER. That is correct.

MR. BOEHNE. I might add to what John Balles said: I wouldn't want to see a copy of the testimony even 15 minutes before it's released to the public.

CHAIRMAN VOLCKER. Agreed. Okay.

SPEAKER(?). [Unintelligible] time?

MR. BOEHNE. Well, I say 20 minutes before. But I'd rather see it 20 minutes after.

MR. PARTEE. Do you mean that you wouldn't send the wire there?

CHAIRMAN VOLCKER. Well, we can send it to New York.

MR. PARTEE. It's a procedural requirements thing.

MR. CORRIGAN. Well, I don't know what the procedural requirements are.

MR. BALLES. What really blew it last time was the fact that the copy of the directive that went to New York was sent to all Reserve Banks. And then all sorts of people, including clerks and secretaries, handled it.

MR. GRAMLEY. That opens it up.

MR. BALLES. And when the GAO came around, we had to have all those people interviewed. I strongly [recommend] that the directive not be sent until after you testify.

CHAIRMAN VOLCKER. Well, I think the only question is New York.

MR. BALLES. Well, the [New York staff who need to know] are sitting here. They know what the directive is. It's up to them, of course, whether they need it in writing.

CHAIRMAN VOLCKER. We'll make an arrangement that's basically in accord with what you're saying.

VICE CHAIRMAN SOLOMON. Yes, but we're overlooking the main point, which is that everybody at this table has heard the decision. And you can count--

CHAIRMAN VOLCKER. We're not overlooking that.

MR. GRAMLEY. You are supposed to forget, Tony!

VICE CHAIRMAN SOLOMON. The question of whether they come to New York or not is only one aspect of it. I don't want everybody to assume that because it comes to the New York Reserve Bank [that any leak is from] the House committee or New York.

CHAIRMAN VOLCKER. I think we can proceed to the short run. Mr. Axilrod.

MR. AXILROD. Well, Mr. Chairman, I really have very little to add to the discussion in the Bluebook. Alternative B essentially continues the path that was adopted at the last meeting of the Committee, which had 8 percent growth in M2 and M3 from November to March and 6 percent growth in M1. [We have projected a very strong] M1 increase in January, which is still subject to doubt because we don't have the figures for the last week of January yet and we are assuming that that is a very high figure. If that is a high figure, then we would expect M1 growth in January to be quite strong and to help sustain growth over the four months at the rate suggested there--around 6-3/4 percent. So, we would have suggested that a somewhat higher growth than 6 percent would be consistent with the 8 percent [growth in M2 and M3]. However, I think there's enough doubt about that to suggest that there is no particularly strong technical need to change the Committee's specifications from the 6 percent that is now in there for alternative C.

CHAIRMAN VOLCKER. What did we have last time: 8 percent, 8 percent, and 6 percent?

MR. AXILROD. [Yes.] But I don't think there's any strong technical need to change that 6 percent even though [6-3/4 percent] is our best estimate, based on an uncertain January. The other two alternatives, Mr. Chairman, are simply: alternative A, which is for more rapid growth in the aggregates; and alternative C, which is for less rapid growth in the aggregates. We believe that alternative B, continuing on the same path, would be about consistent with the same constellation of restraint on reserve conditions. But, of course, there is some uncertainty given the introduction of CRR and what that might mean specifically. In particular, there is the possibility that in a transition period we might place excess reserves even higher than we've had in recent months recognizing, though, that there is a 3 percent carryover in two weeks. So it's not clear that excess reserves would stay higher for very long periods. Our exploration with banks as to how they are situated would suggest that possibility, at least in the transition period.

MR. MARTIN. Steve, did this exploration include exploration of small banks?

MR. AXILROD. Well, they in particular were the ones that said they thought their excess reserves would be higher. The big banks mostly said they would be a little conservative to begin with, but believe they will be close to where they were fairly shortly after CRR is initiated. So, over a sustained period it might be mainly the smaller banks. The borrowing relationships--

CHAIRMAN VOLCKER. I might say I have a little suspicion from what people have said that we're not going to have the weekly money supply figures for a week or two, or at least with long lags. I don't know how prepared you are out there to produce these numbers in a timely fashion.

MR. AXILROD. Our information is that the Reserve Banks are in varying states of preparedness, but we expect everyone to be on the starting line tomorrow or the day after.

MR. CORRIGAN. Yes, but even if the Reserve Banks are prepared, the problems with the commercial banks are a great unknown. There are very, very, conflicting views and opinions. I must say I am a lot more concerned than I think you are or Steve is.

MR. AXILROD. That may very well be, President Corrigan. The reports that we get from the banks indicate that they are as ready as they're ever going to be. And, of course, they have a strong incentive to be able to monitor their deposit flows. There may be problems as there always are in a switch-over in the reporting systems. I would assume that there will be and that we will miss maybe the first Thursday publication or the second and have to delay them a bit. And I would not doubt, Mr. Chairman, that in the first two weeks the money supply figures will be subject to much more revision than normal. But our information is that the banks are reasonably well prepared and the Reserve Banks are reasonably well prepared. I have no doubt, however, that there will be some glitches in the first two or three weeks.

