Meeting of the Federal Open Market Committee

July 8-9, 1986

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, July 8, 1986, at 3:00 p.m., and continuing on Wednesday, July 9, 1986, at 9:00 a.m.

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

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

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

Mr. Bernard, Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, 1/ Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

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

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1/ Attended Wednesday session only.

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Loney, Economist, Office of the Staff Director for Monetary and Financial Policy, Board of Governors
Mrs. Danker 1/ and Mr. Struckmeyer, 1/ Economists, Division of Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Broaddus, Ms. Greene, Messrs. Lang, Rolnick, Rosenblum, Scadding, Scheld, Thieke, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of Richmond, New York, Philadelphia, Minneapolis, Dallas, San Francisco, Chicago, New York, and Atlanta, respectively

Mr. McNees, Vice President, Federal Reserve Bank of Boston

Ms. Lovett, Assistant Vice President, Federal Reserve Bank of New York

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1/ Attended portion of meeting on Tuesday and Wednesday related to consideration of the Committee's longer-run objectives for monetary and debt aggregates.

Transcript of Federal Open Market Committee Meeting of
July 8-9, 1986

July 8, 1986--Afternoon Session

CHAIRMAN VOLCKER. I think we can proceed. We need somebody to move the minutes.

MR. GUFFEY. So moved.

MS. SEGER. Second.

CHAIRMAN VOLCKER. No objections. Ms. Greene.

MS. GREENE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions or comments?

MR. MELZER. What would be the likelihood of continued official intervention? I think in the intermeeting period it was about How would you characterize the size of that? Is there a willingness to continue to intervene on that scale?

MS. GREENE. Well, the figure that you cited was a 3-1/2-month total for the Bank of Japan. The purpose of the intervention on Monday and Tuesday was to demonstrate that they feel as strongly after the election as they did before that it is inappropriate [for the yen] to appreciate any more. So, I would imagine that they would still be active in the exchange market. Whether they would have to do the magnitudes that they have done on certain days in the past, I don't really know.

MR. TRUMAN. That figure is more than just the [intervention by the] Japanese; it includes all of the industrialized countries.

MR. MELZER. That was just for the intermeeting period?

MR. TRUMAN. That includes everybody; it includes the Europeans--the French purchases and the Norwegian.

MR. MELZER. Is the scale of that intervention an extraordinary amount for the six-to-eight week period of time?

MS. GREENE. For the intermeeting period, that is a fairly large amount.

MR. BOEHNE. This goes beyond operations, but what is the main case, if one is [speaking for] Japan, for not easing monetary policy in Japan?

CHAIRMAN VOLCKER. I can recite the case. But if you ask me whether it's convincing at the end of the day I am never very convinced, though the individual arguments are stated with great force and clarity. They say consumption is rising pretty rapidly and the discount rate is at a postwar low. That is always presented as number one. They say: We have reduced the discount rate three times so far this year and it is at a postwar low; consumption is doing pretty well; there are reasonably favorable reports about the rest of the economy and we're happy; money supply is over the targets and the nontarget target.

MR. BOEHNE. What about the Germans?

MR. RICE. What about GNP?

CHAIRMAN VOLCKER. That is the transitory development.

MR. JOHNSON. Over the year, though--

CHAIRMAN VOLCKER. In Germany the arguments are more or less the same. Germany, I think, can make a much better case. There is a lot more evidence that the economy could pick up. They have good investment survey figures, up above 10 percent in real terms; consumption was strong in the first quarter; and real income was way up and they say consumption is bound to be strong. They had a weak construction sector, but that's over now. They feel there is not much they can do about monetary policy; anyway, they are above target.

MR. BOEHNE. What is your impression of the strength of feeling about further appreciation of either the mark or the yen in those respective countries?

CHAIRMAN VOLCKER. What's my feeling about the likelihood?

MR. BOEHNE. No, what is your feeling about how strongly the Japanese and the Germans view a further strengthening of their own currency?

CHAIRMAN VOLCKER. Well, they wouldn't like it, but relative to easing monetary policy, I don't know. They have expressed no eagerness to ease monetary policy. If our exchange rate got weak enough, that would obviously be an influence but they are not going to interpret it as another [unintelligible] this summer. It is going to--

MR. MELZER. I have another question. You mentioned the diminishing willingness to hold longer-term dollar-denominated securities particularly--I believe I heard that correctly in your remarks. What evidence of that have we seen?

MS. GREENE. I think what I said was that the interest differential has narrowed to 50 basis points against Germany and 250 basis points against Japan. I will defer to my colleague to the right as to whether or not he has seen any--

MR. THIEKE. Well, there have been less substantial inflows than was the case around the May refunding, to be sure. And to the extent that there have been inflows, they have been moving in a little shorter on the maturity curve--more into the 7- and 10-year area--in part because of the anomalies that are still at work at the very long end of the government yield curve.

VICE CHAIRMAN CORRIGAN. Also, there is continuing diversification into non-Treasury [securities], presumably in a search for high yields.

CHAIRMAN VOLCKER. Any other questions or comments? If not, we will turn to Mr. Thieke.

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

CHAIRMAN VOLCKER. In the interest of completing my answer to Mr. Boehne, the Germans have the argument that they are low in the EMS; they are a little less low than they were even a few days ago. Both Germany and Japan are relatively low. They say the recent inflation performance is just temporary and they have to guard against the relative resurgence of inflation.

Any questions of Mr. Thieke? Any comments, observations? If not, we have to ratify the transactions for a period marked by remarkable closeness to the borrowings target throughout the period.

VICE CHAIRMAN CORRIGAN. Accidents will happen!

CHAIRMAN VOLCKER. Messrs. Kichline, Prell, and Truman.

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

MR. BOYKIN. Jim, on your $16 a barrel [price assumption for oil], does that mean an average or the price at the end of the forecast period?

MR. KICHLINE. To be explicit, we assumed something like $14 or $15, and it gets to about $16 by the fourth quarter of this year and just stays there. It creeps back up by the end of this year and sits there.

MR. PARRY. The small decline in inventory investment in the second quarter has a very important influence on the strength and pattern of growth in the second half. The April numbers certainly would support that kind of conclusion. In terms of the production numbers for May and what you anticipate for June and the personal consumption expenditures for May, do you think that you might see an even greater reduction in inventory investment than what you have in the forecast? Would you be more optimistic?

MR. PRELL. We approached the second-quarter projections from two sides, adding up all of the available expenditure data we could find--and for inventories that's very limited, given that we have [only] partial data for May in a lot of the real sectors. On the other side, we look at the labor input that we have. The labor input suggests a rather slow growth, pretty much in line with our forecast. The expenditure data are a mixed bag and we come out in the end feeling that that's reconciled with this kind of slight moderation in inventory investment. As we look at the industrial sector, we try to guess what's coming in from abroad, and that's very difficult to say. I think what is important for the outlook is that even though automobile inventories still seem rather high, the manufacturers seem intent on continuing to produce at a fairly high level. They have all of the parts and they will run them out through the end of the model year. In other areas of the economy, manufacturers' inventories have declined and don't seem to be a great impediment to growth. We just feel that in the trade sector, in retail trade particularly, there is some hint of weakness so that ordering may be a little on the slow side there for a bit. But it shouldn't take a major correction.

MR. PARRY. But the PCE expenditures for May, at least at some point I hope in that area [unintelligible].

MR. PRELL. Indeed.

MR. KEEHN. Jim, I hear all the adverse comments about the staggered effects of the introduction of tax reform. I think you said there was a one percent effect next year.

MR. KICHLINE. It's one quarter of a percent on our estimate of real GNP growth. But I should say that that comes about--and is a lower figure, I think, than in some outside forecasts--because we don't assume that the Senate is going to end up with $23 billion net additional [cuts] in 1987 and that we still get all of the Gramm-Rudman cuts. In fact, we think there is going to be some interaction and slippage in that process, so that by the time it comes out it won't be that much of a cut. So we have a limited effect. But don't let me interrupt. I think your point is that concern in the business community seems to be growing over time. Earlier on, there was a sense of uncertainty in some sectors; but now I believe there is a greater realization that the tax reform is going to affect the business sector at large--assuming that it comes out something like this Senate plan.

MR. KEEHN. Well, that was the point I wanted to make. I also wanted to ask a question. It seems to me that we have done this before: We have introduced tax legislation on a staggered basis and, if I remember correctly, the economic effects were a little more significant than what you are suggesting, weren't they?

MR. KICHLINE. Are you talking about ERTA, going back to about 1982 or 1983?

MR. KEEHN. Yes.

MR. KICHLINE. Yes, but I think the fiscal effects were larger. What we have done, rightly or wrongly, is come up with a fiscal package effect that is about $7 or $8 billion more than we had previously, as a result of some additional outlays and somewhat fewer cuts elsewhere. And it has a depressing effect on the business sector, particularly, with an assumed given rate of growth of M2. We assumed with the cutback in demand from the business sector, in multifamily structures particularly, that there would be some interest rate effect; rates come down a little from what we had in the last forecast. So, you get a little more spending elsewhere, and net what we have is something that is sprinkled through the projection. I don't think it is an overwhelming feature, given the basic character [of the tax reform]. But if you assumed something like what happened in 1982, when depreciation schedules were changed as were other things that produced a much larger fiscal impact, then it probably would have a greater damping influence.

MR. KEEHN. Thank you.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I would like to explore the other side of that a bit. Suppose we got substantially less restraint than you are assuming in your forecast? Have you done some sensitivity analysis or something that calculates what that does to the forecast?

MR. KICHLINE. I didn't this time. We have done a good deal of that in the past. The general sense is that the models have a great deal of difficulty handling this, as you know. And that's where I see a little uncertainty, partly because what is built into the current interest rate structure is expectations that something is going to happen. If you remove that and you get a backup in interest rates, you get all sorts of effects that are not easy to capture--at least in the models that we deal with. Basically, in a standard sense, we would assume that you would have a fiscal multiplier that is somewhat larger; how much larger is always open to question. But if you had federal spending that was lower by something like $20 billion, at an annual rate, that would give you something larger than that in terms of its impact on the economy. And $20 billion is about 1/2 percent in real GNP. So, I think there is a lot of uncertainty here. What is basically essential to our forecast is to assume that there will be some fiscal restraint. However that comes about may be a very interesting question between now and October.

MR. RICE. Mike, I think I heard you say that tax reform would have the effect of broadening the tax base of state and local governments. How is that?

MR. PRELL. Well, state governments in particular. Around 30 states, as I recall, have a tax form on which the state's tax rates are applied to the same income concept as the taxable income, or adjusted gross income, that is on one's federal tax return. With the changes that are contemplated in personal income taxes--with fewer deductions and so on--that number will be larger. Thus, unless the states lower their tax rates, they will experience an increase in the revenues they derive from income taxes. There is already some discussion in some states about preventing that from occurring. But I think as time progresses and they look at what their budgets are dictating in terms of revenue needs, undoubtedly some of it will be retained. That's implicit in our forecast. It's a minor element.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Yes, I have a question for Mr. Truman. One of the things that I think has had a big impact on our import demands has been the failure of the values of currencies in Korea, Singapore, and Taiwan to change relative to the dollar. What are you anticipating in the forecast with regard to these areas, and what impact is that likely to have on our import demands?

MR. TRUMAN. We have looked at that quite carefully in putting together this forecast. In the past we focused on the major industrial countries' currencies because, in general, the other currencies moved with them enough that it didn't make that much difference. What has happened since early 1985 is that the dollar has depreciated a lot against [the currencies of] major industrial countries and depreciated [less] against [the currencies of] the developing countries as a group--less so against Asian countries and against Latin American countries, but with a big weight going in there for Mexico. In the forecast, therefore, we have deliberately tried to adjust that out, in terms of slowing the rate of decline that normal models--based upon just industrial countries' currencies--would tell us regarding how much import volume would or would not respond. We also tried to adjust that out on the export side. It's pretty difficult. Quite frankly, we don't have enough experience to do that. But we have given the size of the exchange rate change against industrial countries' currencies a lot of adjustment in the forecast, trying to take account of this factor as well as somewhat related issues like how fast prices change and how fast we get a response [unintelligible]. That's one of the reasons why we get such fairly modest numbers; you may have noticed the numbers I quoted are quite modest [unintelligible] relative to what you might have thought.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Just a follow-up to that question: Have you considered that the imports from these emerging industrial countries around the Pacific Basin are really substitutable for what may not come in from Japan and other countries against whose currencies the dollar has moved substantially?

MR. TRUMAN. That clearly is a factor and I think we have taken that into account. We haven't done, and I am not sure one can do, a close analysis of the [various] imports--to the extent, for example, that Korea is different from India in terms of what it can produce and [unintelligible] imports. There is an offset that I think one ought to recognize: It also is true that Korea is not going to build up big surpluses. To the extent that it is exporting more to the United States and the rest of the world, it also is importing more; and to the extent that we are also exporting to the Korean market we have a competitive advantage vis-a-vis Japan on exports, including the amount of raw materials and that kind of thing, which is nontrivial, that we traditionally have [unintelligible].

MR. GUFFEY. But that beneficial effect may lag somewhat?

MR. TRUMAN. It will come later. But eventually we are going to gain somewhat in operating in some of these Third World markets from the fact that we have depreciated vis-a-vis Japan and Germany. In fact, you can see the other side of what seems to be a block in Latin America and Asia with the dollar's appreciation: As the dollar moved up against all of those currencies we lost.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I want to follow up on that same point too. It's still hard for me to understand how in the forecast you can get rising prices in the out years, both domestically and abroad, when currencies--especially the G-10 currencies--are appreciating relative to the dollar. I see how you can draw a scenario where prices tend to come back a little in the United States as a result of the appreciation of the dollar, with a lag as oil prices level off. I still don't understand how you can get the same trend abroad with appreciation in their currencies relative to the dollar, especially with the fact that their currencies are appreciating even more dramatically relative to the non G-10 currencies against which the dollar is also appreciating. So, I am having a rough time with that scenario.

MR. TRUMAN. The response is that for the G-10 countries as a whole the difference between QIV inflation rates is 2.7 percent versus 2.9 percent. Now, the chart here is a little exaggerated because the higher inflation countries continue to go the other way and are left out of the chart. Switzerland, for example, goes down next year and is left out; [unintelligible] is left out of here. So you have a very small effect and that is coming from the fact that oil prices stop going down and the exchange rate--although the dollar continues to depreciate, it's not at a 30 percent annual rate.

MR. JOHNSON. 10 percent.

MR. TRUMAN. It is something like an 8 percent annual rate, so that is what [unintelligible]. I don't--

MR. JOHNSON. It still seems to me that it would be going the other way.

MR. TRUMAN. I have quoted you the wrong set of numbers--the GNP numbers. It goes up, but one of the points is that for the G-10 as a whole--Sweden is at 4 percent this year and goes down and Belgium comes in a little high relative to Europe, going up about 0.3 percent --it's a relatively small average drop. You have a bigger effect in Japan and Germany partly because those currencies have moved a lot and the move was relatively large compared to the other currencies. The only point I would make is that the change is small relative to the change in the United States; [the numbers are] 2.1 and 2.9 percent in the G-10 [versus 1.4] and 3.9 percent in the United States.

MR. JOHNSON. I agree. I just don't--

MR. TRUMAN. It's the relative change that I think is more important.

MR. JOHNSON. It's small, but I don't even understand the direction. I was checking.

MR. TRUMAN. Well, wages are continuing to go up and there are other factors.

MR. PARRY. Isn't the impact of energy price developments even greater for them because it's a multiplier--

MR. TRUMAN. You are multiplying--halving the dollar price of oil and that times a 30 percent drop in the price of the dollar [unintelligible].

MR. JOHNSON. Maybe we ought to start over. I thought that oil prices leveled out in this--

MR. TRUMAN. Yes.

MR. JOHNSON. And then against depreciating currencies--

MR. TRUMAN. But say that oil prices go down by 8 percent or greater, say, 10 percent. Last year they had gone down about 50 or 60 percent.

MR. JOHNSON. But they are going down.

MR. TRUMAN. Yes, but other prices are going up.

MR. JOHNSON. Above?

MR. PARRY. There is less of an offset to the higher increases in other components in 1987 than in 1986 and that can do it.

MR. TRUMAN. But the year-over-year consumer inflation rates in these countries are still positive and you can ask the same question even with price effects [unintelligible]. It has to do with the other components in the price index.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I have another dollar question for Mr. Truman. I have heard business people say that comparing the current value of the dollar to the absolute high back in February of 1985 tends to overstate the amount of the decline in terms of how they benefit from it. They say it is better to look at something like the current level versus, say, the average for 1984 or the average for 1985 because they point out that they didn't do a lot of transactions at the exact peak of the dollar. So this comparison we use overstates the amount of the deterioration and suggests more of an improvement than they, in fact, would be likely to get.

MR. TRUMAN. [Unintelligible] I would agree with that. What transactions took place were [unintelligible] response to what was going on as the dollar was moving up. That's one of the reasons for the continuation of the effect. You count the negative effects on export and import volume as they lag through the system; at the same time, you begin to add on the positive impact and we don't begin to get much positive impact for a while. Look at it the other way: The dollar started depreciating on this particular index from, call it 90 in the fourth quarter of 1980, and it is now at 110. So it has gone from 90 to 150 plus back down to 110; that suggests that there is a lot of appreciation that has not been wiped out. It's debatable whether it needs to be wiped out completely anyhow, but it is clear that the dollar has still appreciated relative to what was on average the last [unintelligible].

CHAIRMAN VOLCKER. A lot of appreciation against the Canadian dollar.

MR. TRUMAN. [Unintelligible] never appreciate that much.

MS. SEGER. Also, I couldn't hear Mr. Kichline's comment. How much of a downward revision did you say we had made in our collective forecast for real GNP in 1986?

MR. KICHLINE. In 1986? Are you referring to the last chart?

MS. SEGER. You have a summary of forecasts--I think it's chart 19 or something like that--where you show forecasts for real GNP of Board members, presidents, and staff. Sitting this far away, I thought I heard you say something about the downward revision.

MR. KICHLINE. I simply stated that nominal GNP now for 1986 falls below the lower range of the central tendency. I was trying to suggest that there has been a sizable downward revision both with respect to the deflator and real GNP.

MS. SEGER. Okay. Thank you.

MR. BLACK. Jim, isn't that a typographical error on that chart? Shouldn't it be "FOMC projections for 1986" instead of 1985? We are bad [forecasters] if it was for 1985 and we missed it that much!

MR. KICHLINE. [You are right.] This is a result of trying to be cost conscious and using an old chart.

MR. ANGELL. Well, Bob, it may be worse than you did! That's one way to look at it.

MR. BLACK. That's a thought!

CHAIRMAN VOLCKER. Well, you have assaulted the staff with a few questions. I haven't heard anybody committing themselves to the outlook at this point. I don't know whether we want to do that after we look at the long-run ranges. Why don't we put the long-run ranges on the table? Mr. Kohn.

