Meeting of the Federal Open Market Committee

March 31, 1987

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, March 31, 1987 at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Boehne
Mr. Boykin
Mr. Heller
Mr. Johnson
Mr. Keehn
Ms. Seger
Mr. Stern

Messrs. Black, Forrestal, and Parry, Alternate Members of the Federal Open Market Committee

Messrs. Guffey, Melzer, and Morris, Presidents of the Federal Reserve Banks of Kansas City, St. Louis, and Boston, respectively

Mr. Kohn, Secretary and Staff Adviser
Mr. Bernard, Assistant Secretary
Mrs. Loney, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Lang, Lindsey, Prell, Rolnick, Rosenblum, Scheld, Siegman, and Simpson, Associate Economists

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

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Office of Staff Director for Monetary and Financial Policy, Board of Governors

Messrs. Hendricks and Powell, First Vice Presidents, Federal Reserve Banks of Cleveland and San Francisco, respectively

Messrs. Broaddus, Burger, J. Davis, T. Davis, Ms. Munnell, Messrs. Scadding and Thieke, and Ms. Tschinkel, Senior Vice Presidents, Federal Reserve Banks of Richmond, St. Louis, Cleveland, Kansas City, Boston, San Francisco, New York, and Atlanta, respectively

Mr. R. Davis, Senior Economic Adviser, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
March 31, 1987

CHAIRMAN VOLCKER. We have to elect officers first of all.

MR. JOHNSON. I would like to start this by nominating Chairman Volcker to be Chairman and President Corrigan to be Vice Chairman.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. We have a second. Do we have any objections? If not, I won't commit any time. We have a list [of proposed officers]. I guess you want the names on the list. Will somebody read it?

MR. BERNARD.
Secretary and Staff Adviser, Donald Kohn
Assistant Secretary, Normand Bernard
Deputy Assistant Secretary, Rosemary Loney
General Counsel, Michael Bradfield
Deputy General Counsel, James Oltman
Economist, James Kichline
Economist, International, Edwin Truman

Associate Economists from the Board: David Lindsey, Michael Prell, Charles Siegman, and Thomas Simpson.

Associate Economists from the Federal Reserve Banks: Peter Fousek, New York; Richard Lang, Philadelphia; Arthur Rolnick, Minneapolis; Harvey Rosenblum, Dallas; and Karl Scheld, Chicago.

CHAIRMAN VOLCKER. Do I have a motion to vote?

SPEAKER(?). I so move.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Do I have objections? We have the question of the New York Bank as agent. Nomination or objection?

MR. JOHNSON. I move the New York Bank as agent.

MR. ANGELL. Second.

MS. SEGER. Is there a choice on any of this?

CHAIRMAN VOLCKER. If you would like to suggest it, yes. You will take the burden of suggestion.

MS. SEGER. What if I recommend Kansas City, from the heartland--

MR. GUFFEY. Wonderful thought, Martha.

CHAIRMAN VOLCKER. We have two Managers, both of whom I think are so able bodied and sitting here. Do we have a nomination?

VICE CHAIRMAN CORRIGAN. I am not sure you can back that up.

SPEAKER(?). I so move.

MR. JOHNSON. Second.

CHAIRMAN VOLCKER. Any objection? The Authorization for Domestic Open Market Operations has been distributed to you. Do we need to formally readopt this? Do I have a motion?

MR. ANGELL. I move it.

VICE CHAIRMAN CORRIGAN. Second.

CHAIRMAN VOLCKER. Do we have any objection? Next are the Foreign Currency Authorization, Foreign Currency Directive and Procedural Instructions. Do you have a problem with these, Mr. Cross, or what?

MR. CROSS. Well, Mr. Chairman, I do wish to recommend that the Committee consider a change. In the authorized balances, we have an informal limit and a formal limit. The informal limit on marks is presently $6 billion worth of marks. We are now at $5.8 billion worth of marks and the simple accrual of interest earnings, if nothing else happens over the rest of this year, would put us over that $6 billion. The other--

CHAIRMAN VOLCKER. That doesn't appear anyplace in this.

MR. CROSS. That is an informal limit which does not appear in the published record. However, the authorized balances which [unintelligible] was $10 billion, including informal balances of the DM at $6 billion, the yen at $3 billion, and other currencies at $1 billion. The System's overall open position, which is $10 billion, is a matter of record. My proposal to increase the allowance for mark balances from $6 billion to $7 billion would go along with a proposal to increase the total from $10 billion to $11 billion for the authorized balances of all currencies and the total System open position.

MR. ANGELL. While we are making increases, why would we not want to allow more room than that? What reason is there to keep the limits that close?

MR. CROSS. I have no objection to increasing it beyond that.

CHAIRMAN VOLCKER. Well, if I understand it correctly, the only formal limit is that $10 billion limit.

MR. CROSS. That's right.

CHAIRMAN VOLCKER. [Unintelligible] enough yen so that we are going to be comfortable within it, but I don't know about one-way [unintelligible]. We were up to $9 billion, but now--

MR. CROSS. On yen balances, we have more room than we had because we have been spending yen recently. The reason to change it, since it does get published and it does draw some attention, is that now is the time to change it. And I think the $1 billion increase would give us room for what we do not anticipate, assuming we follow the same practices that we have followed in the past.

CHAIRMAN VOLCKER. I myself don't see any problem if we want to raise them further, say, to $12 billion, and consider that informal. We don't vote on it, I guess.

MR. CROSS. I would certainly be very pleased with that.

CHAIRMAN VOLCKER. $7 billion is what you are saying?

MR. CROSS. I am proposing to raise the mark limit from $6 billion to $7 billion. If we raised it further we could--

CHAIRMAN VOLCKER. The issue we formally have to vote on is the overall limit, for which you are suggesting $11 billion. Governor Angell, I guess, is suggesting $12 billion.

MR. ANGELL. Yes.

CHAIRMAN VOLCKER. Assumed under that would be an understanding that marks could go at least to $8 billion, if I may reword it that way, under that $12 billion. Do you want to go to $12 billion? Does somebody want to make a motion to go to $12 billion?

MR. ANGELL. Yes.

MS. SEGER. And I will second.

CHAIRMAN VOLCKER. If there are no objections to that, we will change the overall limit to $12 billion, with the informal understanding that mark balances could go to $8 billion. What's the informal understanding on yen now? I realize that you are going in the other direction on yen now.

MR. CROSS. We have $3 billion on yen as the informal understanding. The present $10 billion breaks down to $6 billion in marks, $3 billion in yen, and $1 billion for other currencies. If we go to $12 billion, we could propose to divide that into $8 billion, $3 billion, and $1 billion [respectively].

CHAIRMAN VOLCKER. Okay, returning to the agenda--

MR. BERNARD. It brings us to the regular minutes.

CHAIRMAN VOLCKER. We have to approve the minutes. Can I have a motion?

MR. JOHNSON. I move we adopt the minutes.

CHAIRMAN VOLCKER. Any objections? Mr. Cross' report.

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

MR. BLACK. Sam, to what extent have the market participants been able to figure out how much we have done in exchange market intervention for our account and for the Treasury's account? Is there a pretty good idea?

MR. CROSS. Well, on a number of these occasions we have been operating in a way to make it quite open and quite obvious that we were there. We have dealt with a lot of banks. We have dealt with them directly and we have done it quite visibly. It's very difficult to be absolutely precise about the amount of our intervention, but certainly market participants know that we have been in there in a very substantial way. And I don't think these numbers would shock them. Certainly, some people are expecting that these numbers are the amounts that we can go in. They have seen a lot. We have not made any statements and the Japanese have not made any statements about the precise amounts, but they know we have been in there very heavily.

SPEAKER(?). Are we sharing this intervention with the Treasury on a 50/50 basis or has that changed?

MR. CROSS. We are sharing it with the Treasury on a 50/50 basis with one minor exception. Generally, we are doing it on a 50/50 basis.

SPEAKER(?). Where is the yen/dollar relationship this morning?

MR. CROSS. The yen is just over 146. The Japanese have had some interest in trying to hold it around the 146 level and so they closed yesterday at just over 146; we closed yesterday at just over 146, although it declined in the course of the day and it declined again in the course of the day in Tokyo last night. They did another or so of intervention, but it closed again at 146. The dollar against the mark is at 1.80-1/2. The dollar did weaken somewhat against the mark yesterday in the course of the trading day and got down to about 1.79-1/2, but then it moved back up and is now at about 1.80-1/2.

SPEAKER(?). Do you attribute much significance to the Japanese fiscal year ending today?

MR. CROSS. It certainly has been a factor.

SPEAKER(?). Will it help us, then, as we get past that?

MR. CROSS. Well, that remains to be seen. It has been a factor; firms have had dollars to deal with because of their need to straighten out their books at the end of the fiscal year. This has been a factor over the past several weeks.

SPEAKER(?). Sam, what's the tone in the market? Is there some growing concern that we really could run into a significant [unintelligible] or is there some feeling that the intervention would prevent that from occurring?

MR. CROSS. Well, it's hard to say. You pay your money and take a choice. It's hard to be too certain. I am sure there is a range of ideas involving a lot of people. Obviously, given this massive amount of Japanese investments, much of it unhedged, there is concern that a real loss of confidence in the dollar could lead to very [unintelligible]. That's obviously hanging over the market. But to what extent that view is held, it's pretty difficult to say. We do know that a fair amount of the dollar sales that they assumed in Tokyo in the past week or ten days has been in the form of investment firms like insurance companies, pension funds, and so forth, doing a certain amount of hedging. So that's certainly a big [unintelligible] supply and demand equation there.

SPEAKER(?). When the Japanese sell dollar-denominated assets, where then do they go with those funds? In what currency?

MR. CROSS. I wasn't suggesting that they were selling on and off although what they have been doing recently is diversifying their purchases much more. They have been buying a lot more Canadian securities, Australian securities, and European securities; and they have also broadened out from government-bond types of investments toward more diversification. But there is also a certain amount of hedging, without selling the assets--hedging against these in order to protect oneself. And that is fairly important to do.

SPEAKER(?). What kinds of techniques are they using to hedge themselves?

MR. CROSS. I imagine they use [unintelligible].

MR. HELLER. Sam, are they all sterilized here and abroad?

MR. CROSS. They are certainly sterilized here. I think, generally speaking, they are sterilized abroad.

MS. SEGER. When you said that the Desk intervened when the dollar got to 1.87 marks, was your next comment sort of a suggestion that maybe we should [not] have done that?

MR. CROSS. No, it wasn't that at all. It was that once it had gone up and we intervened in a very light way--we didn't go in with guns blazing by any means--and once the market realized that we were in there intervening at those levels with all of the attention to the Paris understanding and talk about [unintelligible] and all, it didn't take too much to say, well, now that we have established this [unintelligible], it is likely to be resisted. Now we can see where it is going to go on the other side. So it reduced the expectations of the possibility of a continued rise in the dollar. Fundamentally, I think the position was kind of bearish anyhow. Everybody looking ahead not just a matter of days but a substantial period [knows] we still have the big deficits and the Japanese have their big surpluses. That sort of gives you a fundamental position toward the dollar. And once this had been hit on the up side they began to look toward the down side.

CHAIRMAN VOLCKER. And it's almost like [unintelligible] a mistake.

MR. PARRY. Sam, with the appreciation of sterling and the mark, are pressures developing in the United States?

MR. CROSS. No really, it has been relatively peaceful at times. There has been [unintelligible] had the ability to destruct itself, as it were, after the last [unintelligible] and to get back some of the reflows that had gone out in anticipation of it. Some of the interest rates have come down in some of the countries that had moved them up. So there has been a little return to normalcy on the [unintelligible] side.

SPEAKER(?). What kinds of actions other than exchange rate intervention might be helpful in this kind of a situation either here or abroad?

MR. CROSS. Are you addressing that to me?

SPEAKER(?). I asked a question.

MR. CROSS. I think there is certainly going to be continued watching as to whether any of these policy commitments that were talked about in Paris are actually carried out via fiscal policy or monetary policy. The German economy is very soft; they haven't really taken anything new. They, of course, have been [unintelligible] at the time that they reconstitute their government. But their economy has been very weak, and people have seen that they have done nothing on monetary policy and don't show much prospect of doing anything in fiscal policy except in a framework of next year and the year after next. The Japanese economy is equally well below what it typically runs at, and nothing has been happening there. The problem is that they have to get through this fiscal year and get their budget passed before they can start with a new budget, they say. Nonetheless, nobody has seen anything.

SPEAKER(?). They haven't taken the opportunity to leave some of this intervention unsterilized to give a boost to monetary policy?

MR. CROSS. I think they sterilized it. They feel with their discount rate now at 2-1/2 percent that they have gone pretty far. Also, people don't see anything on the U.S. side. We make comments about the budget deficit and one thing or another, and there is not much evidence there. Still, the main issue that's in the newspapers is the dispute over trade matters and that raises in people's minds the possibility that the way to deal with the trade--if you really get into a trade war--is to pound down the currency in order to deal with the situation in that way. That has been the main issue in the newspapers, so the trade disputes have been a very negative factor. Also, in the present circumstances, a neutral statement by U.S. officials seems to be taken by the market as a kind of a negative. It's a lack of a positive firm commitment--I guess that's the way to put it.

MR. HELLER. You put a lot of emphasis on these statements, but there was an awful lot of hot news that was very bad too. All of the trade numbers that came in were very bad. The current account numbers were very bad. I think that was the real substance that--

MR. CROSS. Absolutely. I thought I had a sentence somewhere in there [in my statement]. We haven't seen any compelling evidence. We know that our exports are looking better, and so forth and so on; but looking at the trade deficits and things like that, all we get is the very bad nominal trade deficits and surpluses with little, if any, evidence of any reversal.

SPEAKER(?). But I presume, Sam, that the firm commitment implies, among other things, some unsterilized intervention or something else that would back up whatever statements are made.

MR. CROSS. Well, I am not sure it would imply unsterilized intervention but I think that it's [unintelligible].

MR. TRUMAN. Fiscal policy area; we are not in monetary policy.

SPEAKER(?). Sam, would you care to speculate at what level of the yen you would think Japanese investors might begin to sell off dollar assets--143, 142?

MR. CROSS. I don't really have any confidence in people's attempts to make estimates of that sort, because I am not sure there is a number out there. I think it depends upon people's attitudes and those are changing all of the time. I think we could have a confluence of circumstances that could lead them to sell. But what might go into it to require that? I am not sure about a specific number, but I think we are obviously in a very dangerous area where problems of that sort could build up very quickly and cause great damage.

SPEAKER(?). You could also have it go so low that investors think the bottom has been hit.

MR. CROSS. Well, that's right--if one were convinced of that. But, again, I don't think we live in the kind of world where there is a magic number that when you hit it, then everybody knows it, and says: Okay, now we buy.

MR. GUFFEY. Mr. Chairman, our current published [foreign currency] directive limits our operations to countering disorderly market conditions. This last episode seems to me maybe not to fall into that category; rather it seems that we are getting awfully close to a managed float situation which--

CHAIRMAN VOLCKER. Not very well managed float.

MR. GUFFEY. To be sure. But the point is either that the directive should be changed if we are going to go the route that we have been on the last couple of weeks or, in the alternative, that we shouldn't be doing what we have been doing--other than the commitment that was made in Paris. That speaks to changing the directive.

CHAIRMAN VOLCKER. Well, we just approved the directive and I am a little hesitant to raise it, but I guess we can. It has been a while since I looked at this, but I take comfort in that it says "shall be generally directed at countering disorderly monetary conditions." It talks about behavior consistent with Article IV.

MR. GUFFEY. Article IV, as I read it, is not a constraint or type of directive, so I go back to the simple phrase countering disorderly markets.

MR. TRUMAN. The reason for that reference, President Guffey, was based on a little history; it was to guard against circumstances in which there was so-called manipulation of exchange rates. That was why we might be more aggressive. The other point, of course, is that this [directive] has been in existence since 1976 and has covered periods in the past similar to the one we had in the last few days.

