TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

September 18, 1979

Prefatory Note

This transcript has been produced from the original raw transcript in the FOMC Secretariat's files. The Secretariat has lightly edited the original to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcript was not fully edited for accuracy at the time it was produced because it was intended only as an aid to the Secretariat in preparing the record of the Committee's policy actions. The edited transcript has not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Staff Statements Appended to the Transcript

Mr. Pardee, Manager for Foreign Operations
Mr. Sternlight, Manager for Domestic Operations
Mr. Kichline, Associate Economist
Mr. Axilrod, Economist

Meeting of Federal Open Market Committee

September 18, 1979

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, September 18, 1979, beginning at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Balles
Mr. Black
Mr. Coldwell
Mr. Kimbrel
Mr. Mayo
Mr. Partee
Mr. Rice
Mr. Schultz
Mrs. Teeters
Mr. Wallich

Messrs. Guffey, Morris, Roos, Timlen, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. Baughman and Eastburn, Presidents of the Federal Reserve Banks of Dallas and Philadelphia, respectively

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

Messrs. Ettin, Henry, Keir, Keran, Kichline, Parthemos, Scheld, Truman, and Zeisel, Associate Economists

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

Mr. Coyne, Assistant to the Board of Governors
Messrs. Gemmill and Kalchbrenner, Associate Directors, Division of International Finance and Division of Research and Statistics, respectively, Board of Governors
Mr. Prell, Associate Research Division Officer, Division of Research and Statistics, Board of Governors
Ms. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Messrs. Forrestal, Gainor and Moriarty, First Vice Presidents, Federal Reserve Banks of Atlanta, Minneapolis, and St. Louis, respectively

Messrs. Balbach, Boehne, Burns, T. Davis, Eisenmenger, and Fousek, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Philadelphia, Dallas, Kansas City, Boston, and New York, respectively

Messrs. Corrigan and Danforth, Vice Presidents, Federal Reserve Banks of New York and Minneapolis, respectively

Ms. Lovett, Securities Trading Officer, Federal Reserve Bank of New York

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September 18, 1979

CHAIRMAN VOLCKER. We'll come to order, if I can find my copy of the agenda! I might tell you before we start that we will have a small alteration in procedure after the meeting. Instead of traipsing over to the dining room for lunch, I thought we would expedite things by bringing you a few sandwiches over here. So, we'll give you a break after the meeting and then we will proceed [with discussions] around this table while we're being fed--adequately, I hope. We will experiment with this procedure and see how it goes. But that does not mean that we should not conclude our work before the usual lunch hour.

MR. WALLICH. It probably will have that effect.

CHAIRMAN VOLCKER. If it has that effect, we'll have another change of procedure at the next meeting! [I need to] get approval of the minutes [of the August meeting]. Without objection, they are approved. Mr. Pardee.

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

CHAIRMAN VOLCKER. Any questions?

MR. BAUGHMAN. Would you explain briefly for me how the foreign exchange swap conducted by the Bundesbank sops up domestic liquidity?

MR. PARDEE. We're in the process of preparing a paper on that, which I hope we will be able to circulate to the Committee. They have dollars in their portfolio. They sell those dollars spot to the market in exchange for marks. Since what they are effectively doing now is simply selling a participation in their holdings of Treasury bills, there are no dollars rattling around in the exchange market. It's simply that the German banks come in with marks on a spot basis and they will be getting them back in 1 month or 2 months, depending on the maturity of [the bills]. So the operation is absorbing marks coming in from the banking system. One of the problems that the Bundesbank has with this operation is that they may be taking liquidity away from the German banks by this process, but they are not mopping up really the [other] side--the effect on the monetary aggregates of the demand for deposits with German banks.

MR. BAUGHMAN. Thank you.

MR. ROOS. Scott, you alluded to the fact that as the energy induced segment of inflation improves--or recedes--it may bring some improvement into the picture. Don't most of the foreign exchange market partipants really look at the monetary induced part of the inflation picture, which of course reflects money growth? Don't they look at that? Don't they recognize that if total inflation were to be reduced from 10 to 8 percent, we'd still have the basic underlying money induced part of the inflation? Won't that still be their primary concern in terms of the market?

MR. PARDEE. Well, the market is concerned about inflation however it is induced. There are some monetarists in the market who do follow closely the aggregates, but they are just one segment. There are others who worry about other things. There are even some chartists out there who couldn't care less about any of these broader numbers that we work with. But they are concerned about inflation, however it is induced.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Mr. Chairman, I don't know what credence we ought to put in the rumors, and maybe we shouldn't even bring them to this table. One of my directors called up very excited yesterday about a rumor that the dollar was going to be devalued, mind you, sometime in October. I suspect, but I don't really know, that this is a pretty distorted view of what comes out of the press reports about a possible realignment of European currencies from the meeting scheduled this coming weekend. Is there anything that we ought to know about that or are you in a position to tell us?

MR. PARDEE. People in the market have a lot of questions as to what happened over the weekend--there was no communique--and I really don't know anything further. As for a devaluation of the dollar at this stage, there's no mechanism to do it since we are on a floating rate basis. As I said, we have been looking at this 180 [German mark] rate that the market has, but we're not wedded to that rate any more than we were to other rates. It's just that we are caught in this box. The moment we back away or seem to be somehow weak in any sense, all of a sudden the speculators--and these include people on the IMM and some of the banks--jump on it. And even more we have corporate treasurers and foreign central banks outside the G-10, who as I say may be sitting on their hands at this moment. But if the dollar should suddenly start [falling], then they will sell. It's a very highly unstable equilibrium condition we're in now, where as soon as the dollar begins to weaken, then we have selling pressure rather than sort of an equilibrating inflow of demand for dollars. So as long as the environment remains this highly charged, with so many silly things going on--I had one fellow tell me that the dollar was going down because it always goes down in September and that's why he was selling dollars. We have the IMF meeting, we have all these other meetings, and obviously the dollar, for one reason or other, isn't going to come out of this period strong. Yet these people are willing to admit that they see around the corner an improvement in the underlying conditions because of the data that have come in over the past month and other recent months.

CHAIRMAN VOLCKER. Mr. Partee.

MR. PARTEE. To say a word in favor of devaluation, it strikes me, Scott, that we're not the only ones by far having trouble maintaining our currency against the mark. I notice, for example, that last week the Swiss were buying their own currency in quantity and selling dollars in order to finance it at the same time we were selling marks and buying dollars; the two institutions were working at cross purposes. And the Germans don't seem to be doing terribly much to keep their rate from rising either. I notice, for example, that the figures you've cited and that we've looked at don't show the German intervention as being very substantial over this period. Well, if everybody is having difficulty maintaining [their currencies] against the mark and if the Germans don't much care and aren't doing anything about it, why is it that we persist in throwing great amounts of money into maintaining this pegged rate of 180 or 181 whatever it is? That's the difficulty with going away from the idea of intervening [only] in disorderly markets. This is not a disorderly market definition, but we intervened in quantity in order to maintain a pegged rate. I do believe the term "devaluation" has some significance when countries operate as if there is a fixed exchange rate.