MR. BOEHNE. I wonder if it would be well when the money supply figures are released for the next several weeks to make the point that these are subject to greater revision than normal because of the switch over to CRR.

MS. TEETERS. We've already said that.

MR. BOEHNE. Well, I'd say it again.

CHAIRMAN VOLCKER. Well, it will be part of the release.

MR. AXILROD. Mr. Chairman, the only other technical point I wish to make is that we assumed that alternative B was consistent with continuing a borrowing level of $650 million. There are uncertainties about excess reserves. There probably also are some uncertainties about borrowings because we can't really be sure exactly how banks are going to decide to manage their positions. If they make mistakes, they may be forced into more borrowing than they are otherwise thinking about; or they may have an excess of caution and so much in excess reserves that they're not going to have much borrowing; or the level of excess reserves will show more variation because of the switch-over. But I think a degree of uncertainty can be attached to both excess reserves and borrowing in thinking about reserve positions.

CHAIRMAN VOLCKER. They are not unrelated. [Unintelligible] supplies of reserves. If they borrowed less, the excess reserves would be less; if they borrowed more, the excess reserves would be more.

MR. AXILROD. That is true.

MS. TEETERS. Are you building additional excess reserves into the reserve paths?

MR. AXILROD. We will do so in the first two weeks. But then there's a 3 percent carryover and after that I'm not sure how we will end up. But certainly in the first two weeks we'll put in more excess reserves than normal, not merely because of this but because there is a reserve requirement reduction of $2 billion in the phase-down for member institutions. That in itself ought to add $100 million or so to excess reserves.

MR. ROBERTS. Steve, have you been hearing from the banks about the free ride in both the vault cash and other categories?

MR. AXILROD. Yes, but that's built into the transition.

MR. ROBERTS. I know the larger banks are anticipating [unintelligible] capitalize them.

MR. AXILROD. We have not seen much of an increase in vault cash related to that in the aggregate numbers. We've looked at it, and it doesn't seem that the banks are behaving very differently.

MR. STERNLIGHT. The free ride is over in the vault cash. And in that period I think it was exercised in just a modest degree. I didn't hear very much about the free ride on the deposits side. The fact that there are 10 to 12 days that never get reserved didn't get much attention.

MR. PARTEE. How was there a free ride? I don't understand this at all.

MR. STERNLIGHT. There was a period of a couple of weeks when vault cash in effect counted double. It counted with the normal lag that has been going on--

MR. PARTEE. Now I see.

MR. STERNLIGHT. --but also banks get more on their [vault cash] schedules in the first couple of weeks of February.

MR. PARTEE. So we ought to have more vault cash for two weeks?

CHAIRMAN VOLCKER. For two weeks.

MR. STERNLIGHT. Well, we've paid them to hold more. But they didn't do as large [unintelligible]; they did it to only a minor degree.

MR. BOEHNE. It's nice to know that the entrepreneurial spirit is alive and well in some places!

MR. MORRIS. Apparently, it's too well!

MR. GRAMLEY. May I ask a technical question of another kind? The selection of November to March as the period to focus on is explained essentially by the fact that that is the same period we used at the December meeting. Why does that take precedence over a December-to-March calculation, given the fact that we have fairly solid figures for December?

CHAIRMAN VOLCKER. What is the December-to-March equivalent of what you have here for November to March?

MR. AXILROD. For M1--I have to make a few [calculations]--it's 7.3 percent.

MR. GRAMLEY. For M2 and M3 it's about 7.7 percent.

CHAIRMAN VOLCKER. 7.7 percent.

SPEAKER(?). You're saying that's the same as alternative B?

MR. GRAMLEY. Yes.

VICE CHAIRMAN SOLOMON. That means that if we made it December to March the numbers would probably be around 8 percent [for M2 and M3] and around 7 percent [for M1].

MR. GRAMLEY. I think December to March is 7.7, 7.7, and 7.3 percent.

VICE CHAIRMAN SOLOMON. Right. But rounding them we would probably come up with a 1 point rise in M1 then.

MR. GRAMLEY. I'm not quite sure why you want to round up.

MR. AXILROD. There are two comments I could make, Governor Gramley. One, it was just simpler in presenting the alternatives not to have to present a lot of numbers--the November-to-March numbers and the equivalent December-to-March numbers. That is one minor factor. The other is that the November base happens to be pretty close to the fourth-quarter average. So at 6 percent, M1 is at the midpoint of the 4 to 8 percent range. But that's happenstance to this period.

CHAIRMAN VOLCKER. Well, we have discussed a lot of technicalities. What do you want to do in substance? Do you want to maintain the existing degree of pressure on reserve conditions or don't you? If you do, then that means alternative B.

MR. PARTEE. There's another point, which we began to discuss: We were expecting last time that there would be a strengthening in the aggregates and in the economy, and we were probably right on the edge of tightening up. The question is: Should that stance be more neutral now because, after all, we didn't get that strengthening?

VICE CHAIRMAN SOLOMON. Well, it is more neutral now; we're simply saying "maintain." If I remember correctly, last time we said "at least maintain."