MR. CROSS. I think it has been interpreted broadly enough to deal with all of the situations since then. It's similar to the undertakings which the United States has with the IMF as to what its exchange rate policy will be. So it's part of a broader--

MR. GUFFEY. Well, I understand the term countering disorderly markets can be interpreted [differently] and I guess that's the prerogative of the Chairman's subcommittee or the Committee. In my mind, what we have been engaging in does not fall within that category.

CHAIRMAN VOLCKER. Well, I don't know whether it does or it doesn't. I guess we are going to be hard pressed to make up other language. Maybe somebody can look at it.

MR. GUFFEY. Maybe somebody should look at it, at least.

CHAIRMAN VOLCKER. I don't think we can do it sitting around this table right now. I designate Mr. Cross to look at this and see if he comes up with any better ideas.

MR. CROSS. Yes, we will look at it in light of what we are doing now and see if it looks like there is something we should change.

MR. HELLER. Sam, has any consideration been given to forward purchases and sales rather than spot?

MR. CROSS. That is one of those endless debates that goes on. We haven't really [unintelligible]. We pretty well had our hands full [unintelligible] spot. I am not sure I am convinced [unintelligible] but it's something we have been watching.

SPEAKER(?). How many more bullets do we have in our belt as far as--

MR. CROSS. Well, with the yen we have in our pocket about $700 million, but these are at a valuation that was set at the time they were acquired; they are now worth a third or so more than that. The Treasury has substantially more. They have $2.1 billion, again at the acquisition cost. And then, of course, we have a swap arrangement with the Bank of Japan of $5 billion dollars.

CHAIRMAN VOLCKER. We still have about a billion dollars in current market value?

MR. CROSS. Yes, a little over $1 billion. The Treasury has around $3 billion at present market value.

SPEAKER(?). And we have spent how much, again, in the last week or ten days?

MR. CROSS. A little over $2 billion.

CHAIRMAN VOLCKER. We together?

MR. CROSS. We--the Treasury and the Federal Reserve and the Japanese--have spent over

SPEAKER(?). So we have spent about half of our holdings?

MR. CROSS. [Unintelligible.]

CHAIRMAN VOLCKER. [Unintelligible.]

VICE CHAIRMAN CORRIGAN. That's right. Silver lining behind a cloud.

CHAIRMAN VOLCKER. Well, if there is no other discussion, we will turn to--

MR. CROSS. We need the approval, I guess.

CHAIRMAN VOLCKER. We have to approve the operations. [Moved and approved.]

MR. CROSS. I am glad we had the election before my report!

CHAIRMAN VOLCKER. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Comments or questions?

MR. JOHNSON. Peter, you have advocated buying coupons in the past. You said there was a possibility for an add need?

MR. STERNLIGHT. I think that's part of the add need ahead. It makes very good sense to buy coupons for some portion of that.

MR. JOHNSON. There has been some controversy over that issue in the past. I just wondered if--

MR. STERNLIGHT. Well, we have been talking about it and I think as we work out this need, which runs to several billions of dollars, there is room for bills and coupons as part of the--

MS. SEGER. At what point would you let the rising federal funds rate override your concern about a weakening dollar? If it got to 8 percent, would you--

MR. STERNLIGHT. Well, if it got to 8 percent as a long-standing matter that would obviously be a concern; even 7 percent, I think, would cause one to sit up and take some considerable notice. We are getting a high rate today just because it's the quarter-end. The very early report I saw had today's funds rate opening at 6-3/4 percent. That was a surprise. To see it getting up to 7 percent or higher on this day--

MS. SEGER. I am not talking about a one-day shot.

MR. STERNLIGHT. On a lasting basis, I'd feel concern about rates that were considerably over 6 percent, given the current set of expectations and the current kind of borrowing need that we have in our reserve paths.

VICE CHAIRMAN CORRIGAN. Clearly, though, if the bottom fell out in the context of the conversation that was taking place earlier between Mr. Cross and--I forget who it was--Si Keehn, maybe, the markets would do [unintelligible] in a very decisive way no matter what we did.

MR. JOHNSON. Like yesterday?

MR. MORRIS. I wouldn't go on to admit that the more [unintelligible].

MR. JOHNSON. Well, that's what got kicked so hard yesterday.

MS. SEGER. I was reacting to Peter Sternlight's comment that our own estimate showed a need to add reserves, but that apparently it wasn't done to the full extent because of the concern about what was going on. I just wondered where those trade-offs come.

SPEAKER(?). In relation to the borrowing target, generally over the intermeeting period you have at least [unintelligible].

MR. STERNLIGHT. Borrowings came in just close to the $300 million, and in this current reserve period they're running around $250 million, which is consistent with the recent period.

MR. JOHNSON. What's coming up, Peter, in terms of reserve needs? Do we have a seasonal draining or adding period?

MR. STERNLIGHT. There is a big seasonal add need, mostly from currency and partly from required [reserves]. We are adding to it somewhat by the foreign exchange intervention that [has occurred]--several hundred million a day at the recent pace. But for this current reserve period, at least on the numbers we were looking at yesterday, there is roughly a $3 billion need to meet in the remainder of this period, and we are just about halfway through; and then there is about a $5 or $6 billion need in the subsequent reserve period and slightly more than that in the period beyond that. These estimates are cumulative; there are some additional needs beyond the $3 billion, which accumulate to about $5 or $6 billion in the next period and to $6 or $7 billion in the period beyond that.

MS. SEGER. So we don't have a contingency plan, then--that if all hell broke loose even more than it has so far--as to exactly what we would do when?

MR. STERNLIGHT. Well, our basic stance has been to meet the needs, following the directive to the extent that there is some day-to-day discretion about the pattern of reserve needs as they unfold. We try to implement in a cautious manner, [and be aware of] anything that could be helpful or avoid exacerbating the international situation. I don't think it makes a tremendous difference; it's more at the margin.

MR. GUFFEY. I have been on the call the last several weeks, Martha, and I think they have been very skillful at that, in terms of attempting to do what needs to be done domestically but dealing with this international situation that is overhanging the market. And I think they have handled it well.

CHAIRMAN VOLCKER. Mr. Kichline.

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

CHAIRMAN VOLCKER. I forgot to ask you to ratify the domestic operations. Would you like to ratify those?

VICE CHAIRMAN CORRIGAN. I move it.

CHAIRMAN VOLCKER. If there's no objection, we can discuss the business outlook.

SPEAKER(?). Jim, I have a question. Inventory investment is clearly an important component of your forecast, especially in the first quarter of this year. One thing that struck me in terms of your forecast is the forecast of negative changes in farming inventories over a 9-quarter period which is clearly unprecedented in the postwar period. I wonder what you had in mind in assuming decumulation in the farm sector over that length of time.

MR. KICHLINE. Part of what is going on there is our assumption that more crops are going to be placed in CCC programs. I am not an expert in the agricultural area but, given the change in some of the farm programs, apparently farmers have been induced to transfer more of their ownership to the government--essentially to CCC stocks, which are rising--and it's coming out of the farm inventories.

SPEAKER(?). So that should show up in terms of more [unintelligible] purchases and federal nondefense.

MR. KICHLINE. Correct.

SPEAKER(?). A little weak.

MR. KICHLINE. Well, that's weak in part because of other things happening in the federal sector. Given the deficit-reducing actions taken last year, we think that real nondefense outlays will be negative this year and next year.

SPEAKER(?). In spite of that CCC development.

MR. GUFFEY. Jim, for the fourth quarter of 1987, your projection in this Greenbook shows personal consumption expenditures down about 1-1/2 percentage points from last Greenbook to roughly a half percent. What are the factors?

MR. KICHLINE. Well, you are looking at an auto story. We decided to put in what has happened over the last two years [unintelligible]. In the third quarter we have personal consumption rising only 1-1/2 percentage points at an annual rate. Part of that, we think, is because of the increase in purchases of autos, with manufacturers once again trying to clean up their stocks in the third quarter. The offset is a weaker consumption growth picture in the fourth quarter. I just might note that, on average in this forecast, we are drifting into a range of very low personal consumption figures. A one percent [growth rate over the two quarters] is historically very low.

MR. BOYKIN. Do you figure in very much of a kick from the home equity loans, from the standpoint of consumption? Do you see that helping very much?

MR. KICHLINE. We haven't done much there explicitly. Our assumption has been that a good deal of that is substituting for consumer credit and other second mortgage loans rather than leading to a substantial increase in consumer spending. That's an open issue.

MR. BOYKIN. The banks seem to be trying to push them pretty hard. I wondered whether or not that would be successful and what it would lead to.

SPEAKER(?). Jim, how about some of the price indices that you follow in a more current sense--commodities indices and so forth. What are they showing in terms of recent behavior?

MR. KICHLINE. I think some of the commodity prices recently have calmed down; the big run-up was from August through early this year when there was a substantial increase. Since then, there has been some bouncing about, particularly in terms of industrial materials prices, but they have been relatively flat.

MR. GUFFEY. Just to continue on with a question about consumption. If you look at services, particularly beginning in the second quarter of 1987, growth rates spend most of their time, actually, at less than 1-1/2 percent. Is there any time that we have ever experienced that other than in a recession? Secularly, growth of service expenditures is probably more in the range of 3 percent plus. I think on a cyclical basis we have seen it for a couple of quarters, but nothing like this.

MR. KICHLINE. I was hinting in our personal consumption story, President Guffey, that basically I think a one percent growth, when we have 3 percent growth in real GNP, is a very [unintelligible] number. In putting this together, we have really looked at the income side as well. In forecasting, as you well know, one can view the saving rate as somewhat of a constraint. I didn't want to see saving rates without the first digit being at least 3 percent; and if that is the case, we really get [unintelligible]. We don't have much in the way of real disposable income growth. We think wealth is explaining the lower saving rate, in part. We are getting some increased spending [unintelligible] wealth positions. But basically, what comes out--if we view the saving rate as having some implicit strength--is that we are going to be forced into slow rates of increase in real PCE. But it is, as you point out, quite unusual.

MR. GUFFEY. This goes back to the old story. You are depending greatly upon the turnaround in net exports to make this a palatable forecast.

MR. PRELL. If the circumstances that we presume will bring that about didn't occur, real disposable income would be a bit stronger and there would be at least some offsets. So we have to look at it simultaneously.

CHAIRMAN VOLCKER. What is the automatic offset?

MR. PRELL. For example, if we didn't get the great improvement because import prices didn't rise substantially, then consumer inflation would be less and, in the first instance, real disposable income would be higher so that consumption wouldn't be affected as much. Basically, our weak consumption is part of an overall adjustment process that is shifting resources away from domestic consumption.

CHAIRMAN VOLCKER. I understand that. But suppose the external side did not improve because business was so weak abroad?

MR. PRELL. Well, interest rate [unintelligible] and a whole assortment of different variables.

MR. JOHNSON. That raises a point that I was asking about yesterday; I still haven't cleared it up quite in my head. I got an answer, but I can't repeat it. The staff's forecast for growth abroad was revised down by a significant amount, yet our GNP numbers haven't really changed. I need a review of how we would make that up.

MR. TRUMAN. We make it up, I think, in the short run in two areas. When we do the forecast we take a look at some of the factors that go into it. Although the effect of the lower growth abroad would be less growth in nonagricultural exports, we also look at prices of those exports. Those we had moving up a bit more than we thought was comfortable and, as a result, we tended to offset the price effect on the volume. [Unintelligible] lower. Looking back over the last 6 months or so, since last July, there has been a substantial decline in [the outlook for] industrial countries; we have 3/4 percent lower level of real GNP at the end of this year than we had last July. There you see it more clearly; essentially, the growth effect is quite pronounced. There you get another offset because the dollar has been much lower. Looking at it from their side, those two [factors] also go together. The dollar was about 6 or 8 percent lower than we were thinking it would be last July. It's projected to be 6 or 8 percent lower at the end of this forecast period. We have gotten a lot of the movement actually [earlier] in the period, so that has had a slight offsetting effect on--

MR. JOHNSON. But is that helping us on the trade side any more?

MR. TRUMAN. Well, I think it's part of the same [story]. Part of the answer to your question about the reasons why growth is weaker abroad is that the dollar has been lower. The direct effect of that in the first approximation is neutral. [Unintelligible] means weaker net exports, if you want to put it that way. The secondary effects, where you get into the big discussion you were just having with Mike but view it from the other side of the pond, [depend on] whether you have the kind of offsetting automatic stabilizers that come along with higher real [income] on the one hand, or on the other hand the negative impact on investment intentions and that kind of activity and [economic] activity in general. If you have nominal targets for your fiscal policy, for example, and inflation comes in lower, then in fact you might find that [government spending] would get better. There could be an offset. That tends not to be the case. It tends to be a taking of those benefits into the [fiscal] position and lower prices in the fiscal situation give you less of an automatic [stabilizer effect]. The third factor, looking back to last July, is that we were cautious about a forecast too strong in terms of exports. The models were saying exports were going to be very [strong], so we tended to judgmentally adjust that down because we didn't at that point see much evidence. Now, in the second half of the year, the evidence was that U.S. net exports were doing quite well; so, although we still have damped down our [projected] rate of increase in export volume relative to what standing historical relationships might produce, we have damped it somewhat less than we had done before. Again, that's one of the factors that is viewed from the side of the trade [balance] as shown on the lower growth [abroad].

MR. JOHNSON. It's the speed of the depreciation that made a big difference in your mind?

MR. TRUMAN. Well, these factors net essentially. This [unintelligible] but my sense is that clearly it does seem to be strongly negative in both Germany and Japan. The investment [is negative], which is one reason why things are being marked out. The other factor is that in [Japan and] Germany they both were looking for growth in [exports] this year, and it doesn't look like it's going to be there. Maybe it shouldn't even have been there, but they were looking for it. The other problem, basically, is the extent to which policy is used to [cushion these effects]. We talked about this some earlier: [whether] these countries tend to push [policy] given the change in the exchange rates or to respond in terms of supporting the adjustment process, if you want to put it that way. The adjustment process coming on the external side may be going along faster than otherwise [anticipated] and that's [negative]. In neither Germany nor Japan do you have a sense that policy is out ahead of the adjustment process; it's being forced by the exchange rate [change]. Sam Cross noted that in Germany monetary policy is [unchanged] although there is a small [chance of] adjustment in the latter part of the year; fiscal policy adjustment is going to come in January 1988. And in Japan [policy] is paralyzed. What little they might be prepared to do, they have essentially been paralyzed by the [political] process. And as a result, any fiscal [policy action] or lack thereof that is likely to come along in Japan is not going to be here for another 3 months longer, later than one might have thought it was going to come last December.

MR. JOHNSON. [Unintelligible] the last comment. I wonder if you have attempted to factor in this latest trade retaliatory measure that has been taken. Is that going to have any effect, or do you have to make some assumptions about retaliation for--?

MR. TRUMAN. We didn't really have it in hand in time to put it into the forecast. Even with it in hand, we would have to [factor in prospects for] retaliation. The other issue is how long it would last even [unintelligible]. We did not want to let them have a strong pricing effect, because essentially they are saying ["x"] equals a certain amount of supply of imports that are just not going to be there anymore. Essentially, it's a question of what the price [response is]; it's going to be [unintelligible] but it's not 100 percent higher; it's [a function of] whatever you think is the [elasticity of the] supply curve absent Japanese suppliers and that's probably not terribly steep.

MR. JOHNSON. But you would expect some upward pressure?

MR. TRUMAN. Well, there would be some upward pressure, but not [too large], assuming that the measures are taken and they are permanent and there is no retaliation. I think the big risk, which seems to be what the financial markets were reacting to yesterday, is that this could get out of hand. There is certainly some risk that it could get out of hand.

CHAIRMAN VOLCKER. What products are we putting these tariffs on, presumably?

MR. TRUMAN. The list of products is $900 million worth of potential tariffs--various consumer electronic products and those types of things.

CHAIRMAN VOLCKER. [I didn't] see the list; it sounded like a lot more than the $300 million they talk about.

MR. TRUMAN. There is $900 million on the list; $300 million will be chosen and they might choose this side [of that figure]. There are two pieces of it: $135 million of third market effects and $165 million of Japanese market effects. They could choose to do one and not the other.