MR. PARDEE. I don't think we're operating as if we have a fixed exchange rate.

MR. PARTEE. It's been quite a while that we've been trying to keep the rate at 180 or 181.

MR. PARDEE. The Swiss also have bought dollars once the market psychology tipped in the other direction. So their earlier sales were in conjunction with a policy of aligning their rate with the mark and, as I said, that did trigger some sentiment that the Bundesbank was hitting on the exchange rate. But once the franc began to rise, they bought dollars just as vigorously as they'd been selling dollars before and they are still prepared to do so. They're interested in stability.

CHAIRMAN VOLCKER. A couple of comments. I don't think it's right to say we're in an interest rate war or anything of that sort, as some of the circus newspaper commentary suggests. As near as I can see, what the Bundesbank has been doing generally is well justified by their internal situation and normal criteria that they would use. Their inflation rate has been going up, and they unquestionably don't like that, and their economy has been doing pretty well. And they seem to be--ebullient may be too strong a word--quite confident about the immediate outlook there. By immediate I'm talking 6 to 9 months, which is rather encouraging from our standpoint and I think from the world's standpoint if it's true. They seem to have a good deal of confidence in it. That does not say that they would mind particularly if the mark appreciated, and that notion is fairly well imbedded in market thinking. On the other hand, I don't think the other Europeans want the mark to appreciate because of the opposite side of that coin from their standpoint and their own inflationary problems. So they are at kind of an impasse within Europe. I think our concern, given the psychological situation and the real situation that Scott outlined, is whether we can have a moderate decline in the dollar against the mark. It's true that the dollar has been appreciating against most other currencies. But if the market gets in its head that the dollar is really going down, would we be able to stop it without spending a lot more money than we're already spending? That is the question. And let me say that it would make me very nervous to try to control a depreciation at this point, given the underlying malaise.

MR. PARTEE. But what do we do if the rate really does need to be 170 instead of 180?

CHAIRMAN VOLCKER. Well, [you say] "does need to be." I don't know what that implies.

MR. PARTEE. In terms of purchasing power parity, rates of inflation--

CHAIRMAN VOLCKER. What can you say about that? In terms of purchasing power parity, you can argue that if 180 was right six months ago, something less than 180 ought to be right now. But that assumes that 180 was right some months ago, which nobody knows. In fact, I get the impression that many people here and abroad [thought] that 180 was really too low six months ago. And I think you have to argue that; otherwise the logic would follow pretty precisely. But there is this question of how to prevent the [decline] from getting out of hand if it happens. Just in case any of you are wondering, this was not a great decision-making meeting in Paris last weekend. A lot of it was devoted to [issues] on the IMF agenda, which are not particularly relevant to current exchange market or economic policy developments. But there was an exchange of views about the business outlook and about policy without any attempt to arrive at any specific operating conclusion. These meetings are a chance to exchange views about the outlook and about policy postures, but [the issue] was not pressed very far, certainly not in an opertional mode. Have you got any recommendations, Mr. Pardee?

MR. PARDEE. Well, if you want to cover them now, yes. Over the next month we will be going through the first cycle of renewal of the swaps that we incurred in the operations in late June and in late July. These involve some 17 swaps, totaling $1,797,000,000. It's the first renewal; I'm just reporting it.

CHAIRMAN VOLCKER. We have a proposal to provide for the first renewals if and when necessary, I take it, and I assume they will be necessary. Any discussion? Without objection, I think that is done. Now we have to ratify the transactions, too. I guess I skipped over that. Would someone like to so move? Without objection they will be ratified. Mr. Sternlight.

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

CHAIRMAN VOLCKER. Comments or questions?

MR. COLDWELL. Well, on the last point, I think it's ridiculous. Can't we at least get some action [by] the responsible part of Congress to quit this nonsense?

CHAIRMAN VOLCKER. Would you like to volunteer, Mr. Coldwell? I think we can duly note that that's the unanimous view.

MR. MAYO. Doesn't the new bill give us some promise, though, that they're going to try to put in a system where the [increase in the debt ceiling] would be sort of automatic without all the testimony and hocus pocus?

CHAIRMAN VOLCKER. I don't know how automatic it will be; I know very little about it. I know they're trying to hoist it off on the budget committee and I don't know whether that's going to [happen].

MR. STERNLIGHT. They're trying to tie the debt ceiling to the budget resolution, but whether that will--

CHAIRMAN VOLCKER. There obviously is logic in that, but whether it's just going to make the budget resolution that much more difficult, [I don't know]. Mrs. Teeters.

MS. TEETERS. The problem of putting it in the budget resolution is that the resolution is not signed by the President. They have to make some sort of alteration in their resolution in order to have it signed by the President.

MR. WALLICH. I would remind you that this is an opportunity to talk about the budget deficit and, therefore, not to be completely despised even though it is rather illogical to first vote [in favor of] the deficit and then refuse to allow it to be financed. But it gives the defeated party a chance to come back a second time and criticize.

CHAIRMAN VOLCKER. That's the theory. It seldom happens in any very orderly way.

MR. MAYO. Well, it's such a waste of time. The Secretary of the Treasury and the staff have to spend untold hours getting ready for something that really involves just spinning wheels.

MR. PARTEE. It seems like it comes around a couple of times a year now.

CHAIRMAN VOLCKER. Among other things, [they] have escalated [the] social security [issue]. It's fully escalated because it was attached to a debt ceiling goal once when we sat there and wondered whether it should be vetoed or not.

We have to ratify the [domestic] transactions, if there are no further questions.

MR. MAYO. So moved.

CHAIRMAN VOLCKER. Without objection, that is done. Mr. Kichline.

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

CHAIRMAN VOLCKER. I wonder if we can confine our comments now to rather pointed questions. Mr. Coldwell.

MR. WALLICH. Jim, in the change of your output [forecast]--and I don't mean to be critical because you've obviously got to change it as things [evolve]--there seems to be a shift, by a rather sizable amount, between the third and fourth quarters on real GNP. You've increased the third quarter by 2-1/2 percentage points and decreased the fourth quarter by 1.1 percentage points. I hear what you're saying in terms of consumption being a cause of the third-quarter increase as opposed to prior expectations. I gather that inventories went up a bit faster than you had anticipated, which may be the cause of most of the shift. The fourth quarter, though, I read you as saying GNP declines in conjunction with [reduced] housing starts and maybe capital spending. Am I reading you right? Are those the principal reasons for this shift?

MR. KICHLINE. Those don't account for most of the revisions. We have anticipated them for some time. The bulk of the difference between Q3 and Q4--that is, getting a deeper negative in Q4--is the inventory side. Other than that, we have had most of the changes built in for some time. The biggest changes really were in Q3 and represent past data. As a matter of fact, in real terms we raised final sales in the third quarter by about $6 billion and $4-1/4 billion of that is consumption. A lot of that is autos. So I would say that for the third quarter final sales are stronger, and the fourth quarter mainly involves adjusting downward the drag of inventories.

MR. COLDWELL. For the fourth quarter you're saying consumption is reasonably stable?

MR. KICHLINE. It's declining slightly in real terms; it's down 1 percent in real terms and we had it down a half percent in real terms last month.