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

MR. MELZER. Don, I might ask a question that was triggered by your statement. You used the phrase a couple of times "should interest rates need to decline." Maybe this is a question for Jim, too. How would that be treated in the model? Would one be able to control interest rates that effectively? There has been talk, for example, of highly stimulated interest-sensitive sectors of the economy. How would a 50 or 100 basis point decline in interest rates affect GNP for 1987, for example, all things being equal?

MR. KOHN. Well, I think Jim can answer that, but let me say that my comments were really meant in the sense that our GNP forecast is considered consistent, as Jim and Mike both said, with rates remaining around current levels. I was trying to deal with the contingency that underlying demands were weak so that, in order to attain an acceptable rate of GNP growth, interest rates would have to fall; and GNP growth would be not stronger than we are projecting but around the rate that we are projecting.

MR. KICHLINE. We have done some simulations; we didn't do the fiscal one, but we have done some monetary ones, basically using M2. And in this particular simulation, if M2 were running at the top of the range--if M2 grew at 9 percent through 1988 beginning now--the model result is that that would be consistent roughly with a federal funds rate 3/4 percentage below what it is now, with that sort of level maintained into 1988. You would get just a few tenths more real growth this year because of the lags but about a percentage point more real growth next year and a bit more in 1988. On the price side with that sort of scenario, prices don't change this year; they are up a quarter to one-half of a percentage point more in 1987 and, according to the model, up 1-1/4 percentage points over what they otherwise would have been in 1988.

CHAIRMAN VOLCKER. [Unintelligible] the usefulness of the model. Does anybody have any particular questions for Mr. Kohn? Have we covered every contingency?

VICE CHAIRMAN CORRIGAN. Don, in the first paragraph in the Bluebook, you talk about the combination of factors that may be influencing M1: lower interest rates on the one hand, and then a kind of potpourri of other things. I don't want to hear a model answer; I want a judgmental answer. How much weight would you give to the interest rate factor in and of itself as opposed to the potpourri of everything else?

MR. KOHN. I think the interest rate factor accounts for the bulk of the acceleration. I think we are getting more of an interest rate response than the models would indicate and in large measure that is coming in the demand deposit component. A higher proportion of demand deposits is in compensating balances because some of the household deposits are out; they were shifted into OCDs. The compensating balance responses to interest rates are very large. In essence, it's one for one--an elasticity of one there. At the same time, our investigation of some of the activity in the secondary markets--in mortgage markets in particular--shows that a considerable amount of demand deposits can be generated through refinancing, through the use of cashier's checks, and the advance repayments of Ginnie Mae's being put temporarily in demand balances before being paid out and passed through to security holders. I hesitate to quantify it; I don't think we can. But I do think that some substantial portion of the demand deposit group in particular is related to this huge pick up in financial activity, particularly in the mortgage market. And our projection of a slowing of money growth over the second half of the year is predicated partly on the wearing out of these interest rate effects. But it is also predicated partly on the presumption that with a more stable interest rate environment the volume of mortgage refinancings will tend to taper off as will some of the other financial market activity. And that would help to bring down demand deposits or at least to level them off.

MR. MORRIS. Mr. Chairman, I remember that we went to controlling monetary aggregates very recently because we didn't know how to forecast what level of interest rates would be needed to get the nominal GNP growth that we sought. Now I think we have come full circle because, as I hear Don tell it, in order to set a range for M1 we have to forecast interest rates for the year. If that is the case, that raises a question in my mind whether it makes any sense for us to set a range for M1 when we don't know what interest rates are going to be in the coming year.

CHAIRMAN VOLCKER. Mr. Morris, M1 emphasis led us away from [unintelligible] so we can go back to it. That gets to the question that I was going to raise. Maybe we can, if not resolve it, at least begin to form some consensus on what we want to do with M1 in these long-range targets. I am not so worried about what precisely the target should be if we have a target, but whether we should have one or rebase it. Do we chose a new target for this year? Do we have one for next year? Do we rebase this year, do we keep what we have, or do we say we are going to be over it and eliminate what we have? Of the various choices Mr. Kohn gave you, what appeals?

MR. JOHNSON. I kind of agree with Frank. I don't think we really know how to set a target at this point for the rest of the year. A lot is going to depend on interest rates and we are not sure what is going to happen. I think that we ought to emphasize M2 and M3, which is sort of what we have done. I think we would be better off not setting a new target for [M1] and playing M1 down while emphasizing M2 and M3. I think that makes a little more sense.

CHAIRMAN VOLCKER. You are talking about 1986? What do you do for 1987?

MR. JOHNSON. Yes, 1986. A lot would depend, I think, on what we see in the demand for money by the end of the year. But of course, we have to set a target now. We could make--

CHAIRMAN VOLCKER. We have to set a target for something; we don't necessarily have to do it for M1.

MR. JOHNSON. I would shy away even from 1987 at this point, saying that we might come back to it if we see velocity stabilize at some point.

MR. RICE. I would hate to see us drop the target range for M1. I would much rather see us retain a target range but announce that we don't expect the growth to be within that range. This way we would be facing up to the fact that--

CHAIRMAN VOLCKER. You say just keep 3 to 8 percent this year and say we are not going to be within it?

MR. JOHNSON. Well, that is what I said. I didn't say drop the target; I said maybe not announce targets for 1987 this year--not until we have a better look at what velocity is doing for 1987.

MR. RICE. I would have no problem dropping it for 1987. It would be easier to drop it for 1987 than for 1986. I would prefer at this time to keep 3 to 8 percent for 1987 too and change it later.

MR. JOHNSON. Yes, that is the same. I don't mind.

MR. RICE. But I would go along with dropping it for 1987, if there is a consensus.

MR. WALLICH. Having it too high is one thing; but having it too low is another.

MR. MORRIS. What is the value of having the range and then announcing that we are not going to be within it?

MR. RICE. I think it conveys a sense of honesty. We are telling the public what we think the range ought to be. Then we are telling them that for reasons that are not altogether fully apparent, we are not going to make the target range. It is more honest to do it that way.

MR. MORRIS. Wouldn't it be more honest to say that the relationship between M1 and nominal GNP has become so unpredictable that we are dropping it as a target rather than say we have a range but we don't intend to stay within it?

MR. JOHNSON. I think there is some information in M1 relative to M2 and M3. What we have seen is a runoff in bank CDs into M1--to some extent a shift in savings from less liquid to more liquid form--and I think it is important to monitor that. I would be much more concerned about M1 if it were rising and M2 and M3 also started moving. It has some relative significance, but I don't know right now whether we could set a target and make any sense out of it.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I am afraid I won't do much more than join the discussions that have already taken place. It seems to me that it is honest to say, first of all, that M1 has [served us] quite well in the past and perhaps will come back full circle to where there will be a restoration of some historical relationship between income and money growth and we will want an M1 target again. As a result, I would prefer not to drop it but rather, as Emmett said, to be more honest and say we'll have a range for it but expect not to hit that range in 1986--and I should think in 1987 also, unless there is a return to some historical relationship. The Bluebook has the language that I think would be appropriate. It says that M1 [would be evaluated] depending on "developments in the economy and financial markets, and potential inflationary pressures." That is the kind of explanation, it seems to me, that would be appropriate after we have said we don't understand what has happened to M1. Therefore, I would opt to retain the 3 to 8 percent range for 1986 and also for 1987, with the explanation. We'll have another opportunity to look at it in February.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I am in favor of dropping the range for M1--in particular for 1987. We don't intend to meet it and we don't really know--

CHAIRMAN VOLCKER. You said particularly for 1987?

MS. HORN. Yes, I favor not announcing a range for M1 for 1987. As to how we handle 1986, I also favor not having a range. Whether we do that by actually eliminating the range we have already set or by saying that it was set and we are not going to come within it, I don't feel too strongly one way or another as long as we don't announce a range for 1987. I think it communicates that for the moment we have to step away from this. As you can imagine, I also have great hopes that we will come back to it one day.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. I reach a rather different conclusion, Mr. Chairman. I think Don Kohn set a very good stage when he said the real question was not what we do with M2 and M3 but what we do with M1. Even someone who has thought, as I have, that M1 has been so important has to admit that it has been behaving very strangely. So, I think it does deserve somewhat special treatment at this point; but I think it would be a decided mistake to downgrade it completely, since it is the aggregate that we can control better than any other. If we downgrade it, then that might jeopardize--and certainly would be perceived by a large part of the market as jeopardizing--our chances of attaining our long-run objective of permanently restoring price stability. I think we have to recognize that [prospective role] at some point--that is, after the more normal relationship is re-established between M1 and the economy. With interest rates having fallen the way they have, and with the general expectation that there won't be a great deal of movement in the last half, I think we might be at the point where we begin to see those relationships resuming in some form or another. So if you buy that part, that gets to the question of whether to take these wider ranges beginning from the first of the year or whether to rebase. As they are set up in the Bluebook, it really doesn't make a whole lot of difference so far as the end point is concerned, because rebasing from 3 to 8 percent results in a growth rate of 10.2 percent above the fourth quarter of 1985 which would be sort of in the middle of these two alternatives--raising the ranges or rebasing back on the fourth quarter of last year. But to me it would be much more logical to rebase, because my guess is that this unanticipated further substantial decline in the velocity of M1 in the first half of the year was due largely to this sharp decline in interest rates; and since we don't expect that to continue, to me it would make sense to sort of forgive that and rebase. But a second and more practical reason to rebase is that if we are going to move this range down over time, it is going to be a lot easier--from a public relations standpoint--to move it down to something that eventually is compatible to price stability if we come down from a rebased 3 to 8 percent than if we had 5 to 9 percent or 5 to 10 percent and then suddenly said next year we want 3 to 8 percent or whatever it is we decide on. I would definitely rebase, and I think 3 to 8 percent might be a good place to put the range. And I would hope that in 1987 we could move it down somewhat from that point.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. I would be strongly against rebasing and also against changing the range. It seems to me that basically we have all concluded that we don't know very much about the relationship between money and economic activity in the last 18 months, but more importantly, that we don't have much confidence that we will know all that much more in the future. Consequently, it seems to me that the most honest thing to do is to leave the range for M1 where it is and simply indicate, as is shown in the proposed language of variant I, that for 1986 we are leaving the range at 3 to 8 percent but we are not going to pay a great deal of attention to it. As far as 1987 is concerned, it seems to me that if you buy that--particularly if you buy the idea that we are not confident of knowing what kind of relationship will exist between economic activity and money in 1987, then the choice is really an obvious one, and that is: Don't set a range. Because if we set a range--be it a range from a changed base or whatever--it implies that we have some degree of confidence about a reassertion of a predictable relationship between money and economic activity. And I don't have that confidence.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. As far as the balance of 1986 is concerned, I would couch M1 in terms of a monitoring range as we have used that term in the past. In that setting, I would probably have a mild disposition to have what I would call a realistic range for the year, not rebasing it. But I could leave it at 3 to 8 percent too. I prefer a monitoring range with a realistic range. I come out rather differently in terms of 1987. I would prefer to have a target for 1987 and I would couch the language for the M1 target for 1987 in terms of suggesting that that range is based on the assumption of a return to a more normal velocity relationship. And if that were not to materialize, I would demote it in February back to a monitoring range. I have no strong theoretical persuasions about M1 or any M, but I am inclined to the view that, as sure as we sit here, the day will come when we are going to want to have M1. And if we completely discredit it to the point where nobody pays any attention to it, it is simply not going to be possible to resurrect it when it suits our purpose. So, I think we need some continuity there, but I would be quite flexible as to how to achieve it; certainly, for the balance of this year a monitoring range is fine.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, for 1986, I certainly would not like to see us revise the range because doing that would imply a sense of confidence in what we think M1 should be later on in the year and I don't think we have enough information, given the recent behavior of M1, to have that kind of confidence. By the same token, I wouldn't like to see us rebase because by rebasing we, in effect, would be forgiving the growth of M1 that has taken place already. That, too, implies that growth in M1 was due to a one-time phenomenon that is now going to be corrected. So, I think that rebasing or revising is not the way to go. Nor would I think it desirable, given the history of M1 over the past several quarters, to announce a range and then say we are not going to pay any attention to it--that we are going to overrun the range for the rest of the year. So, I think the better course of action is to put this M1 aggregate on a monitoring basis. Now, maybe this is a matter of semantics. But some people have talked about dropping M1 and dropping M1 means discrediting the aggregate and saying that it is over and done with--that we probably are not even going to look at it and we are not going to assimilate the information that it gives us. I think that would be a mistake and I would not like us to do that. I would like us to do what we did about a year ago and that is to have it on a monitoring range, observe it, and take whatever information it has but not set a range for it. I take it that we don't have to--

CHAIRMAN VOLCKER. How can you have a monitoring range without setting--?

MR. FORRESTAL. Well, setting target numbers. I don't think we have to set a public target for M1 if it is a monitoring range. In any event, I don't think it ought to be a target in the sense that we have had it up until now. I'd put it on a pure monitoring basis for 1986 and I would be inclined to wait for 1987 and not do anything about 1987 at the moment.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Well, I agree with the point that it is very difficult, given M1's recent performance, to come up with a range in which I would have much confidence. But having said that, I think we would be well advised at this juncture at least to consider establishing a range that we have some chance of hitting for this year, albeit perhaps a slim chance. In some sense, I think our credibility is a bit at stake if we continually run with something like 3 to 8 percent and then acknowledge as quickly as we say that, that of course we are not going to hit it. That leads me to some thoughts along the lines of alternative I or II, as expressed in the Bluebook, for the balance of this year. We obviously can achieve the same thing with rebasing; I am indifferent as to whether we do it through rebasing or simply by establishing a new range that we have some possibility of hitting. Obviously, alternative II is probably somewhat more likely in that regard. One of the other advantages of doing that is that as we look ahead to 1987, if we establish a revised M1 range consistent with alternative II, which was 6 to 11 percent, we could at the same time consider a somewhat lower range for next year with all the caveats that have been appearing in our directives and in our ranges for several years--well, for at least more than a year now. In my mind, that would at least be a signal and demonstrate our intent to work toward price stability over time. So, I would favor something like 6 to 11 percent for the balance of this year, with something lower next year for the purpose of moving in the direction that I think we ultimately want to go.

CHAIRMAN VOLCKER. I don't want to get into just what the range should be at this point, assuming we have one. Governor Angell.

MR. ANGELL. It seems to me that a midyear change in the range would make more important what we do not want to make more important. The markets have already understood very well; they haven't had to have any guidance from us that we are permitting M1 to grow faster than the 3 to 8 percent range. So I think the less said, the better. Leave 1986 as it is. I would strongly endorse Mr. Corrigan's position that at some point in time--when, we do not know--inflation might once again return. You understand I say "return." And if it were to return, then velocity would behave in a manner consistent with those periods when inflation was a factor and it would be very important for us to have the M1 tool ready to go. My particular preference would be for 1987--well, you don't want to talk about percentages. But I do think it is important for us to have M1 in there. I don't think we need--

CHAIRMAN VOLCKER. You can make a vague statement about that.

MR. ANGELL. Well, my vague statement would be that I would prefer for 1987 what you may remember I preferred for 1986: a 3 to 10 percent range because we do not know at this point in time how velocity is going to behave in the deflationary environment that we are in.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, it seems to me that the immediate problem is probably more one of form than of substance. We talk about honesty, and I guess that's in the eyes of the beholder. I would think that would be a straightforward change in the range--not dropping it and not rebasing it--to the money growth we would anticipate, much as Gary said. I would just do a straightforward change in the range at this point and say this is what we anticipate M1 will do--without having to say that it's a monitoring range or that we don't know what it's doing or that we are not going to be paying very much attention to it. The numbers might look a little large--larger than we are used to seeing--but I would be pretty straightforward on that. For 1987, I would keep M1; there again I would be inclined to make the best judgment we could about what money growth numbers we anticipate, and I would construct the ranges around them. Again, they might be a little large, but I would do that here at midyear, because before we have to really settle on that early next year we would have the opportunity--if more normal relationships develop--to make an adjustment downward. I would rather go to the up side now and come down [later] rather than shoot low and have to go over. Those are good economic terms!

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, I wouldn't change the range for 1986 or for 1987, nor would I rebase for 1986, because I think for all the statements that we could make, I would have very little confidence in any range or any base that we might choose. But I wouldn't drop the aggregate either for 1986 or 1987. I would think of the two periods as a continuum; I would leave the target where it is for this year and reestablish the range at the same level for next year, but make it perfectly clear that we might expect the results to be at very considerable variance with the target, and that in the interim period we are placing our emphasis on M2 and M3. I think [Jerry] made an important point: that at some point these relationships are likely to come back into line and that we are going to want to reuse M1 when we have the confidence that those relationships have been reestablished. If we keep it in the menu, I think it would be easier to accomplish that than if we drop it at this point.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I really think our credibility with financial market participants would be enhanced by admitting what is obvious: that we don't know what is going on with M1 and we can't really explain it. The relationship between monetary growth, as measured by M1, and economic activity has certainly broken down. Therefore, we are better off not coming up with a quantitative range because regardless of what we call it--a monitoring range or something else--the Fed watchers still look at the numbers and they still plot and compare actual M1 figures to whatever range we have mentioned. Also, the media pick these numbers up and do the comparison regardless of our warnings about how risky it is to make something out of it. They still do. I think we would be better off dropping it--maybe "dropping" isn't the proper term; maybe "putting it on ice" or something like that would be the terminology to use. I think we are just misleading people when we keep a numerical range for either 1986 or 1987.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I have gone back and forth in my thinking about this. I wanted to hear some of the discussion here today. In general, I think it's very important that we have a narrow aggregate like M1. And I guess M1 is the best one we have right now because of the control characteristics and historically, anyway, the relationship to GNP. Now, whether any of the work going on to come up with a better narrow aggregate will pay off and we will come up with such an aggregate, I don't know. But for the reasons Governor Angell and President Corrigan cited, I would favor an approach that maintains the credibility of M1 down the road should we need it. One thing that concerns me about either rebasing or increasing the growth ranges at this juncture would be the implications that might be read into that in terms of how policy would be conducted in the second half. If somebody tore it apart and said: "Well, 6 to 11 percent looks like a pretty broad range but that implies month-to-month money growth from June to December of less than 8 percent" we conceivably could be sending a signal of tightening at a time when I don't think we want to do that. I think, politically, too many people are trying to jump on us right now in terms of policy, and [adopting] that range might increase that.

CHAIRMAN VOLCKER. Just so I get it clear in my mind, is it literally true that 6 to 11 percent implies 8 percent from now on?

MR. KOHN. Eleven percent implies just about 8 percent from June to December.

MR. MELZER. In any case, whether it is established as a monitoring range or whatever, I think there is potentially a problem in terms of resetting the range at this juncture that could really affect the credibility of this aggregate down the road. In other words, we should only reset the target if we pretty much rededicate ourselves to trying to meet that target. I don't think that we have a credibility problem with markets right now in terms of M1; I think they know we have been treating M1 differently. If we were just to say that we are not going to meet the target and put it on a monitoring range through the balance of this year, that would not create a problem. I would agree with what Jerry said that we ought to have targets for next year. I think that's important. We could see circumstances where we will need the rationale to support a firming in monetary policy and that likely would provide it. So, I would like to get from here to there maintaining as much credibility as we can for the M1 aggregate or a narrow aggregate that might take its place.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I think the behavior of M1 is still going to be so [uncertain] that the main issue is whether it is a viable target, regardless of whether or not its growth is going to be very strong. [Unintelligible.] So I would argue, not to trust too much in what we can do in terms of the M1 numbers, but to in effect [monitor it]. [Unintelligible].