MR. JOHNSON. I love this rationale, which is we [don't] want to put a tariff on the chips themselves because U.S. producers buy those. We will put it on the electronic equipment that's processed from those chips and [not] import it. It's just unbelievable analysis.

MR. TRUMAN. [Unintelligible] was called with the agricultural trade--

MS. SEGER. Maybe I misread it, but I thought that one of the major objectives was to use this playing tough to get the Japanese to knock down some of the barriers that are keeping our products out.

MR. TRUMAN. That's absolutely the motivation. The question is whether, rather than knocking down the barriers, they respond by pushing them higher. Then we have [unintelligible]. If I had to guess, I would think it's going to move in the direction of the [unintelligible] may not come down $300 million but they might come down [unintelligible] worth and you won't get the retaliation. But there is certainly some risk that things will go the other way.

MS. SEGER. What would happen if either Germany or Japan slipped into a recession? I am hearing about the weakening of their economies and their disappointments with their performance and the downward revisions [unintelligible] of their own governments.

MR. TRUMAN. Both of those economies are large relative to [their neighbors]--Germany with respect to Europe and Japan with respect to the Far East. In fact, in terms of the world economy, the Far East has been one of the brighter spots in terms of overall performance. I would think that the issue of negative numbers is not so important. The point basically is [not] whether growth is above or below zero; the point is that growth in these countries, which is [unintelligible] at this stage [is slowing], partly because [unintelligible] lagging behind. Two percent growth in these countries at a time when non-U.S. [growth rates] are very modest and one was hoping for something like 3 percent--that is 1/3 of the way to zero.

CHAIRMAN VOLCKER. Two percent for Germany when you have--

MR. TRUMAN. We have 1 percent [fourth-quarter to fourth-quarter] for Germany; we have 2 percent for the G-10 countries as a whole.

SPEAKER(?). Ted, I recently saw a chart that I think you produced that showed a comparison of the growth of real GNP and domestic demand in Japan. It was surprising to me, and also very dramatic, that their domestic demand was growing at a rate twice that of GNP, I think.

MR. TRUMAN. All of these countries have had quite good growth in domestic demand. The problem and the puzzle is--and we looked at this before the February chart show because I was puzzled as to when [unintelligible]--we didn't seem to see corresponding things. I would say as professionally as we could [figure out] the numbers as to basically what happened in 1986, there seemed to be a counterpart with the developing countries--the oil and non-oil producing developing countries--in 1986 rather than the United States. OPEC pumped a lot more oil last year and the price went down. We all bought it. Their price went down and they cut back on their [imports]. Of course, then the terms of trade were going against other developing countries, [not] like Japan. So domestic demand has [generally] been holding up reasonably well, but the overall level also has been on a downtrend and that's--

CHAIRMAN VOLCKER. Domestic demand doesn't look so bad compared to the GNP. You couldn't call that great in absolute terms, considering what their potential is. Are there other comments on the business scene here?

VICE CHAIRMAN CORRIGAN. Do you mean of a more general nature?

CHAIRMAN VOLCKER. Of a more general nature.

VICE CHAIRMAN CORRIGAN. Let me make a couple of more general comments. I don't feel that there is any fundamental difference in the economic outlook today as compared to what we have been talking about for the past couple of months. As I said before, I tend to go hot and cold on this trade improvement situation and right now I guess I am cold, partly for the reason that has just been talked about and that the performance in some of the industrialized countries looks pretty sour. But even beyond that, I still am a little skeptical about the extent to which there have been broad-based opportunities on the import or the export side to see the kind of breakthroughs that would seem to be implied in the current forecast. Although one can be surprised, I am a little more skeptical on that front.

I can't quite shake a question in my mind, too, about the inventory situation, even though I understand the auto part, and the CCC part, and all the rest of it. I sense, when I look at the production side of the economy against the backdrop of the inventory situation, that one of two things should be true that aren't showing up in the numbers. One would be that export growth is stronger than the numbers suggest. The other is that there is some demand in the economy someplace that isn't showing through. Again, I don't think there is anything decisive there, but it does continue to raise a bit of a question in my mind on the inventory side. In the context of the external situation--this point has already been made--the escalation of the tensions on the trade side is a new and troubling development which, in my mind's eye, simply reinforces the view that the greatest risk by far at this point lies with the dollar. Any material further depreciation in the dollar is going to exacerbate the situation in countries like Japan by extending the J-curve. It seems to me that you can make an argument that in relative terms Japan is already in a recession, although not in the statistical sense that we define recessions. But on top of that risk on the dollar side, the other risk that I think is closer at hand than we would like it to be is that a further dollar depreciation will trigger at least a mini chain reaction on the financial side that could be very, very destabilizing in the short run. So the net is probably a somewhat higher level of apprehension about the economy, which is Kentucky windage in nature. But I have a significantly heightened concern about the dollar situation in the immediate circumstances that we face right now.

CHAIRMAN VOLCKER. What is Kentucky windage?

VICE CHAIRMAN CORRIGAN. Kentucky windage means I don't have any numbers to back up those hunches, just a bit of a feel in the air. You throw a piece of grass up and you see which way it blows.

MR. BLACK. It's the allowance you make for the errors in the accuracy of your rifle.

SPEAKER(?). Did you learn that in Manhattan, Jerry?

VICE CHAIRMAN CORRIGAN. You could associate it a little if you thought--

CHAIRMAN VOLCKER. That's all a very precise science; now I am really confused. Mr. Morris.

MR. MORRIS. Mr. Chairman, I have been getting anecdotal evidence from our New England manufacturers that their exports were doing pretty well. But when I looked at their employment numbers, the last four or five months of 1986 showed pretty quiet employment in manufacturing. The non-manufacturing economy is doing well; the unemployment rate had drifted below 4 percent, and now it's running about 3-1/2 percent. So I asked our manufacturers: If you are doing so well in exports why isn't this showing up in manufacturing employment? The answer was that domestic capital goods demand is so weak that it has been offsetting the strength in the exports sector. In January we had an uptick in manufacturing employment at a 7 percent annual rate. Now, one month in these numbers is not enough to give a signal, but at least it supports the proposition that maybe the improvement in exports is going to try to [unintelligible] the first time on the employment side. My Boston airport indicator is still looking pretty good. In the three months ending in January, air freight exports in pounds were up by 16 percent over the year-earlier numbers, and air freight imports declined for the first time on a year-to-year basis. It was down one point, so the numbers are still confirming the anecdotal evidence. The employment numbers still haven't shown through to any great extent, but we may be at a turning point in manufacturing employment, depending on the export side.

MS. SEGER. Do any of the exports go by ship or is it all air from Boston?

MR. MORRIS. I am told that about 90 percent of the high-tech exports go by air freight, because their value-to-weight ratio is high.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Mr. Chairman, discussions with our directors and others in business in the Twelfth District indicate that business conditions are improving to some extent. There clearly are exceptions, and the two that I would note would be Alaska and the central valley of California. However, California's total employment has been quite strong. California's employment represents 60 percent of the District and it surged in February, pushing the District's unemployment rate below the national average. Some fragmentary data that we have on retail sales for the beginning of the year indicate that the fall-off that was so pronounced at the national level in January was not shared by the Twelfth District. Also, data that we have on trade from the Pacific Coast ports provide some evidence of improvement in our net export position, as the trade deficit has narrowed significantly in the past 12 months.

Turning to the national economy, our forecast indicates a somewhat worse trade-off between growth in output and inflation than is incorporated in the Greenbook. We have slightly less growth in 1987 and 1988 and inflation--at least in our forecast for 1987--is 1/2 percentage point higher. We have a similar inflation outlook for 1988 because we agree with the Greenbook that we are likely to see upward inflationary pressures arising from import prices persisting through all of next year. However, in contrast to the Greenbook, we expect these inflationary pressures to emerge as early as the second half of this year. Thus, we see a period of upward pressure on nominal short-term interest rates beginning soon and probably extending into the second half of 1988. In my view, it will be necessary to allow nominal interest rates to rise; if we don't, short-term real rates may be pushed too low. We also are looking for somewhat stronger growth toward year-end 1987 than the Board staff, as we have slightly higher consumption and, of course, the trade account begins to improve at that point. Thus, we believe that it may be appropriate to allow real interest rates to nudge up toward year-end. In our view, it would be a bit too risky to allow the pickup in demand pressures to the point where the temporary price shocks become a factor in longer-term inflationary expectations. In our view, the gap between actual and potential [GNP] is really pretty small. Some estimates that we ran suggest it's on the order of one percentage point. Therefore, available slack in the economy is also small, and we think that inflationary risks at the present time are fairly significant.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. While the conditions in our District are largely unchanged from previous periods, at least in the fundamental sense, I do have a feeling that there is a better tone out there. It is entirely possible that this has been affected by the winter. We really have had exceptionally mild weather this winter and, as a consequence, anything that would normally be adversely affected by the weather is doing very well. Construction is the very obvious example. Home building is strong. Jim Kichline has commented on that, but in the Midwest in January and February home starts were up something like 40 percent over the previous year--obviously very heavily weather-affected. Commercial office building continues to be, I think, astoundingly active. There are a number of new buildings that are planned; despite a creeping up in the vacancy rate there are more buildings going up. As a consequence of all this, all the building materials people--cement, masonry, and the like--are doing really exceptionally well. There do continue to be plant closings, but I think they are slowing down a bit and there is some offsetting good news. Last week, or maybe earlier this week, Youngstown and Nippon announced a very sizable joint venture--a $400 million coal power plant. That is the first significant development in the steel industry like that for quite some while. Employment in the District is also a bit on the positive side. In January our employment increased by the national average; that is the first time we have had that in some while.

Even the farm sector looks a little better or, at least, maybe not worse. Farm earnings are probably going to increase this year; that does not really reflect a fundamental change but rather the huge government subsidies. I will say, though, that the livestock business has been and continues to be pretty good. There is some improvement or expectation of improvement with regard to corn exports, offset a bit by lower soybean exports. We think land values are--we've been saying this for a while but we have a growing confidence--in a zone of stability that ought to be helpful to the banks. If that does occur, we have a hope that the whole farm sector may be at a zone of stability, if you will, albeit at a very low level, as it has been for quite some while. There is renewed concern out there about the Farm Credit System; but despite that concern there is, I think, the absolute expectation that at the end of the day the Government is going to be there and provide support for that. But certainly, that has put an air of uncertainty into it all.

On the trade picture, we would have somewhat of a disagreement with the staff forecast. We have commented already on it, perhaps, but the people I talked to are not experiencing the improvements in exports that the Greenbook would suggest. They are concerned about weak conditions in foreign markets and, therefore, the opportunity for their products. But on the import side, there is very, very broad agreement that we've got some improvement. The companies that are manufacturing products for the domestic markets are finding a better receptivity there, a little less out-sourcing, and an increase in domestic production. And that is certainly an improvement. With regard to the exchange rates, just a specific comment: told us that the increase in the deutschemark has basically priced German equipment that is used in the paper industry out of the market for the first time in quite some while. noted that in the machine tool industry, U.S. labor rates are now lower than is the case in Japan. That is also a very significant change for that industry.

On inflation, I think the picture is a bit mixed. The labor situation continues to be good. The people I talked to about contracts are continuing to get what they think are very favorable deals--some as low as 1 or 1-1/3 percent. Generally, most of them were under 3 percent with pretty good work rule changes resulting in productivity improvements. Pricing on other commodities and materials, everybody says, is fiercely competitive--that they can't raise prices, etc., etc. But I am hearing of more instances of the 3 to 4 percent increase and occasionally the 5 percent, so I think there is a bit of an upward movement on that. In a specific industry, the paper industry, a broad upward trend in [the prices of] the commodities that they use, and most specifically polystyrene resin. I think there is a special reason for this, but they have had a price increase on that of about 30 percent in the last year.

In some ways we certainly are in very close agreement with the staff forecast; we see no recession or a strong break-out on the up side either. We are a little apprehensive that the export side may not be quite as strong as we expect. On the inflation side we see nothing yet to be alarmed about but are beginning to sense some upward pressure out there. It is not pervasive yet but I think it is the area that we want to watch.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I don't think I can contribute much to what has been noted on the national level or the international level. In our District things seem to be going along really very well. I am impressed with the drop in the unemployment rate that we have experienced. A year ago it was about 6-1/2 percent in our District and now it is about 5 percent and probably will slide under 5 percent. In places like New Jersey, where it was 5-1/2 percent a year ago, it is now under 4 percent; in Delaware it was a little under 5 percent and now is approaching 3 percent; and we have areas in our District where the unemployment rate is under 3 percent. So, we are experiencing a tightening in wage costs in the area. As in the whole Northeast, wages seem to be rising faster than they are elsewhere in the country. A good bit of it is in construction, especially residential construction; retailing is stronger than expected; and loan growth is running 1-1/2 to 2 times the national rate. We are getting the same kind of experience that Frank Morris has had in manufacturing. Growth in that sector has been about flat and yet they seem to have some positive things to say about export growth. But I think that has been offset by the capital goods area. So, in the Northeast and the middle Atlantic, especially in the eastern part of the District, things are going along really very well and for some areas I would call them boom kind of conditions.

MS. SEGER. Does this include the steel towns that I read about?

MR. BOEHNE. No. If you take a look at our District, for example, areas like Lancaster and York and Harrisburg have unemployment rates of right around 3 percent. If you drive 100 miles west of that, in areas like Johnstown, you have rates of 8-1/2 to 9 percent. In Wilmington you have about 3 percent unemployment; you can go across the Delaware Bay into some sections of South Jersey and you will find 7 percent unemployment. You wonder about the mobility and the skills of the people. But overall, the general tenor in the District--especially in the Eastern part of New Jersey, in Delaware, and in the southeast quadrant of Pennsylvania--is that they are doing very well. Even in places like Johnstown and Altoona, and Scranton to some extent, people will say that conditions are not as good as in some other parts but they are better than they were a year ago.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. The same general report can be given for the Sixth District as the one that Ed Boehne just gave. The reports that we're getting, both in terms of the data and anecdotal information, seem better to me than what I have heard for quite a long time. We are getting quite good reports on the service industry generally. Retail sales have been much better than most retailers had expected, and to a certain extent I suppose that is not very surprising. But what is heartening, I think, is that we are hearing increasingly optimistic reports from the manufacturing sector for the first time in a number of important industries. These include industries such as paper and chemicals and especially textiles and apparel. The petrochemical companies mention very strong orders, as do the apparel manufacturers, and some of this is export-related. We see the same thing Frank Morris mentioned in terms of manufacturing, where the orders are increasing due partly to export-related activity and employment is not moving up very much, if at all. But the explanation we get, and I think it is valid, is that there has been so much automation put in and productivity is so much higher--particularly in the textile industry--that you are not going to see a very rapid increase in the number of employed people. So, generally throughout the District it looks pretty good and confidence is very high. Even in the construction industry, where we had expected some downturn as a result of the tax act, I am hearing from people like architects, real estate people, and construction developers that their firms have never been busier in the month of February. This, of course, is basically in the large metropolitan areas like Atlanta and Nashville, and to some extent Miami, which are experiencing some boom. To be sure, we continue to have difficult areas. Agriculture may have reached the bottom; we're beginning to see that land values are coming back a little. And Louisiana continues to be in a depressed state. Even there, with the recent firmness in the price of oil and strong tourism, I think they feel a little better about their situation and, of course, they are putting a lot of hope and a lot of expectation in the visits of both the Republicans and the Pope!

Looking at the national economy, our forecast is very much the same as the Greenbook. The outlook and expectations we have over the rest of the year have changed very little since the last meeting of the Committee. We differ a bit with the Greenbook with respect to inflation: we think the deflator will turn out to be more toward 3-1/2 percent rather than the 2.7, 2.8 percent that the staff has; and as opposed to the constant rate of increase in each quarter that the staff seems to be expecting, we anticipate that an upward trend will set in during the latter half of the year. Wage contracts and settlements continue to be on the modest side, although I am not sure what is going to develop at the end of the year with the UAW and others coming on stream. But I think the more important thing is that the second-stage impact of rising import prices could be a bit stronger than reflected in the staff forecast. And given the lesser deceleration in service sector inflation, I am a little concerned that in some sense we still have an underlying rate of inflation in the economy that is closer to the 5 percent area than it is to 3 or 4 percent. That is more a gut feeling than anything that I have in terms of statistics.