MR. PARTEE. It all dropped off one side of the--

MR. BOEHNE. Right. But it ought to be an evenhanded directive indicating we would tighten or loosen depending on incoming developments. The [previous directive] was asymmetrical.

MS. HORN. I would argue that, although some individual monthly and quarterly numbers have come in perhaps not quite as strong as we expected, Lyle's general point about the risks in the economy next year being non-symmetrical on the strong side for a variety of reasons should make us want to be at least evenhanded in this directive.

CHAIRMAN VOLCKER. When does the leading indicator [index] come out?

MS. HORN. Oh, that's a point.

MR. PRELL. It was up 0.6.

CHAIRMAN VOLCKER. Did the housing number come out?

MR. KICHLINE. The housing starts?

CHAIRMAN VOLCKER. No, not starts; did the housing sales come out today?

MR. KICHLINE. That I don't know.

MR. PARTEE. The leading indicator was up 0.6? And was the previous month revised?

CHAIRMAN VOLCKER. Yes. They are strong in any event.

MR. STERNLIGHT. It is up 0.2 now; it had been slightly down.

MR. GRAMLEY. I had come into this meeting prepared to argue that the weight of the evidence, as I see it, leans if anything in the direction of suggesting that we ought to be just a bit tighter. I still interpret the fourth quarter as a very strong quarter with very strong private domestic final purchases. We have money numbers now which fortunately--I mean fortunately for my argument--look stronger in the fourth quarter and continue to be strong into the first quarter. We're talking about a December-to-March increase in M1 of about 7-1/2 percent. The M2 and M3 figures are much more tranquil. At a minimum we ought to be evenhanded, I think, in the statement of the alternatives.

MR. PARTEE. Yes.

MR. CORRIGAN. That's about where I am. But I could use--

CHAIRMAN VOLCKER. Excuse me, but are these figures on page 10 [of the Bluebook] all revised figures? Is that why I don't recognize them?

MR. AXILROD. Yes, they are all based on the revised series.

CHAIRMAN VOLCKER. And to get that 12 percent in January we have to have a big increase in the last week in January?

MR. AXILROD. Yes, close to $4 billion.

CHAIRMAN VOLCKER. Boy! What makes you think we're going to get that?

MR. AXILROD. Our projector is often right!

CHAIRMAN VOLCKER. Unfortunately, you could also make the statement that he's often wrong.

MR. MARTIN. I would take some issue with Lyle's thesis. I think there were several areas in which the data were disappointing or surprising. Some series came out for December and for the fourth quarter that indicate that there are risks and vulnerabilities in several areas. The leading indicators, of course, may now have been reversed. But the international situation is certainly not encouraging. Housing has vulnerabilities that I think have not been adequately analyzed by anybody--no reflection on our staff. And the fact that a lot of equipment has been purchased by industries is not the whole answer; a lot has been purchased from foreign sources. It wasn't all just imports to the consumer; there were imports to business. And we have not had the kind of investment revival that has been typical in recoveries. This has been kind of a defensive retrofitting. That's not a gross private domestic investment surge. It's a defensive [approach]: How can we stay in there with the prospect of a diminishing market share? I think there are a great many vulnerabilities in several areas here. It isn't all on the positive side. I would go for an evenhanded language format, but I don't think we can ignore the downside risks in this situation.

MR. MORRIS. I agree with Pres. I think the weight of the evidence in the last month is that the growth rate in the economy is decelerating. And the fact that the leading indicator series index was up 0.6 confirms that because that's a standardized index where the normal month's change is 1 percent. So, the 0.6 increase suggests a slowing in the rate of growth.

CHAIRMAN VOLCKER. What do you mean the normal increase is 1 percent?

MS. TEETERS. There is a built-in increase, a trend.

MR. MORRIS. The trend norm for that index, Paul, would be a 1 percent growth rate.

MR. MARTIN. And the GNP isn't back at a 1973-to-1980 trend line. If you put any kind of trend line in there, we're still below.

CHAIRMAN VOLCKER. I don't know. That's news to me. How is that index constructed so its normal increase is 1 percent a month? That means the average of all the components has to go up 1 percent a month? The work-week has to go up 12 percent a year and the stock market has to go up 12 percent a year?

MR. MORRIS. No, the index--

CHAIRMAN VOLCKER. And the money supply has to go up 12 percent a year?

MR. MORRIS. Maybe we ought to get a paper out on how we--

CHAIRMAN VOLCKER. Well, you have stimulated me to look into it. But it seems very strange.

MR. MORRIS. I'm quite sure I'm right that anything less than a 1 percent rise would suggest some modest deceleration in the growth rate of the economy.

MR. PARTEE. Well, forgetting these more abstract issues that [unintelligible] in the GNP, the production index is up less and the employment is up less than it was before. I would point out that the stock market has declined significantly. And, therefore, although Lyle could be right, I think we have to wait for evidence to confirm that there will be more strength than the 4 to 4-1/2 percent kind of normative number that people have in mind.

MS. TEETERS. Well, if the world turns out the way the staff has projected, it is pretty obvious what policy should be. I don't think we are going to get this smooth, even, deceleration of the rate of growth. We're going to get a good quarter and a bad quarter and a good quarter and a bad quarter. And if we don't look through that, we're going to make mistakes. We have to take into account the average of where we think we're going, and the trend seems to be that the economy is calming down. So, it seems to me that we should wait and see whether that has really happened or not before we tighten up.