MR. COLDWELL. So your swing in these two quarters is principally an inventory swing. Is that what you're saying?

MR. KICHLINE. Well, it's [a swing of] $16 billion dollars from the third quarter to the fourth quarter, and that would translate into roughly 2-1/2 to 3 percentage points at an annual rate.

MR. COLDWELL. Which is about the difference--

MS. TEETERS. One question, Jim: Is this the first time you've shown an actual liquidation of inventories?

MR. KICHLINE. I think we had the courage of forecasting a minus 0.1 a couple of months ago, but it was very small.

MS. TEETERS. And you haven't shifted the timing of that liquidation?

MR. KICHLINE. No, but the size of it has become different; that is, the second- and third-quarter accumulation has been larger than we had anticipated earlier and we now have a larger correction in the fourth quarter.

CHAIRMAN VOLCKER. You have a pretty good decline in goods consumption in that quarter. Mr. Timlen.

MR. TIMLEN. Jim, my question relates to the development of last Friday, the apparent settlement of the General Motors negotiations. I was wondering if you had any hard information as to the terms of that contract as signed and what implications it may have for prices and as a precedent for other contracts or a possible reopening of contracts in 1980.

MR. KICHLINE. Well, we don't have detailed information. We checked late last night and found that the Council on Wage and Price Stability didn't have the contract yet, so I didn't get so discouraged about not knowing the details. We do know that the wage increase was pretty much in line with past contracts; on our estimate we would assume that it might amount to about a 28 percent wage increase over 3 years. Pension benefits for current retirees were also raised but we don't know how that would be valued and we don't have the details. Our general expectation right now is that it probably is in the 33 to 35 percent range for a 3-year period. I don't know how that will be priced out by the Council on Wage and Price Stability. It may well fit within the guidelines. But in any event--

MR. PARTEE. That's about the area of the teamsters [settlement], isn't it?

MR. KICHLINE. That's right, it's not really out of line with what we had expected earlier but it is a sizable increase. So the publicity associated with that I think would have a negative effect in terms of holding wages down.

CHAIRMAN VOLCKER. I don't have much better information but what I have conforms with what Mr. Kichline just said. Mr. Balles.

MR. BALLES. Jim, you have a rather strange looking pattern in the quarterly trend in the GNP deflator, if I've got the right numbers here. For this year it's 9.3 percent in the first quarter, 9.2 in the second, 8.7 in the third, and then it suddenly jumps to 10.3 in the fourth quarter. There's probably an answer for that, but what is it?

MR. KICHLINE. The federal government pay raise.

MR. BALLES. Could that be the entire [reason] as far as you see it?

MR. KICHLINE. Well, that's a large part of it. The pay raise will be a 7 percent increase, and I don't think the seasonals take proper account of that. It's a shift in mix. The fixed weight [measure] is actually declining 0.2 percent from the third to the fourth quarter. There may be other factors at work, I'm not sure. But the fourth quarter usually is one to look at for a pay raise at the federal level.

MR. BALLES. I realize that that's a factor. I'm just surprised at the magnitude--that it could swing the whole GNP deflator by a point and a half. I'm not questioning the figure; I'm just expressing my surprise.

MR. KICHLINE. I don't know, something else may be at work. I just can't answer your question other than that the federal pay raise is one influence and I would think it would be the major factor.

MR. TRUMAN. We also have [for] the third quarter an increase in the import prices--because of the oil price increase--which has a depressing effect on the measured GNP deflator in the third quarter. So some of the third quarter "lowness," if I might put it that way, is in the deflator itself; we don't see so much in the fixed weight, PCE measure.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. I think we ought to look at the wage behavior of this year with a sense of encouragement, not discouragement. With inflation running what it is, I think it's surprising that the settlements in the electrical area and even in the automobile area for current employees have been remarkably restrained. Maybe they've done a better job than we have here in terms of inflation problems.

CHAIRMAN VOLCKER. You say even "in the automobile area." I take it you--

MR. WINN. Well, in this case, for current employees it looks as if the total cost might come out to 11 percent--that's my estimate --on an annual basis. [The total is] 33 to 35 percent and part of that is for the retirees, not for the current employees. So if you adjust that back down, given double digit inflation behavior, I think that's remarkable restraint, really, in the labor area.

MR. TIMLEN. But does the 33 and 34 percent include the extra time off, extra vacations?

MR. KICHLINE. It does not.

MR. WINN. But the electrical settlement really wasn't that--

CHAIRMAN VOLCKER. Well, I think what you say has some validity looking backwards. I don't know where to put the automobile agreement; I have a little doubt about that. That's a question we have: Looking forward, will that rather favorable record, considering what has been happening in prices, be sustained? I think this is one of the major issues we have here.

MR. WINN. I understand that this is not making our problem any easier, but I think we ought to recognize that there has been some restraint this year.

CHAIRMAN VOLCKER. I might say in terms of these guidelines that I don't feel up-to-date on that and I don't know the details. I understand the argument has been whether to have a guideline at all, with the alternative being this tripartite labor/management/public commission to look at wage settlements and pricing behavior. It gets posed in those [unintelligible] terms because I take it that labor has said that they will not participate in a tripartite arrangement with any numerical guideline. The Administration likes the idea of the tripartite commission but has not been willing, so far anyway, to go along with the idea of giving [the commission] absolutely no guidance in terms of numerical guidelines. That's where the impasse is.

MR. MORRIS. Well, I think they'd be well advised to drop the guidelines. To raise the guideline going into a recession doesn't seem to me to be a great contribution toward stability. And all these inequities and distortions are building as we go along.

CHAIRMAN VOLCKER. Well, that's a tempting course except when you look at what I think Willis, by implication, was referring to. Wages have been fairly well restrained given this price behavior and given the pressure for a catch-up. So, is it really wise to drop [the guidelines] right now? That's basically the issue they're struggling with--the fear that everybody will say they want a very sizable catch-up. I was startled the other day when the FAC was here. At a dinner

--I think most of the Board members were there--the bankers were arguing for some catch-up and some understanding. They were arguing in general terms until one banker kind of let the cat out of the bag and said we want, for instance, 11 percent this year. That is quite a bit; he's talking about a nonunionized work force that presumably was [getting] 7 percent. Well, if you suddenly jump from 7 to 11, even nominally--I don't know how typical that is but this is the way one fellow was thinking--where does that leave you? That's what they're worried about. They say that's just a catch-up and it's only for one year, but if you build it into your [whole] labor force what happens? It's not an easy issue. I was tempted by the position that you took and the more I thought about it, it seemed awfully risky. The recession hasn't gone far enough to have any restraining influence. Any other questions on [the staff's presentation]?

MR. WINN. I'd just like to make one more comment, Paul. It seems to me that we're in an environment in which we have the most advertised recession in history, with talking our way into it perhaps contributing more because I think we're going to get an uptick in this third quarter, too. I don't know how that's going to be manipulated from a press [standpoint]. When you talk to business people they all tell you that their business is still very strong. But then they will "bad mouth" because everybody else is bad mouthing and that's what they read. I think psychologically we may have built ourselves into a box.