I think there is a very serious downside risk to this outlook, if we agree that a significant portion of the year's forecast growth is attributable to a turnaround in the foreign trade balance; we keep revising downward our estimates of growth in other nations, particularly Germany and Japan, as someone else has just indicated. Obviously, that partly reflects a fall-off in U.S. imports from them; but with weaker growth abroad, I think that we could get weaker export expansion also. So it seems to me that there is very little reason to expect more improvement in the trade balance in 1987 than we did six weeks ago and, perhaps marginally, there may be some concern that it won't be as good as we had expected. But, as someone also has mentioned, the real threat is the dollar and the increasing likelihood of protectionist legislation of some sort that will bring retaliation by our trading partners. I am not sure that we have any particular way to solve this at the moment except through monetary policy, perhaps, and its effect on the dollar. But I think that this is a very, very important issue and one that I am very concerned about.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. On this point about manufacturing, Frank, we not only saw a big pickup in January--8.1 percent at an annual rate--but an annual growth rate for the last three months of 3.2 percent. So we have been seeing the strength in manufacturing for some time now and it is reflected in non-agricultural employment more broadly. Retail sales are reported with a considerable lag, but I think that retailers generally feel pretty good about the way things are going. Someone made the comment before that economic conditions are a little better than they might have thought. I think retailers generally feel good about things on that side. A lot of these sectors could have been affected by weather, as residential construction was, but I think there is a sentiment that there is some fundamental underlying strength as well. The one area of weakness that has shown up more recently is nonresidential construction. Yet in one of the local businessmen who is in the commercial glass business, or quasi-commercial or whatever you call that, indicated that late last year and early this year they have put through two 5 percent price increases both of which stuck, after a long history of trying to put them through and they just wouldn't stick. And they are looking at maybe another 5 percent increase down the road this year. On a broader front, I personally am somewhat skeptical as to whether the effects of the lower dollar, which I think will filter through in many ways over a long period of time, can really be handled as a one-time level adjustment, as perhaps energy prices would be viewed, in terms of inflation. I would be somewhat concerned about the ability to contain, as Bob Forrestal mentioned, the secondary effects arising out of higher import prices.

Finally, on another note, we had a group of institutional investors in for lunch last week--this is perhaps somewhat irrelevant at this point in that it has already happened--but I was struck by the level of anxiety about market valuation. Generally, people felt that the U.S. stock market on a valuation basis was overpriced but in comparison to other world markets it looked like a great buy right now. So in the cases where investors maybe had taken some U.S. funds offshore, where they have enjoyed tremendous gains both in the currency and those market movements, they now look at the relative valuations and say maybe the U.S. market isn't a bad buy. But there was this general anxiety that a rising tide lifts all ships and that that is not a very good fundamental underpinning for the level of markets.

VICE CHAIRMAN CORRIGAN. Tide capsizes all the ships.

MR. MELZER. Yes, I think. Again, I was struck--and maybe it was just because this was at our Reserve Bank and they were saying what they thought they ought to in the central bank--that, generally speaking, they felt that the liquidity that had been provided wasn't having a lot of impact on the real side of the economy. It was all going into the financial markets and it was blowing up this balloon and creating anxiety about what might happen should that balloon burst.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With respect to the staff's forecast of the economy we have no great quarrel. I will just say that we are a touch stronger on personal consumption and less optimistic about the turnaround in net exports to the extent of about $5 billion or so. Where we would differ is on the projection for prices. On the deflator, for example, we are roughly a half percentage point or more higher than the staff. I think this has been mentioned two or three times around the table up to this point and we would be consistent with those comments.

With respect to the District, I am delighted to tell you that over the past couple of weeks, in meetings with boards of directors, businessmen, bankers and others, there is a decided turn in the outlook. More optimism has been expressed over the past two weeks to a month, I think, than I have seen in our part of the country for three, or maybe even four, years. There isn't a great deal of good hard evidence that there has been a turnaround. It may be part of the optimism that comes in the Midwest when the sap begins to rise--people's outlooks become a bit more optimistic. I was accused of that by Governor Angell when I mentioned it to him earlier. But the fact of the matter is that there is some evidence of a turnaround. For example, in Oklahoma, there has been some leasing activity in the oil and gas area with leases on a three-year basis of $35 to $50 an acre. That is not a great amount compared with what they got two or three years ago, but it does provide a cash flow that eases some of the strains for the lenders, particularly those small banks located in the petroleum-producing areas.

Also, as has been mentioned earlier, there seems to be some stabilization in the price of agricultural real estate. There are reports that some sales have taken place in remote areas such as western Nebraska in which fairly good prices were established; and some sales are actually moving property. There's an interesting development that's occurring with the Farm Credit System. It started with the St. Paul Farm Credit Bank, and perhaps Gary Stern can expand on it, but they are adopting a new program in which they are going to accelerate the sale of the agricultural real estate that they now have by using a program of incentives based upon term, price, and particularly interest rates. For example, they will go as low as 4.9 percent for 3, 5, or 7 years, and after that time the interest rate rises to a market interest rate for the 25- to 30-year amortization period of the loan. It is obvious that the price of the property that is being sold is not the true price because of the incentives being granted. But it is something that has received some rather positive comments. And if you are concerned about the amount of land that might be dumped on the market through this by the Farm Credit System or other lenders, let me just tell you that there are about 4-1/4 million acres now in the hands of lenders and that represents only about 5 percent of the agricultural real estate that is normally sold in any given year. So it is not a big amount but it may mask a bit the problems in the Midwest because much of it is centered there. There is an optimistic tone that hasn't been present in the past.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I have been impressed for some time at the ongoing employment gains at the national level. It seems to me that rather healthy employment gains have been underway for roughly six months or so now, going back to September. I must say that that kind of improvement seems to be evident, at least anecdotally, in many of the comments I hear around the District extending over roughly the same period of time. But it is not mirrored in many of the other national statistics that I look at, although maybe if one looks carefully at some of the consumer spending data, excluding autos, or some of the construction data, one can see some of it in there. I conclude from that divergence between what I am hearing anecdotally in the District on the employment gains versus some of the other statistics that the recovery remains uneven and unbalanced. But I also wonder if it isn't a fact that a lot of our statistics don't focus on services and trade, and finance, insurance, and real estate, and so forth, where a lot of this activity, in fact, lies.

On the inflation side, I have been expecting, of course, that we would see some deterioration this year in any event, and I haven't changed my views about that. I would report that in talking to some people in the District, in two very different kinds of businesses--pulp paper, lumber, etc. and in health care which is a small but stubborn component in the CPI--prices, at least in general, have been rising more rapidly once again. There seem to be growing indications of some rebuilding of price pressures, at least in those two sectors out our way. Despite what I would consider my basic satisfaction with the immediate economic outlook and conditions in the District, I must say that, if anything, I am less optimistic about the longer term. It seems to me that some people have touched on this. Many of the things that we have talked about over the last several years that might go wrong seem to be in the process of going wrong at the moment, as I view it. The dollar has been touched on: what that means for Germany and Japan and what that means for domestic inflation. All those things are not looking good. Protectionism adds to those concerns. The LDC situation looks to me to be worse. Probably I could add to that litany if I really tried. But I guess my message is that as I look at that and what it might imply for economic performance here and abroad I am, if anything, more concerned.

CHAIRMAN VOLCKER. We will hasten to Mr. Boykin.

MR. BOYKIN. I did look real hard for something positive: I was able to leave the District for a few days! Mention has been made on the manufacturing side of exports and the effect of the dollar. That is, or appears to be, a positive factor in the Eleventh District --lumber, paper, and chemicals seem to be responding. Attitudes, which I think really are important, have not changed all that much. I would say that some people are not quite as pessimistic although I certainly would not consider people optimistic at this point. Looking at some of the negatives that remain in the Eleventh District, construction, which I've reported on, is a big thing, of course. We don't see much possibility for a turnaround in that. In commercial construction Houston had a negative absorption. Dallas does have a higher vacancy rate than Houston but our absorption is doing better. The thinking was that we probably were two or three years away from a major announcement on a new building. Now that has been extended to probably three or four years, indirectly, because we have had a major announcement of 900,000 square feet coming on the market in downtown Dallas with the InterFirst-Republic Bank combination; they are going to free up that much space--their prime or best space--through that consolidation. The rig count is off slightly after growing steadily for about six months. Retail sales are weak. I can confirm what you say, Roger, about leasing. In Oklahoma we just leased a little mineral interest that the Bank has there and we got $105 an acre but we went out for five years and I think it amounted to about $3,000.

MR. BLACK. The Bank has?

MS. SEGER. Are you speculating in oil?

MR. BOYKIN. No, this goes back to the '20s and '30s. We were given quitclaim deeds and we haven't been able to get rid of this. We should have given it to you when you took Oklahoma, Roger! The employment numbers have been a surprise for us in Texas because we have been reporting eight consecutive months of growth in employment. Those numbers have now been revised and, as a matter of fact, we have had eight consecutive months of decline.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. At the time of our February meeting we had slightly higher projections on real GNP and inflation than the Board staff had. The staff has not changed its overall projection, although it has changed the shape or the profile, and we left ours pretty much the same--partly out of conviction and also probably because we knew if we made another forecast that we would have two errors rather than one. The main point of difference that we have with the staff is in the area of residential construction. We think, given the sharp drop that we have had in mortgage rates, that it ought to be a little stronger than 1.3 percent. Even more important than that, the staff's downward revision in construction and personal consumption expenditures, to which several people have alluded, is pretty significant. It has come down from 4 percent in 1986 to 1 percent in 1987 and we have not had that low a rate of growth since 1981, which was a recession year. In view of the proliferation of home equity mortgage loans--which I would think would make a difference--and also the wealth effect of the stock market, we think that that's apt to be a little stronger. We come out about the same on the net exports of goods and services, although I think that is probably the most vulnerable part of all of our forecasts. Things don't look all that good abroad now but we would stick with about what the Board's staff has said.

As I mentioned, in the area of inflation we are a little higher than the Board staff. Although we are still predicting a fairly moderate inflation in the implicit price deflator for next year, I think this price level bears some closer monitoring. There is a lot of money and liquidity out there and that is going to be felt at some time. We have had a substantial depreciation of the dollar and there has been an increase in capacity utilization, and all these things ought to work to put some upward pressure on the dollar at some point. It may come a little sooner than most people seem to think. Some of the pickup in industrial prices, as shown in the Greenbook and also reported in several of the District surveys contained in the Beige book, suggest that there may be a little more there than meets the eye. I hope not, but it is something that I think bears some watching for the time being.

CHAIRMAN VOLCKER. Mr. Hendricks.

MR. HENDRICKS. Thank you, Mr. Chairman. The economic situation in the Fourth District is broadly consistent with what the staff has forecasted. Most sectors of our economy, believe it or not, are expanding begrudgingly and fitfully. Metal producers, of course, continue to suffer from excessive worldwide supply. Housing, on the other hand, seems to be holding its own and, in fact, is moving forward at a rapid pace. Some others have commented on housing starts in the Midwest and we are no different. The directors and others with whom we speak admit to feeling that the worst is now behind them in terms of the foreign trade front. You can twist their arms a little and they will admit it. Domestic producers say that it is easier to compete now against imports but that competition is still very intense; yet they seem to feel as though they are back in the ball game. Our staff feels that we still are a long way from being secure about the economic fundamentals governing the current account. The improvement could take longer and may require a lower dollar than we think today. Our people don't see as much strength, perhaps, in exports as is indicated by the Greenbook forecast. One interesting thing our staff did was to take a look at capacity in the various sectors, and there are spotty areas where capacity utilization is beginning to approach the highs reached back in 1978 and 1980. Several of the industries are at their long-term 20-year average. Somebody mentioned some pressure on prices in textiles; they're showing up to and beyond their 1978-to-1980 highs. So just as a general comment, there may be some spotty places in the economy where capacity [constraints] are beginning to show up. As I said at the outset of my comments, the staff's outlook in the Greenbook is very consistent with the conditions we see in the Fourth District.

CHAIRMAN VOLCKER. Governor Heller.

MR. HELLER. I agree with the growth and inflation forecasts of the staff. I was happy to see that the first quarter was revised upward; I always thought that the tax would have an overall beneficial effect. Let me focus mainly on the external side. As many speakers have pointed out, our main problem is the high and persistent trade deficit. Sooner or later we will have to correct it. But at the going exchange rates that trade deficit will continue to persist, as the staff's projections have shown for the exchange rates and foreign growth, I should hasten to add. The staff projections in the Greenbook, I think, already have incorporated the decline in the value of the dollar. Obviously, if foreigners were willing to expand their economies that would help on the trade side. But as we have also learned they are unwilling to do so. So the question that will be before us here is whether it will be advisable for us to delay the adjustment in the exchange rate by letting interest rates drift upward. I think that that would lower the growth projections we have for the U.S. economy which are only running slightly above 2-1/2 percent. That wouldn't help the world economy; the LDCs would be hurt by higher interest rates and clearly their export markets would be hurt by having lower growth in the United States as well. I am willing to let interest rates drift up if it would be necessary in order to help on the price front. But in spite of the few hiccups that we have seen, overall the projections still show that inflation is essentially flat in the profile for the year as a whole, and I am comfortable with that projection. So I think that the debate we are really going to focus on in our later deliberation is whether we want to focus monetary policy on domestic or international projections.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. There does seem to be a growing consensus about the world economy, so I don't think I need to elaborate much more on low world economic growth rates. That's certainly not good news, as all of us know, in regard to the LDC's debt and to many other things that are very important to us. Unfortunately, in the news on the U.S. economy it is hard to see any bright spots, because if we do get any rebound--and if it is rather significant--in view of the world economy that may very well overwhelm the exchange rate effects. So we would end up having a bad world even if we meet U.S. growth projections. So that is somewhat of a negative.

I tend to be sympathetic with the staff's view on the inflation rate because I think a global perspective is very, very significant. I noted here today that I haven't yet heard a president of a Reserve Bank who has come in with an inflation rate that is lower than staff's. I hear a lot that are higher. I am about up to the staff's level now on inflation because there has been a development in regard to the spring storms that might have an adverse effect on food prices. That is, this blizzard in the Midwest occurred at a rather unfortunate time with regard to calving and there is a lot of livestock damage--anecdotal at this point. We don't know what the numbers are but the situation could be somewhat severe. I guess there is some benefit in that we have moved a lot of that cow/calf operation to Florida and that works pretty well for reasons I have not quite understood. You feed cattle, or start them off, on a very poor grass diet--I am not trying to draw aspersions to Florida--but then you transfer them to the good blue foothills grass and you get marvelous kinds of changes. So we don't have as much of the cattle exposed as we did before, but that undoubtedly would have an adverse impact.

I would second what has been mentioned about agriculture. We are now beginning to see farmers who are having prosperity and ranchers who are having prosperity come forward. For quite a while farmers who were making any money tended to be very quiet about it in this kind of environment, but they're beginning to come forward. It does appear that most of the land purchases are being made by farmers, not by out-of-farming interests. It may very well be that our agricultural banks are going to get through this year to a period where in 1988 we may have some better news. I wish we could say the same thing about banks with LDC debt.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I think just about everything has been covered. For my own benefit, I'll summarize my thoughts a bit. I have heard from a lot of the Districts that things look better. Production is picking up and employment looks a little better in the trade-related area and in some manufacturing. I think the aggregate statistics reflect some of that and that is encouraging. What concerns me a little is how much of this production that we are seeing is going into inventories. How much of it is really meeting domestic consumption? There seems to be some circumstantial evidence of some involuntary inventory buildup. It is more in the automobile area than anywhere else, but there are at least some signs of inventory pressure even in the non-auto area. That may be just the rebuilding of stocks to more normal levels but given the low forecast that we have for domestic demand--which a lot of comments reflected around the room--you just wonder if all that production and greater optimism we are seeing are going to be permanent or if there will be a flash into inventories. If so, there is some risk and a little concern as to whether this production activity is going to be continuing. That bothers me a little, especially when we are marking down growth abroad and the potential for our export markets. So, we may not be seeing the strength in the future from the export side that we had been expecting earlier.