CHAIRMAN VOLCKER. Well, I don't know whether we're close to a conclusion. Is it clearly the consensus that--forgetting about what we do in the future--right now we "maintain." Is that the right word to put in there?

MR. MARTIN. Yes.

CHAIRMAN VOLCKER. Nobody wants to ease up and nobody wants to tighten now?

MS. TEETERS. Which draft are you working from?

CHAIRMAN VOLCKER. Well, it doesn't make any difference for this purpose, but I'm now working off of mine. Do we just put the word "maintain" in there?

MR. PARTEE. That is [unintelligible].

CHAIRMAN VOLCKER. Yes, I know that. The [housing sales numbers] are out?

MR. ZEISEL. They came out at 10:00 am.

CHAIRMAN VOLCKER. We had some strange figures for new house sales. They went way up--28 percent--and it's all in the South; everyplace else they went down. It's the highest figure since I don't know when. [Unintelligible.] The [press release] says you have got to go back years before you find a month this high.

MR. GRAMLEY. Existing home sales are the bulk of the buying.

VICE CHAIRMAN SOLOMON. This is new house sales or existing house sales?

CHAIRMAN VOLCKER. New.

MR. GRAMLEY. Existing house sales came out earlier. They too were up, but not--

MR. ZEISEL. They were up 8 percent.

CHAIRMAN VOLCKER. You have to go back--I forget, but I think it's 10 years or so to get a new home sales figure this high. Or maybe it was 1978. I think it was.

MR. BOYKIN. There are sold signs everywhere in Dallas.

MR. RICE. Is it all over the South or is it restricted to--?

CHAIRMAN VOLCKER. I didn't look at the data. I was told it was in the South and that the West is down, the Central region is even, and the Northeast is going no place. It's all in the South. Very strange. It's all in Dallas, [Bob]?

MR. PARTEE. Everybody's going to move to Dallas!

CHAIRMAN VOLCKER. Well, if "maintain" is the right word, let's look at this draft I gave you.

MR. WALLICH. You've dropped "at least."

CHAIRMAN VOLCKER. Yes.

MR. PARTEE. Oh yes, I think that's desirable.

MR. MARTIN. I do also.

MR. PARTEE. It ought to be more evenhanded.

MR. GRAMLEY. Why don't we just take the sentence out of the last operational paragraph and use it?

CHAIRMAN VOLCKER. What's the sentence out of the last operational paragraph?

MS. TEETERS. You're going to add that reference to CRR. Is that it?

CHAIRMAN VOLCKER. I just stuck the CRR reference in the last sentence. But before we get to the CRR issue, this was deliberately changed from what it was last time, rightly or wrongly. I put the possibility of lesser restraint first and said we're not going to tighten unless we have in effect both more rapid growth in the aggregates, within some limit, and good business news.

MR. GRAMLEY. I don't think that's the thing to do. I much prefer an evenhanded treatment, and I think evenhandedness in this case would mean staying with the existing language. The existing language lets the qualifying comment about the strength of the recovery affect both.

CHAIRMAN VOLCKER. Where's he reading from?

MR. MARTIN. Where are you reading from, Lyle?

MR. PARTEE. I don't know where you're reading from either.

MR. GRAMLEY. I'm reading from the draft domestic policy directive that the staff passed out.

MR. PARTEE. Page 6?

MR. GRAMLEY. On page 4, line 77. The old language is "depending on evidence about the continuing strength of the recovery" and so on.

CHAIRMAN VOLCKER. Well, before you get there, let me just note that the first thing my draft does is list M1, M2, and M3 all together. And that immediately follows this other language about the relative weights.

MR. PARTEE. I think that's all right.

MS. TEETERS. I object to that. We didn't put M1 back into the primary position again.

CHAIRMAN VOLCKER. Well, I think it is to be read in the light of what is in the previous paragraph.

MR. GRAMLEY. I don't think so. I don't think the markets are going to interpret it that way.

MS. TEETERS. I don't think so either. I think we should have an M2, M3 sentence and then an M1 sentence. And I would put it back in a monitoring range because that's where it still is as far as I'm concerned.

MR. PARTEE. Shouldn't we have a show of hands on who wants to put M1 back in and give it more equal weight? I don't have a count on that; maybe you do.

CHAIRMAN VOLCKER. Well, we disposed of that for the long-term ranges.

MR. PARTEE. Yes, and it comes up every time we have any kind of discussion.

MR. CORRIGAN. It's easier to do [unintelligible] short term.

MR. PARTEE. Everyone is quite predictable as to what they will say.

VICE CHAIRMAN SOLOMON. I think your position has changed, Chuck, hasn't it?

MR. PARTEE. I've been putting it back in for quite a while.

CHAIRMAN VOLCKER. Well, one way we can do it is to say M2, M3, and M1. I don't think it's read in the light of what the previous paragraph says.

MR. BALLES. Let sleeping dogs lie.

MR. PARTEE. Well, we could do M2, M3, and M1. We could say "M2 and M3 at annual rates of about blank percent and blank percent respectively, and M1 at about blank percent."