CHAIRMAN VOLCKER. A strange phenomenon, I confess, is that everybody has assumed we are in a recession and we are getting an increase in the gross national product. I don't know. That's still a forecast, of course.

MR. PARTEE. The businessmen always say that, Willis.

MR. WINN. I know, but they read it in the press.

MR. PARTEE. Their business is off 1 percent from the very highest level it ever reached; that's a very good rate of operation. It's the inflection, and I thought the Redbook started to point out quite a few areas of inflection.

CHAIRMAN VOLCKER. If I may just add one question, Mr. Kichline: How do you get an increase in output per hour in the fourth quarter while the gross national product is declining significantly?

MR. KICHLINE. We have a substantial employment adjustment built into this forecast, so it's coming out of labor input.

CHAIRMAN VOLCKER. That would be unusual at that early stage--wouldn't it--of a decline [in activity]? Can that adjustment move that fast?

MR. KICHLINE. Well, it's part of what would be a fairly smooth and rapid adjustment, which is built into our forecast on the inventory side. My view would be that I have been surprised that we haven't had more in the way of reduction of labor input to date. And in light of new information on inventories and final sales, it becomes clear. But I don't think it's unusual. The August reading was one that seems to me to point in that direction and once that has begun, if you look back at prior recessions, it has gone on quite quickly for several months in a row. So I would think we're on reasonably safe ground in expecting labor input to drop off in the fourth quarter.

CHAIRMAN VOLCKER. You have unemployment getting to where by the end of the year?

MR. KICHLINE. Averaging about 6.9 percent for the fourth quarter, so it would be close to a 7 percent or 7.2 percent rate [in December].

MR. WINN. I don't want to monopolize this, but I'd like to raise one more question about your inventory calculation for the fourth quarter. We're going to have a big crop harvest in corn and soy beans and with the price changes being what they were I wonder if that may not throw the inventory calculation off again in that period [unintelligible] storage space.

MR. KICHLINE. That's right. I'd say the price side is a very tricky part of this. We have in the third quarter an inventory valuation adjustment of slightly over $40 billion, and once it gets into those huge ranges, it becomes very difficult. In the fourth quarter, we expect something smaller but still large to prevail. On the crop side, I would only say that exports have been coming along very well; it may not show up in nonfarm or farm inventories here. In addition we have built into the forecast some taking up of those crops by the Federal government in terms of the Commodity Credit Corporation, so it may not appear in private sector inventories.

MR. MAYO. One of the main problems on the crop issue is the inability to move the crops. Rail capacity is very low. With the Rock Island strike and so forth, the Iowa farmers are really going to [unintelligible]; they just can't move anything. They still have a large share of last year's crop sitting there.

CHAIRMAN VOLCKER. Mr. Axilrod, do you want to give us a perspective on financial relationships?

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

CHAIRMAN VOLCKER. Let me ask a couple of questions. You went over three reasons why the money supply increased more rapidly over the late spring and summer. It struck me last night that there may be an additional reason. I'll just comment on it. You do all these equations and everything else to get something called gross national product, which is the gross domestic product. And you have a price rise in there, whatever it is, of less than 10 percent or around 10 percent. In fact, we've had a big increase in the oil bill as well, which doesn't enter into the gross national product. It leads to a considerable discrepancy on other price indices from the gross national product deflator. [What] if we said in some sense that the additional money supply was financing the additional oil imports?

MR. AXILROD. It's quite possible; these equations may very well not be picking up the true transactions needs if they don't have the full price effects of the imported prices in them. And they don't. The GNP is measuring domestic output prices. So that's quite possible, in which case we would not really be supplying more money than historical relationships would suggest but about the same amount. In either event, [money growth] would be rapid but we'd have a somewhat different explanation of what we might expect in the future. It would tend to argue less, I would think, for a slowdown in the future [stemming from people] just deciding to invest their excess cash but would depend more critically on a real slowing in the economy.

CHAIRMAN VOLCKER. Or one would hope to get a leveling in the import prices.

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. I was confused last night when I looked hastily at these flow-of-funds projections. Maybe there is an obvious explanation but we talk about short-term credit demands and commercial bank demands being very heavy these days. When we look at these figures for the half year--we only have them on the half-year basis--they show a decline in total credit demands. There's a decline in the first half of the year and then a further decline in the second half. If I look at bank credit it slows from the first half to the second half and the decline is a little steeper in business loans. If I look at demands for nonfinancial corporate businesses, they are declining; the rate of growth in short-term debt declines significantly. And I look at the household [sector] and they have a rapid increase in deposits and a decline in direct purchases of credit market instruments. I don't know where money market funds are in there. Are they under credit market instruments?

MR. PRELL. They've been shifted, I think, this month.

CHAIRMAN VOLCKER. Well, that helps explain it. Even so, [their growth] was fast in the first half of the year, too. But this column of figures seems a little inconsistent with what we talk about happening in the market in the short run. Is that because we got a drastic change in the fourth quarter or what?

MR. AXILROD. Well, there is a considerable drop in what we projected in bank loans and commercial paper raised in the fourth quarter. Also, we were talking mainly about business credit demands but there has been a slackening currently in consumer credit demands. So we have a little tapering off in the current quarter relative to the second quarter and essentially we are in a downward trend in terms of credit demands and credit funds raised in the second half of the year beginning about now--just as we're supposed to be getting a lower growth in money beginning about now. These are in our projections.

CHAIRMAN VOLCKER. I haven't looked at the quarterly figures, but one reading of this is that it does [suggest that] we're on the verge of a rather steep decline in the fourth quarter. Do you have quarterly figures?

MR. AXILROD. Well, we have total funds raised coming down in the third quarter relative to the second, but the second quarter was an unusual peak. And the third quarter is above the first quarter, though well below the second and then it goes down further in the fourth quarter. But again, the fourth quarter remains above the first quarter.

MR. KICHLINE. I might note that in the third quarter the evidence we now have--or at least it is our current projection on the consumer side--suggests that household funds borrowed will drop $14 billion at an annual rate from the second-quarter level. And going into the fourth quarter, that's down another $7 billion. So in the household sector, we think [a slowdown in borrowing] is under way in the third quarter. With regard to nonfinancial businesses, we currently project total funds raised to be down about $8 billion in the current quarter and down an additional $18 billion in the fourth quarter.

CHAIRMAN VOLCKER. But the third quarter will show a big increase in bank loans and--

MR. BLACK. Mr. Chairman, it's not all that unusual to have a burst in bank credit as the economy moves into recession. The cash flow of business is--

CHAIRMAN VOLCKER. My question is why it didn't show up in these figures.

MR. KICHLINE. We have business loans projected to be increasing slightly less than the terrifically high second-quarter pace. So in the current quarter it is down $6 or $7 billion at an annual rate.

CHAIRMAN VOLCKER. It is down.

MR. KICHLINE. And it drops $14 to $15 billion in the fourth quarter.

MR. AXILROD. However, I would add, Mr. Chairman, that that's partly offset in the short-term markets by an increase in borrowing in the commercial paper market. We have a projection for September which has lower business loans than we had in July and August.