That is somewhat of a problem which brings me to the dilemma that I keep worrying about. I think we all agree that the dollar is at levels where we wouldn't like to see it go particularly lower. Having it go lower would make it counterproductive on the trade side as well as the inflation side at this point. But I think the concern is: should we get dragged down by trying to stabilize the dollar against some countries who are experiencing economic decline? I worry a bit about the overall macroeconomic effects of trying to stabilize the dollar against some weakening economy. At the same time I am at a loss for knowing what to do about it simply because I think there is a risk to our financial market stability, especially in the short run--and maybe even for inflation in the long run--if we don't try and do something about the dollar. It is a real predicament that we have to deal with and the protectionist sentiment that we are seeing surface is part of that problem now. I just hope we don't have to get into a situation where we are defending the dollar because of a confidence problem associated with destabilizing exchange rates against currencies whose countries are showing continued decline. That is a real risk; in my mind that seems to be the major problem and I just don't know exactly how we should deal with it.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. My own forecast is a little below the staff's forecast, at least in terms of the overall growth for the economy. In going back to the time when the staff first presented its forecast for 1987, I have had this concern--which I have heard here at least seven times already today--about the ability of the trade picture to improve enough to make the contribution to our overall growth situation that we seem to have expected and we continue to expect. Also, I must say that I am still not convinced, even with exchange rate adjustments and even with more American businessmen interested in exporting, that we in fact can do a lot more exporting--because of not necessarily having the kinds of products, or enough of the kinds of products, that are wanted in other parts of the world. I have been lectured on this matter by some Germans over the last couple of weeks or months, so I hope they haven't unduly colored my view. But I think there is some of that going on. Also, I am not convinced that all the markets in the world are really open to our products; I think the events of the last few days have suggested that some other people have wondered, at least, whether the Japanese markets were open to our products. So, that concerns me.

On the domestic side my nagging concern continues to be the auto industry. They already have very substantial supplies of new cars sitting in various dealer lots and showrooms. There have been some cuts in production and there have been some downward revisions of production schedules. But my woman's intuition suggests that maybe scheduling changes have not gone far enough and that we will see more of them. Therefore, I hope that the staff's forecast does prove to be right because I do want a good healthy economy, and I like faster growth rates rather than slower growth rates. But I really think we are putting a lot of our eggs in one or two baskets and I just hope we don't stub our toes.

CHAIRMAN VOLCKER. Mr. Kohn, can you be fast?

MR. KOHN. Okay. [Statement--see Appendix.]

[Coffee break]

CHAIRMAN VOLCKER. I think we can proceed and decide what to do. I don't think this is the simplest situation we have ever been in. The course of action in one way seems pretty obvious. But whether that is really satisfactory to the situation, the answer is probably no. Things are not under our control. I'd say our decision is easy in one sense: It is a little hard for me to see, in listening to what everybody has said, that we would want to move importantly in one direction or another from where we have been just in terms of the business outlook and ordinary domestic criteria. I guess the question is: Under what conditions would we want to move at all significantly? The aggregates are coming in low, which can't upset me after a year or 18 months of coming in high. I don't see that as a strong reason for easing, for a fair amount of time anyway. That leaves us with the question of the dollar and the international situation and all those related concerns that have been discussed, which are very difficult issues. Obviously, they are by their nature a multilateral concern as well as our concern. I would just note in that connection that the G-10 meets next week. [Unintelligible] for all those numbers we ought to extract great wisdom out of the meetings next week. I wouldn't count on that but there is an opportunity for a closer discussion with our major trading partners next week. [We could provide] some sense of what we might think is useful in terms of entering into those discussions. Who wants to say something?

VICE CHAIRMAN CORRIGAN. I will if no one wants to. As I look at the situation now, in my judgment, we would have to be prepared to let interest rates go up a little for a little while in order to avoid a situation where they had to go up a lot for a long while. In the context of the alternatives in the Bluebook, following them in a conventional sense, that would lean me toward the alternative C side of things. But I don't think the alternatives in the Bluebook are really the best way to think about the situation at the moment.

CHAIRMAN VOLCKER. I am beginning to worry about that when I look at this, too. Let me just interject a comment. As I said, I don't see any reasons to change strongly. I am thinking about it in terms of borrowings right at the moment. It was implicit in what I said that if the aggregates continue to come in below 6 percent--or 6.9 percent, or whatever the staff has here--I wouldn't see that as a strong signal for easing at this point. I don't know whether those aggregates are too high or whether the staff always judges them absolutely correctly.

MR. JOHNSON. I think they are too high if interest rates pick up.

CHAIRMAN VOLCKER. Well, who knows what they are. But I don't think that is the crucial variable for this period.

VICE CHAIRMAN CORRIGAN. That's partly what I was just trying to say. I don't think it is very easy to think about policy in terms of conventional alternatives A, B, or C. The way I would state it is that I would be prepared, in the face of continued weakness in the exchange market, to see the borrowings level go up--in the extreme maybe even as high as $500 million, say--in the hope and the expectation that that would be temporary. The idea is to avoid having to permanently increase interest rates. But I do worry; I am not at all sure that we have seen the real test in this exchange market. If we were to see the kinds of pressures, or even more pressures than we have seen in the last few days, materialize in the very near term I don't think we could head that off just through intervention. And in those circumstances, I think we would have to be prepared to show our hand a little in the hope that that could get us over the hump.

CHAIRMAN VOLCKER. Just for purposes of clarification: If I understand you correctly, you are saying do nothing now but be prepared to raise borrowing if the exchange market comes under still more pressure.

VICE CHAIRMAN CORRIGAN. And I would be prepared to go up to at least $500 million in those circumstances.

MR. JOHNSON. Can I just comment on that? I think Jerry has a good point. My only concern about it is that I think we might need discretion for something like that. I would hate to see us make the fundamental move on monetary policy when I think [the move] even more clearly lies with the surplus countries. So, I would only want to do that if we saw some tendency for them to let money market rates drift down so that we would get that interest rate differential we need. To see the fundamentals change in the right way over there would seem to be the desirable feature.

VICE CHAIRMAN CORRIGAN. Oh, the best of all possible worlds would be that. As I have tried to describe this, I would not view this as a fundamental change in policy; I would view it as almost a tactical change that says we are prepared [to move] at least for a transitory period. To some extent we have been finessing that a little, as someone said earlier, just in terms of the way we have been conducting our open market operations from day-to-day. All I am saying is that I would be prepared to go a little further than simply finessing open market operations from day-to-day in the face of renewed downward pressure.

CHAIRMAN VOLCKER. You're saying do nothing today, if I understand you correctly.

VICE CHAIRMAN CORRIGAN. Depending upon what's going on in the market. I think it means do nothing today.

CHAIRMAN VOLCKER. I don't mean today; I mean on borrowing.

VICE CHAIRMAN CORRIGAN. I know.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, this seems to me too like a good time to hold our policy steady. I would opt for "B" and I would maintain that tilt toward restraint in the language of the directive. There's a good case for making this language symmetrical, which is what I generally favor, particularly now with the aggregates slowing down. That case can be made; but I think over the last couple of years we assumed that at some point the rapid growth in the aggregates was going to be followed by a slowing in those growth rates as they adjusted to the downward drift in interest rates. That is what we may be seeing now. And, like you, I would be very reluctant to do anything in the way of ease if the aggregates continue weak for a while because, if anything, the economy looks a little stronger to me now than it did. So, that would not be any signal to me that we ought to act in that direction in the immediate future. I would not favor putting a greater weight in the written directive on the foreign exchange side, although I think we would necessarily emphasize that. We already have language in the directive now, and if we use the kind of language suggested in the Bluebook I would have some concern as to how the markets might interpret that. Although I certainly don't know, I fear that the markets might think that means more of a [unintelligible] than probably we have in mind. I wouldn't want to give that kind of signal. I would just ride with the reference that we already have in the directive about giving due attention to foreign exchange matters.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. I come out in essentially the same place. Let me just mention a couple of things. While it is implicit, I think, in the discussion, maybe one thing that ought to be mentioned explicitly is that the problem with the dollar is not the level but the rate of decline that we have experienced--more than 7 percent between the December and February meetings. I am not sure what the decline is through yesterday, but it's probably on the order of 5 percent on a trade-weighted basis. So, one thing that is important in thinking about the dollar is that we are not necessarily saying that this is the right level but that some stability is desirable. Picking up on Governor Johnson's earlier point--it seems to me that the message being sent to us there is really quite a negative one if our real growth outlook is considerably more attractive than that of our major trading partners and yet our currency is weak. I think that is saying something about what people think about the inflationary prospects here. I recognize that there are a lot of risks on the table with respect to the economic outlook, but going back to what Jerry Corrigan said earlier, the most destabilizing risk would be that of losing control of the dollar on the downside after the very rapid declines that we've had. So, in my mind that alone takes away any thought of easing. In fact, it seems to me that the dynamics we've been witnessing here, with a weaker dollar and how that spills right back into the bond and stock markets, are what will unleash the liquidity that's in the economy that we've been talking about for some time. It's going to lead people to tend to want to liquidate financial assets and, I would guess, be much more inclined to spend. That could really add to the momentum in the economy, particularly on the price side, which is where my concern would be. It really comes down in my mind to a question of whether we tighten now or wait. I guess we can all take some comfort in the slowdown in the growth of reserves and money but, on a quarterly basis, we're really talking about M1 slowing down to 11 percent in the fourth quarter; for the average through March the projection is around 9 percent. Reserve growth also has slowed down from very extraordinary rates toward the end of the year. But we're still talking about historically high rates. In my mind, there's no reason to be at all concerned about slow money growth. Eventually, although it's not a very happy choice, it seems to me that we will likely be put in a position of having to tighten policy. I don't know whether it's now or later. It seems to me that the arguments against any move now are these international discussions that you mentioned, Mr. Chairman, and also the trade negotiations with the Japanese right now. While I don't necessarily agree with it, I could see that at this point--as a negotiating tactic, really--the dollar bashing is the club we have in trying to reach some agreement in a very short-term sense.

So, all things considered, I'd be in favor of maintaining the existing degree of reserve restraint now. But if we can't hold the dollar at about this level, then I think we have to be prepared to move to a firmer policy much more quickly. Or if, at the present degree of reserve restraint, we see a pickup in the rate of growth of money in relation to what's projected here--let's say we have 9 percent on the table for the period ahead--I think we're going to have to pay more attention to that. I say that for all these other reasons: inflationary expectations are quite high now, and I don't think we have the latitude as a central bank to ignore extremely rapid money growth. The slowdown from the rapid rates of last year, from 13 percent down to 9 percent, is okay. But if we see either a pickup in monetary growth--and when I say pickup I mean in relation to this 9 percent projection for the quarter--or a weak dollar, those would be the things I'd be looking at as short-term indicators of the need to respond in the direction of further tightening.

CHAIRMAN VOLCKER. For what it's worth, just to bring you up to date, Mr. Kohn tells me that the March figure is likely to be a little lower than what's been indicated to you--by more than a percent, I guess, for M1.

MR. KOHN. About 4-1/4 percent for March.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Mr. Chairman, I would favor alternative B and, like President Black, I would favor language that tilts toward firmness. As I indicated previously, I believe that inflationary pressures will require some interest rate increases in the second half of the year; and if inflationary pressures surface sooner, policy may have to respond earlier as well. With regard to the aggregates, I think it's quite likely that we will run into a period where they are growing toward the low end, or even below the low end, if we see interest rates rising. If that's the case, we're likely to tolerate that. I would think that we would have to change the wording of the directive because the way the directive is worded today any change from the existing reserve restraint depends primarily on the behavior of the aggregates, taking into account business conditions, etc. I think we almost want to reverse that and have as the primary determinants what we really are focusing on, which is business conditions and progress against inflation, and so forth.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I think Jerry Corrigan captured my feelings very well. That is, I would favor no immediate change in policy but I would be prepared to move to a higher borrowing level. Having that in mind, and trying to capture that within the framework of the way we talk about these things, that is somewhere in the "B-C" area. I'm not sure that I would be prepared to go to $500 million. On the other hand, I feel that there may be some advantage to showing some modestly higher interest rates earlier rather than later--that is, to permit the market to understand that somewhat higher interest rates effected by the Federal Reserve, as opposed to just the technical factors, would be acceptable in the near term. However, the point is--and I think Jerry made this point very well--that this does not mean a change in Federal Reserve policy but rather the management of Federal Reserve policy at or about the level that we presently operate. The other thing that I would just mention is that, contrary to some other comments that have been made, I would move the reference on the dollar in the directive to a more prominent level; I would move it up in that sentence as proposed in the directive language and as mentioned by Don Kohn.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. As I look at the domestic economy, Mr. Chairman, I don't see any case at all for doing anything with respect to policy at the present time. We have had reports around the table this morning that reflect perhaps somewhat better economic conditions than we had last time. The forecast isn't all that bad, although inflation looks like it's going to be ticking up toward the end of the year. But I think all of this is premature with respect to policy. For purely domestic reasons I would prefer to stay where we are. The only reason that I would favor a move in interest rates or a move in the borrowing is because of the dollar. Again, I think perhaps we are in a position where we can afford to wait a little longer to see what happens with the dollar. It's possible that this Japan bashing that's going on with respect to the semi-conductor situation may resolve itself. When we get past this quarter some of the window dressing that the Japanese are engaged in may sort itself out and we may have a little easing of the pressure on the dollar. If that doesn't happen I would certainly want to be in a position to move rapidly to counter any further significant drop in the dollar. With respect to Governor Johnson's point, I think it certainly would be wonderful if we could get the interest rate differentials to contract a little. But even if our trading partners don't make those moves, if the dollar were to fall somewhat more I'd be prepared to go ahead unilaterally on our own.

With respect to the directive, I too would favor giving a more prominent place in that directive to the foreign exchange situation. One other point that I would make is that I'm not so sure that the word "instability" that is in the directive is the right one. The phrase "in light of the recent instability" strikes me as being a bit on the strong side. I would prefer language that would suggest recent weakness of the dollar.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. It seems to me that no change, or alternative B, is the right place to start because we have so much uncertainty in regard to the direction our economy is going. We just don't have the facts out there that tell us exactly which move we ought to make. And the last thing we ought to do is to make a move in one direction and have it turn out to be the wrong move. I think we need stability when we don't seem to get too much stability from other Executive branches of this government. We need to stabilize here; we need not do something dramatic. The only certain thing I can see is the dollar's downward momentum; it just doesn't seem to me that that's apt to turn around. At some point in time, we're going to have to be willing to give that high priority or top priority. In fact, at some point in time, we're probably going to have to be willing to make it the dominant priority in order to change this momentum that exists. I do believe it would be very important for us to get West Germany and Japan and other G-10 countries also to recognize that this is a critical juncture and that at some point here we are going to have to be willing to [unintelligible] monetary policy. It would be most important that we have them prepared to make steps at the same time we might make a step. So, we really ought to be sure that any upward pressure on interest rates in the United States in this environment calls for downward pressure on rates abroad. I think the world economy dictates that. It seems to me that the transition for us ought to be to look at the monetary aggregates. I don't think we ought to announce anything different about the monetary aggregates now, but I do think we ought to look carefully at the M2 and M1 growth paths. If they are within this 3 to 7 percent range and conditions remain as they are and the dollar continues to move downward for some time, that might be acceptable. But at some point--

CHAIRMAN VOLCKER. 3 to 7 percent range?

MR. ANGELL. Well, there's no number like that in the Bluebook but it seems to me that a 3 to 7 range gives the path for the dollar--

CHAIRMAN VOLCKER. Okay. You just made that up, I guess?

MR. ANGELL. I just made that up, right. Given the path of the dollar, we want monetary restraint more than we otherwise would have wanted; but we don't want to have an abrupt movement there, and we want to negotiate with our--

CHAIRMAN VOLCKER. 3 to 7 percent is what you're thinking of for M2 and M3?