VICE CHAIRMAN SOLOMON. Right. It's a little more consistent.

CHAIRMAN VOLCKER. I have been given the following figures for alternative B if we use December to March: 7.8, 7.8, and 7.3 percent. I suppose what we would put in there is 8, 8, and 7 percent if we cite December-to-March figures. We have 8, 8, and 6 percent for November to March, if you want to be essentially where we were last time.

MR. CORRIGAN. You're talking about putting 8, 8, and 7 percent in with Governor Partee's language?

CHAIRMAN VOLCKER. Yes. "...with growth of M2 and M3 at annual rates of about 8 percent and M1 at 7 percent respectively from December to March."

VICE CHAIRMAN SOLOMON. I think that makes more sense.

MS. TEETERS. Doesn't the "respectively" go before the M1?

CHAIRMAN VOLCKER. We don't need the "respectively."

MR. PARTEE. We don't need it at all, I guess, because it's the same number [for M2 and M3].

MR. GUFFEY. I'm sorry. How would it read again?

CHAIRMAN VOLCKER. "In the short run the Committee seeks to maintain the existing degree of pressure on bank reserve positions, anticipating that approach will be consistent with growth of M2 and M3 at annual rates of about 8 percent and M1 at an annual rate of about 7 percent during the period from December to March."

MR. PARTEE. Maybe we ought to say "M2 and M3 each at annual rates of about 8 percent."

CHAIRMAN VOLCKER. To make sure we're not adding up the two!

MR. PARTEE. Well, I sort of miss the "respectively," too. But "each" becomes a substitute for "respectively." Then the next sentence is nonfinancial debt.

CHAIRMAN VOLCKER. Then the growth of nonfinancial debt sentence is the language we've used before. Is that acceptable?

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. Now we get down to what we might do and how, going back to what Lyle was talking about. Let me look at this again and decide.

MR. WALLICH. There seem to be four elements that are weighted in favor of lesser restraint. One is the phrase "lesser restraint would" whereas the other says "greater restraint might." Also--

MR. PARTEE. That should be "would."

CHAIRMAN VOLCKER. We had nothing in the last directive about lesser restraint.

MR. GRAMLEY. That's right.

MR. MARTIN. That's correct. It was asymmetrical.

MR. GRAMLEY. But the language as it is put here was on page 4 [of the draft directive]. If we changed that lesser restraint from "might" to "would," that would make it perfectly symmetrical or almost perfectly symmetrical. Maybe we'd have to put the "somewhat" in there before "lesser" to make it perfectly [symmetrical].

CHAIRMAN VOLCKER. Well, the sentences become almost identical except that the order is reversed by putting "lesser restraint" first. In the "lesser restraint" sentence the difference is "might" and "would," as you noted; otherwise, I think it's the same. The language of the other draft has "somewhat" too. It's very close, but I myself think it's a little better showing [we need more evidence] to tighten than to ease at this point.

MR. WALLICH. I don't care about the order and whether the lesser goes first or not, but the asymmetry in the words does strike me as meaningful. I would rather not have it.

CHAIRMAN VOLCKER. Now, what asymmetry in the words do you mean?

MR. WALLICH. Well, either "would" in both cases or "might," but I prefer "would." And I'd eliminate the "somewhat."

MR. PARTEE. Well, it's going to be a moderated response in any event in either direction.

MR. WALLICH. Then we could add "somewhat" on the easing side.

MR. BLACK. That's his fallback position!

MR. CORRIGAN. But the asymmetry goes even beyond that because we would be saying less restraint subject only to the condition of a shortfall in money and credit growth. Whereas on the other side, it's not just the "might," it's more rapid growth of money and stronger business and--

MR. PARTEE. I don't read it that way. I read that whole first phrase as applying to both parts, the lesser or greater restraint. We're taking into account the economy.

MR. GRAMLEY. No, Jerry's right, I think. The "evidence of stronger business expansion, inflationary pressures" and so forth modifies the "greater restraint" whereas nothing--

MR. PARTEE. You think that modifies "greater restraint"?

MR. GRAMLEY. Yes.

CHAIRMAN VOLCKER. Yes, that's what it was meant to do.

MR. GRAMLEY. The way to be evenhanded is to go back to the language on page 4 of the draft directive and put that sentence on the front end that refers to depending on evidence about the continuing strength of economic recovery and other factors bearing on the inflation outlook.

MR. PARTEE. That's what I was reading.

MR. GRAMLEY. But Paul is not.

MR. PARTEE. Oh, I see. Okay.

MR. BLACK. I think we ought to decide which sheet we're going to read from. It's close.

MR. PARTEE. That's why I said it seemed to apply equally on either side.

MR. GRAMLEY. We've come to agreement too easily. It's not time yet!

MR. BLACK. We could have a long coffee break.

VICE CHAIRMAN SOLOMON. I think that Steve's proposed operational paragraph on page 18 is quite evenhanded.

MR. PARTEE. Page 18?

SPEAKER(?). In the Bluebook.

CHAIRMAN VOLCKER. It's the same wording, isn't it? I think that's the same as what you're looking at on page 4 [of the draft directive].