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. I have two additional comments. With regard to 1986, I would be reluctant to support either alternative I or II because I don't have much confidence that they could be reached, particularly if for some reason we felt that a somewhat more accommodative policy would be appropriate in the shorter term. The second point relates to a comment Jerry made. I agree with Jerry that we should have a target for M1 to operate on in 1987. But please keep in mind that this is July of 1986, and what we basically could be saying is that we are not specifying a target in July because we do not have enough information. One could certainly address that issue for 1987 at the beginning of December, if one wanted to, for operational purposes.

CHAIRMAN VOLCKER. It's not quite relevant, but I would remind people that once we tried to do that with all the targets. We said: We aren't quite ready; we'll set them at the end of the year. And Mr. Proxmire sent us back, threatening us with a legal suit. But I don't think that's relevant, really, in terms of just one of the aggregates. Do you have anything to say, Mr. Boehne?

MR. BOEHNE. Well, I must confess that I find this to be one of the lesser issues of our times, so I haven't been able to generate strong feelings one way or the other. I think I would come down on the side of keeping the 3 to 8 percent target--but, in effect, suspending it--on the grounds that it might be useful at some point. I would also keep it for 1987, but surround it with as many caveats as I could conceive of.

CHAIRMAN VOLCKER. Mr. Morris, you are against anything [relating to] M1. You would say drop it and bury it?

MR. MORRIS. My position is very simple, Mr. Chairman. I don't think we can measure money in the old transactions balance sense in the United States. I don't think that we are going to be able to do it next year or the year after that or the year after that. I think it is nostalgia that is reflected in all of these comments about M1 returning to its historical relationships; the probability of that, given the changed character of M1, has got to be extremely low. It seems to me that at some point we ought to say we can't measure money in the old sense because of all of the institutional changes that have taken place and, therefore, we are going to use liquid assets instead of money as a target. I would have M2 and M3 and, since we always have three targets, I would add total liquid assets.

CHAIRMAN VOLCKER. Whose growth is very low this year.

MR. MORRIS. I know it; and it's not incompatible with what's going on in the economy either. It has been decelerating since mid-1984; and if you look at the rate of growth in nominal GNP, that has been decelerating too.

CHAIRMAN VOLCKER. So was debt a few years ago and that has been rising like crazy.

MR. MORRIS. I think I tried to unsell debt some time ago.

MR. BLACK. It's not necessarily the old relationships that would have to re-emerge but predictable relationships. I think the trend of velocity is going to be lower in the future than it has been in the past.

MR. MORRIS. We will need a predictable relationship for an extended period of time. You don't take one six-month period of experience or a year's experience and get predictable relationships.

MR. BLACK. I agree with that.

MR. JOHNSON. We really need some time series on how much in NOW accounts are people's savings.

MR. BLACK. We need a lot of future information so we would know what to do next year too. That's really what it comes down to. I don't think we have to have the whole relationship resumed but we have to have predictable relationships if we are going to use any kind of monetary target. But the alternative, which you posed very well a while ago, Frank, is choosing a level of interest rates, unless we do something like Chairman Volcker once suggested when I made a similar assertion that we can stabilize the exchange rate. But basically in a country like this, we have two choices: use some aggregate or pick the appropriate level of interest rates. And the question, I think, is on which path we'll make the smallest mistakes.

MR. ANGELL. We're probably going to make big mistakes on both of them.

CHAIRMAN VOLCKER. Or commodity prices or something.

MR. MORRIS. Well, I think the biggest mistake we could have made would have been to follow M1 the last 4 or 5 years. I think we would have set this country right on its ear.

CHAIRMAN VOLCKER. Well, I think there is some disagreement about how much weight we want to retain on M1 for some indefinite future period that we don't quite know about. I don't know how to resolve that problem. I suspect it's unresolvable in the sense of getting agreement among the members. I have a little logical difficulty with a monitoring range regarding what it means or at least whether we really want to do it. If we establish a monitoring range that means anything, we've got to establish a new target.

MR. JOHNSON. I think what most people mean is that we monitor it but not really set a range.

CHAIRMAN VOLCKER. I'm really addressing it to the only persons, at least on this Committee, who said set a new range. When you come up against Mr. Melzer and Mr. Parry, the problem is: How do you know what you want to set?

MR. PARRY. If you talk about language for 1986, variant I doesn't use the term "monitoring" but accomplishes it.

CHAIRMAN VOLCKER. We could change--

MR. PARRY. I think it's nice without it.

CHAIRMAN VOLCKER. We could write down a new range and say this is now a monitoring range. I don't know what we would say.

MR. RICE. We could keep the present range and say it's a monitoring range.

CHAIRMAN VOLCKER. Well, except that the present range is a monitoring range. We are monitoring how far outside the range we are now. It seems a little strange.

MR. FORRESTAL. We used that term "monitoring" in 1982 or 1983, I think it was.

CHAIRMAN VOLCKER. But we had a range.

MR. FORRESTAL. Did we? That was my question. Did we set a target at that time?

CHAIRMAN VOLCKER. Sure, we did.

MR. JOHNSON. We could keep the 3 to 8 percent, but [unintelligible] July.

MR. MORRIS. I think Manley's idea is the right one. We should say we are going to monitor M1 and we are going to monitor debt, but we are not going to set ranges for either of them. We are not going to set any monitoring ranges.

CHAIRMAN VOLCKER. All I am trying to think about is how we should word it. In the wording we can say all sorts of things; but how operational it is, I don't know.

VICE CHAIRMAN CORRIGAN. That is not what monitoring ranges have meant in the past.

CHAIRMAN VOLCKER. With a monitoring aggregate in the past, we have had a range. There's no doubt about it.

MR. MORRIS. What I am suggesting is that we say we think we may be able to learn something from the M1 data and from the debt data and we are going to continue to monitor that data but we are not going to set a monitoring range.

MR. PARRY. Doesn't the language of that first variant get us out of some of these problems? It doesn't use the word "monitor" but it says on the second page on page 21 [of the Bluebook]: "In light of the uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth of M1 in excess of the previously established 3 to 8 percent range for 1986 could be acceptable, depending upon the behavior of" etc.

CHAIRMAN VOLCKER. What page are you on?

MR. PARRY. Page 21, the second line beginning with "In light of." This is variant I.

CHAIRMAN VOLCKER. I think we would say something like that.

MR. PARRY. And that gets away from having to use the word "monitor."

CHAIRMAN VOLCKER. Well, the great majority of the Committee members--

VICE CHAIRMAN CORRIGAN. But we would have a number, just--

MR. PARRY. Oh yes, for 1986--the one we established in February.

MR. JOHNSON. I would change "could be" to "is."

CHAIRMAN VOLCKER. We don't need [precise] language now.

MR. BLACK. It seems to me that whatever numbers we put in there ought to be predicated in part on what we think we are likely to want next year. If you think we are likely to want a lot of growth in money then 5 to 10 percent makes more sense; but if you think by next year a lower figure would make more sense, then the rebasing argument comes into play. Then it comes down to 3 to 8 percent or 3 to 7 percent or whatever we might decide looks more logical from a public relations standpoint.

CHAIRMAN VOLCKER. Well, just summarizing the discussion, a great majority of the Committee members want some variant but don't want to horse around with it--just admit we are running over it for this year. The majority of the non-Committee members want to do the same thing. So, unless people have any great changes of heart I think we are someplace in that neighborhood. We don't need to decide this issue right now, but that is where we are unless there are great changes of heart tomorrow. Unless somebody gets persuasive with a gold tongue, we're much more evenly divided regarding next year. It's pretty evenly divided; I'm not being too precise about it. I don't think these are the most crucial issues; I agree with Mr. Boehne on that. I presume the choice is that we either say we don't know right now and we may or may not have a range by the time we get to the end of the year and have to decide, or we write a figure down--I would presume something like this year's--and say we'll decide at the end of the year whether we really need it or not because we are not at all sure that we mean it. And there isn't an enormous amount of difference between those two choices.

MR. BOEHNE. Which one do you feel more comfortable uttering?

CHAIRMAN VOLCKER. I think I probably would feel slightly more comfortable saying we'll get around to it at the end of the year, but I am not sure it makes a lot of difference. The only loss in doing that, and I don't think this is an enormous issue so long as we get the right language, is how easy it is to return to it if we want to. Clearly, it's pretty simple to return to it at the end of the year, if we really want to at that point. If we don't want to then, and we stated the range earlier, it isn't going to help much. I don't think the difference is all that enormous.

MR. RICE. Do you think the difference is of any significance for public understanding of what we are doing?

CHAIRMAN VOLCKER. Well, I presume if we didn't have a target, we would say: We are not crazy about being over it now, but we think we half understand and half don't understand it; and if M1 continues to run high and these other [aggregates] are running high we anticipate that we would get worried about it. We would look at it and take it into account, but we don't have any particular number in mind. If it was running high in connection with the others that would be of some significance to us. Next year we would like to see it a lot lower, but we are not ready to commit ourselves at this point.

MR. BOEHNE. I would urge my colleagues around the table to rally behind the Chairman.

CHAIRMAN VOLCKER. Given that you [don't] think it's an enormous point, I think that's about where we are at the moment. We will start tomorrow with the business outlook, which we haven't really dealt with, and then return to the long-term ranges in an operational sense. But I would hope not to linger too much over this M1 issue and be able to dispose of that in something like five minutes tomorrow. With the background of this discussion, I think that's roughly where the weight lies. So, unless somebody wants to be very persuasive tomorrow and feels very strongly--

MR. GUFFEY. May I ask for an explanation of the discussion that you just had with yourself with respect to 1986 and 1987 with regard specifically to the use of the term "monitoring range"?

CHAIRMAN VOLCKER. In that discussion I don't think I used the term "monitoring range" because we wouldn't have a range. We would say "monitor."

MR. GUFFEY. That's all I wanted to know.

SPEAKER(?). 9:30 a.m. tomorrow?

CHAIRMAN VOLCKER. Why don't we make it 9:15 a.m. because we have plenty of things to discuss before we go up to that lunch. Or, we can start at 9:00 a.m. if you want to. Let's start at 9:00 a.m. I had some crazy thought to say about this, but it has escaped me.

VICE CHAIRMAN CORRIGAN. Just to pick up on what you did say: The logic of what you are saying is that if we don't have a monitoring range, at least in an historical context, M1 is less important than debt because with debt we have always had a range.

CHAIRMAN VOLCKER. Well, I guess I would respond to that in some logical sense that may be correct. I don't think it really is correct. I think I am more certain even about the appropriate course for M1 right now than I am for debt. I do get worried about debt rising substantially faster than the GNP, I guess; I might not do anything about it but it doesn't seem to me right in the long run. I am not sure that one can say that about M1 in the very long run. For 1986 and 1987, I am not sure I can say it. I think something is the matter with debt rising as fast as it is. I am not sure that something is the matter with M1 rising as fast as it is for this limited period of time. Sure, if it grows that fast for five years, we would be in trouble. But if we are in some kind of transition to a new world, maybe M1 relative to GNP is still very low historically.

Debt is very high historically. That is suggesting that we [should be] more worried about the level of debt than about the level of M1 in some sustainable sense.

VICE CHAIRMAN CORRIGAN. I am not sure I quite follow that "relative"--

CHAIRMAN VOLCKER. Well, it's statistically true, I think. When you look at the levels, it's statistically correct.

VICE CHAIRMAN CORRIGAN. But in the historical context that we use these things, wouldn't you say it's also true that--

CHAIRMAN VOLCKER. [Growth in] M1 is very rapid relative to that of GNP for this period in time. There's no doubt about that, historically. They are both equally out of line in terms of the year-to-year growth path.

VICE CHAIRMAN CORRIGAN. So treat them equally and have a range for both.

CHAIRMAN VOLCKER. You are going to get your two minutes to [expound to] everybody in a much longer discussion tomorrow. You can be really persuasive, but I guess you are going to have to convince people that they may not want to swear by your new range but monitor by it. Suppose you made the range the numbers the staff has here. What are they: 6 to 11 percent or something?

MR. ANGELL. No, 3 to 10 percent.

CHAIRMAN VOLCKER. Well, you are talking about next year; I am talking about this year. Suppose you made it 6 to 11 percent? Does that make you feel more comfortable than some other figure in terms of--?

VICE CHAIRMAN CORRIGAN. Well, it makes me feel more comfortable only in the sense that we might run into the situation that you yourself described, where the economic situation was different from the one we are looking at right now and M1 was growing at 15 percent and M3 and M2 were at 9 percent. If we didn't have any kind of a quantitative range for M1, I don't see how we could bring it to bear in a policy context. But at least if we had some kind of a quantitative range, it seems to me more credible that it would manifest itself in those circumstances.

MR. ANGELL. Are you arguing for 1987?

VICE CHAIRMAN CORRIGAN. Yes, for any period. I don't think it matters in a literal sense in the near term--certainly not the [next] 12 months or so. But I just have this nagging feeling--

CHAIRMAN VOLCKER. I'll give you one to go home and think about overnight. Suppose the economy was moving more rapidly than all of these projections, and everybody was feeling much more buoyant, and maybe M2 and M3 were a little high but not outside the ranges, but M1 was behaving quite nicely within your new 6 to 11 percent range. Say it's only 10-1/2 percent.

VICE CHAIRMAN CORRIGAN. That would bother me.

MR. ANGELL. That could be a real problem.

MR. MORRIS. Or it could be like 1976, when M1 came in very low.

VICE CHAIRMAN CORRIGAN. We can't deal with every contingency with one set of numbers. All I am saying is that I think there is a danger of getting into a position where we have no quantitative hook whatsoever.

CHAIRMAN VOLCKER. Well, we will see tomorrow, with a short additional argument, whether you can persuade your colleagues.

VICE CHAIRMAN CORRIGAN. Sounds reasonable.

[Meeting recessed]

July 9, 1986--Morning Session

[Secretary's Note: Chairman Volcker called for a discussion of the economic outlook.]

MR. KEEHN. Well, Mr. Chairman, our outlook for this year and next year is consistent with the staff forecast; our numbers are close in a broad sense. In the Midwest conditions of expansion continue but certainly at a slower pace than in some other parts of the country. The consumer side out our way is pretty vigorous. Retail sales have been improving and one chain we talked to had the [best] May they have had in years. Auto sales seem to be pretty high, about equal to last year's level. But the manufacturing sector, as always, is pretty mixed. There are parts of it that have been doing well and continue to do well; building products are an example of that. All of the people in the building products side are operating pretty much at the top of their capacity. Those parts that have been weak show no particular sign of improvement. A somewhat recent development is that two large crane manufacturers in the Midwest in effect have gone out of that business; they just decided to get out.

CHAIRMAN VOLCKER. What kind of manufacturers?

MR. KEEHN. Heavy crane manufacturers. Farm equipment and railroad equipment are operating at about 25 percent of their levels of the late 1970s. Every once in a while, maybe for myself, I take a look at the railroad numbers. In May of this year, for example, there were all of 950 cars ordered. For the five months through May 1986, ordering has been at about the 6,000 level. That's up from 1985, but for the full year in railway equipment there is the anticipation that there will be about 10,000 cars ordered. That compares with the peak level in 1979 of about 90,000. That certainly is one example of a troubled industry.

There are two specific areas that I thought I would comment on. One is construction activity, which in the District and in Chicago particularly, has been and continues to be extraordinarily strong. On the residential side, housing starts in the District for the [first] five months of the year are up 24 percent as compared with those five months a year ago. In Illinois they are up 57 percent and I think that's the largest increase of any state in the country. In Chicago the number is even much larger than 57 percent. So, we have a very significant housing boom going on.

In the nonresidential sector, floor contracts are continuing at what seem like increasing levels. For the five months of this year floor area contracts on nonresidential [structures] are up about 5 percent; that's a contrast from the national figures, which indicate a slump. And in Chicago the office boom continues despite the strong activity that we have had over the last two or three years. Many buildings are being announced; in one way or another some 14 million square feet have been committed to over and above what is already going on. My conclusion on this is that in the construction side we have some trends going on that certainly seem pretty unsustainable.

On the inflation side, the news continues to be pretty good. Pricing is terribly tight. Everybody I talk to says that both raw material and product prices are extremely tight, with very little give, and increases certainly just aren't sticking. That's true even for the industries that are going through pretty high levels of activity. Paperboard is an example. That's an industry that is doing well. This April they had the biggest April that they had ever had in that industry and yet even now the pricing is only very modestly recovered from the amount that they lost during the recession. I commented before on labor contracts that have been settled. I think the news there continues to be pretty good. By and large the contracts are coming out on a three-year basis at about 3 percent or a touch under--a higher settlement in the first year but declining in the second and third years. But importantly--and this goes back to a chart that Mike Prell was showing yesterday--I am hearing that there are very, very substantial work rule changes in these contracts. Although managements are going after the financial side, they are really going all out after the work rule side. As a consequence of those substantial work rule changes, in terms of unit labor costs, I think the outlook is pretty good. Two steel companies have settled their contract negotiations; hourly wages were reduced and in both cases the COLAs were eliminated. Inland Steel's contract was up for a vote. The ballots were counted yesterday and I don't know how it came out, but that would suggest a similar pattern. Caterpillar settled over the weekend. They have not announced the terms of the deal, but they did reach a negotiation and the expectation is, or it's entirely possible, that it will call for a wage freeze but that they did not get rid of the COLA. They wanted to get rid of the COLA but they did not.

CHAIRMAN VOLCKER. Who is that?

MR. KEEHN. Caterpillar. I know you saw the and I think he was suggesting to you a higher number than, in fact, worked out. It sounds like they got a freeze but didn't get rid of the COLA. They went into [the negotiations] thinking they'd have a higher number. Deere is next on the list and they will have a very tough negotiation; they would like to get rid of the COLA and they would like to get a freeze as well. I might mention that there is a little mini-exception to this 3-year, 3 percent pattern that I mentioned. It relates to us. The Chicago Building Trades have been [unintelligible]--those that had an impact on our building projects. There was a settlement there over the weekend for a 2-year contract and a 5 percent annual increase. But I think that's a very narrow, very specialized kind of situation. Net, the labor cost situation seems to be pretty good and the outlook for the next year or so okay.

I have a final comment on this tax legislation. As I talk to people, I have a growing feeling of gloominess on the business side in that the shift of the burden from the consumer to the business side seems to be having a heavier toll, at least on outlooks. And I think the introduction of the changes on a staggered basis is causing apprehension. I hear what Jim says as to the impact but, at least as I hear the comments, it sounds like it might have a greater effect on 1987 than perhaps they have provided for [in the forecast]. As we look at it now, we expect the expansion to continue, though certainly at a more modest pace than was our expectation earlier in the year. But at this point, as we view it, we are very, very dependent upon the consumer; and I think as a consequence it will be important that we do anything we can do to deal with the consumer side of this.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Our forecast is very similar to that of the Board's staff. We do have a slightly more rapid pickup in the second half of this year, but I must admit that more recent information that we have about inventories raises the likelihood that the pickup will get a later start. Also, our forecast for business fixed investment is slightly greater than that of the Board's staff. For 1987, our forecast for growth is virtually the same. We differ in our inflation forecast; but I think our forecast of a percentage point higher number for inflation is not all that significantly different, given the uncertainties associated with the forecast at this time.