MR. ANGELL. Well, M2 and M1.

CHAIRMAN VOLCKER. M2 and M1?

MR. ANGELL. That is in this current environment of dollar weakness.

CHAIRMAN VOLCKER. Governor Heller.

MR. HELLER. Like most speakers before me, I favor alternative B. I think it's important to keep U.S. economic growth going and also to maintain inflation at a subdued pace. I was very happy to see that the Ms have been slowing, and I think we should not do something that pushes them very sharply from their current paths. I'd like to note that short-term interest rates are already very high in real terms. With federal funds trading today between 6 and 7 percent, if you take the GNP deflator of 3 percent you're talking about a short-term [real] interest rate of between 3 and 4 percent. I certainly wouldn't want to follow Germany and Japan into their slowdown just for the sake of holding the dollar exchange rate against those two currencies at the present time, as has been noted many times before. The dollar has not depreciated very much against the broader basket of currencies. As is implied by the staff projection, if we prevent the dollar from falling we will get lower growth rates than are actually indicated here. So we're risking the chance of a substantial slowdown, if not a recession, in the United States. That certainly wouldn't help the world economy, as such. We've mentioned before that we should intervene in disorderly markets and I agree with that. With all that taken into account, I favor symmetric language in the policy directive and would not move the dollar to a more prominent place in the directive itself.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I think the economy is strong enough that there's certainly no case for pursuing an easier policy even if the aggregates should come in for the next month or so below the projections indicated. I'd like to call your attention, though, to the fact that we've already had some tightening in the last few days. We've had the long-term government bond yield go up about 30 basis points. If that should stick, we should expect to see a similar rise in corporate bond and mortgage rates. As far as moving to a higher borrowing level and a tighter policy, I think that depends a lot on the nature of the overall circumstances. I'm inclined to take the same position that Governor Heller did: that with the world economy growing so slowly, if we're going to stay on a path of improving our balance of payments position we've got to be able to increase our market share in a world that's not growing very fast. And I'm not sure we can do that at the present level of the exchange rate. I don't know where the equilibrium rate is but I suspect the dollar has to come down somewhat further before we get enough momentum going to begin to restore our balance of payments position. So it seems to me that if we're going to raise the borrowing level we ought to have a conference call so that the members of the Committee really can appraise the situation in the light of what's going on domestically as well as what's going on in the foreign exchange market. If we're getting a modest, gradual, downward drift in the dollar I don't think we ought to be concerned about that. If we get a sustained number of days [of weakness], as we've had recently, of course, that's another matter. It depends on the conditions, and I think they're kind of hard to describe in advance. That's why I suggest that we should have a conference call.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Given all the current and prospective problems we face, I favor alternative B in terms of a borrowing target, at least as the starting point. I think we should not roil things here any further unnecessarily. I would maintain the kind of asymmetry that's in the directive and I would be in favor of greater emphasis on foreign exchange market considerations. As Jerry Corrigan mentioned earlier, in the period ahead we may be in a situation where intervention alone doesn't do it; we may have to be prepared to back that up with something more meaningful. Beyond that, I would add that I don't know what the right level for the dollar is, but I am concerned that a lower dollar as a consequence of accommodative monetary policy at this point will not solve our trade problem in any sustained or any satisfactory way. It seems to me that in the longer run that's going to produce either higher inflation or weaker domestic investment than we would like to see, or some combination of both over time. I'm quite concerned about that; that is a longer-term matter. I think we have to be very careful with the dollar here and I don't know that having it go lower at this juncture, as a consequence of monetary policy, is a helpful development at all.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I would also favor alternative B for the reasons that have been given--the uncertainties. I do like Jerry's approach of starting with $300 million borrowing but being prepared to move fairly rapidly a little higher. It seems to me that what is really important right now in this very current environment is what's happening to the exchange rate, and that can move awfully fast. In terms of the response and implementation of policy, I differ a little with Frank Morris simply because of the logistics of taking whatever action might be required. I would be willing to go along with an understanding of being prepared to move and to move very quickly toward a little more restraint. Likewise, then, I would make the exchange rate a little more prominent in the directive because that's kind of what's guiding the policy decision right now, at least in my mind.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. For the reasons stated it does seem to me that this is an appropriate time to maintain our current level of reserve restraint. That suggests a borrowing level of, say, $300 million. But depending on developments in the exchange market as they may evolve, if we were going to err I'd be in favor of erring a bit on the high side rather than the low side. And I think the wording of the directive ought to be phrased to reflect at least that level of restraint. Translating that to the federal funds rate, if the rate were to continue at the present level X--what's going on today, which I think is an aberration--or even trend a little higher I wouldn't necessarily fight that.

CHAIRMAN VOLCKER. It has moved down, I guess. So, before you make your case, the federal funds rate has come down since this morning.

MR. STERNLIGHT. It came down to the 6-1/4 percent area after having been as high as 6-3/4 percent. So it wasn't working out--

CHAIRMAN VOLCKER. Still, I didn't know what you were referring to.

MR. KEEHN. 6-1/4 percent was exactly what I had in mind.

CHAIRMAN VOLCKER. Okay, I just wanted to make sure that you were--

MR. KEEHN. It seems to me that that level is one that we ought not to necessarily fight. [From the discussion] around the table earlier, I think it's clear that our principal focus is on the international side, particularly the exchange markets. Therefore, I do think that the directive ought to reflect that. I think it's an honest statement that would not in any way be surprising to the markets. The kind of wording that Don Kohn has in the Bluebook relating to that is an appropriate statement.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I think we have some breathing room on the domestic economy and our focus is on the international situation. I think it needs special emphasis both in the directive and in the conduct of policy. I find it hard to imagine a situation in which we would ease policy over the next six weeks. So I come out with the view that we ought to stay where we are for now, with a directive weighted on the side of restraint. Whether we have to exercise that restraint depends on how developments, particularly international developments, unfold.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I agree with the statements that where the economy is headed is a little uncertain now. So I don't think that we want to make any clear-cut moves in monetary policy. That's why I support something like alternative B. But I am concerned about some of the potential destabilizing activities that are going on in the financial markets. So, even though I really wouldn't want a change in policy, I think that it may be necessary to at least reserve some potential discretion--or maybe the answer is to have the potential for a conference call--to deal with a situation that might require some uptick in the borrowing level. I would reemphasize what I said before: that my preference would be not to do anything like that, or at least to make our best effort to convince our trading partners who have these large surpluses to be less reluctant on their own domestic policy. That's where I think the real problem lies more than it lies here. I'd hate to see us dragged into their scenario by trying to defend the dollar when it's sinking against those currencies. And that is a real risk. But I think we have to deal with the destabilizing market activity. There is a real threat of inflationary expectations surfacing if we let it get out of hand. So there might be room for some discretion. I'm not sure whether having the discretion to run the borrowings up to a certain level is the right approach. We recently had some trouble figuring out what the relationship between borrowings and the interest rate spread is. So, if we were to say something like a $500 million borrowing target, I'm not sure what funds rate would be necessary to produce that. We might want to think more in terms of just adjusting the funds rate a little rather than trying to hit some borrowing level when we're not sure what funds rate it requires. I don't know what that means exactly--maybe a conference call or some sort of consultation. The problem is that the developments that surface require quick action and I'm not sure there's always the time to sit around and have a conference call about it. Maybe there's some room for some discretionary allowance there. I think we ought to at least give this upcoming G-10 meeting a chance. I hope we've got that much time without something happening in the exchange market to give us more of a problem, but--

CHAIRMAN VOLCKER. So far it's getting weaker by the minute.

MR. JOHNSON. Yes. Hopefully we can maintain the current approach until after that meeting. Anyway, that's the dilemma.

MR. MELZER. There used to be a range in the directive for borrowings, which may be appropriate here. We could maybe skew it a little in the direction of the sentiment that has been expressed.

CHAIRMAN VOLCKER. Where is the exchange rate?

MR. CROSS. The yen is down to 145-1/2, which is down another 1/2 a yen in the course of today and below the levels where it has been for the past couple of days in Tokyo and New York. It is under pretty heavy speculative pressure right now.

CHAIRMAN VOLCKER. Just a little longer and we can get it down to 145.

MR. HELLER. Then you get a different directive.

CHAIRMAN VOLCKER. Mr. Hendricks.

MR. BLACK. Just delay the vote awhile.

MR. CROSS. It may be there now.

MR. HENDRICKS. Although the business statistics have improved in the last couple of months, they don't seem to be impressive enough to suggest a significant step-up in the pace of expansion. We're concerned about some price developments that we see on the horizon and the pressure on the dollar in foreign exchange markets. With respect to the prominence of the exchange rate in the directive we would favor not changing it. And, of course, the alternative that we support is the "B" path.

CHAIRMAN VOLCKER. We have exhausted my list. Ms. Seger.

MS. SEGER. Is it possible to vote with a question? How much confidence do we have that getting interest rates still higher would, in fact, stop the decline of the dollar? I hear that come through in these comments and in the votes, but could someone just lay some probability numbers on the table for me?

MR. ANGELL. We can reduce the supply of reserves enough to get the dollar to be stabilized but we don't know what rate of interest that might entail.

MR. PARRY. Isn't the important answer that term interest rates would [unintelligible] less of a problem now? With higher interest rates, the chances of success are greater than with constant interest rates.

MR. JOHNSON. As long as we don't spread the impression of seriously weakening the economy.

MS. SEGER. Yes, and that is exactly my point. I would hate to be chasing the dollar with higher interest rates and take down an economy that in my judgment is performing okay, but not terrifically. Certainly, there's some unevenness about the performance. The expansion is getting old by historical standards, and not knowing what that exact relationship is I just get a little nervous. As Wayne keeps telling me, what odds do you play? Because I do find the uncertainties overwhelming, both currently and prospectively, I would vote for just staying put. I would hate also to give the impression that just international considerations are driving what we do. If you listen around the table, obviously, that's a major factor. But when the directive is made public I would hate to give the impression that we've thrown everything else out.

MR. JOHNSON. I think the international situation only comes in to the extent that we see it affecting the domestic financial markets and inflationary pressures here. That's where the feedback comes.

MR. ANGELL. It may become so destabilizing that the international situation may come to the front no matter what we do. It just seems to me that we must be prepared for rather decisive actions at some point; we may have to draw the line and say it, because once markets become destabilized--

VICE CHAIRMAN CORRIGAN. It [unintelligible] for you.

MR. JOHNSON. Jerry makes a good point there; I'd rather build with some gradual changes in interest rates than have to force this with a big bang at some point.

SPEAKER(?). I think it's axiomatic that there is some level of interest rates that would stabilize the exchange rate. The problem is: What level is it and what is the cost that goes with it?

MS. SEGER. You'd have to pay along the way, too. Right?

VICE CHAIRMAN CORRIGAN. I certainly agree, Bob, with what you are saying: Heaven knows what the "right exchange rate" is vis-a-vis the yen or anything else. I don't know that either. But we're in a period now where, as best I can judge, the market risks are very asymmetric. Because they're asymmetric and because of the interdependencies, at least as I see them, between the exchange market, the domestic bond market, the stock market, and so forth, strategically we're in a position right now where a stitch in time can save nine. That's all I'm trying to say. If I had to take my chances in terms of snugging or [unintelligible] or whatever word we want to use to try to provide some protection against having to draw the line the hard way--to use your term--I'd rather take that chance. I'd rather err in that direction now in the hopes that it could forestall what I could easily conceive of as a much more difficult situation.

MR. HELLER. Let me speak against that a bit. If we start to tighten up now and are unsuccessful at holding the dollar where it is at the present time, I think we will not see any improvement in the trade and current account balances, especially in view of the situation abroad. Then as the bad data continue to come in on the trade front, the markets will say: Well, the current level is clearly inappropriate for the exchange rate. They will test us, and we will not be able to sustain the current exchange rate. So I think it is probably more prudent to let the exchange rate drift down a little until it is at a level where we can see an improvement in the current account and the trade account. Then if you spend your ammunition you have a chance to convince the markets that you will hold it.

MR. ANGELL. But, Bob, the time--

MR. PARRY. Bob, but the question is: What's going to take you there? The question is whether or not you're going to need somewhat higher interest rates to get that smooth movement. I think the interest rates that Jerry and others are talking about do not involve doing something to preserve the rate as it exists today necessarily, but to provide a more orderly movement. And I think that linkage is key.

MR. HELLER. Well, okay. But take, for instance, the one suggested sentence in the operational paragraph that says "In light of the recent instability of the dollar in foreign exchange markets, particular emphasis will be placed on conditions in these markets in operational decisions." That [conveys the] feeling that we should be holding the going exchange rate with monetary policy.

MR. PARRY. I'll be honest with you: I have a little difficulty understanding what that means. When I first read that I thought what it was telling the market is don't get confused by our sterilization actions, the fact that we'll be putting in reserves to sterilize our foreign exchange [intervention]. I'm not sure I understand what that sentence means. I think something probably ought to be in there, but I'm not sure this is it.

CHAIRMAN VOLCKER. Well, let me raise a few questions about the directive. I don't think we'll solve all these problems by the directive. I'm not sure the traditional type of directive at all meets the current circumstances, but let me assume it does. By saying "maintain the existing degree," that "maintain" may be for a very brief period of time in some people's views. Suppose we really did something radical--I'm just thinking out loud here. We write that first sentence, and then forget about this sentence that's stuck in there about foreign exchange markets, and go down to the sentence that says "somewhat" or "slightly" and "might" or "would", whatever it says. I'll get radical here: Suppose we make it totally asymmetrical and say "might be acceptable depending upon developments in foreign exchange markets"--put that first--then "and taking into account the strength of the business expansion, progress against inflation," and so forth. Then go back and say "This action is expected to be consistent with growth in the aggregates" and so forth and so on.

MR. PARRY. I think moving the aggregates away from that position is good.

CHAIRMAN VOLCKER. Let me repeat it and see whether we've got a basis for something here. Maybe it ought to be tightened a bit because it's going to take a lot of changing. "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions." Then we say somewhat or slightly or whatever--let me come back to that. "Somewhat (or slightly) greater reserve restraint would (or might) be acceptable depending upon developments in foreign exchange markets and taking into account the strength in the business expansion, progress against inflation, and conditions in domestic and international credit markets." That doesn't say anything about the aggregates. We just say--

MR. PARRY. Just add a phrase "and the behavior of the aggregates."

CHAIRMAN VOLCKER. Just leave that in there: "taking into account the behavior of the aggregates and the strength of the business expansion..."

MR. ANGELL. But does the behavior of the aggregates at this point imply the ranges we've already announced? I don't think we--

CHAIRMAN VOLCKER. Let's leave out the aggregates then and go back to the other sentence. We can say "This action is expected to be consistent with growth in M2 and M3 over the period from March through June at annual rates of ____ and ____ percent." Do we want to say anything about M1? "M1 is expected to remain substantially below its pace in 1986." Okay. So, just reverse those and leave the wording. Somebody get that typed and we can talk about substance. I don't think there's any doubt, obviously, that if we move we would be much better off if the others moved also. In fact, we might be better off if the others moved without our moving.

MR. ANGELL. At this point in time, that's the best alternative.

MR. JOHNSON. That's probably about the best.

MR. MORRIS. If we move we reduce their incentive to take action.

CHAIRMAN VOLCKER. Well, as they see it, they don't have much room to move.

MR. ANGELL. But since the world economy would not be adversely affected by some increase in U.S. interest rates if we had an offsetting decline in rates [abroad]--

CHAIRMAN VOLCKER. Well, let's assume all that. It can take a lot of convincing; whether that's possible or not is another thing. [The problem with] fooling around with the level of borrowings is that, essentially, that's a very loose steering wheel. We could push for a higher level of borrowing for two weeks and before you know it the exchange market would be out there and not have any understanding that that was going on and the funds rate wouldn't move at all.

MR. ANGELL. Maybe this is the time to think about publishing our minutes.

CHAIRMAN VOLCKER. We have other vehicles that are less precedent-setting.