VICE CHAIRMAN SOLOMON. It takes care of Lyle's point.

CHAIRMAN VOLCKER. Yes, but it's the same language he is looking at, isn't it? Exactly.

MR. AXILROD. Yes, Governor Gramley is reading from page 4 of the draft directive, which is the same as page 18 of the Bluebook.

CHAIRMAN VOLCKER. It's the same language, isn't it?

MR. AXILROD. Well, the language you're talking about--that particular sentence--is exactly the same.

MS. TEETERS. If we do that, in the phrase "significant shortfall" do we want to take out the "significant"?

CHAIRMAN VOLCKER. That is a small difference; nonetheless, that's the only difference of significance, I guess, here. My own feeling is that I'd want a little more evidence before tightening than I would before easing at this point.

MR. GRAMLEY. I'm on the opposite side of that.

MR. MARTIN. I would support the need for a little more evidence to tighten.

MR. PARTEE. I think we ought to be pretty evenhanded.

MR. BLACK. In face of the evil [unintelligible] at all times.

MR. CORRIGAN. I certainly want to be at least evenhanded. The problem I have is that if events work in a direction where we want to ease between now and the next meeting--which is an unusually long time--it's a pretty easy thing to do, but the opposite is not easy to do. To me, that in itself argues for trying to keep it symmetrical. I don't know what is going to happen, but I personally don't think an asymmetrical approach is the prudent thing to do. I still think that the risks are on the other side.

MR. BOEHNE. I'll buy the evenhanded directive with the understanding that the Chairman would just think a little longer.

CHAIRMAN VOLCKER. That is certainly the Chairman's mood.

MR. GUFFEY. This directive isn't adopted for that purpose. It's for the public.

MR. CORRIGAN. I don't have any problems with Mr. Boehne's suggestion at all. It's the written word we have to worry about.

MR. GUFFEY. That's correct.

MR. ROBERTS. Well, I understand the nuance, but if we had all those things together--if we had more rapid expansion of the aggregates, stronger business, and inflationary pressures--the Chairman probably would take the action and we wouldn't be worried about those things.

MR. GRAMLEY. The point is: Suppose the business news comes in strong, which I expect it will, and the aggregates tend to fall short. Then what do we do? Do we ease or not? And I don't want to ease in those circumstances. I don't want to ease because I think the risks for the year as a whole lie predominantly on the side of more growth than the staff is forecasting and stronger inflationary pressures. If I'm right--and, of course, I may not be--then easing now in response to those [monetary aggregates] signals would be the wrong thing to do.

MR. PARTEE. What if the opposite should occur? What if the aggregates come in strong--and, after all, for January they are projected to be strong--and the economic news were to continue to be soft? What would you do then?

MR. GRAMLEY. If it were soft enough to really question the continuation of recovery along the lines that the staff is forecasting, then I would plan to ease.

MR. PARTEE. So it's the economic indicators that are moving you rather than the aggregates?

MS. TEETERS. Why don't we move the phrase "in the context of the business expansion and inflationary pressures" to the front of the sentence? Then it will modify both.

CHAIRMAN VOLCKER. Well, then it becomes more neutral. That's the way Steve had it, but it depends upon whether you want to be that neutral.

MR. WALLICH. I would favor that. The lesser restraint without some business signal seems to be an almost purely monetaristic reaction.

CHAIRMAN VOLCKER. I think we've had some business signals.

MR. WALLICH. We can write that in if we have business news.

CHAIRMAN VOLCKER. The question is whether it takes more, I guess.

MR. MARTIN. I think it takes more to tighten.

MR. PARTEE. We could leave it at the end, Paul, but put in another comma and, using your draft, say "both viewed in the context of continued strength in business expansion..."

VICE CHAIRMAN SOLOMON. I vote for neutrality in relation to Lyle's scenario. I see no reason why we should signal that lesser restraint is more easily triggered than tighter restraint.

MS. TEETERS. If we are going to take Chuck's suggestion, we could say "both viewed in the context of economic and inflationary developments."

MR. PARTEE. After all, we would always do that anyway, wouldn't we? We wouldn't set policy without looking at the economy.

MR. GRAMLEY. I hope. We've done it.

SPEAKER(?). In 1982.

MR. KEEHN. Would it be too revolutionary to take the whole thing out?

MS. TEETERS. Yes, because we're not going to adjust policy on the basis of the aggregates, I hope. They have been much too erratic to base a decision on them [just] because they're going up or down relative to the rest of the world.

MR. KEEHN. Well, it seems to me we would do what this says anyway. It's part of our normal operating procedure. And if we take the whole thing out, we're going to operate in the way that we normally would.

MR. GRAMLEY. Do you mean take out the whole works--the references to more restraint and lesser restraint?

MR. KEEHN. Yes.

MR. GRAMLEY. That takes away some of the lack of evenhandedness.

MR. MARTIN. Let them guess! Right, that builds character.

MR. GRAMLEY. So, if things don't work out this way, the Committee will decide what to do about it.

CHAIRMAN VOLCKER. Well, my problem is very simple. I don't feel evenhanded about this.

MR. ROBERTS. I agree. I don't think it should be evenhanded.