CHAIRMAN VOLCKER. I have a quarterly figure here now, which shows a very sharp drop in the fourth quarter in the short-term debt of nonfinancial corporations. It's very sharp. Mr. Roos.

MR. ROOS. Yes sir, Mr. Chairman. In listening to Steve, I found myself very much confused or disturbed by an underlying question that maybe he or someone else can answer. In Steve's analysis of what's happening in M1, he decribed three possible or at least two exogenous factors. One is the public's desire to draw down cash balances and the possibility that somewhere along the line the public added to cash balances. Steve did allude to the possibility that we contributed to the explosion of M1 by trying to stabilize the fed funds rate at a time of strong credit demands. I think you, Mr. Chairman, mentioned the possibility of the oil situation contributing to this. I get the feeling that we sort of feel that these exogenous factors that are beyond our control are really what leads to an unexpected explosion in the rate of M1 growth. Then when Steve gets to his suggested alternatives, he essentially concentrates, if I heard him correctly, on what we ought to do on the fed funds rate--either stand pat or let it tick [up] or let it recede. My question, and I ask this really as a noneconomist, is: Can't we through our open market operations control the rate of M1 growth in spite of these exogenous factors? I get the feeling that we continue to react to some [developments] out there that we can't control. Couldn't we in this room this morning, if we decided that we really wanted to, set a target for M1 growth and mechanically through open market operations over a long period of time achieve that target?

CHAIRMAN VOLCKER. Mr. Axilrod.

MR. PARTEE. The answer is yes.

MR. AXILROD. I'll be very elliptical, Mr. Chairman, in the interest of saving time. I was of course couching my own discussion in the terms in which the Committee has been framing its policies. If the Committee had been framing its policies in terms of the monetary base or reserves or something like that as an operating device, I would have couched the discussion in those terms. It's perfectly true that the monetary base or reserves have expanded much more rapidly in the past two or three months than they had in the previous two or three months. In part that's because of efforts to hold the funds rate down; in part it's because currency, which has a bigger weight in the base, has increased more rapidly. And in part it's because banks have begun adding to holdings of CDs and absorbing more reserves that way, whereas in the two or three previous months when M1 had been growing CDs had been dropping, releasing reserves available to support money. So reserve growth didn't have to be as rapid in order to support the same amount of money. I add those latter factors in order to indicate how complicated it is to have a relationship between reserves and money that is stable because the deposit mix and thus the need for reserves is constantly shifting, and preferences for currency versus deposits are constantly shifting. So it's very hard to come before the Committee and say: If you set the monetary base or reserves to grow this much, I can guarantee this much money. And it would be even more difficult to tell the Committee what federal funds rate or what interest rates are likely to emerge from that--questions the Committee obviously would want to and need to know.

So I'm not saying it's impossible and I'm not even really indicating my preferences in the matter. But it's not going to be any less difficult, in a practical way, to control money with reserves than it is to control it with the federal funds rate because it will always involve the Committee in two decisions. [First], what should be its fundamental target. Is the money target that it is setting right or wrong and should it [change] in light of changing circumstances? And [second], what is it going to do about interest rates? Does the Committee in fact want them to go up or down in the way that they would be going if we adhere fairly ridgidly to a preset reserve target. I hasten to add that I don't mean to say that I don't think it would be useful to have a reserve or a base target. Personally, I happen to think it would be useful.

MR. ROOS. Well, Paul, the reason I asked the question--and I ask it purely in a constructive way, not to just reopen the classical argument--is because of the problems that we've had in controlling money growth. [Given] your statements, which I think are great, that we're never going to accomplish our ultimate goal until we achieve some discipline in terms of monetary growth, couldn't we discuss these issues again? Maybe I am out of order to raise this now, but couldn't there be a discussion again of whether or not our traditional policy of targeting on interest rates, in spite of the possible adverse consequences in terms of money growth, [is appropriate]? Shouldn't this be given another look in view of everything you've said and in view of the less than happy experience that the FOMC has had over the past years in achieving its goals of stability in terms of the inflation problem? Shouldn't we take a look at this in some way?

CHAIRMAN VOLCKER. My feeling would be that you're not out of order in raising that question, Mr. Roos. We would be out of order in having an extended discussion of it today, because I don't think we're going to resolve it. I presume that today, for better or worse, we have to couch our policy in what has become the traditional framework. But I think it is a very relevant question, which has come up from time to time, and I think we should be exploring it again in the relatively near future. And I would plan to do so.

MR. MORRIS. Do we still have the Committee on the Directive?

CHAIRMAN VOLCKER. I think we do, and we'll consult with that Committee. Are there any other questions specifically directed toward Steve's report before we open [the discussion] up more generally?

MR. BALLES. Steve, I'd just like to deal with the first of the three possible explanations that you gave. If I heard the words right, I interpreted you as saying that there has been some revival in money demand.

MR. AXILROD. In the first one, I was trying to say that to some extent people may have reduced their demand deposits and savings deposits earlier because of ATS accounts and the high interest rates and found that they just couldn't run with such small deposits so they've put some back in. [I would] just sort of forget that addition; it's an offset.

MR. BALLES. I realize that's a possibility. I must say I'm skeptical, though, as I look at the sharp rise we've had in short-term interest rates in that same period when the growth of the Ms has taken place. I would have thought that would have encouraged further the use of RPs and money market instruments, and we know from the facts that that did occur. So I find it difficult to believe that that's a plausible explanation or a very solid one.

MR. AXILROD. Of the three explanations, I would put the lowest probability myself on that one.

MR. BALLES. I would, too.

MR. AXILROD. It's relatively low, but in the absence of evidence I was reluctant even to weigh them.

CHAIRMAN VOLCKER. Well, if there are no other questions--

MR. PARTEE. Well, on that point though, John, we were getting an increase in velocity of 9.8 percent in the fourth quarter and 12.3 percent in the first quarter. That just couldn't continue. It may have gone too far the other way; it was negative in the second and third quarters--or slightly negative. Certainly something was going on there in the way of a shift. It was a rate that just couldn't continue.

CHAIRMAN VOLCKER. I'm still confused somewhat by these figures when I look at the quarterly flow of funds. We have had higher interest rates recently, which are normally accompanied by an increase in individual purchases of credit market instruments, if I remember these flow-of-funds ambulations correctly, and a decline in deposits. Instead, we had an enormous increase in deposit holdings by individuals and a very big decline in the rate of growth of credit market instrument holdings during the third quarter when interest rates were rising. We'd normally expect the reverse to happen.

MR. KICHLINE. Well, that's in part the definition of money market mutual funds, the problem in the switch from--

CHAIRMAN VOLCKER. You just [reclassified them] between those two quarters without telling anybody.

MR. KICHLINE. No, but money market funds grew very rapidly [and] the structure was changed. Between the second and third quarters money market funds are expected to have grown very rapidly at an annual rate.

CHAIRMAN VOLCKER. And they're in deposits.

MR. KICHLINE. And they're in deposits, not in credit market instruments. So if you look at past history, it's quite a distorted picture.

MS. TEETERS. Didn't you correct the history?