MS. SEGER. Was that a motion?

MR. ANGELL. No, it wasn't a motion. I don't think there are enough votes to make a motion.

CHAIRMAN VOLCKER. We can always raise the discount rate--just to put another option on the table.

MR. ANGELL. That might be appropriate at some point in time.

CHAIRMAN VOLCKER. We can more deliberately, as somebody suggested, try to push the federal funds rate a bit without worrying about precisely what level of borrowings it takes. It might take very little if we did it in a certain way.

MR. ANGELL. Yes, we might say $300 to $500 million, consistent with a federal funds rate and--

MR. PARRY. Aren't there some operational advantages to perhaps running with a little higher borrowing level? We think of $300 million as being almost the low point that one can reach, and there might be some greater flexibility if we were working with a slightly higher borrowing target in our operations.

CHAIRMAN VOLCKER. That may be true, but it conflicts with no movement if that's what we want to do in terms of our present stance. The in-between course, which we've been doing to a very small degree, is trying to avoid actions that might inadvertently ease the market in the sense that where the federal funds rate is on particular days when the dollar is declining [unintelligible] but we have not been anticipating reserve needs. Somebody said--Mr. Keehn, I think--that what we ought to be doing is erring on the high side. If we keep the $300 million borrowing target that may capture what we ought to be doing at the moment. I don't know how we reduce this to a formula. So far as this consultation issue is concerned, I think if we were making a big step we would consult or if we were changing the discount rate a consultation would come about. But I don't know if we want to consult every time we nudge slightly here or there, if we know what direction we are nudging in.

MR. MELZER. Put a range in?

CHAIRMAN VOLCKER. Well, just for our own information I don't think we need a range in the directive. Certainly, nobody is talking about moving above $500 million without a reconsideration of the decision. We'd probably consult before we got there anyway, but as a deliberate matter, one never can tell where a particular week is coming in. I have no problem at all if you really want to change that.

MR. JOHNSON. How about something like this: We would stick to the $300 million borrowing, but if conditions got disorderly we would let slide our reserve adding and that might spill over into a higher borrowings level. We don't really know what that might be. We would try to hit our $300 million on borrowing, but if we had to postpone--

CHAIRMAN VOLCKER. I would be very cautious about how we do it. The way I would interpret it is erring a bit on the high side. I don't know what else we can say. I can describe it. We'll basically continue at the moment aiming at $300 million on borrowing. I hear a lot of sensitivity about the exchange rate. I hear very little sensitivity about coming in low on the aggregates side. If anybody is very sensitive to that they better say so; I didn't hear anybody being very sensitive on that.

MR. HELLER. I would like the funds rate where it is, but I wouldn't want to push it.

MR. JOHNSON. It all depends on how the economy looks.

MR. HELLER. I think they want to flatten it out.

MR. ANGELL. We don't have any guarantee at this point that these negative velocities will not return. That's why I want to go slowly.

CHAIRMAN VOLCKER. We are not talking about forever, obviously. When are we meeting again?

MR. FORRESTAL. The middle of May--the 19th.

MR. ANGELL. Right. Economic conditions could make what I think is now [unintelligible] at the lower end of the range--to be at 5-1/2 percent--seem wonderful. If the economy were to deteriorate--

CHAIRMAN VOLCKER. Well, there's no question that if the economy were going down the tank we would want it a little higher. We would begin getting more sensitive to these aggregate figures.

MR. JOHNSON. If interest rates drift up we can expect to see those aggregates slow even more from what we're predicting.

CHAIRMAN VOLCKER. We are not predicting anything all that slow as I would read it.

MR. JOHNSON. I mean from what we've been seeing.

MR. ANGELL. It's pretty slow final demand isn't it? Isn't U.S. final demand almost zero, fourth quarter to fourth quarter?

MR. PRELL. Domestic final sales.

MR. JOHNSON. You are talking about final sales, which run about 1 percent in the forecast.

MR. ANGELL. Right.

CHAIRMAN VOLCKER. For the year as a whole, domestic final sales are what?

MR. KOHN. 0.7.

MR. PRELL. That's private domestic final sales.

MR. ANGELL. 0.7?

MR. PRELL. Private domestic final sales, consumption and investment.

CHAIRMAN VOLCKER. Private domestic final sales. You haven't got government up much do you? There's probably not much difference for domestic final sales.

MR. ANGELL. But you have state and local, which is a little higher than that.

MR. PRELL. Well, government purchases are down 0.3, so adding them in would make the number a little lower.

MR. ANGELL. Adding them in would make what?

MR. JOHNSON. Make it lower.

CHAIRMAN VOLCKER. A little lower.

MR. ANGELL. That's not a very--

CHAIRMAN VOLCKER. It's not a very good forecast. [Unintelligible] that's precisely what you would like to see happen if we do not get the expansion from the foreign side.

MR. ANGELL. That's right. That's exactly what we'd like to have happen.

CHAIRMAN VOLCKER. Well, I think what we're talking about is starting at something like $300 million, pursued cautiously so long as the exchange rate is so sensitive. If the exchange rate really got weak we would contemplate moving up certainly to $400 million or so. Much above that, we'd want to have a conference, anyway. That would be the sense of it.

MR. JOHNSON. Yes, I'd rather say more like $400 million, because of this problem with borrowings and the funds rate.

CHAIRMAN VOLCKER. Obviously, we would prefer to see the others come down; I'd prefer to see any distinct moves made in that direction. We can talk about other moves if different situations arose but not decide that here. We are putting a lot of weight on concern about the dollar--if it got too unstable--and we are somewhat less worried about the aggregates. So, let's read this. The first thing we have to do is decide, generally, this "somewhat" and "slightly" business.

MR. ANGELL. I think "somewhat" is a little more decisive in this environment.

CHAIRMAN VOLCKER. I would be inclined to say "might"--not because I think it's a weaker word, but because we are really talking about a conditional thing.

MR. JOHNSON. Yes, "might" is the word.

MR. ANGELL. Yes, but you need "somewhat" for reserve restraint.

CHAIRMAN VOLCKER. "Somewhat greater reserve restraint might be acceptable depending on foreign exchange market developments, taking into account the strength of the business expansion. This action is expected to be consistent with growth of M2 and M3 over the period from March through June at annual rates"--. Now, we had this one suggestion on the table that we stick in a rather wide range. That would be unusual but maybe it's what the doctor orders here in terms of capturing what people are talking about.

MR. ANGELL. 3 to 7 percent.

CHAIRMAN VOLCKER. 3 to 7 percent. The upper part of that range, actually, goes a bit above what the staff has on alternative B but, obviously, the midpoint is below it.

MR. ANGELL. But whether we want the upper or lower would depend upon developing conditions and portfolio preferences and the dollar.

CHAIRMAN VOLCKER. If we put in something like that, the meaning is, if I understand it correctly, that we would get concerned if growth got below 3 percent. That would become a factor saying we should ease regardless of what the rest of this says.

MR. MELZER. Couldn't you finesse that?

CHAIRMAN VOLCKER. [We would] move in that direction and vice-versa if it's above 7 percent.

MR. MELZER. Could we not deal with that in a less explicit way by just putting the behavior of the aggregates phrase in the second sentence and keeping the third sentence what it usually has been, which is really our best guess?

MR. PARRY. I think the way to do that, which would capture what we have said, is to say "Somewhat greater reserve restraint might be acceptable depending on developments in foreign exchange markets, the strength of the business expansion, progress against inflation and conditions in domestic and international credit markets, taking into account the behavior of the aggregates." We've got it all there.

MR. ANGELL. But the trouble with--

CHAIRMAN VOLCKER. We can do that, but it puts less emphasis on the foreign exchange markets than I thought people wanted.

MR. PARRY. Well, it's there and it's first.

MR. ANGELL. Bob, the problem is that if we don't specify someone might assume that growth of M2 and M3 below the present target path would be unacceptable. Right now we have a target path that we have announced. What I am suggesting is that in light of the conditions in the international foreign exchange markets we need a lower band. That would give us some options between--

MR. PARRY. I don't think we have reached an agreement on that, have we?

MR. HELLER. I like what Bob Parry said. We don't want to look just at foreign exchange markets, and say everything else is secondary, which is what this phrasing says as it is written. I don't think we want to do that either. So what Bob is suggesting--taking out the first phrase--gets us there.

CHAIRMAN VOLCKER. It depends upon how much weight you want to put in here. I would have read the Committee members as saying they want to put special weight on the dollar.

SPEAKER(?). I think that's correct.

MR. HELLER. A lot more than on the domestic conditions?

CHAIRMAN VOLCKER. I think we have to distinguish here. It's not necessarily saying more in any fundamental sense. It's saying that looking at the next seven weeks--or however long before we meet here again--we think the most likely factor that would make us be tighter is the dollar, not all these other things.

SEVERAL. That's right.

CHAIRMAN VOLCKER. It's not saying we would tighten. It just says that we think the dollar is the critical or the most important variable for these seven weeks.

MR. JOHNSON. I agree with that to the extent that my concern about the dollar is its effect on the domestic economy. I certainly wouldn't worry about it so much if I thought it was going to have a neutral effect on domestic inflation.

VICE CHAIRMAN CORRIGAN. Well, that's not going to be an issue in six to seven weeks.

MR. JOHNSON. No, I am just saying that in the long run it's got to have some feedback on the economy.

MR. BOYKIN. Couldn't the M2 and M3 growth be handled, in view of what goes before it, by saying that the action is expected to be consistent with growth in M2 and M3 over the period at annual rates "around 6 percent"? Just say "around" that. We don't really know.

CHAIRMAN VOLCKER. That's what we traditionally say. Governor Angell's formulation, I think, does add something. With that wide a range, it's quite unlike what we usually say. To go over that previous sentence again: It says that the Committee is putting particular weight on the foreign exchange markets during this particular period of time. In effect, it is saying that's the only reason why we are likely to tighten during this period. It doesn't expect the business expansion and all of that other stuff to lead to some tightening. It doesn't absolutely say it that way but it leans in that direction: that this is the one factor that--

VICE CHAIRMAN CORRIGAN. But by the same token, it doesn't say that if the economy just died next week--although to me that is highly unlikely--that we wouldn't ease either.

CHAIRMAN VOLCKER. It doesn't say that we would tighten, but it doesn't say that we would ease. I think we would have to change the directive if we were to ease. Obviously, that can be done. If the economy took a nose dive next week we would have a little consultation and say in light of the economy taking a nose dive we decide--

MR. GUFFEY. I have the impression from the discussion around the table that the only tightening that would take place would be to manage the dollar to some lower level in an orderly fashion rather than that we would tighten policy for any other reason. That is to say, I think the original intent was not to tighten policy except to manage the dollar down to a lower level.

CHAIRMAN VOLCKER. The way this is written, I would read it in terms of likelihoods: that by all odds that's the most likely thing. It doesn't exclude [the possibility] that we would tighten if the aggregates got much higher, or if the business expansion were stronger, or if inflation rose. They are all mentioned here. But the way it is written suggests that what we are really worried about is the dollar.

MR. ANGELL. But I would suggest that if the dollar were to be under increasing downward pressure, long bond rates would move up on us anyway. We would have the worst of all worlds.

MR. STERN. The anxieties in the markets are such that that's correct.

MR. ANGELL. We have to show that we have control over what's happening--that we are not sitting here without acting when action is needed.

CHAIRMAN VOLCKER. Well, the choices are pretty simple. It's just a matter of emphasis. We can write a whole separate sentence about the dollar; Mr. Kohn has one example. We can do this in-between course. Or we can take out the "taking into account," which is a small change from what we had before--so small that I think it's almost invisible. But we are left with [unintelligible] directive.

MR. BOEHNE. I like it the way it is. I have just one technical question. We say conditions in domestic and international credit markets. Do we mean that international credit markets are separate in our minds from the developments in foreign exchange markets?

CHAIRMAN VOLCKER. Well, I don't know if I do. We can say conditions in the credit markets to avoid that.

MR. MELZER. The way this is worded right now, though, it seems to me that we are not looking at the aggregates at all, which I am not sure is right. I wasn't advocating putting them up there in the "depending on" phrase but I would put them in the "taking into account" litany of things that we look at. Otherwise, we're just saying we don't take them into account at all and we are just making a prediction of where we think they are going to come in.

CHAIRMAN VOLCKER. That's because that's the way we traditionally do it. If you have any better wording--

MR. BOEHNE. I wouldn't read it that way. It seems to me that we are saying that we expect all of the above to be consistent with M2 and M3 at whatever rates of growth we decide on. And if M2 and M3 aren't consistent with that we would probably want to take another look at the situation.

MR. GUFFEY. During the 7-week intermeeting period?

CHAIRMAN VOLCKER. Do you want to put that sentence back where it ordinarily is as the second sentence?

MR. MELZER. I wasn't suggesting that. I was suggesting just putting in this phrase that was dropped out when this was retyped.

MR. ANGELL. I thought there was some feeling that the dollar should move up to the--

CHAIRMAN VOLCKER. Mr. Melzer would put it in after the taking into account, if I understand him right: "would be acceptable depending on developments in foreign exchange markets, taking into account the behavior of the aggregates, the strength of the business expansion, progress..." That's easy to do.

MR. ANGELL. But how do we deal with the growth of M2 and M3? Suppose M2 and M3 continue on the 4 percent path and then go below the--

CHAIRMAN VOLCKER. We still have that sentence in here and we have to put something in there. We have at least two proposals on the table. We have Mr. Angell's, which was 3 to 7 percent. We have somebody else's, which was "around 6 percent." There is a substantive difference between those two.

VICE CHAIRMAN CORRIGAN. 6 percent or less.

MR. KEEHN. Just a thought: Does putting in a range now of, say, 3 to 7 percent, which is lower than the annual range of 5-1/2 to 8-1/2 percent, condition it with regard to time? Might that suggest to somebody that we're easing up on policy here? Would putting in a lower range than we have established for the year suggest that we are sneaking up on a policy change?

MR. ANGELL. It just means that we are rebasing.

MR. KEEHN. It's a different set of numbers than are generally out there and understood by the market.

MR. MELZER. If we say "about 6 percent," it's pretty clear to people that we are shooting for the lower end of the cone, and everybody knows the uncertainty associated with that. I think we've already sent the message if we say "about 6 percent."

MR. KEEHN. It may be true that in the past we have not always hit the trajectory exactly.

MR. HELLER. Bob, it is better than missing our cone.

MR. ANGELL. But they are not precise.

CHAIRMAN VOLCKER. Why don't we go up to eight?

MR. HELLER. I prefer six.

CHAIRMAN VOLCKER. This is not too big a deal here. I rather like the 3 to 7 percent because I think it reflects the flavor of what was said. But whether or not 3 to 7 percent is precisely the right range--

MR. HELLER. I would think the 3 to 7 percent conveys that we are tightening. After all, the midpoint of 3 to 7 percent is 5 percent. Five percent is really alternative C, and there were not many people who were speaking in favor of alternative C. So, implicitly, we're changing the thrust of what people around the table have said.

MR. ANGELL. But it's not really tightening. It just indicates that we may be going to tighten. It sets the parameters out for tightening.

CHAIRMAN VOLCKER. It depends upon what you think of as tightening.

MR. HELLER. Then you should be wanting to vote for alternative C.

CHAIRMAN VOLCKER. If you are talking about the aggregates pure and simple, it's tightening. If you are talking about borrowing as the measure [unintelligible]--

MR. HELLER. If you argue for "C" then I think 3 to 7 percent would be appropriate; but if you don't argue for "C"--

CHAIRMAN VOLCKER. Alternative C says $500 million borrowing, which is not what people are focusing on.

MR. HELLER. Well, for growth rates of the Ms it says 5 and 5-1/2 percent.

MR. STERN. I don't see that at all. I think all we are saying is that we wouldn't be too concerned, other things equal, if the aggregates came in on the low side over the intermeeting period.

VICE CHAIRMAN CORRIGAN. We could say growth of M2 and M3 of around 6 percent, but the Committee would--

MR. HELLER. I am not concerned with that either; but I am concerned with our taking policy actions to get it down there.