In the Twelfth District, the general economic picture remains quite mixed. We have quite a few industries that are doing well, such as commercial aircraft, electronics, and retail trade. But we also have our share of weak industries. Agriculture is weak and a little weakness has shown up again in the forest products area. The thing that I would like to note is that in recent discussions with our directors and also with our business and agricultural advisory council and others in the business community, there has been a noticeable erosion of confidence in the last month or two. Before we were hearing optimistic signs from all of these people; now they seem to think that things have become noticeably worse. Basically, I think their comments are reflecting the weakness that actually did occur in the second quarter. And frankly, they expect it to continue in the second half. I sometimes think that their forecasts are based primarily on what they see over their shoulder or what they are experiencing at the present time. But I think it is significant that their sentiment has changed in the last month or so. On Thursday, we will have a meeting of our board of directors. It's interesting to note that at the last two board meetings there has been a very close vote against lowering the discount rate; I really think it's quite likely that that's going to change at this Thursday's meeting.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. When you have a spate of bad news such as we have had the last month or two, it's very tempting to focus on that part alone; I think all of us tend to do that. The good news is that the same thing happens on the other side and I think it's good for us to step back a little and try to take a little longer perspective than we sometimes do. If I remember correctly, back in April we were all pretty bullish because we had several fundamental factors that we thought were going to oil the wheel for the last half of the year: we had the declines in prices; the depreciation in the dollar; and then the continued low inflation. All this seemed to suggest to us that things were going to accelerate. And that was a very short while ago. Now, of course, we have reached the point where the depressing effect of the oil price decline on the producers is apt to be replaced by or surpassed by the positive effect on the oil users. So putting all these things together, it still seems reasonable to me that we ought to have a pretty fair increase in the second half of this year. We have revised our figures downward as a result of the bad news that has come in, but we are still just a tad above where the Board staff is and about where the consensus is of the Reserve Bank presidents' forecasts. If we get some more information that is below par and in particular if we don't see some improvement in the trade situation, then I think we are going to have to take another look at it. But for the time being we think that we might have [growth of] 3-1/2 percent in the third quarter and maybe 4-1/4 percent or something like that in the fourth quarter.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, in the Sixth District growth has been about the same as in the nation as a whole over the first half of the year. But over the last month or so we have seen some weakening of the District economy on average. To be sure, we still have some pretty positive sectors in the economy. Consumer spending has held up pretty well: merchandise sales have been good, particularly in the furniture area, which had been hard hit by imports but recently seems to have been helped by the pickup in housing in the Southeast; and auto sales, while off a bit, still continue at a pretty high level. Single family housing has been good and, like other parts of the country, we have benefitted from the slackening of European and other overseas travel and tourism has picked up considerably. That has been a positive element in most areas of the District.

I have been reporting pretty favorable news in the Southeast over the past year or so, but this time I think I would have to point to some very serious problems that have developed. First and foremost, of course, is the energy sector with a contraction that I believe has been more severe than we had expected earlier. And the weakness has spread beyond the energy sector itself and is reaching into state governments. For example, in Louisiana I heard a report that the state government is cutting back severely in the university system; programs are being cut and I think that will continue in other parts of the state as well. The lumber industry also has been badly hit. Commercial construction is a concern. Vacancy rates in most cities are not quite as high as the national average, but they are increasing; we are at a level of almost 20 percent on average. And a recent development that could become a very serious situation if it continues is the very severe shortage of rainfall that we have experienced. We have seen in most of the Southeast the most severe drought in over 100 years. That is having an impact, of course, not only on agriculture, which is already weak, but on other areas as well; and that impact is going to become even more severe if we don't get some relief. Water rationing, for example, is in effect in many places and now is beginning to have some effect on business production. Going back to the energy sector for just a moment, I wanted to mention that the rig count of Louisiana is now the lowest since 1949.

Looking beyond the Sixth District to the nation as a whole, we too have changed our forecast for the latter part of 1986. We don't think that activity is going to be quite as strong as we had forecast earlier. We are about on the same mark as the Board staff in terms of growth for the latter part of 1986. For 1987, I think we are showing slightly higher growth. Our difference with the Board staff's forecast in 1987 I think relates basically to inflation. We see inflation somewhat higher than the Board staff; the difference there, as I have analyzed it, is that we perhaps are attributing a little more impact to the dollar effect than the Board staff is.

I have just two final comments that echo what Si Keehn was saying. People that I am talking to around the District are very apprehensive about the effects of the tax bill. I think the uncertainty surrounding it is certainly causing them to pause with respect to business investment. But having said all that, when I talk to people generally, the confidence level as of maybe a week and half ago was still pretty high. People in individual businesses say "My business has never been better." In trying to analyze this, I have just a very quick impression [along the lines] of what we were just talking about this morning. People who are reporting very good results for the first half of 1986 are basically the smaller and middle-sized businesses. I don't hear that from the larger concerns. I just throw that out for what it may be worth. I don't know whether that has general applicability or not.

In summary, Mr. Chairman, my feeling is that if we don't see some faster activity emerging pretty soon, I think the more positive--the more acceptable--outlook for 1987 really may not develop.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. The Third District continues to do better than the nation as a whole. Construction activity, particularly the housing market, has been quite good. Pennsylvania ranks second only to California in the total number of existing homes sold during the first quarter, and the average cost of a house in the Northeast is higher than the cost of a house in the West for the first time in recent history. Nonresidential construction has begun to soften some, but not to the extent that it has in the nation as a whole. Retail sales have been especially good in the Philadelphia area; I think it has something to do with the relative strengthening of expectations about the economic future of the area, which for a number of years was not good. I think it is beginning to catch up to people as the outlook is better. Manufacturing continues to be something of a drag, but not as much of a drag as in the rest of the country. If you look at things like help wanted advertising, that has reached a high point and continues to be expanding. It's awfully hard, particularly in the suburbs, to go into stores without seeing signs in the windows asking for people to apply. I find the same kind of dichotomy, however, as Bob Forrestal does. There does seem to be more optimism among people in smaller and medium-sized businesses than those in the older, traditional large firms. I guess that has to do with just the nature of the economy. I have not sensed a general deterioration in sentiment, as Si has. I think sentiment is still reasonably optimistic for later in the year, although it may be more fragile than it was a few months ago.

Turning to the nation, there is something of a dichotomy in what I have just said about my own region and my views about what is going on in the nation. I am more bearish now about the outlook than I was a few months ago. The reasons have to do with both the timing as well as perhaps some changes in the fundamentals--or at least our perception of the fundamentals. In recent discussions around the table, I think most of us have tended to emphasize the positive things about the economy: the drop in the dollar and oil prices, etc., etc. Yet there are a number of drags: in petroleum, in farming, in export demand, and tax reform itself. While most people think it's probably good over the long pull, there is definitely a drag in the short pull.

My sense is that we have tended to over-emphasize the effects of the stimulative factors and have not taken into account, at least to enough of an extent, those factors that are dragging on the economy. Part of it is timing, but I think some of it may be more fundamental than that. So where I come out is that, yes, I still think there is going to be a pickup. But I am less sure of that than I was; I have more doubts about it. I find it quite difficult to see the threat of too much economic growth in the months ahead, but I could much more easily visualize too little. On the inflation front, I think inflation is an ongoing threat and we have to be careful about it and sensitive to it. But it does strike me as less of a threat now than the threat of too anemic an economy as we go to the end of 1986 and into 1987.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. My forecast is similar to the staff's forecast, but I have found myself in the last three or four months relatively concerned about the downside risks of the forecast. I focus these concerns on two particular areas. First of all, like many others, my forecast depends on a significant improvement in exports and I wonder whether that is really going to come to pass. The other area that I focus my concerns on is the long list of imbalances in the economy. I'm not quite sure how that works through the forecast as would the failure of net exports to improve; but the list is long and this seems to me to be a very difficult economic environment for a recovery to continue.

Turning to the District, our recent numbers show no significant strengthening but no significant deterioration in economic activity. From businessmen in our District--our directors among them --I sense a growing caution but not yet disappointment in the economy. Perhaps they are not disappointed on the trade side because they were always skeptical about the trade rebound; they didn't expect it and it hasn't happened. They continue to report intense import competition and we, like Si Keehn, also have industries that simply have been unable to lift their prices. Again, as in Si's District, our businessmen and directors seem fairly happy with the labor arrangements they have. I know it's fashionable to talk about changes in work rules when you have labor settlements, but I hear that talk often enough and from enough people that I think they are not posturing--that maybe this is really happening. I hear a lot of good feelings about the whole labor arrangement that businessmen are facing. A lot of the them seem to attribute the present sluggishness to the up-front problems with the oil industry. We have a reasonable amount of that in Ohio; Marathon just announced layoffs yesterday, as a matter of fact. In conclusion, I think the economic outlook is good, but the risks are increasingly on the down side.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, the New England economy is still growing extremely well as exemplified by the fact that McDonalds is offering $4.95 an hour and is still having trouble finding people to flip hamburgers. But my reading is that the national numbers are very disturbing. I have been very optimistic that we were going to see an acceleration in real activity in the last half of the year, certainly on the basis of what the broader monetary aggregates have done in the first half. That suggests that we ought to be seeing about a 7 percent nominal GNP growth, and I thought that was just about right. But the staff is now forecasting 5 percent instead of 7 percent. And I am inclined to agree with Mr. Boehne and Mrs. Horn that if there's something wrong with our forecast, it could be that the forecast is too optimistic. I see a sense of contrast between [the economy and] the financial numbers. If I were sitting on a desert island and had only the financial numbers, I would say there is a tremendous boom going on in the United States. But if you look at the numbers for real activity, the last month gives no encouragement that we are going to get a faster rate of growth in the third quarter. The new orders figures certainly don't suggest it. The deceleration in the rate of payroll employment gains doesn't suggest it. I really don't understand what is going on out there. The system is not responding according to the rule books that I would follow. So, I find this very disturbing. For months I have been thinking that monetary policy has been doing everything it could to produce a healthy economy. I am less confident of that today because of the seeming failure of the real economy to respond to what the financial economy has been doing.

MR. BLACK. It looks like the string we're pushing on is a wet string!

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, as I have been reporting, things have not been going all that well in our District. The Eleventh District economy seems to be about the weakest in the country. Not only has our situation gotten a little worse, we expect it to deteriorate even further and possibly at a bit faster pace. The Texas unemployment rate in June rose to 10-1/2 percent, and that's the highest level in modern times, certainly, for Texas. New Mexico and Louisiana expect to show increases in unemployment when their data become available. The last report for Louisiana was 13 percent and that's probably on the way up. As conditions worsen in energy, construction, and manufacturing, that is having some fairly severe effects on our financial institutions. If you read the papers, it's pretty hard not to see one of our Texas organizations being featured in one of the articles. Their performance has really not been all that good! Looking at it from a supervisory standpoint, we don't [rate] our major bank holding companies very high from a supervisory level! Those that seem to be doing a little better we wonder about, because some of their major subsidiaries haven't been examined for a year or year and a half and that makes us a little concerned over what the true situation might be.

Now, I tried very hard to find some positive elements of strength in our District to report this time, but I just was not successful. Aside from this regional report, though, I continue to feel with regard to the broader picture that there will be some modest pickup in the second half of this year. Our forecast is in the middle of the forecasts of the Reserve Bank presidents. And we think this is sustainable into 1987, if there's some monetary stimulus that comes about to offset the economic drag of the uncertainties that are inherent in the fiscal environment.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. In the Eighth District, I'd say things are going along pretty well. We've heard a couple of comments about a change in psychology; I haven't detected too much of that. Psychology among businessmen is pretty much the same as it has been according to what I've picked up. On an annual basis, we've had a good year in terms of nonag employment gains; they have exceeded the national gains by about a percentage point. Manufacturing employment has been pretty much flat, although in the most recent three-month period we had modest gains there. Retail sales were lagging somewhat early in the second quarter, although the sentiment was that the second quarter and the third quarter would come in quite strong. Residential construction has been mixed. Single-family construction has been and continues to be very strong, particularly in St. Louis; commercial construction activity in St. Louis, which I think in general has lagged behind some other cities in the country, continues to be strong and in the District overall it is down less than nationally.

In terms of the broader picture, our forecast would be for the same rate of real growth as the Board's staff has both for the balance of this year and next year and somewhat higher on the inflation side. In terms of real growth, while that's lower than I might have expected a month or two ago, I'm not particularly troubled about looking at 3 to 3-1/2 percent real growth as a projection, given the overall growth rate that seems to be prevailing in the world and productivity gains and so forth. So, while it's lower, it's not something that at this point troubles me to the extent that I'd be inclined to react to it.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Dealing first with our District, the cross-currents that have characterized the economy in the District are a generalization between the rural economy and the urban economy. Those cross-currents persist, with the urban economies in general doing reasonably well and the rural economies continuing to struggle. Beyond that, looking at some of the state-by-state data, one of the things that has emerged recently is that the numbers in the two states in our District that have some involvement in the energy area, Montana and North Dakota, clearly look worse than the rest of the District. In the rest of the District, while growth isn't as gloomy, in general I would say it's certainly respectable and reasonably broad-based. But because of the energy involvement it looks like there is some contraction, certainly in Montana, and maybe some flatness in North Dakota. Beyond that, one of the more interesting things that has happened recently, and was a surprise to me, was that three or four new nonresidential construction projects have been announced for the Twin Cities. Whether that is good in the long run, of course, is an open question because I think we are close to--if not already at--an overbuilt situation. But in the short term that probably does augur well for employment and so forth in the metropolitan area.

As far as the national outlook is concerned, I share the optimism evidenced in the Board staff's forecast, and indeed, I might be inclined to go a bit beyond that. It seems to me, as Mike Prell suggested yesterday, that there are several factors that we can identify right now that clearly have been retarding the economy--things like what is going on in agriculture, the adjustment in the energy sector, nonresidential construction activity in general, and the lack of improvement in the trade situation to date. It seems to me that we can at the same time identify a couple of those negative factors that have been retarding the economy as having a fairly high probability of turning around at some point. In particular, I'm thinking about a prospective improvement in trade and certainly at some point a slowing, if not a stop, in the deterioration stemming from the energy side. It's impossible, I think, to say with any precision when that may occur. But I think we can look forward to some diminution in those factors that have been inhibiting economic growth. And when that is coupled with what I think are still some very strong fundamentals--the kinds of things that we have talked about in the past like lower interest rates, a lower value of the dollar internationally, lower energy prices, and so forth--to my mind the case for some acceleration in the pace of economic activity is still a compelling one. But I would repeat the caveat that I think it's impossible to say with any precision exactly when this may materialize. I didn't find the second-quarter performance particularly discouraging in this regard, because it seems to me that we have been well aware and have been saying for some time around here that the adjustment has been occurring in energy. We've been well aware of the so-called J-curve effects on the trade side and weren't confident--or at least I personally didn't expect--that somehow in the second quarter things were going to start to improve materially. But I think the basic case, and certainly my own expectation, for some improvement in real growth is still there.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Just a couple of quick words about the District situation, which I think is a lot like others have described in that small and medium-sized firms, even in manufacturing, are doing quite well to very well. Nonresidential construction and the housing markets are very, very strong, especially in the New York metropolitan area. The service sector--and of course there's a special premium on financial services--is in a state of near frenzy. But there's a great question in my mind as to how sustainable that is. The large firms, especially large manufacturing firms--both those that [operate] there and those that are headquartered there--are by and large pretty dismal in terms of their outlook. Even in the case of IBM, which earlier in the year seemed to think that things were about to take a turn for the better, certainly doesn't have any conviction behind that outlook at this juncture.

In terms of the national economy, my own forecast is very similar, and almost identical, to the staff forecast in both the aggregate sense and in most of the details. But I must say, I have perhaps as little conviction about a forecast at this point as I've ever had. I could easily put together a forecast that's stronger and I could easily put together one that's weaker. Some of the factors that have been mentioned--energy, commercial construction, and agriculture--are the obvious things that would point in the latter direction. But abstracting from those particular areas of concern, I have two overriding concerns: the first is this financial sector dichotomy that Frank Morris referred to. I too find it very hard to rationalize the patterns of behavior that we see in financial markets --not just in the United States but around the world--with what seems to be going on in the real economy. And I have a nagging feeling that we may be a little more accident prone there than we would like to admit. I say that not with a view on nonperforming loans at banks, as much of a problem as that can be in its own right, but more that when I look at the sheer volume and volatility that we see in the financial markets these days, I can't help but think that when we have a 62 or 63 point change in the Dow-Jones average in one day, that in itself feeds on this sense of uneasiness that a number of people have been referring to around the table. It makes you scratch your head a little and say: What the heck is going on here?

The other area of great concern that I have that transcends these particular sectoral concerns is the continuing economic, financial, and indeed political, implications of the trade and current account situation. I read all the books about J-curves and all the rest of the [hype] but I must say I still have, and perhaps increasingly, a great deal of difficulty seeing how we will work ourselves out of that situation in an orderly way short of a recession-induced correction, which would obviously be very, very messy.

As a number of people have suggested, I too sense that maybe confidence levels have ebbed a bit. I think the reason for that may well be associated to some extent with these financial market goings on. But I also think that there's a little phenomenon taking place now where for a variety of reasons--including, for example, the court ruling on Gramm-Rudman--the imbalances that have been there all along are maybe showing through in a more transparent way than has been the case. Again, I think we've got to keep some perspective on those imbalances. The staff forecast, for example, is going to produce an unemployment rate in 1986 of 7.1 percent. Now, the last time we had an unemployment rate of 7.1 percent was in 1980. When you look at what has happened since 1980, there have been some very good things: the inflation rate has come down from 10 to 2-1/2 percent and we are now in one of the longest economic recoveries on record, despite this enormous trade deficit. But when you look beneath that, in 1980 we had a trade surplus in real terms in excess of $50 billion. We now have a trade deficit in real terms of $140 billion. In 1980, the budget deficit was $50 billion or $60 billion; it's now $200 billion plus. In 1980, the personal saving rate was 7 percent; now it's 4 percent. And those fundamentals are not going to change very easily. To some extent, I think what we're seeing right now is a renewed appreciation that those fundamentals are there. And the final irony, of course, is that if indeed the economy were slipping badly, one of the things one thinks about doing is trying to provide some fiscal stimulus. But as a practical matter, we're not exactly in the ideal position to be able to do that. It all comes back to saying that the whole ball game seems unfortunately to rest on monetary policy. It's a very difficult outlook; and I guess I would be in the camp with those who are more worried rather than less worried.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. What has happened and what is happening in the Tenth District is not greatly different than what I have described in past meetings, and that is, that it's a very unbalanced situation. In the urban areas, things are going quite nicely except in Oklahoma, which is particularly impacted by the energy and agricultural situation. And in the rural areas there's growing desperation as to how this whole thing will play itself out.