MR. KICHLINE. Well, we didn't have any money market mutual funds pre-1974, so if you look at--

CHAIRMAN VOLCKER. You didn't reclassify them between the second and third quarters; it's just that they've grown more rapidly.

MR. PRELL. The second quarter was also changed. The numbers are consistent. What you have in the first half of the year in effect was that households purchased a lot of Treasury securities at a time when foreign central banks were selling off Treasury securities. In terms of the overall pattern of flows--

MR. KICHLINE. Excuse me, relative to 1966, 1969, and 1970, given our treatment of these securities today, we're finding a money market type instrument being classified as a deposit. It's really the same [phenomenon] as in 1966, 1969, and 1970 when funds moved out of banks into other higher yielding instruments.

MR. AXILROD. There is one other factor, Chairman Volcker. Beginning in that period in the second half where we had that sharp swing back to savings deposits, which I have been interpreting as part of this precautionary mood [response], they had been declining rather sharply. Then they've been increasing in very recent months and that swing would also affect these numbers. It may not be the major factor but it's another element different from previous cycles that may be affecting these numbers.

CHAIRMAN VOLCKER. Well, let's proceed with general comments on the business outlook and policy prejudices--or policy orientation anyway. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, first let me make just a comment on retail sales. We are probably the only District that has maintained that questionable old series on department store sales, but in the four weeks ending on September 8, such sales showed a very strong increase relative to the year-ago period. All in all, that average was up 10 percent whereas cumulatively through [September 8] from the beginning of the year it's up 7 percent.

CHAIRMAN VOLCKER. It was up how much?

MR. BAUGHMAN. It was up 10 percent from a year ago in the four weeks ending September 8; and from the beginning of the year through those four weeks it's up 7 percent. So there was a definite step-up, compared to what had preceded that 4-week period, which occurred pretty generally across the metropolitan areas in the District. Those [whose sales] I had reported earlier as being very strong attributed it to an apparent increase in purchasing by people coming from Mexico. They continued strong but they did not show the surge that other centers did in that last 4-week period. That's just by way of suggesting that in our part of the country, at least, there seems to have been something happening to nonautomotive retail sales because these were department store sales.

With respect to the financial sector, as I was listening to Steve's comments, they seemed almost exactly to replay some conversations we had in the District last Wednesday evening, at which Governor Teeters was present. [Those comments were] to the effect that in a prior period with 13 percent interest rates, bankers were working very hard to discourage borrowers. At the present time they are still out searching for loans. Apparently they find it profitable to add to loans now, whereas in the earlier period they did not. They say that they feel no credit restraint and they do not see a reluctance on the part of their customers to borrow. There was a comment, for example, that 13 plus 3 percent for real estate loans--these were bankers talking so the loans were not primarily residential mortgage loans--just doesn't seem to deter people. They go ahead and sign up and don't even ask a question as to whether they couldn't do it for less.

With respect to labor markets, the thrust of the conversation in our part of the world is tight labor, high turnover, and losses of efficiency as a result of high turnover. I don't know whether we have that sort of situation in labor markets elsewhere or not. But it seems to me--and I am inclined to disagree a little with the view Willis Winn was expressing that we are lucky not to have more than an 11 percent annual rate of increase contracted for 3 years in the automobile industry--that building that sort of [wage increase] into the economy almost guarantees that we are not going to make any significant progress fighting inflation for 3 years. That's particularly so in an industry where the indications are that it's moving to supply a diminishing proportion of the domestic market. So we have a market structure that is permitting wages and prices to be pushed up in that industry. And we're really exporting jobs from the industry and importing increasing amounts of automobiles produced abroad. That seems to me to be inconsistent with moving toward the objectives we presumably have in mind.

I don't see any answer to this problem in our conventional use of monetary and fiscal tools except a very, very long, drawn out and very painful one. So it seems to me that we should be trying to encourage the government to think of ways to break into some of these wage and price processes in the interest of trying to move more rapidly to moderate inflation without going through the necessity of creating horrendous amounts of unemployment for a long period of time. That's all I have, Mr. Chairman.

CHAIRMAN VOLCKER. Governor Coldwell.

MR. COLDWELL. Mr. Chairman, I have been listening here for some time, trying to cipher out what I think this economy is going to do. I think Steve's comment that it is uncertain is probably a good portrayal of my position. I have doubts that the staff's switch between the third and fourth quarter is going to come out as perfectly as they show it here. I doubt that they would defend the precision of the 0.7 [forecast] or anything like that anyway. It seems to me that we still have some strength left in this economy. And the portrayal of credit demands still reflects, I think, the basic attitude that inflation will continue. If there is anything certain in this world right now it seems to be that inflation will continue, whether at the current 10 percent rate in the fixed weighted index or at 9 percent plus. I am bothered about this forecast showing even through the end of 1980 more than 9 percent inflation in terms of the average from Q4 '79 to Q4 '80. The prospects we have had detailed for us by the staff have shown weakening, tied primarily as I understand it to an inventory position and personal income assumption. Housing is expected to decline, but barring a change in attitudes--unless the ceiling rates in state usury laws become more binding--it still appears to me a pretty speculative area of inflation. Oil [prices], of course, are something that seem to move ahead; and with a minimum of 10 percent inflation for this year, I suspect we are going to get another shock in oil prices next year, unless somebody can find some way to dampen the demand severely.

So, as I look over what is coming up, with high aggregates growth with which we are financing these [activities], with rates not dampening the strong credit demands--that is, the financial side of the economy still indicating strength--the recession seems uncertain and the inflation certain. I still think that the policy position of this Committee ought to be to do what it can to dampen inflationary expectations. That doesn't mean that we have to charge into major changes in either the federal funds rate or anything else. I suspect the answer I would come out with is that we have to get the money supply figures under better control, which means putting some rather severe limits on what we would accept as a peak rate of money supply growth over the coming 2-month period. And if we exceed that, then we take another tightening step and so be it. If the money supply growth does subside, as the staff seems to think it will eventually anyway, then we can afford to be a little more relaxed and perhaps even turn [rates around], following the market down. But for the coming period, Mr. Chairman, I would counsel the Committee to continue the path it has been on, slowly moving up its [funds rate] targets to force a curtailment in money supply growth.

CHAIRMAN VOLCKER. Let me just interject, if I may, to the presidents in particular: We have a lot of discount rate proposals in, and anybody who wants to comment on what has been proposed as your turn comes up, [please do so]. Let us know what course [you favor] or what rationale you want to present or whether you disagree with your directors.

MR. BLACK. Mr. Chairman, do you want us to do that now or when we get to the specifications?

CHAIRMAN VOLCKER. I think in a general way you could do it now, but you may want to return to it more precisely when we get to the specifications. Governor Wallich.

MR. WALLICH. Mr. Chairman, it seems to me that we face basically a question of timing. If the economy goes into recession, as it may already have done--interrupted temporarily maybe, but perhaps a more prolonged one than we originally thought--at some point we have to ease. But at the present time it seems to me the signs are still on the other side. The aggregates have been very strong; in a sense that's been an easing rather than a tightening even though interest rates have risen. Inflation shows itself to be more persistent than before and we have the old picture where we tend to underestimate inflation. That also means that real interest rates are less than one thinks, at least the upper end. We are now getting to the point where we are getting positive real interest rates. I guess Chase with its move [of the prime] to 13 percent made us honest. But that is only before taxes. And as we look down the road, it seems to make people increasingly accepting [continued] high inflation and thereby perceiving a lower long-term real interest rate.