MR. GUFFEY. But is it important to put that in the directive--that you just described as evenhanded the understanding that I think is fairly consistent [with the views expressed] around the table that we would operate in such a way that it would take somewhat more evidence to tighten up?

MR. MARTIN. It hardly meets the criticism that we fail to communicate the nuances of our policies to the public.

MR. GUFFEY. Well, I think it is more important that we be fairly consistent with what we've done in the past. And there is a nuance, if you will, by simply making it evenhanded now as opposed to the greater inclination for restraint that was in the immediately preceding directive. So I think there is a nuance that can be read in it if we use evenhanded language.

VICE CHAIRMAN SOLOMON. Why don't you ask for a preliminary show of hands between evenhanded and--

CHAIRMAN VOLCKER. I know where my hand is.

MR. PARTEE. He doesn't particularly want to see the other hands!

MR. GRAMLEY. I would like to be clear that I am a lot more concerned about policy than I am about words. And what I would like to have some indication of is whether everybody is leaning in the direction that you're indicating--that they would rather ease than tighten. To operate erring on that side is one thing; I want to go in the opposite direction, if anything. I will live with evenhandedness but I care a lot more about the policy than I do about the words.

MR. ROBERTS. Well, for clarification: Why wouldn't you have greater restraint if the aggregates were growing faster and if there were strong evidence of stronger business and inflationary pressures?

CHAIRMAN VOLCKER. I would. I want all those things.

MR. ROBERTS. Why do you need to say "might" then? I understand you want to be careful but if all those things applied, it would seem to me that it isn't necessary to be that careful about it.

MS. TEETERS. Well, not spoken here is the point that we have to keep an eye on what is happening on the international scene too.

CHAIRMAN VOLCKER. That is part of my problem.

MR. ROBERTS. That's a point, sure.

SPEAKER(?). Well, that has been a continuing problem all along. But it is true that there is a clear expectation of inflationary pressures later this year.

MR. PARTEE. No, I don't think so.

MR. MARTIN. Commodity prices don't show it.

VICE CHAIRMAN SOLOMON. It certainly is a market [expectation].

MR. PARTEE. It's a very good possibility, but I don't think there's clear evidence.

VICE CHAIRMAN SOLOMON. A quarter of a point is probably the maximum we're talking about and I don't think that is going to change the international situation in terms of LDCs and the debt problem.

MR. CORRIGAN. Again, the way I look at this is that part of the problem is that the better we are in the short run, the worse we are in the long run. I wouldn't mind necessarily if we had a first quarter and a second quarter that were even a shade lower than the staff projection because I think the possibility of being able to keep the expansion going throughout the balance of the year into 1985 actually is enhanced by that. From my vantage point that is the primary reason why I would favor being evenhanded. If we ended up with a really robust first quarter and robust money growth in the first quarter, that just complicates the heck out of the task in the second quarter.

MR. MARTIN. But the premise is that if we have a weak first quarter, we would have very little sign of inflation. We would have the Argentineans messing up their restructuring. Those would be the circumstances.

MR. CORRIGAN. I don't think there is anything we are going to do here that's going to influence the Argentineans.

VICE CHAIRMAN SOLOMON. Amen.

MR. CORRIGAN. If we have to ease, that's easy to do. I don't have any problem with that side of it at all. It's the other side that I worry about.

VICE CHAIRMAN SOLOMON. Economic recovery in the other industrialized countries is picking up faster than we expected. The very minor changes that might result out of this policy in terms of interest rate levels are not going to be a significant factor.

MR. MARTIN. Unless you're talking about--

VICE CHAIRMAN SOLOMON. Unless we have a move of a whole point. But if we're talking about what I assume you are talking about--say, a quarter of a point--

CHAIRMAN VOLCKER. What I'm talking about depends on how far things are off. Well, I'm not going to die with this language here. I am just picking this up: "Lesser restraint would be acceptable...

[etc.] while somewhat greater restraint might be acceptable given more rapid expansion of the aggregates, both viewed in the context of the strength of the business expansion and inflationary pressures." I feel a little biased at the moment as I look at the situation. But this is all in the context of not doing anything at the moment. Is that language acceptable?

SEVERAL. Yes.

CHAIRMAN VOLCKER. When do we meet here again?

MR. BERNARD. March 27. That's eight weeks from now.

CHAIRMAN VOLCKER. Well, if anything happens, we'll have a consultation anyway before we decide to move. That's for sure. And with that understanding, I think we can just leave it. What that next sentence says is that we aim at a little higher excess reserve levels at least during the first couple of weeks and play it a bit by ear as to whether we pull it down thereafter. We could get a good deal more volatility in the federal funds rate during this period. I don't think we ought to be too sensitive to that but at some point I suppose that would be a measure of how much excess reserves were needed. But if it bounced up to 10 percent or so for a while or went down to 9 percent or below, I don't think we have to be jumpy about it. Just to take a guess, do we add about $200 million in excess reserves in this first two weeks?

MR. STERNLIGHT. Well, $200 or $300 million perhaps, in light not only of CRR but also the phase-down in reserve requirements.

MS. TEETERS. You've been putting in around $400 million, haven't you?