Having said that, I guess I'd like to focus on a couple of good pieces of information. One would be that the wheat crop is out and was a good crop. The weather in the growing season has been very good for all the crops, generally speaking, in the Tenth District. And I guess I take some comfort that they are having a drought in the Southeast, which will improve the commodity prices spilling into the Tenth District or [unintelligible].

CHAIRMAN VOLCKER. It doesn't seem to be improving much.

MR. GUFFEY. Not very much; I'm afraid that's right. Another piece of information that comes out of a quarterly survey that we conduct has to do with agricultural real estate prices. There was a further drop from the fourth quarter to the first quarter of about 5 percent in agricultural real estate values. That's down roughly 21 percent from a year ago and roughly 50 percent of the values posted in 1981, which was the high point. But the good news that may be showing through is that ranch land, for example, was down 7 percent, but crop land was only down 3 percent; and that is a slowing in the decline in crop land values. So, to the extent that you're searching for any good news, I suppose you could dwell on that only briefly to say that maybe we're getting close to the bottom of the decline in agricultural real estate values.

With respect to the energy sector, it continues to worsen. For example, in the District there are 193 rigs now working and that's roughly 1/3 of the number of rigs that were working at the end of January of 1986, just a few months ago. In the banking sector, particularly that part that services agriculture and energy, [the news is bad]. At the agriculture-related banks the loan-to-deposit ratio is only at 53 percent, which is the lowest level since we began doing the survey in 1976--which merely says that the banks can't find any credit-worthy borrowers. This demonstrates some of the pain and the distress that is showing up and clearly is present in the agricultural and energy areas.

With respect to manufacturing in the District, the farm machinery and oil equipment manufacturing is weak. On the other hand, auto assemblies, which are a very big component of our economy, are still going full out. In general aviation, aircraft for example is a very depressed part of the economy. Tourism is very strong, apparently in large part because of people travelling in the United States rather than going abroad.

Turning attention to the nation, our projections are very similar to the staff projections. But increasingly, I am concerned about the pickup we have been expecting in the third and fourth quarters as well as in 1987 because it seems largely dependent upon the net export position. The swing that the staff has built in is fairly dramatic between now and the first quarter of 1987. If that does not come to pass, it seems to me that the economy is going to continue to buck along at a 2 percent [rate] in the period ahead; and it seems to me that perhaps that's not satisfactory for the long pull. To the extent that monetary policy [through] interest rate levels can impact that, I guess I would be more inclined today to do something along that line than I have been in the past, even though it will help only at the margin and not be of great benefit in my view to my section of the country. But at the national level, I'm coming closer to feeling the need to do something more in the monetary policy area.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. It seems to me that the most significant factor we face is that the world economy is not really going much of anywhere; it's stagnant. And I think it's behaving about like we would expect the world economy to behave in a period in which international credit had been on one path--on a 20-25-30 percent growth path--and then entered a period of much slower growth. Adjustments get to be very difficult. And world trade is no longer [moving in] an expansionary fashion. I think maybe we are beginning to find out why it was that protectionism got to be such a significant movement in the 1920s and early 1930s. In this environment it's only natural that everyone will worry more about their market share than they will about a growing market. And in this environment I think it's very difficult for us to expect to make as much gain on our balance of trade as we would like to make. I think it's going to be very difficult for those who enjoyed huge balance of trade surpluses not to have pretty slow growth economies unless they do something about the deflationary impact on their economies.

Apparently, I see inflation somewhat differently than others do. I have come to see it less as a set of numbers that behave in such and such a pattern than to see inflation laws and attitudes. I see an attitude that says that prices rise and prices don't fall. And during such a period, individuals are anxious to restructure their portfolios away from monetary assets to real assets. During inflationary periods, you see, people are rewarded who are good at making portfolio shifts like that. In such a period you find--whether you're in the farming business or in the oil business or whatever business you're in--that you make more money depending upon how fast you borrow money and how fast you buy equipment and how fast you spend money.

But a deflationary environment is really quite different. A deflationary environment is one in which people begin to see that prices can fall as well as rise. It seems to me that John Maynard Keynes in his Treatise on Money gave some really good indications about what one might expect to happen during such periods. And it seems to me that what is happening in the world's economy reflects the actuality of inflation being less than anticipated. I might suggest that if we're to do our job in economic analysis--of course, we cannot always forecast without any errors. But whenever we as a profession begin to forecast the rate of inflation over a 5- 6- or 7-year period and all the errors are in one direction, then I think one could make some case for the fact that inflation expectations are misplaced. And those with time lags in production find out they can't sell their product at the price they thought they could, so people's behavior changes. It seems to me that we're finding that kind of behavior change under way. And in this behavior pattern more firms are going to devote attention to cutting costs than they are to trying to buy a lot more equipment. The adjustment process is really rather significant. So, even though I used to be more pessimistic than others in some ways, I turn out to be somewhat more optimistic in a sense. We have undergone such a significant deflation in many areas of our economy and we're still kind of hanging on and I think that's a real plus.

I believe we have to recognize [changed conditions] in agriculture, and Jerry may have been somewhat of a stimulus there. But when direct government payments to farmers and price support activity and direct payments for compensation for [unintelligible] differences are moved from a $12 billion annual rate up to a planned $24 billion annual rate and it is missed so badly, as I believe this last agricultural bill has missed it, that the actual expenditures [unintelligible]--they are going to run more like $32 billion than $24 billion--that puts a lot of support money out there. And eventually that's going to hold up.

If we can continue to try to have some patience and be cautious and make careful moves so interest rates adjust to changed conditions in the world, it seems to me that we have a chance to continue along on what some may think is a rather slow growth path. The only disadvantage of that slow growth path may be that it makes it very difficult to get the government budget back in shape. As you know, when things happen in agriculture as they have happened, then those Gramm-Rudman targets get out of kilter. So that adjustment process may be very, very slow. But it seems to me that we have a good chance to keep expansion going for some time in the future. I'm not going to be too pessimistic on the basis of the numbers coming out right now; I'm going to be optimistic as long as we respond with interest rates to market perceptions in regard to these world economic conditions. I would certainly have a different forecast if I thought we were going to peg short-term interest rates and prevent them from responding to market conditions. So, I'm in a position of saying that my forecast is exactly the way it was in February. I'm not sure that is all that good but it may not be all that bad, if we can avoid any major deflationary or financial market disruptions that [brinkmanship], I suppose, runs a risk of encountering.

CHAIRMAN VOLCKER. I don't want to interrupt this because we've got to move along. But I don't understand this chart that we had yesterday on government payments to farmers. It only shows that they are about $12 billion and I thought they were more like what Governor Angell was reciting.

MR. PRELL. Those numbers include the direct payments, that is, largely the deficiency payments. There is a certain amount that the government is committed to making up if the farmers' prices are below a certain level. There is also the dairy cow reduction program. [Our number] doesn't include CCC and some of the other programs that Governor Angell was mentioning.

CHAIRMAN VOLCKER. They certainly include something [unintelligible]. Governor Rice.

MR. RICE. Mr. Chairman, I think the staff's forecast is about the best way of looking at things right now. I continue to look for the pickup in the second half, though it likely will be less of an acceleration than I expected a month ago and probably will be later in the second half than I expected. But like others, I find the situation looks more clouded than usual, in part because of some of the factors pointed out by Frank Morris and Jerry Corrigan. It is very difficult to read what is going on right now. At the present time, I have less confidence in my view of the future than I have had in some time. It could be that I am being, as are others, unduly influenced by the most recent data that we have seen over the last month. I hope that is so. But if we stand back and look at what is going on, I think we have to recognize, as Gary Stern pointed out, that some of the factors that have been dragging down the economy are likely to become less influential in the future. The fundamentals that we counted on to spur the economy are still there. In my mind, it is hard to imagine that business fixed investment will come in lower than the staff forecast. It seems to me that [the forecast] in that sector is probably a rock bottom outlook. And while a turnaround in net exports may be delayed somewhat further, it is hard to imagine that it will be delayed beyond the second half. I expect that we will see this acceleration before the end of the year, and my own guess is that the risks are not on the down side--that we are not likely to get a poorer performance than the staff's forecast. If anything, it will be somewhat better than the staff's forecast. Now, all of this is clouded further by the overhang of tax reform. Tax reform, of course, is factored into the staff's forecast. But in my mind, there are certain psychological effects that can't be factored in, which could perhaps have a more restraining impact than one would imagine at the present time. This would be especially true if the revenue raising provisions kick in ahead of the cut in rates. So, while I would repeat that the risk is probably on the up side of the staff's forecast, there are these imponderables out there that are very difficult to factor in.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. Well, I think business is sluggish and I think it has been sluggish for most of this year. Economists, both within and outside government, that I have spoken with in the last week or so seem to be busily revising their forecasts--mostly downward--probably in reaction to the recent rather weak indicators. Back in February, I think Wayne Angell and I had the two lowest forecasts for real GNP growth for this year; mine was 2-1/2 percent. And after hearing all the bullish comments at the table, I was feeling guilty about it so I took advantage of Jim Kichline's offer to accept revisions and I put it up to 3 percent. Now I have moved it back down to 2-1/2 percent; I'm going round trip on this. Unfortunately, I just don't see what is going to cause business to pep up. I would like to see it happen; I would like to see stronger growth in the second half of this year. I would like to see a very healthy, dynamic economy next year too, but I just have doubts about our ability to pull it off. I know we are relying very heavily on a trade turnaround, but the people in trade that I speak with have convinced me that it is going to be very difficult to do. We have already seen that the lags are longer; they are going to be still longer. I agree with the comments of President Keehn and Governor Rice and some of the others about the impact of tax reform. Just the uncertainties that have arisen from the proposals have tended to curb businesses' enthusiasm for expansion and modernization. And if what is in the Senate bill actually becomes law, the disincentives to investments are very, very great. That is the way I read it, and this--

CHAIRMAN VOLCKER. The way I read it, [unintelligible] it could only be worse than what's in the Senate bill by the time it gets finished in conference.

MS. SEGER. Yes, but what I am saying is that even what is in the Senate bill will provide major disincentives to investment, even though we desperately need to modernize our manufacturing sector, particularly. Anyhow, I also sense that there is some deterioration of confidence. The latest survey done by the National Federation of Independent Business, done in late June, showed a significant slipping in the optimism among their members, particularly in their expected gains in real sales for the rest of the year. Also, they have revised downward their inventory and capital spending plans. I sense too that some of the inventory numbers and some of the new orders numbers were distorted by these labor negotiations; individuals were building up additional inventory to hedge against strikes in copper, aluminum and steel and now it looks as if those strikes will not take place. They will have to work these inventories off. In the auto industry, I think some of the strength in sales is more apparent than real because they are having to make such tremendous efforts to get these sales--very great interest rate incentives are required, or cash rebates to customers, or additional rebates to the dealers themselves--and it is just very very difficult to get these [sales]. Their inventories are also hefty, particularly at General Motors. I can't imagine that this won't eventually lead to some pruning of production schedules. I would like to be a raging bull but I guess I can't quite do it today. Thank you.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I think everybody has just about covered all the points, so I will try not to be too long-winded. There are a couple of things I want to stress. First, I was generally very optimistic too--in fact, I put in probably one of the stronger forecasts for 1986--when we first gave these forecasts back in February. Of course, for 1986 my forecast is now down in the 2 percent range from about a 4 to 4-1/2 percent range. What has happened between the two periods for me is a growing pessimism about the situation abroad in terms of the domestic growth possibilities in the other industrial countries. There were strong expectations there; and I think our forecasts and the staff forecast were totally reasonable--exactly what you would expect if we had gotten reasonable performance abroad. But things have been coming in substantially weaker than what we expected overseas; I think we were looking for something on the order of 3-1/2 to 4 percent real output growth in the non-U.S. OECD countries. I really am getting very gloomy about that; I never thought that they could sustain the situation politically in those countries with the kind of conditions that exist. But not only are they sustaining it, their political strength seems to be growing, which is a really strange phenomenon in these days and times. I don't think we can expect much on the export side of the market, and I think that what we put into the growth path as a result probably ought to come out. That leaves the domestic economy much more dependent upon domestically generated stimulative factors and I think that becomes harder to do when no one else is participating in this real growth process, because it runs the risk of exposing our exchange rate and producing some pressures. Of course, if the rest of the world is going to pursue recessionary conditions, I am not as concerned about the exchange rate fallout as I would be otherwise.

So, I think that is the dilemma we are in. And under those conditions, I think price pressures won't be as great. As a matter of fact, because of that, I think current nominal interest rates could translate into higher real interest rates than we now think exist. It may be the case that what is happening now to the domestic side is that real interest rates are [higher] than we think they are. I made this transition too: I also have some concerns about the uncertainty associated with tax reform. I think that will pass when we get a bill out of the way. But still, there are a lot of factors like this that we have to deal with. I would not be worried about the second half. I agree with what Jerry was saying: that everybody expected a weak second quarter. We had been forecasting that all the way back since last year. The problem is that the early indicators for the third quarter don't look good. We are not seeing the kind of evidence that we would expect to see in making the transition from a weak second quarter to a stronger second half. I think that's the problem and the reason that is the problem is what I mentioned earlier--what is going on abroad. It is almost a helpless feeling to see what is going on abroad and not be able to feel there is something we can do. But I think that is the situation.

CHAIRMAN VOLCKER. Do you want to say something, Governor Wallich?

MR. WALLICH. I can't [unintelligible] normal. Allow me next time to have a chance.

CHAIRMAN VOLCKER. Well, I think we have completed our go-around on the business outlook. I don't have anything much to add to it, except I would pick up on the comments that Governor Johnson just made and that Governor Angell made to some extent. We have had a lot of what seem to me to be shocks--if that is the right word--on the domestic economy: oil and tax reform are probably depressants; we have been looking at overbuilding in construction for a long time and that's headed south; we have had an awful agricultural situation. We have had 3-1/2 years of expansion. I'd say maybe we are overcoming some of those depressing influences by a rather large amount of monetary and financial stimulation, which has its own difficulties down the road as to its sustainability.

But the key problem is this trade problem. I don't think we are going to solve it by depreciation. That may be necessary over a period of time. We have had quite a lot. Without a better business picture around the world, I think depreciation in the short run will worsen the business picture abroad as well as be a depressing influence now on their economies. Our growth has not been all that great during the first half. However, in the world view it is not bad; in fact, it is better. The most depressing thing to me, in a structural kind of sense, is that our economy is not growing very fast and we are still growing faster than they are abroad--in particular when our growth is being undercut by a continuing decline in the trade balance right up to date. So long as that problem exists, we are on a collision course with something because we can't grow and build up the rest of the world when we are starting with a trade balance [deficit] of $140 billion or whatever it is, as opposed to three or four years ago when we started at close to zero. Over a period of time I think that also is related to the budget problem. But how do we get stimulus abroad? We would like some stimulus here, but it is going to have to be less than what we get abroad in order to begin working on the underlying problem; it is a nice trick, which isn't within our control in any easy way. It is really remarkable [to find] when you talk to these foreigners how happy they are about the situation. They seem to be perfectly content not to have much growth or a bit of growth at the expense of rising trade surpluses.

MS. HORN. Paul, would you comment on a strategy that would involve our easing policy or lowering the discount rate or whatever? What kind of pressure would that put on foreign countries to, say, stimulate their economies?

CHAIRMAN VOLCKER. I think we ought to presume [that] in our short-run policymaking. I want to turn to the long run now, but I would say that we are going to have a decline in the discount rate, say this week, if I read the tea leaves correctly. I didn't hear anyone around the table say they were particularly adverse to that. We just ought to assume that. It is all backwards; the foreign countries ought to be reducing [interest rates] or providing some kind of stimulus. I think many of them would say that ideally they ought to be getting some fiscal stimulus--that they ought to be reducing taxes or something. That is what the German monetary people say and that is probably what the Japanese monetary people feel, but it is not going to happen regardless of what is desirable. The second best approach for them would be to ease monetary [policy]. Based upon what I know, if we visibly [act]--say, by changing the discount rate--I would assume that the Germans and the Japanese will not respond. They say they will not respond. Whether they will or not depends upon developments in the market. The idea that we can orchestrate a general decline by the Japanese, Germans and ourselves this week or next week or the following week, I think is just not obvious. I do think we will see some declines by the French, the British, the Swedes, and maybe by somebody else in Europe, but I don't know who else. That may set up, apart from our change, a force that would leave the Germans embarrassingly stuck out by themselves and may raise [pressures] on the Japanese. I think economically a change by the French, British, and the Swedes won't make much different. But I think that is what will happen: there will be a pretty prompt change from some secondary countries but not a change by the Germans and the Japanese on round one. We talked vaguely about making a change in September, but that is a little beyond the horizon that seems immediately relevant. But I think that is the situation we face. Now, if we talked about a really big discount rate change, I don't know whether that would change [the reaction]. But I make these comments in the context of a 1/2 point change on the discount rate. That is the way they talk. What the chances are, say, within a two week period, that they would feel somewhat forced to change, I think depends largely upon the exchange market and other factors; but that is not their mood now.

Let's turn to the long run, to [M2 and] M3. I don't know to what degree we can short circuit this [discussion]. We are comfortably within the ranges for M2 and M3. Does anybody have in mind proposing a change in the M2 and M3 ranges for 1986?

VICE CHAIRMAN CORRIGAN. No.

CHAIRMAN VOLCKER. So, we can assume that they stay the same and dispose of that quickly. Then we move to 1987. That's a different page, isn't it?

MR. BERNARD. Page 23.

CHAIRMAN VOLCKER. There isn't much difference in what is being presented to us but we're free to propose anything between keeping it the same next year or moving it all of one half percentage point. I don't detect any enormous economic significance in the difference between 6 to 9 percent and 5-1/2 to 8-1/2 percent; there might be some psychological difference. Obviously, the slight reduction fits in with the idea that we ought to lower the ranges over time. And if you match this against the forecast--I might mention that you all have an opportunity, as usual, to change these forecasts in the next couple of days. So, you ought to review them and see whether you want to [make any changes] in the light of this meeting. Otherwise, we have a nominal GNP projection by the staff of 6-1/2 percent and [forecasts by] everybody else that run over a full range of 5 to 8 percent, probably, but [cluster] at 6 to 7-1/2 percent. Either of these proposed ranges for next year seems comfortably to encompass a straight relationship [of money growth] to nominal GNP and would allow for some decline in velocity.

MR. JOHNSON. What has the velocity of M2 been?

CHAIRMAN VOLCKER. Well, historically, you're looking--

MR. JOHNSON. I know it has been around zero.

CHAIRMAN VOLCKER. Historically, it has been pretty close to zero, but it has been declining in the last two years.

MR. KOHN. The last several years it has been declining 2 to 3 percentage points.

MR. JOHNSON. So an 8-1/2 percent upward bound would account for that pretty much.

CHAIRMAN VOLCKER. Well, it depends upon which way nominal GNP is running.

MR. JOHNSON. If we get a 6-1/2 percent nominal.