Now, the economy itself seems to me very spotty. What we have in good part is an automobile recession. This is reflected in the Redbook. Many parts of the country are still very strong and if we were to ease at this time those strong areas would of course bump against their ceilings increasingly and produce more demand pressure and inflation there. I would add that there are other things that might give us concern about high nominal interest rates. Most have not yet materialized. The suspicion that there might be some sort of crunch ahead seems not to be valid based on what we hear. There are no real supply constraints on credit. We think of how we've shielded the housing sector through the money market certificate. That just means that we need more restraint across the board in all sectors--that is, in lower aggregates or higher interest rates. I would remind you again that what's going on in the Euro-markets means that the relevant monetary aggregates that we ought to focus on, if we had the data, are growing faster than what we see.

Finally, as to the immediate situation, it seems that the market interprets the behavior of the aggregates and of the economy as something that will cause us to tighten. So while we should not slavishly follow what the market seems to expect, nevertheless we have to recognize that we disappoint the market at a cost--at a cost in credibility--and I see no reason for that at this time. I would therefore argue in favor of a mild increase in the funds rate in order to slow the aggregates. Thank you, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. Thank you, Mr. Chairman. I would like to take a little different position than has been taken up to this point. I believe one thing that is very good in the discussion that we have been having is that we are talking about longer-run strategy--a kind of cyclical strategy, I think. Everything that has been said up to now is in that vein, and that's good because I think one of the problems we have in these meetings is that we tend to operate month-to-month and get short-sighted. My strategy is somewhat different than Phil's or Henry's. I happen to think we are in a mild recession and that the recovery will be a protracted one. In that situation I also think that in our strategy we need to avoid mistakes that we have made in past cycles. One mistake that we have made is overstaying restraint and the other mistake is overstimulating when the economy weakens. I think Phil is entirely correct that we need to take an action that [makes] a dent on expectations; it's just that my course would differ somewhat from his because I feel we need to take increasing care to avoid precipitating a serious recession. That would have bad effects on expectations that would ultimately confirm inflationary expectations because it would precipitate action that would be designed to stimulate the economy and would in the longer run have negative effects on expectations.

That means that in the current situation I would be willing--not happy, but willing--to see somewhat higher growth rates in money for a time than I would ordinarily like to see. But that's in the expectation that we will be getting slower growth in the months ahead. I think it also means that we will have to exercise care against overstimulating as the economy proceeds to weaken, and that means resisting somewhat declines in interest rates that might otherwise occur and having somewhat slower money growth than we would have had in similar periods in the past. In other words, [I'm suggesting] a strategy of kind of leveling off the peak and filling in the valley.

There are risks in that, many risks. First of all is the assumption that the economy will behave the way I am assuming. Second is that the money supply in fact will start to slow down in coming months. But for the moment I would take that risk and stand pat; I'd stay where we are and live with somewhat higher growth rates than I ordinarily would like to see. If that proves to be wrong and money growth continues exceptionally strong--that is, above the ranges--then I think we have to move the federal funds rate up. But [for now] I would stay essentially where we are.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, I have increasing difficulty in trying to define how tight credit is. We see the ambivalence, if one can use that term, in our own area with farm credit, small business credit, credit for builders and so forth very tight. Banks are very tight and it doesn't filter down like it's supposed to in a fluid system from the big banks. We don't have the moral suasion problem that we had five years ago--or if we do, we really haven't recognized it--where many of us made real efforts to contact individual banks about their overextension of acquisition credit and REIT credit and so forth. So I guess this leads to a question to Steve or anyone else on the staff who wants to volunteer: What is your interpretation of the extent of the insulation of the large banks from our attempts at credit tightening because of the availability of funds from abroad?

That makes it extremely difficult for us to define how far we can go, much less [how to] implement whatever definition we arrive at.

MR. AXILROD. Well, perhaps not in complete answer but in partial answer, President Mayo, I would think that the availability of Euro-dollar funds abroad has made it necessary to have interest rates a little higher in this market than we would otherwise because large firms can simply borrow a little cheaper abroad than they can here. On the general point you are raising, what I tried to say earlier was that my instinct was that the 13 percent prime rate was producing some real restraint. In simple terms, if people expect the rate of price inflation to be less than 13 percent, it's immediately a very restrictive rate. Now, we will have [firms] perhaps expecting that their sales are going to weaken, in which case that adds to the restrictiveness. So the rate is the main factor at present, and the need for higher rates domestically is greater because of this lower rate in Euro-dollar markets.

MR. MAYO. So you think we can offset the availability through the rate?

MR. AXILROD. If we can't, I think we probably have to throw out the history of economics.

CHAIRMAN VOLCKER. Are you suggesting, Mr. Mayo, that we ought to think about some kind of moral suasion?

MR. MAYO. I'm raising the issue, Paul. I haven't made up my own mind on it. It's an issue that we have not discussed around this table in this cycle and we certainly did five years ago.

CHAIRMAN VOLCKER. Do you have any concluding comment you would like to make?

MR. MAYO. No, I'm throwing this up for grabs at this point. I don't know how to attack the moral suasion issue this time, Paul, because of the availability of such a flood of funds in the international markets. We are not talking about what was an attempt in a mild way at "credit allocation"--if I may use the naughty term--five years ago when we were trying to get [banks] to stay away from purely acquisition credit and trying to keep the REIT situation stable yet not expanding. This time what I have in mind in bringing this up certainly doesn't relate to our banks and foreign loans; it isn't that aspect of it. And I don't know to what extent moral suasion could do us much good here. It's a much broader question to go out and say to the big money market banks that we would prefer that you not borrow from abroad. That's a very hard thing to say. What do we do about it? I don't know, but I think it's a worthwhile question to kick around a bit.

CHAIRMAN VOLCKER. Some of this borrowing from abroad, I think, is just borrowing back money that Americans put abroad in the first place.

MR. MAYO. That's true.

CHAIRMAN VOLCKER. I'm not sure how much, net, there is.

MR. MAYO. Well, to the extent oil money or OPEC money is involved and that's sloshing around, that somehow gets to the big banks and insulates them from monetary policy. I hope that Steve's answer on [rates] is an accurate statement. I certainly do.

CHAIRMAN VOLCKER. Obviously, if anybody else wants to comment on this question, I would be delighted to have the comments. My own feeling has been that it's probably pretty late in the day to begin talking about moral suasion. I don't know whom we would morally persuade.

MR. MAYO. That's the real problem.

CHAIRMAN VOLCKER. We may do more damage, unless we see particular speculative problems and takeovers or whatever. I'm not sure [how we can succeed in] that process.

MR. WINN. On this issue, Paul, I hear more comment in the market about credit controls of various types as the way of doing it to avoid Reg--

CHAIRMAN VOLCKER. My response would be a fortiori applied to credit controls. I don't know what we want to control at this particular point in the cycle, but--. Mr. Kimbrel.