MR. STERN. I don't think that's contemplated.

MR. JOHNSON. I think we need to make it clear though.

MR. HELLER. I think we need to make that clear in the language.

MR. JOHNSON. We don't give that impression because we do say that a growth rate similar to that is consistent with alternative C.

MR. ANGELL. Then there is a substantial difference of opinion here, because in the environment of a weakening dollar and the commodity price effects that are associated with such a weakening dollar, I really do not want to go above, say, 7 percent. I really would want to tighten in that environment. So I think there is some policy difference that's cropping up.

CHAIRMAN VOLCKER. Look at what the first two sentences in the operational paragraph say. First, there is no change at present. The second sentence says there might be a tightening. And the third sentence says we expect that all to be consistent with something between "B" and "C." That's right because that's what the operational language says.

VICE CHAIRMAN CORRIGAN. Why couldn't the sentence on the Ms say that the Committee expects growth in M2 and M3 in the period from March to June at rates of about 6 percent and then add some language to say that we would be tolerant of slower growth rates than that, given the circumstances of the very rapid earlier growth.

MR. JOHNSON. What might clarify the M2/M3 issue is to say what we would normally expect for M2 and M3, assuming no change in reserves.

CHAIRMAN VOLCKER. That is technically correct, but it attaches such precision to these estimates that are never that good.

MR. BOEHNE. I think what Jerry is saying--

MR. JOHNSON. Otherwise we may be assuming a change in reserve restraint. If we put a number other than what we say is consistent with no change in reserve restraint we are assuming a change in reserve restraint.

MR. ANGELL. The only reason I don't want reserve restraint right now is because it seems to me that we've got a very low money growth path right now. I don't know whether that's going to continue or not, but in light of a very low growth path to put restraint on right now runs a risk I am not willing to take. But if this growth path proceeds along the bottom edge of our target--

MR. JOHNSON. But that's not what the staff is projecting.

CHAIRMAN VOLCKER. Does anybody support 4 to 7 percent, for which the average is 5-1/2 percent?

MR. JOHNSON. We have a projection here for M2 and M3 under certain assumptions. Assuming no change in reserve restraint, it's a certain amount; assuming differently it's a different amount. And that's building in what already has happened to the aggregates.

CHAIRMAN VOLCKER. It's a half of a point difference.

MR. JOHNSON. I am just saying I would be comfortable with changing those numbers if we said "might" or something--if we qualify it to say, assuming no change in reserve restraint, we would expect M2 and M3 to be 3 to 7 percent.

MR. ANGELL. Assuming that the dollar continues on its present path and assuming that the growth rate of M2 were to return to a 9 percent rate or an 8-1/2 percent rate, would you want any restraint?

MR. JOHNSON. All I am saying is that there is a projection consistent with a certain set of assumptions. If you change those assumptions you get different paths. There is no doubt about it; if certain conditions arose I'd want to change the conditions affecting that.

CHAIRMAN VOLCKER. Let me talk you into 4 to 7 percent. We just change these numbers. You're putting too much weight on the staff's numbers. What we say is that we want to be where we are now or maybe tighter under certain conditions.

MR. JOHNSON. Under certain conditions.

CHAIRMAN VOLCKER. So, we say we expect that approach--I would say "approach" instead of "action"--to be consistent with a range using two numbers that allow for our normal one percentage point uncertainty around the projection plus another one percentage point down on the low side in case we do tighten. Now, that ought to make it beautifully consistent with what the staff technically estimates. We often put in something like a 5 to 7 percent range that is consistent with the 6 percent [expected].

MR. JOHNSON. That's sort of extracting the midpoints. That's a range of midpoints.

SPEAKER(?). But we often do it.

MR. BOYKIN. In trying to be consistent, we are becoming inconsistent simply because we are saying that we don't want anything to change. But then we are saying if we have to change, the M2 and M3 growth rates relate to no change. We don't know what the monetary aggregates would do when we respond because we don't know what the response would have to be.

MR. ANGELL. I believe that a continuation of M2 along a 5 percent path would be consistent with the dollar stabilizing.

MR. JOHNSON. That's not true. That's not what the staff says. They have already built the March numbers into their projection.

MR. KOHN. The staff would be the first to admit that there is a range of uncertainty around that.

MR. ANGELL. We all agree but that's--

MR. KOHN. One percentage point was perhaps being generous to the staff.

MR. JOHNSON. But then that means that you expand on either side of that uncertainty.

VICE CHAIRMAN CORRIGAN. We can say 6 percent or less; let me try that again.

CHAIRMAN VOLCKER. We can say 6 percent or less but I guess the substantive question is whether we, in fact, would be concerned if the aggregates came in at 4 percent, let's say. If they came in at 4 percent, all other things being equal, would that be a cause for easing?

MR. JOHNSON. Not if we had to restrain reserves.

MR. BOYKIN. Not [unintelligible] at this point in time.

MR. BLACK. I think the only feasible alternative to what you suggested is 6 percent.

CHAIRMAN VOLCKER. We can say 4 to 6 percent, or we can say around 6 percent or less.

MR. BLACK. That's the best one if we don't go with 4 to 7 percent.

CHAIRMAN VOLCKER. There are no substantive differences.

MR. HELLER. I prefer 4 to 7 percent, though, to 6 percent or less. That really tilts it; that lets it get to zero if you want it.

CHAIRMAN VOLCKER. I don't think it would be interpreted as getting it down to zero.

MR. ANGELL. There is some advantage in having us know what would precipitate a conference call.

MR. JOHNSON. In this first sentence in the operational part of the directive we say maintain the existing degree of reserve pressure and we say there is a contingency there. But if we are going to put in an M2 and M3 range consistent with that operational sentence, it should be what the staff has projected, what the statistical alternative would be. We might follow that up with a sentence that says--

MR. HELLER. Well, how about doing it like that. Use the first sentence and then say "This approach is expected to be consistent with growth in M2 and M3 over the period of around 6 percent." And then say "Somewhat greater restraint would be appropriate, depending upon foreign exchange markets..." and so forth.

MR. MELZER. I don't view that third sentence as really the operational language. I can't ever recall a conference call, when I have been involved, over the aggregates misbehaving. This is simply saying--

MR. BLACK. We used to do that.

MR. JOHNSON. All I am saying is that we have these numbers in the directive that were [adopted] in the past and people could easily get the wrong impression.

MR. BOYKIN. In the wording, these numbers are associated with our action to maintain, which is the first sentence. So, I don't think we have to put in ranges or other numbers because we are talking about something that might happen.

MR. JOHNSON. It might help to move that sentence up, like Bob said, to immediately after the first sentence on the aggregates.

MR. BLACK. Somebody from west Texas; there's always been a [different] world down there.

MR. HELLER. If we move the sentence up, we have a consistent directive up front and then we have our exception that follows.

CHAIRMAN VOLCKER. I will just transpose the question. Do you understand the third sentence? The third sentence will then be that the aggregates might come in lower than that and that's fine. It's all the same substance.

MR. JOHNSON. I think it's easier to assume that the aggregates would come in lower if the sentence on the aggregates is right after the first sentence and then we say "Somewhat greater reserve restraint..." Obviously, somewhat greater reserve restraint means lower aggregates.

MR. HELLER. I think switching the sentence really makes a big difference.

CHAIRMAN VOLCKER. Greater reserve restraint would take place because the reserve aggregates are high. A comment about the behavior of the aggregates in that sentence might amount to the same thing.

MR. JOHNSON. Yes, I see what you are saying.

VICE CHAIRMAN CORRIGAN. The way it's structured, I don't really care what we put in the second sentence about the aggregates.

MR. JOHNSON. I'd just say that we believe the staff projection [unintelligible].

CHAIRMAN VOLCKER. 4 to 7 percent is the staff's projection.

MR. JOHNSON. 4 percent is below what they project with no change in reserve restraint.

CHAIRMAN VOLCKER. This allows for some change in reserve restraint, the possibility of some contingency. Where this sentence is located, it encompasses the contingency as well. I am going to have to look at what the staff puts down in these forecasts.

MR. JOHNSON. It seems to me that if we are going to say "this action is expected," we have to have some assumption that action is taken other than no change.

CHAIRMAN VOLCKER. I would change the word "action" to "approach," which encompasses the first two sentences.

MR. HELLER. Mr. Chairman, I think that's where I see the difference. If the third sentence says "This approach is consistent with growth in M2 and M3...", then that surmises both sentence one and sentence two. I would rather have it the other way around and say we are implementing a policy of the existing degree of reserve pressure and this approach is consistent with M2 and M3 growth. And then I would say if things in the foreign exchange market happen, then we could have a bit more restraint.

CHAIRMAN VOLCKER. Well, that's fine, if you interpret that as saying that if that next sentence happens then we can get slower growth in the aggregates. I think they are substantively the same thing, but I am not sure that's the way it would be interpreted. Ordinarily, just as it is now, the second sentence is read to mean we will seek greater reserve restraint if the aggregates are exceeding what we say. That is the ordinary construction of that sentence. It starts out with the aggregates and it says we will take note of the change in that.

MR. ANGELL. That's why we moved the aggregates down--so that would be less of a problem.

MR. STERN. I think the structure in the draft reflects the concerns about the exchange markets. The 4 to 7 percent range also encompasses alternative A.

MR. ANGELL. It sure does. I am trying to understand why it was I used to enjoy Manley's persistence when he was on my side.

VICE CHAIRMAN CORRIGAN. We better settle on something; we have to live with each other for the next two-and-a-half days.

MR. HELLER. The original draft that Mr. Kohn produced is a good draft, in a way. You have taken out that sentence that's in all caps, but otherwise that basically hits what we are really trying--

CHAIRMAN VOLCKER. It hits maybe what you are trying to get to.

MR. ANGELL. There does seem to be a bit of a policy difference here.

CHAIRMAN VOLCKER. There is, but I don't think it's a very big one.

MR. JOHNSON. I don't think there is a policy difference at all. I certainly support more restraint, and I think you will get lower aggregates out of that restraint.

CHAIRMAN VOLCKER. Then I think you ought not worry about this language if you really don't think there is a policy difference, because I think it's saying what you are saying.

MR. MORRIS. For the benefit of the newcomers at the Federal Reserve, I should note that the first statement Willis Winn made when he came to an FOMC meeting and we were talking about the directive was, "This is the largest editorial committee I have ever sat on."

MR. GUFFEY. I assume from the discussion that what we are talking about in terms of restraint is only roughly a quarter of a percent in any event.

CHAIRMAN VOLCKER. What?

MR. GUFFEY. It's only roughly a quarter of a percentage point, in any event, measured in terms of the federal funds rate. About 6-1/4 percent, I think, was the sentiment around this table.

CHAIRMAN VOLCKER. Clearly, without a consultation I think that is [true].

VICE CHAIRMAN CORRIGAN. As a practical matter, we have stuck every conceivable number in the book into these directives in the past, including ones that don't even appear in the Bluebook.

CHAIRMAN VOLCKER. We can say an annual rate of 6 percent or somewhat less, or 4 to 7 percent, or 5 to 7 percent, but I think it doesn't make that much difference.

MR. JOHNSON. Around 6 percent.

CHAIRMAN VOLCKER. There is nothing the matter with around 6 percent, depending upon what you think of it. These forecasts are almost always wrong by several percentage points. The substance here is: Are we more concerned if it comes in at 3 percent or at 9 percent? That's the question. As a practical matter, the staff is saying that they expect it to be somewhere between 3 and 9 percent and--

MR. ANGELL. If it's 9 percent, I think we better get excited.

CHAIRMAN VOLCKER. Would you get more excited if it came in at 9 percent than at 3 percent?. I think that is the issue.

MR. JOHNSON. Tell me what has happened in the meantime.

MR. KEEHN. Yes. What is going on?

MR. HELLER. And why is it coming about? There is a big difference whether it comes about--

CHAIRMAN VOLCKER. It's the only thing we know about it. We don't know about these other things. If everything was as it is now and it came in at 9 percent, would you--

VICE CHAIRMAN CORRIGAN. For M2 or M3 in seven weeks, I would have a stroke. M2 and M3 don't [unintelligible].

MR. ANGELL. And the long bond would go to 8-1/4 percent.

CHAIRMAN VOLCKER. I think this is the substance. If nothing else changed visibly, would you be more unhappy with 9 percent than with 3 percent? I am one who would be more unhappy with 9 percent.

MR. ANGELL. I am, too.

MR. BLACK. I think everybody would be.

MR. JOHNSON. I think that's true. Of course, we haven't found M2 and M3 to be very interest sensitive. They don't seem to be nearly as interest sensitive as M1. Maybe for M1, I would be.

CHAIRMAN VOLCKER. I don't know how interest sensitive they are. All I would say is that after what happened last year, and given what's going on, if they come in at 9 percent I would be more unhappy than if they came in at 3 percent. I am not saying that it would be the end of the world.

MR. ANGELL. I would hate it because they are coming in at 3 percent and I don't want to ease when they are coming in at 3 percent. Aren't they coming in at 3 percent?

MR. JOHNSON. What's happening now is built into the projection of the staff, which is around 6 percent. Now, unless you believe that it's going to continue this way--

VICE CHAIRMAN CORRIGAN. Put 6 percent or somewhat less.

MR. ANGELL. We can say somewhat less. I think Bob Heller doesn't want to say somewhat; he would rather say 4 to 7 percent than somewhat less.

MR. HELLER. If you change the words--the way you said it I would be happy.

CHAIRMAN VOLCKER. We have 4 to 7 percent, 6 percent or somewhat less, or around 6 percent. Of the members of the Committee, who would prefer to say, of these three choices, "around 6 percent"?

MR. JOHNSON. I would say around 6 percent.

VICE CHAIRMAN CORRIGAN. What were the others: 6 percent or somewhat less?

CHAIRMAN VOLCKER. Members of the Committee: Do you want to say around 6 percent, rather than 6 percent or somewhat less?

VICE CHAIRMAN CORRIGAN. My preference is 6 percent or somewhat less.

MR. ANGELL. The Chairman has given three alternatives.

CHAIRMAN VOLCKER. Three alternatives: 4 to 7 percent; around 6 percent or less; or around 6 percent.

MR. HELLER. Will you explain the differences between the 6 percent and--

MR. ANGELL. That's the Chairman's prerogative.

CHAIRMAN VOLCKER. Who would prefer around 6 percent, period? That's unmodified, symmetrically around 6 percent. Well, that's half the Committee already. I suppose the others don't care whether it's 6 percent or less or 4 to 7 percent.

MR. BOEHNE. I could live with all of them.

MR. KEEHN. I would rather say 6 percent or less.

VICE CHAIRMAN CORRIGAN. I would, too.

MR. ANGELL. 6 percent or less is all right with me.

CHAIRMAN VOLCKER. Well, who prefers 6 percent or less? Then what do we get?

MR. ANGELL. Mr. Chairman, you get to vote if you like. It's 6 to 6.

MS. SEGER. We need to have 13 people on the FOMC.

MR. BOEHNE. Who "could live with" an alternative might be a good way to get rid of this issue.

CHAIRMAN VOLCKER. Let's take a new vote. It's going to be around 6 percent and the vote will be on whether we add "or less." Who is in favor of adding "or less"? I changed the word "action" to "approach."

MR. ANGELL. And the word "approach" is better.

MR. BOYKIN. If you change the word to approach, then 6 percent or less I can live with very well; in fact, I would favor it.

CHAIRMAN VOLCKER. "Somewhat greater reserve restraint might be acceptable depending on developments in foreign exchange markets, taking into account the behavior of the aggregates, the strength of the business expansion, progress against inflation, and conditions in credit markets. This approach is expected to be consistent with growth in M2 and M3 over the period from March to June at annual rates of around 6 percent or less. Growth in M1 is expected to remain substantially below its pace in 1986." And I presume we still have 4 to 8 percent or whatever we had on the range for the federal funds rate. We are ready to vote, so we will vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Boehne	Yes
President Boehne	Yes
President Boykin	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Keehn	Yes
Governor Seger	Yes
President Stern	Yes

CHAIRMAN VOLCKER. Adjourn the meeting.

END OF MEETING