CHAIRMAN VOLCKER. It would allow for it.

MR. JOHNSON. Yes, I think we can afford to take it down a half point from 9 percent.

CHAIRMAN VOLCKER. Well, a half point obviously shows some progress toward a lower range. I don't think the substantive difference is great, but I don't know. Does anybody else want to say anything?

MR. MORRIS. I prefer to keep it unchanged. I think that we would hope to have substantially larger nominal GNP [growth] next year than we're going to get this year. This year, with a projection of 5 percent nominal GNP [growth], we have M3 in the middle of the range. It doesn't seem to me there's much of a case--if you take those two key situations--to shrink the ranges.

CHAIRMAN VOLCKER. Well, I am not sure one would expect this kind of decline in velocity to persist in those particular aggregates. Does anybody else want to say anything?

MR. ANGELL. Yes, I would agree with Frank. I think we just don't know at this point. I don't see any reason to change; I don't think the gesture of a half point means that much at this point.

MR. PARRY. I guess I come out differently. It seems to me that if we want to signal a concern about continuing to make progress against inflation, it might be a very good move to reduce it by half a point.

CHAIRMAN VOLCKER. What are you actually projecting for M2, for what it's worth? I am not sure it's worth all that much; nonetheless, what is the staff projecting for M2 and M3 for the year?

MR. KOHN. For 1987?

VICE CHAIRMAN CORRIGAN. 1986.

CHAIRMAN VOLCKER. For 1986.

MR. KOHN. Around 7-1/2 percent and about the same--

CHAIRMAN VOLCKER. Right at the midpoint.

MR. KOHN. Yes. And about the same for 1987, within a few tenths of a point.

CHAIRMAN VOLCKER. I presume that, as for M1, in a much more moderate way you would assume that M2 and M3 velocity might tend to decline with a significant decline in interest rates.

MR. KOHN. That's correct. The larger the decline in interest rates, the more of a tendency for that. M2 velocity actually declined 3 percent last year.

CHAIRMAN VOLCKER. It's anybody's guess, but my guess would be that the decline in interest rates is going to be considerably greater this year than it is likely to be next year. I'm assuming that we may get some more [rate declines] before the end of this year.

MR. JOHNSON. I hope that's right.

CHAIRMAN VOLCKER. Let me just get a general show of preferences. This is quite a narrow difference between 6 to 9 percent and 5-1/2 to 8-1/2 percent. Nobody wants to talk outside that range, I take it. How many would favor 6 to 9 percent? I'll get preferences from everybody now, just for the fun of it anyway. How many prefer the other way? We are going to be pretty evenly split, I am afraid. We have a pretty even split.

VICE CHAIRMAN CORRIGAN. Do a "could live with"--

MR. ANGELL. Our 6 to 9 percent won.

CHAIRMAN VOLCKER. Pardon me?

MR. ANGELL. We had 7 or 8 votes for 6 to 9 percent.

CHAIRMAN VOLCKER. Well, I didn't count very carefully but it's pretty close, I think. Does anybody want to make an argument one way or the other here?

MR. JOHNSON. Well, there's not a big difference between the two. I was just thinking of the psychological effect: that [a half point reduction] may still be showing a commitment to getting inflation down at the same time that we may be abandoning M1. In other words, an 8-1/2 percent top on the range for M2 would still allow for a pretty explosive situation with M1, if we have something that looks like what we got this year. You're saying that M2 is growing at a rate of about 7-1/2 percent this year so far, is that right?

MR. KOHN. Yes.

MR. JOHNSON. And we see what's happened to M1. If that pattern were to continue, we could still be within our M2 range even with that M1 pattern.

CHAIRMAN VOLCKER. This is no life or death matter to me, but I come out about where you do as a matter of preference, in terms of everything else rising pretty rapidly. I [don't] think we're going to get in great trouble with 5-1/2 to 8-1/2 percent and it's probably somewhat better to be in that posture rather than the other. But it's not a life or death matter; I'm not going to put my body over railroad tracks for a half a percentage point.

MR. JOHNSON. Same here.

MR. ANGELL. Well, it seems to me that even if we had 6 to 9 percent, we would have plenty of room to be at the bottom end. If we find that we can get growth at the bottom end, then I think that's the time for us to lower the ranges, rather than bring them down a half point and then have to take them up half a point some time. I would rather demonstrate that we can do well within that 6 to 9 percent range. But it's no big deal.

MR. GUFFEY. First of all, let me say that I would prefer to leave it at 6 to 9 percent, given a forecast that falls within a very narrow range for the remainder of 1986 and 1987--and particularly given that only a modest acceleration of inflation is being forecast. Furthermore, the fact is that we'll be in the fifth year of a recovery. That wouldn't seem to me to be the time to be moving money growth to the lower level to give the impression that we're going to work against inflation, when indeed the [inflation] forecast is pretty modest for the period ahead.

CHAIRMAN VOLCKER. You can say that there's justification for moving it lower; but a few people look at it differently, I guess.

MR. PARRY. It seems to me that if we are possibly going to become somewhat more accommodative in the shorter term, then it would be useful to have a message about our continuing concern about inflation over the longer term. And I can't think of a better way to do that than to reduce the range for 1987 at the same time that we are going to be talking about the possibility of shorter-term ease.

MR. ANGELL. Bob, I share your sympathies. And there will be a point in time that I would like to be able to play that card of reducing the ranges. I just believe there will be another time when we will need that emphasis, whereas today we would almost be giving it away. I would rather use it when the time comes that we need to say we are going to plant our feet [against] any reinflation. That's when I want to play that card.

MR. JOHNSON. On that point, it seems to me that it might work better to lower it now even if we have to give it up later, because right now we're talking about additional short-term ease and it might be good to offset that psychologically with some future commitment. We can always play that card if it looks like we're in a situation when we have to later.

CHAIRMAN VOLCKER. We have the arguments on the table. Does anybody have another argument they want to put on the table?

MR. MORRIS. The other argument is that it doesn't make a heck of a lot of difference, Mr. Chairman.

MR. JOHNSON. Well, I think we would all agree with that.

CHAIRMAN VOLCKER. Well, let me get down to the [preferences of] Committee members. For 6 to 9 percent: 1, 2, 3, 4, 5. For 5-1/2 to 8-1/2 percent: 1, 2, 3, 4, 5, and I count myself with that as my preference, so, 6. We only have 11 members these days, don't we? We can't be any closer than that. That's--

MR. ANGELL. Well, we [concede].

CHAIRMAN VOLCKER. If this minority is ready and willing to concede, we'll assume the 5-1/2 to 8-1/2 percent. So, it's 6 to 9 percent for this year and 5-1/2 to 8-1/2 percent for next year. Let me return to M1. I haven't thought about this exhaustively overnight, but let me try something out just to see whether I am in line roughly with where I thought the sentiment lay yesterday in not trying to destroy M1 completely. I tried to visualize how this would be presented in a table; it also would be reflected in the language, obviously. Suppose we leave the 3 to 8 percent for this year and put it in brackets or add a star or maybe both in presenting the table and we say: "The Committee did not change this target for this year in view of all the uncertainty, but it certainly expects growth to run above it this year." That's for 1986. For 1987, we could put in a target and also express a considerable amount of uncertainty. That leaves the question, then, of precisely what the target should be. And in the language we would indicate that even though all of these targets are tentative, this one is doubly tentative for next year. So, we leave it there in a formalistic sense, but disavow it as having any real operational significance at this point. The operational significance, with further explanation, would be stated in language presumably in the [Humphrey-Hawkins] report, and in my statement [to Congress], that we would get more concerned over a rapid increase in M1, if it were accompanied by rapid increases in M2 and M3.

MR. ANGELL. Yes.

CHAIRMAN VOLCKER. And the converse, too, I guess: that we would not be particularly concerned in view of all the factors--interest rates and so forth--if a rapid increase in M1 were not accompanied by excessive growth in M2 and M3. Now, does that reasonably capture the spirit or not?

MR. ANGELL. Yes.

MR. RICE. That's mine.

MS. HORN. Yes.

MR. GUFFEY. That contemplates setting a range for 1987?

CHAIRMAN VOLCKER. Well, that contemplates setting a range for 1987, but we'll have to discuss what range to put down for 1987. We had two alternative proposals yesterday. One is rather pro-forma to keep it at the 3 to 8 percent with all the reservations I suggested, and Governor Angell resuggested a much wider range of 3 to 10 percent. That looks so wide; it looks a little peculiar, unless we can make it 5 to 10 percent or something. But if you want to make it higher--

MR. BOEHNE. Since we want to keep some link with M1, though we don't have the foggiest notion as to what it ought to be, we ought not to be tinkering around with the range up or down 1/2 point or a whole point. It makes more sense to me to keep it at 3 to 8 percent.

CHAIRMAN VOLCKER. I think we can. I don't think we should fool around by a 1/2 percentage point or something like that. That doesn't make any sense to me.

MR. ANGELL. My view on M1 is that when you go back and look at the data on velocity of money, historically, 6 is a very, very fast velocity. V1 fell from over 4 for 1918 to under 2 for 1947; that was a 29-year period that velocity dropped. And, of course--

CHAIRMAN VOLCKER. From when to when?

MR. ANGELL. From 1918 to 1947 V1 fell from over 4 to under 2, and I don't know where--

CHAIRMAN VOLCKER. That's when Milton Friedman wrote his great tome saying there was an inexorable secular decline in velocity.

MR. ANGELL. Yes.

CHAIRMAN VOLCKER. At which point it rose from 2 to 4.

MR. ANGELL. Yes, but I believe that there is some evidence that we've entered another period like that [earlier one]. And the reason I want 3 to 10 percent is because I don't know when this [policy] accommodation we've been implementing for some time might take hold. If it does take hold, I'm not going to be satisfied to have an 8 percent M1 growth path.

MR. JOHNSON. I agree with that. The point is that it could be even greater. Who knows what it could be? I'm just saying: Why not [leave it]? I would prefer not to even tinker with that.

CHAIRMAN VOLCKER. Whatever we say for next year--I'm just repeating myself--will be in brackets or something.

MR. JOHNSON. I would almost like to treat that 1987 target as if we're not really taking it seriously at all until we get closer to that point. Then we will look at it and maybe leave it there. Just indicate in the language that we're leaving it there, but we're really going to address it when we get to that point.

MR. ANGELL. Well, I think that would be a good idea, too. I'd be glad to postpone the debate until next January or February, because at that point in time we will have more evidence as to what velocity might be. If we tend to get a decline in velocity throughout this year, then I think a case could be made for that adjustment.

CHAIRMAN VOLCKER. I'm inclined to think we ought to leave it the same or leave it out. To change it requires too many explanations; we would have to explain both why we changed it and that it doesn't mean much. That's putting an extra burden--

MR. ANGELL. Well, I'll switch to the 3 to 8 percent real fast then, because I want it in; I want an M1 range.

MR. BLACK. Well, the thing that bothers me, Mr. Chairman, is that nobody wants M1 growth of 3 to 8 percent. That's not really operationally very significant. As we closed yesterday, I thought Jerry was making a very good point in arguing for wider ranges and higher ranges. I personally prefer to rebase. But I'd prefer what he was suggesting to this because if by chance--and maybe it's a very remote chance--M1 does reassume some of its previous characteristics, we really don't have anything operational that we can do with this 3 to 8 percent target at all, but we could with a larger one. We could try to come in under that, if that should happen.

CHAIRMAN VOLCKER. For this year, you're talking about?

MR. BLACK. Yes.

CHAIRMAN VOLCKER. I think we settled this year. We're talking about next year.

MR. BLACK. Well, I misunderstood that. I knew you suggested that, but I didn't realize we had settled it.

VICE CHAIRMAN CORRIGAN. Well, from my perspective, the Chairman's suggestion accommodates the concern that I had.

MR. BLACK. I guess I misunderstood the point that you were making.

VICE CHAIRMAN CORRIGAN. Well, we can finesse it, but the thrust of this proposal is acceptable to me.

MR. PARRY. It seems to me that we all are saying that we don't have any confidence about the relationship between money and the growth of economic activity at this time. Therefore, I don't understand why anyone would try to set a range for 1987 at this time. Is there some procedural reason why it makes sense?

CHAIRMAN VOLCKER. Well, I think the argument for doing it is just to keep it in the ball game. Some people feel it may be harder to come back and set a range next year.

MR. MORRIS. I question whether we're going to have any better basis for setting a range next February than we do today.

MR. PARRY. It's possible.

VICE CHAIRMAN CORRIGAN. I think of it simply as an insurance policy, that's all. There could be a set of circumstances some time between now and the end of 1987 in which we'd be darn happy to have M1 in the ball game. And if we retire it now, it's going to be hard to--

CHAIRMAN VOLCKER. But if we leave it out, I presume what we would say is that we simply are not setting a target now and we will re-examine--

MR. PARRY. --before year-end or something like that.

MR. JOHNSON. Yes; we could just have language like that.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. GUFFEY. But if we did re-establish [an M1 range] in February, the markets quite likely would make a lot more out of it than if we just re-established 3 to 8 percent now and then changed it as we looked at it in February. I would opt to leave 3 to 8 percent in for 1987.

CHAIRMAN VOLCKER. If I understand correctly--on the theory that it is more important that we [not] fiddle around with it--I think the choice is between leaving it at 3 to 8 percent or leaving it out completely. If we leave it at 3 and 8 percent I envision presenting it enclosed in brackets and with an asterisk, footnoting why we have left it unchanged for this year. We certainly feel quite open about changing or even not having it at all next year.

MR. ANGELL. I like the very way you said it first, with the brackets and the asterisk and leaving it in. That gives a signal that we are going to look at it again in February.

CHAIRMAN VOLCKER. Well, let me get a preference among the Committee members for just leaving it out or for 3 to 8 percent, with suitable brackets, asterisks, and footnotes. Let me take the 3 to 8 percent with brackets and asterisks. Seven. That leaves four on the other side.

MS. HORN. And one of those four would be happy either way.

CHAIRMAN VOLCKER. 1, 2, and who's the other? Since this isn't a big deal, can those four live with it the other way with [unintelligible]? Let's look at the language of the directive. Well, we have this debt question too. Where are we on debt?

MR. KOHN. We're above the top of the range right now, at close to 13 percent, and expect to be there through the year. Our projection for the year is around 12, 12-1/4 percent.

CHAIRMAN VOLCKER. The range is 8 to 11 percent.

MR. KOHN. Yes, 8 to 11 percent.

CHAIRMAN VOLCKER. Last year when we faced the same problem, we said we were going to keep the range the same because we thought debt was too high--that we were going to run above and we really couldn't do much about it, but we didn't like it much. There is no difference now, but we can make it [unintelligible]. Is that acceptable again for 1986? Do we leave it there and say we are likely to run above it?

MR. ANGELL. Leave it and say we will run above it.

CHAIRMAN VOLCKER. But for next year, what are we going to do? Your forecast for next year is what?

MR. KOHN. 10 percent, I think.

CHAIRMAN VOLCKER. 10 percent.

MR. KOHN. 9-1/2 to 10 percent, or something like that.

CHAIRMAN VOLCKER. If that's what you are actually forecasting, it would be within the range.

VICE CHAIRMAN CORRIGAN. Look out!

MR. STERN. Why are we keeping it at all? We don't do anything with it. We have all sorts of reservations and the guy who sold it to us has bought it back!

MR. MORRIS. I recognize my mistakes, which is not true of all of you!

CHAIRMAN VOLCKER. Why don't you make some money, Frank?

VICE CHAIRMAN CORRIGAN. There is a little danger in that argument because the same could be said of M2 and M3.

CHAIRMAN VOLCKER. I don't know if we [should] keep it. Assuming for the moment that we keep it, given the forecast I don't see much point in changing it next year. Or are we running too high?

VICE CHAIRMAN CORRIGAN. Just as an aside, Mr. Kohn, I thought the work that the staff did on debt was really quite good.

CHAIRMAN VOLCKER. Was there anything in there that we could use to say debt isn't quite as high as it looks? It still has to look high relative to GNP, but would it be within our targets with appropriate adjustments?

MR. KOHN. No, because the double counting reduces last year's growth rate but would actually tend to increase this year's in the sense that there is less double counting--fewer state and local government purchases of Treasury issues and so forth projected for this year than last year. So, it is not really going to help. Adding the equity in does change things a bit.

MR. JOHNSON. Can we make a big technological adjustment factor?

CHAIRMAN VOLCKER. Even the equity, I suppose, wouldn't affect it much.

MR. KOHN. That's right. It was close to 2 percentage points last year, and this year it hardly would affect anything at all.

MR. JOHNSON. If we mark-to-market relative to household wealth, doesn't it look a lot better? It does. We can play the capital gains game.

VICE CHAIRMAN CORRIGAN. It depends on whether you did that Monday or Tuesday.

MR. JOHNSON. Yes, I guess we waited too long--two days too long.

CHAIRMAN VOLCKER. Does anybody object to leaving it the same as it is this year? I think the argument against taking it out is that to some extent that says we don't care about it. Personally, I do care about it--[not] in the sense that it's going to affect our policy significantly, but I don't like to give a signal that we are perfectly comfortable with the amount of debt being created.

MR. ANGELL. If the Chair wants it in, I think we ought to have it in.

CHAIRMAN VOLCKER. I don't think it's a big deal, but it's just another burden of explanation.

MR. JOHNSON. I agree. I would leave it in.

CHAIRMAN VOLCKER. The range is 8 to 11 percent now and the language the way this is written is: "The associated range for growth in total domestic nonfinancial debt was retained at 8 to 11 percent." There is no acknowledgement there that it is running high. The language you showed me this morning, Mr. Kohn, was that assuming we kept the M1 range? I forget.

MR. KOHN. No, the language I gave you this morning for 1987 was assuming that a range was not set.

CHAIRMAN VOLCKER. Well, I am looking at [the language for] M1 now, not debt, in variant I: "In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth in excess of the previously [established range] would be acceptable"--

MR. BOEHNE. "Could"--

CHAIRMAN VOLCKER. Okay, "could be acceptable"--[they begin] to look the same--"depending on the behavior of velocity over"--. I was wondering whether we should break up that sentence and leave it the way it is with a "would" or just put a period after "acceptable" and then say "The extent of"--

MR. ANGELL. --"the overrun".

CHAIRMAN VOLCKER. "Overrun" or whatever the word is "would be acceptable to the extent that growth would continue to depend upon the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and potential inflationary pressures" or something like that. I'm not crazy about the word "overrun."

MR. ANGELL. "Faster growth."

MR. MORRIS. "Such rapid growth."

CHAIRMAN VOLCKER. We are talking about relative to the range.

SPEAKER(?). Relative to the [unintelligible].

MR. JOHNSON. "The extent of M1 growth relative to the range"--well, that is still not saying over. "In excess of the range."

MR. ANGELL. Overrun describes it.

CHAIRMAN VOLCKER. Maybe we should just forget about the range. "Acceptable growth in M1 over the remainder of the year will depend upon...." Or we could just say "The behavior of M1 will be judged in the light of...."