VICE CHAIRMAN SOLOMON. It has been $400 to $450 million, although the average in the last several weeks would probably be more like $500 to $600 million.

MR. PARTEE. You're talking about $200 or $300 million more than that?

MR. STERNLIGHT. Yes.

MR. AXILROD. If we were ordinarily putting in about $400 million, at least $600 to $700 million.

MR. PARTEE. So, it's about even on the marginal reserve measure with borrowing of $650 million and excess reserves of $600 to $700 million?

MR. AXILROD. It may run higher and then borrowing may run a bit higher. We just don't know what the pattern of borrowing is going to be over the course of the two weeks. If they borrow an enormous amount early--

CHAIRMAN VOLCKER. I think the implication is that you'll probably be aiming at small positive free reserves for these first two weeks.

MR. BOEHNE. What's the advantage in this transitional period of allowing the funds rate to bounce all around rather than containing it some?

VICE CHAIRMAN SOLOMON. We have to allow a certain amount of bouncing around, I think, even if it shows up in the last two days; otherwise people are going to feel that we're really pegging the rate.

CHAIRMAN VOLCKER. I think that's the only problem here. We could just peg the federal funds rate during this period, but I don't know that we want to create that--

MR. BOEHNE. I'm not advocating that. I'm just curious as to how you--

MR. ROBERTS. Well, there is a danger that we might over-supply reserves too if we did that, and then we would have the problem of withdrawing them later on.

MR. BOEHNE. We could under-supply them too.

MS. TEETERS. Didn't we have a pattern of very low borrowing until Wednesday and then borrowing shot up the last day?

MR. AXILROD. Recently, that's what we've had.

MR. ROBERTS. Every day is going to be Wednesday now.

MR. AXILROD. I don't contemplate that going on for 13 days.

MR. BOEHNE. As long as the funds rate bounces around over this week or several weeks that would be okay. But if it tended to settle in at 10 percent or 9 percent, that might be telling us something.

CHAIRMAN VOLCKER. Well, I think it might. I don't disagree with that. I'm a little reluctant to say we want the fed funds rate at 9-1/2 percent or something, so let's use [unintelligible]. On the other hand, if we're not using it and, as you say, it settles in at some high or low level, I think that's evidence of the level of excess reserves they want.

MR. GUFFEY. May I ask a technical question? At the end of the two week maintenance period will there be a carryover available? Will a 3 percent carryover for the first two weeks really amount to 6 percent on a weekly basis?

MR. AXILROD. Well, it's twice as much, in effect, on the last day. That's right.

MR. GUFFEY. So, you could come to the end of the period and apply a 6 percent carryover factor the first two weeks and you could have very high excess reserves.

CHAIRMAN VOLCKER. No, it's 3 percent. It would be 6 percent if it was one week but they will have a two-week settlement period.

MR. AXILROD. In the first two weeks if you're in deficiency or surplus, you can carry over 3 percent into the next two weeks.

MR. GUFFEY. Yes, I understand that. But is there any carryover that applies to the first two weeks?

MR. AXILROD. Oh. You mean from now.

MR. GUFFEY. Is there a 3 percent carryover?

MR. AXILROD. No.

MR. GUFFEY. It's still the 2 percent?

MR. AXILROD. Yes. I'm not quite sure how we worded that transition, now that you mention it.

MR. BLACK. It's 2 percent or--

CHAIRMAN VOLCKER. You'll have fights with all your banks as to whether they had a carryover, if we're not clear about it.

MR. AXILROD. If they have a carryover, it would be the 2 percent of the [unintelligible]. Last week they carried over 2 percent.

MR. GUFFEY. But for the second week in the two-week period what's the carryover?

MR. AXILROD. I think they would carry it over into the two-week period. I don't think it would be carried over into the first week. I would think the proper interpretation is that they carry it over to a two-week period.

MR. BLACK. Just think of it as an elongated carry-over.

MR. GUFFEY. If we don't understand it, they won't understand it.

CHAIRMAN VOLCKER. Well, things may not vary very much because they won't know what to do either so they'll continue to trade federal funds just at the level they are now. That is quite a possibility. We just have to evaluate this as time passes and assume that we could have lower excess reserves in the second two-week period, particularly if there are signs of persistent ease during the first two weeks.

MS. TEETERS. It may move up when we get into settlement.

CHAIRMAN VOLCKER. That may be correct. Well, are we prepared to vote? I guess so. What we say is "seeks to maintain the existing degree of pressure...M2 and M3 each at annual rates of about 8 percent and M1 at an annual rate of about 7 percent from December to March. Growth in nonfinancial debt is expected to be within the range....Lesser restraint would be acceptable in the context of a shortfall in money and credit growth from current expectations, while somewhat greater restraint might be acceptable with more rapid expansion in the aggregates, both viewed in the context of the strength of the business expansion and inflationary pressures." And then we have this sentence on contemporaneous reserve requirements and the usual sentence on the federal funds rate range, which I presume we're keeping at 6 to 10 percent, which is now hallowed by tradition.

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. We're finished already?

MR. BERNARD. Yes.

CHAIRMAN VOLCKER. Coffee break time.

END OF MEETING