MR. ANGELL. Instead of saying "and potential inflationary pressures" I would put "price movements." I think we want to look at price movements whether they are up or down.

MR. STERN. At the end of that sentence, do you want to say something about international developments?

CHAIRMAN VOLCKER. I don't know whether we will have time to vote, we have so many--! I guess they are about the same. It just sounds a little better to say: "Acceptable growth of M1, however, for the remainder of the year will depend on the behavior of velocity,"--we don't have to say "over the balance of the year" because we just said "the remainder of the year"--"growth of the other monetary aggregates, developments in the economy and financial markets, and the degree of inflationary pressures."

MR. ANGELL. Well, inflationary or deflationary. It seems to me that we run the risk that someone could look back and say: These guys don't realize that they have a deflation going on. I just think we ought to have a balanced approach here.

CHAIRMAN VOLCKER. --"and price pressures." That could be in either direction.

MR. ANGELL. And price pressures.

CHAIRMAN VOLCKER. Why don't we put that last, anyway; we sure don't want to emphasize inflation. Now, turning to debt, I had wording--

MR. KOHN. Mr. Chairman, in 1984 when the same problem was faced--that [time] it had to do with debt and M3 also--this sentence was put in the directive: "It was anticipated that M3 and nonfinancial debt might increase at rates somewhat above the upper limits of their 1984 ranges, given developments in the first half of the year, but the Committee felt that higher target ranges would provide inappropriate benchmarks for evaluating longer-term trends in M3 and credit growth."

CHAIRMAN VOLCKER. Read that to me again.

MR. KOHN. Translating it to the situation now: "It was anticipated that nonfinancial debt might increase at a rate somewhat above the upper limit of its 1986 range, given developments in the first half of the year, but the Committee felt that a higher target range would provide an inappropriate benchmark for evaluating longer-term trends in credit growth."

CHAIRMAN VOLCKER. Actually, the debt measure is expected to slow quite a bit after the first quarter.

MR. KOHN. Yes. Well, that's partly the carryover effect of the strong growth in December that affects the quarterly average numbers. But we are looking at growth rates of around 10 or 10-1/2 percent for the year on an end-of-period to end-of-period basis. It's not really slowing all that much, going quarter by quarter.

CHAIRMAN VOLCKER. Well, I don't know if this is any good, but let me try something along these lines: "Given rapid growth in the early part of the year, the Committee recognized that the increase in debt in 1986 may exceed its monitoring range of 8 to 11 percent but felt that an increase in that range would provide an inappropriate benchmark to evaluate longer-term trends in that aggregate." Stick that at the end. The directive would now read: "The Federal Open Market Committee seeks monetary growth..." After the sentence on retaining the 6 to 9 percent we would go to M1 and say: "With respect to M1, the Committee recognized that, based on the experience of recent years, the behavior of that aggregate is subject to substantial uncertainties in relation to economic activity and prices, depending among other things on the responsiveness of M1 growth to changes in interest rates. In light of these uncertainties and of the substantial decline in velocity in the first half of the year, the Committee decided that growth in M1 in excess of the previously established 3 to 8 percent range for 1986 would be acceptable. Acceptable growth in M1 over the remainder of the year will depend on the behavior of velocity, growth in the other monetary aggregates, developments in the economy and financial markets, and price pressures. Given its rapid growth in the early part of the year, the Committee recognized that the increase in debt in 1986 may exceed its monitoring range, but felt that an increase in that range would provide an inappropriate benchmark in evaluating the longer-term trends of that aggregate."

Tne trouble with this all is that I can see that Mr. Proxmire is going to say: You have two ranges that are meaningless. What are you doing here? And so forth and so on.

MR. JOHNSON. He has moderated his tone on M1 a bit, though. I noticed when I went up for my confirmation hearing that he hit me hard on the growth of M1.

CHAIRMAN VOLCKER. Regardless of his tone, procedurally he will say that we are shirking our duty by expressing such ranges. The defense will be: Oh no; we have ranges here for M2 and M3. He won't be happy, but I don't know any other way we can handle it.

MR. ANGELL. We rely upon you to explain it.

MR. JOHNSON. He'll put something in the Congressional Record.

CHAIRMAN VOLCKER. He would say the same thing if we had no ranges.

MR. GUFFEY. I wonder why you use all those words?

VICE CHAIRMAN CORRIGAN. Do you really think [we need] a disclaimer for debt? How far over do you think it's going to be?

MR. KOHN. Well, we are projecting about 12-1/4 percent.

CHAIRMAN VOLCKER. If we don't say anything, the obvious question is: "Is it going to be within that?" And then I say "No."

MR. MORRIS. Well, we don't know. The projection is fairly close.

CHAIRMAN VOLCKER. It is pretty close, but I don't know. If the projection were 11-1/2 percent, I would say "Yes." If it were 12 percent, "I don't know."

MR. KOHN. I think we were projecting 11-1/2 percent at the February meeting and that's probably why [the range was retained]; the projection was close enough to the 11 percent at that time.

CHAIRMAN VOLCKER. I am going to have to give an explanation, anyway. I am inclined to think some explanation like this is what I would have to say.

MR. BOEHNE. I suppose it would be too straightforward to raise the range to 8 to 12 percent and say that we think that's a better fit with what's going on in the economy and in M2 and M3.

CHAIRMAN VOLCKER. That would be a choice. But we could overrun that too. These are the choices, I think: raising it, or dropping it, [or leaving it the same]. Whether we drop it, raise it, or leave it the same, I think we have to say something like this.

MR. ANGELL. There might be some sentiment for just dropping it.

VICE CHAIRMAN CORRIGAN. That's harder to explain.

CHAIRMAN VOLCKER. If we drop it, then we have to add quite a few paragraphs saying that we haven't found it very useful.

MR. JOHNSON. If we leave it and they ask questions, you could defend yourself by responding that we haven't had good results relating it to anything that would explain why--

MR. MORRIS. We could drop M1 on the same basis.

MR. JOHNSON. That's right, but at least there is some historical pattern of a relationship there; there has never been--

MR. BOEHNE. There's more nostalgia too.

MR. ANGELL. M1 is a sacred cow.

CHAIRMAN VOLCKER. Can't think of anything else for a while, in terms of a pure correlation--

MR. JOHNSON. I guess it's rates as well.

MR. MORRIS. Ben Friedman sold the debt/income relationship to me; and then it immediately went [off track]. That's why we may be better off not taking up total liquid assets, because I'm afraid--

MR. ANGELL. [That's why] they pass sunset laws.

MR. JOHNSON. All of these things have been pretty good as long as the relative prices didn't change. When they did--

CHAIRMAN VOLCKER. Well, I think I'll get boxed around the ears by Mr. Proxmire. I guess I can survive it. [For debt] we take this sentence with the language [I read]. Is that right? [For M2 and M3] we keep 6 to 9 percent and we keep [M1] in the table and the range appears as 3 to 8 percent. All we say in the directive is that we are going to exceed it. How much we exceed it is not stated for now. Let's vote on that as what we are going to have for 1986.

MR. BERNARD.

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

CHAIRMAN VOLCKER. Now, 1987. The first thing, I think, is that we don't put M1 in there in the paragraph. "For 1987 the Committee agreed on tentative ranges of monetary growth, measured from the fourth quarter of 1986 to the fourth quarter of 1987 of 5-1/2 to 8-1/2 percent for M2 and M3." I think I would put the debt last again; I'm not sure if it's going to be 8 to 11 percent again, but I'd put it last. Then we would say "With respect to M1 [unintelligible]."

MR. JOHNSON. The sentence sounds all right.

CHAIRMAN VOLCKER. Well, the sentence sounds all right; but I think if we are going to put 3 to 8 percent in the table, we have to say something about it.

VICE CHAIRMAN CORRIGAN. Just say "With respect to M1."

MR. JOHNSON. I would just add on to that, though, that for the time being we are carrying forward--

MR. ANGELL. I think we ought to leave the sentence that is already in there with respect to M1.

CHAIRMAN VOLCKER. I think the sentence that is in there is all right. I'd take out the word "particularly" and I would take out the word "reappraisal" and just make it "appraisal." But I think we have to say something about or precede it with "While the Committee has plugged in"--

VICE CHAIRMAN CORRIGAN. "Carried forward" is kind of a passive [wording].

MR. MELZER. "While the tentative 3 to 8 percent range [for M1] has been carried forward, the Committee recognizes"--

MR. ANGELL. That does it.

CHAIRMAN VOLCKER. Why did we pick 3 to 8 percent?

MR. ANGELL. Because you rejected my 3 to 10 percent.

MR. MELZER. Rather than that, why don't we say "the 3 to 8 percent tentative range has been carried forward"?

CHAIRMAN VOLCKER. I don't know; maybe I am getting too fancy. But let me try something like this: "While the range of 3 to 8 percent for M1 in 1987 would appear appropriate in the light of most historical experience, the Committee recognizes that the particular uncertainties surrounding the behavior of M1 velocity over the more recent period would require careful appraisal of the target range for 1987."

MR. ANGELL. That's just perfect.

SPEAKER(?). That's great.

VICE CHAIRMAN CORRIGAN. Wonderful.

SPEAKER(?). A winner; that's pretty fancy.

MR. ANGELL. It doesn't only help us with 1987; I think it also does something about 1986.

CHAIRMAN VOLCKER. I am making a big modification in my mind. "The Committee recognized the exceptional uncertainties"--that sort of particularizes it. Well, does that sound all right? Does anybody have anything else to say? We have 5-1/2 to 8-1/2 percent for M2 and M3. Debt we can keep the same or make it less; it was 8 to 11 percent. For 1987, we can keep M1 the same [as for 1986]; we are not saying whether we are setting it as a tentative range or not. It depends on what we want to do. And in the table we would put [the range] in brackets with an asterisk. Are we ready to vote?

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
President Horn	Yes
Governor Johnson	Yes
President Melzer	Yes
President Morris	Yes
Governor Rice	Yes
Governor Seger	No
Governor Wallich	Yes

CHAIRMAN VOLCKER. We better go have a donut and return. I do think, with regard to the short run, that I personally would make the assumption that the discount rate will be reduced in a few days.

[Coffee break]

CHAIRMAN VOLCKER. I don't know how many of you read that [staff memo] on debt. The question is whether an abbreviated version of that should be added to the Humphrey-Hawkins report as an appendix. [Secretary's Note: Several members expressed agreement.]

CHAIRMAN VOLCKER. Who wants to say something about the short-run posture?

MR. BOEHNE. Well, given all that has been said about the economy, I'm for alternative A with a 6 percent discount rate and a $300 million borrowing figure.

MR. PARRY. That puts the funds rate about where?

MR. BOEHNE. 6-1/2 percent isn't it? Or is it less?

CHAIRMAN VOLCKER. I don't see any reason not to assume that the funds rate would go down as much as the discount rate.

MR. BOEHNE. 6-3/8 percent, then.

VICE CHAIRMAN CORRIGAN. I would support that.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. Could I just clarify a procedural issue? For example, the discount rate issue aside, I would be in favor of maintaining the existing degree of restraint. It becomes a curious sort of thing. One could argue that what Ed just expressed a preference for was an unchanged degree of reserve restraint, with the $300 million borrowing target, but with a different assumption on the discount rate. I will address my comments to that, but it's a little tricky in terms of how the record reads and what we ultimately vote for, it seems to me.

MR. PARRY. But that's not an unchanged degree of restraint if the discount rate is down and we maintain borrowing at $300 million.

MR. JOHNSON. You would want a higher level of borrowings.

MR. PARRY. You would want a higher level of borrowings.

MR. MELZER. Yes, but I don't know how I can vote for an action that presumes something that hasn't occurred yet.

CHAIRMAN VOLCKER. Let me suggest something in that connection, just in terms of clarifying the record. To me it seems very awkward--and undesirable--to put in the directive some action that hasn't been taken yet, however probable it may be. But I don't see anything the matter with making clear in the record of the meeting that many people suggested--if that's the way it comes out--an unchanged degree of reserve restraint on the assumption that the discount rate is reduced and that when it is reduced, they presumably might be in favor of a lesser degree of reserve restraint. But [there should be] something in the record so that when people read the record it says that decision was made in the light of an anticipated reduction in the discount rate, without actually putting it in the directive. Now, people may have different opinions about the discount rate; but if that is the underlying assumption, I think that ought to be clear in the record someplace, whatever the directive says.

MR. ANGELL. We might say "in view of the anticipated reduction in interest rates"--it wouldn't have to be the discount rate--in order for the $300 million borrowing number to make sense.

CHAIRMAN VOLCKER. I would resist putting that in the directive with [unintelligible].

MR. BOEHNE. That's a bear trap.

CHAIRMAN VOLCKER. But I think it can be made clear in the policy record, if that's what we are assuming and if that were the basis--for many people anyway--for however they voted.

MR. BOYKIN. There's a way around this, if the Board wanted us to leave for a few minutes.

MS. SEGER. Kill two birds with one stone.

MR. MELZER. Anyway, I'll tell you what my main concern is. I am sensitive to some of the political considerations at this time and also to the views of other Committee members about the uncertainties and concerns. What concerns me the most is this: We have just received the court ruling on Gramm-Rudman, which could have a major effect on the psychology in the markets about deficit cuts; and we have experienced lately a weakness in the dollar and have heard reports about the possibility of a diminished willingness of foreigners to hold dollar-denominated securities, given shrinking interest rate differentials, and so forth. I think there could be a considerable risk, because of these two developments taken together, in our moving at this time to reduce our rates; it sounds as if it might be unilateral, at least for a while.

CHAIRMAN VOLCKER. I don't think it will be quite unilateral, but it will be with minor actors rather than major actors.

MR. MELZER. That concerns me. We have been worried from time-to-time, to a greater or lesser extent, about the risk of losing control of the dollar on the down side. To think only about the dollar having been under pressure maybe wouldn't be enough, but if you take that against the backdrop of the Gramm-Rudman decision and this being an election year, I worry a little about that psychology in the context of what probably will be viewed as a continuing stimulative fiscal policy and a monetary policy that moves toward further accommodation. Beyond that, I expressed my views on the economy before. I probably will reduce my projection but I think [the lower growth] is still at an acceptable rate. And I would argue that with the current borrowing target we have run a very accommodative monetary policy. Just to pick up on your point, Wayne, about not resisting rates adjusting to market levels: One might even argue that having pumped in reserves at a rate of 22 percent or so over the last three months, we might be resisting what would be a natural upward movement in the funds rate, not a downward movement. I don't want to make a big argument out of that particular point, but the point is that we have been adding reserves at a very rapid rate.

CHAIRMAN VOLCKER. Sorry to interrupt, but I want to raise a procedural point. We were going to invite the Justice Department lawyer who is defending us, hopefully, in this [Melcher] suit to come over after lunch. But he couldn't come after lunch. I don't know what the chances are that we will be finished by 12:30 p.m. or 12:45 p.m. today. We may run into the time of the luncheon for Mr. Axilrod.

MR. MELZER. So you want the short version! I have just two other points. I would also question, in terms of looking at the next six months, what impact a reduction in rates is really going to have. I am not sure it's going to have a very significant impact in terms of real output in the short run. The numbers that Jim gave us yesterday on what the inflationary impact might be out in 1988--whether you believe them or not, and I realize there are a lot of [unintelligible] between here and there--[lead me to] think that we are getting down to a relatively few bullets left to fire in terms of monetary policy. I don't know where we cross that ragged edge of tipping expectations over, but my sense is that we are getting preciously close to that. And with that in mind, I am not sure I would trade my flexibility right now because if this one goes through and there continue to be weak numbers, we will get jumped again. So, I don't know where one should make one's stand, but those would be my reasons to argue for the existing degree of reserve restraint, alternative B.

MR. BLACK. I agree completely with Tom, but I think the discount rate decision precludes our doing that, so I think we have no alternative but to go with "A" or something akin to it. But I think his case is persuasive; we have done all we can, I think.

MR. RICE. I would like to join Tom on that too for the most part. I agree with most of what he said.

CHAIRMAN VOLCKER. But we have a theoretical action. If the discount rate is reduced, we can increase the reserve restraint a little. As for the argument about changing the discount rate and the effect on the economy, we haven't got a good choice. There is obviously a lot to these arguments. If it were entirely up to us--if you conceive of it as I do--the question is whether we have any chance of getting some improvement abroad. To a considerable extent, the dilemma for us is that it may [depend] less on our policy than on other people's policies. And this is going in reverse from the way it should go. I don't deny that for a minute. But it's not going to go without our moving. It is also true that we are not going to get an immediate response, as near as I can see it, from the Germans and the Japanese. But should we properly sit here and say: "Well, if you are not going to move--and at least as aggressively or more aggressively than we move--we are not going to do anything"? Where are our responsibilities? [Rather than] sit here saying that, we can take a chance that we can push them a little, given the risks that you eloquently described, which I think are there. It's a question of where the risks lie. I don't think the change--unless it's a much bigger one--is going to have any very significant effect on our short-run or intermediate-term business outlook. Does it have an effect on theirs? It goes in that direction. Maybe it's not very powerful; it's a pretty weak reed, but it's the only reed we have. It's the only argument we can make.

MR. JOHNSON. I agree wholeheartedly with what you are saying. I think that's the whole issue. It's almost a feeling of being held hostage by our trading partners. [That's been the case] for almost five years now, really. How long are we going to stay hostage in that situation when at some point we have various domestic concerns? You are right; there is the risk that you described. But I am a bit more optimistic. I agree that a half point on the discount rate, if it's followed by a $300 million borrowed reserve level, is not going to change the world by any means. Still, I think it's more than just hitting the interest-sensitive sectors that are already running almost full out. It was pointed out by the staff that to some extent the lower interest rates have been offset by tax reform and that the cost of capital really has been relatively unchanged. And I think we could affect that efficiency of investment at the margin with an interest rate decline. As you say, it's not going to change the world; but it certainly could do more for new orders than what we have been seeing. That's the way I am looking at it--that hopefully it could add some pressure at the margin--even though it sounds like we are going to have to wait until the fall.

MR. RICE. Maybe a 1 percent discount rate reduction would do more.

MR. JOHNSON. There's no doubt about that. The only other point would be the additional psychological [effect]. I don't think we want to look panicky; we want to look confident in what we are doing and not like we made a mistake and now are trying to get ahead of the ball game. But you are right; a 1 percent discount rate reduction would exert more pressure abroad if it affected [their actions], but if they chose not to--

MR. RICE. And do more about the cost of capital.

MR. JOHNSON. That's right.

MR. RICE. If we really want to do something, or if we think that we have things to do that we should do--

MR. JOHNSON. Yes, but I think we have to draw the line too on the potential. I agree with that.

MR. RICE. I just don't think we need to--

MR. JOHNSON. That obviously can be carried to the extreme, to the point where one has done too much.

CHAIRMAN VOLCKER. Well, I have a practical question. I don't know how we can resolve it here. If the discount rate does go down and the constellation of psychology is such that the dollar gets in a lot of trouble and the others don't move, there's a question of whether the assumption we make here should be changed in the market.

MR. STERN. Or, we could nudge up the borrowing target a bit initially, particularly on the argument that over time we would like to see more done abroad than here. It sort of sets the stage for that, at least initially, and then we can play it from that position.

MR. RICE. But we wouldn't get the reduction in the funds rate.

MR. JOHNSON. We would have a growing disparity--

MR. STERN. It would come up in the middle somewhere.

MR. JOHNSON. That's the problem. There would be a growing disparity between the funds rate and the discount rate and we would have to [unintelligible] if we wanted to--

MR. STERN. The funds rate would be at a somewhat lower level than it is today, but we wouldn't let the full 50 basis point [reduction in the discount rate] show through.

MR. JOHNSON. No, but the gap would widen.

MR. STERN. Yes, the gap would widen; that's right. And that might be a little initial insurance on the performance of the dollar.

MR. JOHNSON. The only problem is that I think that might be interpreted very bearishly.

MR. MORRIS. I think the foreign exchange market has already discounted, largely, a 1/2 point reduction. A one percentage point reduction would surprise them. Gretchen, what is your view on this?

Certainly, a one percentage point reduction would be a surprise in the foreign exchange market; but what about a 1/2 point reduction?

MS. GREENE. I think you have to distinguish between what the market is expecting and the announcement effect even when an expected action is taken. I think the market is pretty much expecting a 1/2 point reduction, but the announcement of a 1 percentage point drop would have an immediate impact, particularly if what happens here comes sooner than the market might have thought.

VICE CHAIRMAN CORRIGAN. I think the market--or at least a good part of the market--also thinks that a half point would be more coordinated than what we are talking about right now.

MR. RICE. I'm sorry, I didn't understand.

VICE CHAIRMAN CORRIGAN. I think the market probably expects that, if we come down a half point, at least one of the other two major countries would do the same.

MR. JOHNSON. I think the expectation is that Japan may do something. They don't seem to be indicating that they want to do something, which may be of some surprise in the exchange market. But that's the whole question.

MR. MORRIS. If there were a major decline in the dollar, wouldn't that put very heavy pressure on the Germans and the Japanese to go along with this reluctantly?

MR. ANGELL. Absolutely. Japan is going to be in there intervening and, of course, whether or not that does any good remains to be seen. But if they don't do any good with intervention--if they sterilize all of their intervention--they will end up having some very low yielding returns in the United States. So, we put some pressure on them. It seems to me that the elasticity of their exports in regard to their exchange rates is much more sensitive than ours, [unintelligible] improvement of our balance of trade. So it seems to me that Japan eventually will have a jolt if they do not take action.

MR. JOHNSON. They would be setting their domestic economy up for a real ride.

CHAIRMAN VOLCKER. The danger in the whole situation--and I don't know how to avoid it--is that if we do have a real decline in the dollar and they are not very eager to act, their business outlook may deteriorate from what it is now.

MR. JOHNSON. I think it will.

MR. ANGELL. That's correct.

CHAIRMAN VOLCKER. If they don't act, then we are worse off. But I think that's not demonstrable until it happens.

MR. JOHNSON. Right.

MR. ANGELL. But it seems to me that with a cut in [our] discount rate at this point, when the market finds out that Japan and

Germany haven't cut theirs we could expect some real pressure on the yen to appreciate further. I don't see how that can be avoided. But that does put pressure where it belongs; and I think that they will be rational people and, in that environment, that they will move.

MR. JOHNSON. If they continue not to move and if they let their economic situation deteriorate domestically, at some point we conceivably could end up in a situation like 1983, when they were lagging so badly and our stimulative effects actually led to a strengthening of the dollar. Boy, we would really get a trade problem out of that! In other words, it could be perceived that they were getting so weak that it would weaken their own currency. And then we would have a strengthening dollar in a situation of the United States moving [toward ease] relative to those countries. It might be a double whammy on the trade side.

CHAIRMAN VOLCKER. Well, I think what we are saying is that all of this isn't very predictable.

MR. ANGELL. But I will go with alternative A.

CHAIRMAN VOLCKER. I don't know what alternative A really means. I guess I don't have much faith in projecting these numbers to the last percent. I take it that it ought to mean $300 million to--

MR. ANGELL. It means the $300 million; I don't think we ought to change the degree of reserve pressure. If we lowered that to $200 million, I think it would be a little more difficult to run the Desk than keeping $300 million.

MR. THIEKE. It certainly becomes a trickier process to try to control the relationships at that level of borrowing.

MR. ANGELL. So to me it would make sense for us to keep the $300 million--maintain the same pressure that we have had--and do what we want to do with the discount rate.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, that's the way I come out, Mr. Chairman. I am not sure what alternative A means in terms of these Bluebook specifications, but I do think there is a case domestically for monetary accommodation--even though it is not going to cure all of the problems in every sector of the economy. I have been preaching patience for a long time but my patience is running out. So, I think we need to try to give the economy a little kick, and I would do it through a lowering of the discount rate to 6 percent. And I would keep the borrowing at $300 million. If the Board doesn't lower the discount rate, then we have to come down to a frictional level of borrowing if we are going to provide more accommodation. I think that would not be desirable, so I would like to see a discount rate cut and $300 million of borrowing.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I am for a $300 million borrowing level. I am assuming a 50 basis point drop in the discount rate, essentially for the international reasons--the effort to get into that business a little and see how things develop.

CHAIRMAN VOLCKER. Mrs. Seger.

MS. SEGER. I am for alternative A with a $300 million borrowing target and a swift cut in the discount rate. I do think that lower rates would have some beneficial effects on the economy, particularly in the capital spending area. With the changes coming from tax reform--assuming they materialize--there would be lower returns on investment. Therefore, to the extent that funds can be borrowed at a lower rate, that would increase the number of projects that become feasible; so, I think it would have that impact. Also, I think it would make it easier for debtors to carry their existing debt burdens at lower rates, whether they are farmers or home buyers or whatever. So, I favor "A."

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. I would favor the recommendation of Bob Forrestal and Karen Horn: reducing the discount rate by 50 basis points and maintaining the borrowings at $300 million. I hope that we would characterize that as a lesser degree of reserve restraint because it is.

MR. ANGELL. Yes.

MR. JOHNSON. As a matter of fact, what funds rate would be consistent with that in your opinion? It should be about the same as the discount rate, but I just wondered if the--

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. I would be counted in the alternative A [camp] with a discount rate decrease and $300 million on borrowing.

CHAIRMAN VOLCKER. Anybody else have anything to say?

MR. JOHNSON. May I? I don't know if I expressed my [view]. I'm for alternative A, which is a $300 million level on borrowing.

MR. RICE. If we weren't going to reduce the discount rate, I would be in favor of alternative B.

VICE CHAIRMAN CORRIGAN. So would I.

MR. RICE. But given the reduction, I would have to go along with alternative A. I don't know yet how I am going to vote on the discount rate.

CHAIRMAN VOLCKER. Anybody else want to say anything? We have some other issues. One is how to express all this. I think we are interpreting alternative A very loosely at this point, until I get instructed [by you] otherwise. Why don't we look at the directive? I don't know how to interpret the sentiment [on borrowing] if the discount rate were not reduced. Those people who have said a $300 million borrowing level, would they be inclined to say less than a

$300 million borrowing level? I am not sure that's the preferable course; I am not suggesting that. I just want to get theoretically--

MR. GUFFEY. The answer to that is "yes," as far as I am concerned.

MR. FORRESTAL. Yes, it would be for me too. But I think you pointed out the practical problem. What do we do with a frictional borrowing level of $150 million?

CHAIRMAN VOLCKER. I just want to make sure that I'm not imposing something on you. People are saying--if they think we ought to be making some move in the easing direction--that it should come preferably through the discount rate rather than a lowering of the borrowing.

MR. JOHNSON. It makes a lot more sense.

CHAIRMAN VOLCKER. I suppose the question that arises right in the first sentence--there is an awful lot of crossing out [in the draft and] it is a little hard to read. There may be some ambiguity, however much we explain it. [We can] explain it in the overall record but there is still some question, technically. If we say unchanged borrowings, is that the same as saying unchanged degree of pressure on reserve positions? If not, I don't know how to reword this without saying the discount rate is--

MR. PARRY. Just say that we are going to try to achieve a lesser degree of reserve restraint. For practical purposes, that [discount rate reduction] causes the funds rate to go down 50 basis points.

MR. JOHNSON. Do we have to quote a borrowed reserve target?

SPEAKER(?). No, we never do; just leave it out.

VICE CHAIRMAN CORRIGAN. The first sentence is still a problem because, as always, it says "maintain" or "increase" or "decrease." That is the--

MR. MORRIS. Couldn't we have a sentence in there saying that we interpret the same level borrowing with a lowered discount rates to mean a lessening in reserve pressures?

SPEAKER(?). We have a reserve--

CHAIRMAN VOLCKER. We can say that in the overall record.

MR. JOHNSON. I think the thing to do is to leave the sentence as we have it in the beginning and say "decrease somewhat the degree of pressure on reserve positions." We are not reporting the borrowed reserves target, so--

MR. ANGELL. Because we are decreasing it from where it was.

MR. JOHNSON. If we actually published the $300 million borrowed reserves target, it would be hard to interpret that as a decrease in reserve pressures. But if we are not reporting the borrowed reserves target and say "decrease reserve pressures somewhat," then--

VICE CHAIRMAN CORRIGAN. Let's say: "The Committee seeks one way or another to decrease reserve pressures."

MR. JOHNSON. That's right. That is just saying that the Committee is reducing reserve pressures and it is not saying how.

SPEAKER(?). I think that is all we've got to do.

SPEAKER(?). I agree with that.

SPEAKER(?). That's right.

CHAIRMAN VOLCKER. How can we say [the Committee] decreased reserve pressures? Maybe the Federal Reserve System did, but the Committee did not.

MR. JOHNSON. But since we--

CHAIRMAN VOLCKER. Suppose we took the opposite course. "In the implementation of open market operations for the immediate future"--

MR. BLACK. That has the elements working against each other.

MR. ANGELL. Well, we could say "maintained [the existing degree of pressure on reserve positions], consistent with lower patterns of interest rates."

MR. JOHNSON. That is what we have been trying to avoid all these years.

CHAIRMAN VOLCKER. We have been trying to avoid being specific about a borrowing target and being specific about interest rates.

MR. BLACK. Couldn't we approach it this way? The consensus of the group seems to be that we want to ease reserve pressures. If tomorrow the Board approves a cut in the discount rate, then we do it one way; if the Board doesn't, then we do it with a lower borrowed reserve target. The Committee doesn't have to address that at this point. As Manley said, I think all we need to put in there is "decrease." Since we never specify our borrowed reserve target in any of these--

CHAIRMAN VOLCKER. Well, presumably we would say if [unintelligible] exactly the same borrowings. It is going to be confusing as the devil to people.

MR. ANGELL. The reason we would have the same borrowings would be because after we voted to decrease reserve pressures somewhat the Board lowered the discount rate. That would make it necessary to go back and--

MR. RICE. We don't hit the borrowing target exactly anyway--

VICE CHAIRMAN CORRIGAN. We are only off by $15 million.

MR. BOEHNE. Well, there is a very precise way to say it: "In the implementation of policy, etc., the Committee seeks to decrease somewhat the existing degree of pressure on reserve positions given the current discount rate;" or alternatively, "seeks to maintain the existing degree of pressure on reserve positions given a decline in the discount rate."

MR. ANGELL. We said ["maintain"] in December.

MR. JOHNSON. That is actually not true. If the discount rate is lowered, we are not maintaining the same degree of reserve pressure.

MR. BOEHNE. Well, it depends on how you define it. If you define it in terms of borrowings, we are. If you define it in terms of the amount of reserves put into open market--

MR. JOHNSON. You are right. But we have to spell it out then.

CHAIRMAN VOLCKER. Suppose we just added on here: "In the implementation of policy for the immediate future, the Committee seeks to decrease somewhat the existing degree of pressure on reserve positions, taking account of the possibility of a decline in the discount rate."

MR. BOEHNE. That's the way to do it.

VICE CHAIRMAN CORRIGAN. We could even just say "taking account of the level of the discount rate." That covers the possibility that the Board, in its wisdom, doesn't want to lower the discount rate.

MR. BOEHNE. We are taking account of possible changes in the discount rate. That's the way to do it.

MR. KOHN. Mr. Chairman, you could say something about easier conditions in reserve markets to get away from this "degree of pressure" language that seems to be confusing. For example: "The Committee seeks somewhat easier conditions in reserve markets taking account of etc." In the past "pressures" has been a stand-in for the borrowing objective. We have said "maintain" even when the discount rate has gone down or been about to go down before and that would show through in the federal funds rate.

VICE CHAIRMAN CORRIGAN. What was your language again? It was the best idea.

CHAIRMAN VOLCKER. To just say "decrease the existing degree of pressure on reserve positions taking account of the possibility of a change in the discount rate."

MR. ANGELL. That is fine. That hits the spot. It is not quite the level of writing you did earlier, but--

CHAIRMAN VOLCKER. I think it can be explained in the policy record. "For growth in M2 and M3 over the period as a whole--". I would resist going from [the existing language of] annual rates of about 8 to 10 percent, which are nice [round] numbers, to whatever we have [in the Bluebook]--8-3/4 percent and 7-3/4 percent.

MR. BOEHNE. 7 to 9 percent.

CHAIRMAN VOLCKER. 7 to 9 percent.

MR. ANGELL. That's fine.

CHAIRMAN VOLCKER. If you want to dissent, dissent now. Well, let me try something on the M1, since I think it is consistent with what we just said. Instead of putting in a number for M1, what if we say "Growth in M1 will be judged in part in light of changes in M2 and M3," or something like that? I suppose there is some chance that if we put in this high number for M1, we'll come in below it. We are starting July pretty low; on the other hand, if we come in way above--

MR. ANGELL. Yes, with a cut in the discount rate--if the elasticity of the demand for money is anything like it has been--we are probably going to get another boost.

CHAIRMAN VOLCKER. I will accept that. There is a good chance that it will come in way below or way above.

MR. JOHNSON. Well, your language doesn't pin us down to a number.

VICE CHAIRMAN CORRIGAN. How about saying: "The growth of M1 is expected to moderate from its extraordinary pace in the second quarter. Its behavior will be evaluated in the light of..." I don't think we want to leave the message that a 20 percent growth rate or something--

CHAIRMAN VOLCKER. What was it in the second quarter?

MR. KOHN. I think it was about 17-1/2 percent.

CHAIRMAN VOLCKER. "While growth in M1 is expected to moderate somewhat"--

MR. ANGELL. We've been wrong before.

CHAIRMAN VOLCKER. --"it will continue to be judged in the light of the behavior of M2 and M3 and other factors." All right. I don't see anything the matter in general with the proposal that Mr. Kohn or somebody made here in capital letters: "Somewhat greater reserve restraint" etc. That about covers it. It doesn't say what to do if we get strength in the business expansion and powerful developments in the exchange markets.

MR. JOHNSON. It still leaves uncertain what we would do in a situation where M1 continued to explode and M2 and M3 did okay and the economy kept declining. I am just saying that is not covered in here; I hope we don't have to face that.

CHAIRMAN VOLCKER. It is covered by inference. We're not going to pay much attention to M1, if it is not confirmed by M2 and M3.

MR. JOHNSON. Well, I was just thinking about this one sentence here that says: "Somewhat lesser restraint might be acceptable in the context of a marked slowing in money growth and pronounced sluggishness in economic performance."

SPEAKER(?). That's out.

MR. JOHNSON. All that in the brackets comes out? I see.

CHAIRMAN VOLCKER. We still have the question of "woulds" or "mights." I would make it the same for both. Any preference between "would" and "might"?

VICE CHAIRMAN CORRIGAN. I would make both "might."

MR. JOHNSON. I think that is the safest.

CHAIRMAN VOLCKER. A final issue is the federal funds rate range, which we changed to 5 to 9 percent last time. The midpoint of 5 to 9 percent is 7 percent.

MR. ANGELL. This will take us down to 6 percent to--

CHAIRMAN VOLCKER. Obviously, we are going to be well within this range, but I don't know where.

MR. BOEHNE. Would 4 to 8 percent be consistent with it?

MR. ANGELL. Let's say 4 to 8 percent.

CHAIRMAN VOLCKER. 4 to 8 percent or 5 to 9 percent.

MR. MELZER. How about 3 to 10 percent?

MR. ANGELL. That combination does not apply with the world [unintelligible].

CHAIRMAN VOLCKER. How about 5 to 8 percent?

MR. JOHNSON. 5 to 8 percent doesn't really fly. Well, I don't know; I guess it is getting closer to the range.

CHAIRMAN VOLCKER. We could make that big policy change of narrowing the range all the way to 3 percentage points!

MR. PARRY. I don't understand what you accomplish by doing that.

CHAIRMAN VOLCKER. It goes half way to 4 to 8 percent and it does center the range sort of where we expect the rate to be. It is closer to the center of what we want.

MR. ANGELL. So just leave it the same, 5 to 9 percent.

CHAIRMAN VOLCKER. Leave it the same?

MR. FORRESTAL. If we change it, we might be suggesting that we anticipated a discount rate change.

CHAIRMAN VOLCKER. We already did that.

MR. JOHNSON. It is spelled out.

CHAIRMAN VOLCKER. We have already said that we are anticipating a decrease by the words "taking account of a discount rate change." And we are saying if the discount rate doesn't change, we want an easing of pressures. In no--

MR. PARRY. How would a narrowing of the range be interpreted?

MR. BLACK. That we are moving closer toward a federal funds target.

MS. SEGER. Typographical error!

MR. ANGELL. I don't think we ought to tell anybody what we are doing!

CHAIRMAN VOLCKER. I don't think it could be interpreted as much--

MR. PARRY. I think there probably will be about three articles in the financial journals talking about it, saying we are getting closer to interest rate targeting or something like that.

MR. BLACK. That's the main significance.

MR. RICE. It might be interpreted as tightening.

VICE CHAIRMAN CORRIGAN. I would leave it the way it is, but I really don't care. There are three possibilities: 4 to 8 percent, 5 to 8 percent, or 5 to 9 percent.

MR. PARRY. Let's vote.

CHAIRMAN VOLCKER. Who prefers 4 to 8 percent? It's going to be more than one-third.

MR. JOHNSON. I'll throw my vote in.

CHAIRMAN VOLCKER. Who prefers 5 to 9 percent? Who prefers 5 to 8 percent? You really want 4 to 8 percent? Okay, put in 4 to 8 percent. Should I read all this over again? "In the implementation of policy for the immediate future, the Committee seeks to decrease the existing degree of pressure on reserve positions, taking account of the possibility of a change in the discount rate. Growth in M2 and M3 over the period from June to September is expected to be at annual rates of 7 to 9 percent. While growth in M1 is expected to moderate somewhat from the exceptionally large increase during the second quarter, that growth will continue to be judged in the light of the behavior of M2 and M3. Somewhat greater or lesser reserve restraint might be acceptable depending upon the behavior of the aggregates...etc." And we have 4 to 8 percent [for the funds rate range]. If there are no other comments, we will vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
President Horn	Yes
Governor Johnson	Yes
President Melzer	No
President Morris	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. I guess we are finished.

END OF MEETING