MR. KIMBREL. Mr. Chairman, from our vantage point we are seeing some contrasting developments early on. The farmers are very excited; generally expectations are for one of the best farm years ever. Business people are still reading the papers and saying "I read that but I don't feel it in my business." Developments in residential sales and construction in the area are harking back to the early '70s. It's incredible some of the stories we are hearing about sales and possibilities in certain areas of the District. We add to that, of course, the visit of an unwanted gentleman hurricane in the Mobile area and that confuses things. The banks were not open yesterday, and we are not sure that they are going to be open today. And 10,000 people are still without power. So, we don't know what the total impact of that is going to be.

Business loans in the District have not followed the national pattern. They are somewhat weak, but consumer attitudes are also discouraged and uncertain. Add to that [what we said in] our earlier discussion of the growth in the aggregates and the apparent lack of restraint on [such growth] in recent months. [Nevertheless,] at the directors meeting last Friday the feeling was I think unanimous that there is not going to be a credit crunch but that inflation is going to be about as strong [as it has been] for at least the rest of the year. Add to that the uncertainty of foreign exchange markets, and I have to associate myself with the expectation that maybe [the slowdown] has gotten somewhat deeper during the last month since I have been involved with the Desk and I think there is really some urgency that we ought to be directing more attention to restraining money growth. I don't detect in the markets any great concern that if we do that, they are going to fall out. So I would hope that we would at least maintain our present posture with possibly some leaning against any new growth--as much as anything else to try to preserve our credibility. I recognize that we have been hoping for slower [monetary] growth for some months; but it hasn't come and I am not persuaded that it's imminent. I guess that pretty well suggests that I would have no difficulty agreeing with our directors' recommendation to increase the discount rate a full 1/2 percentage point.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I don't have any serious quarrel with the staff's projections on the economy. But I think they are probably on the optimistic side, if they've missed, because it seems to me that this trouble we have is more in the nature of a worldwide problem with the petroleum shortage, inflation, and turmoil in the foreign exchange market. So I would not see nearly the improvement in the foreign trade sector that the staff has projected. I think all these problems are going to intensify the domestic problem. In dealing with the recession that we are in, I think we have a unique set of problems here that we really haven't [encountered] in the postwar period, as Dave Eastburn indicated. I don't think the past action in earlier recessions gives us much of a guide as to how we ought to proceed in this one. There was an excellent article by Paul McCracken in The Wall Street Journal yesterday that spelled out the sort of procedures I think we ought to follow. What I believe we have to do, since I think inflation is the main problem, is to address that problem almost entirely. More troubles are going to build up and we also are going have more serious problems on all fronts, including the unemployment front down the road. And to me dealing with inflation means getting a hand on the aggregates.

As we set our targets today and as we approach the end of the year--when we are going to be judged as to whether we have hit our long-run targets or we haven't--we ought to bear in mind that there is a good deal of confusion among the public and probably on the part of some members of Congress. I find it confusing myself [as to] what our M1 targets really are for the fourth quarter of last year to the fourth quarter of this year. You will remember that in July we decided we would not change them; we left the M1 range at 1-1/2 to 4-1/2 percent but the consensus around the table as I read it was that for internal purposes we would think of that as being 3-1/2 to 6 percent since we revised downward our estimate of the ATS/New York NOW account effect from 3 to 1-1/2 percentage points. Now, this spurt in the aggregates that we had in August and September is going to make it very difficult for us to get a good fourth-quarter rate. And under all three alternatives in the staff's projections they are talking about a rate from the fourth quarter of last year to the fourth quarter of this year of 5.3 percent. If we add to that the 1-1/2 percent ATS/New York NOW account [effect], that comes out to 6.8 percent, which I find is sufficient evidence to indicate that we have been too easy. Although I sympathize with Bob Mayo's position--it's hard to judge these things sometimes--when I see bankers out fighting for loans as they are now and I see a lot them adding to their investments, I have to conclude that credit conditions may not be as tight as they appear [on the basis of] interest rates alone.

Looking back in the history of economic thought, when we didn't have all the statistics we now have there was considerable feeling on the part of economists at the time that you could look at the behavior of the foreign exchange rate and the price of gold and that would tell you whether you had too much money or not. [Those indicators] clearly say to me that we are much too easy. But I view these long-run targets that we established in July as calling for a midpoint of 6 percent pre-ATS and 4-1/2 percent post-ATS, and I think we ought to endeavor to come as close as possible to these midpoints. I think this use of homeopathic doses of federal funds rate increases in the past has pretty well ruled out any hope we have of achieving this if indeed we can control the aggregates by manipulating the federal funds rate. I have some doubts about that and some sympathy for Larry Roos's approach, but I do think we want to offset as much of the second and third quarter overshoots as possible, and I would--

CHAIRMAN VOLCKER. I'm not quite sure what target you are talking about, Bob. Maybe you can--

MR. BLACK. This is M1, Mr. Chairman.

CHAIRMAN VOLCKER. Did you say a 6 percent midpoint on our range?

MR. BLACK. That's what it would be pre-ATS.

CHAIRMAN VOLCKER. Pre any ATS.

MR. BLACK. That's right, without any ATS. I believe that's what we were thinking about. Then you remember we went to 1-1/2 to 4-1/2 percent, which gave us a 3 percent midpoint when we thought the ATS effects were--

CHAIRMAN VOLCKER. You are talking about a concept that isn't portrayed on our nice little charts at all.

MR. BLACK. That's right.

MR. PARTEE. He's adding the ATS back in.

MR. BLACK. That's right. I think that's the way we have to judge it. At least we have to clear up that confusion ourselves. Lord help you when you have to explain this to the Congress and to the public because I get confused every time I think about it! When we get down to the specifics, I would like to propose that we take some actions to try to get close to these targets, although I don't think we can achieve them [fully] because of past misses.

CHAIRMAN VOLCKER. Mrs. Teeters.

MS. TEETERS. I think you have overlooked that [M1 growth in] August came in at 6.8 percent. We haven't had a continuous 10 percent rate of growth; at the end of August the rate of growth of the money supply dropped. And if you look closely, it's in currency. The rate of increase in demand deposits has been coming down all summer. Can someone explain to me why we have a sudden increase in demand for currency? I don't know the explanation for that. I would point out to you that we have raised interest rates 100 basis points [very recently]. That's a big increase in basis points. We have a prime rate of 13 percent, and nobody pays prime--it's prime plus. So we are talking about interest rates in the market that are 15 to 18 percent, and it's not just on consumer loans. We have really gone very far, very fast in the past 6 to 8 weeks. I think it's time that we slow down and see what we are doing because the major impact [of our tightening actions] is going to be in the fourth quarter of this year and the first quarter of next year.

I'm a little puzzled about this availability argument. The lack of availability previously has always been in one [sector]; it has always been in the mortgage market. I suspect that in other areas of the market there was really enough money available, except maybe in the summer of '74. Now that we have said that we don't want to put all of the restraint on one industry, the word goes around that there is plenty of available money and nobody is being hurt by this. People have got to be squeezed out of the markets at this point. It may not be the big banks or big corporations, and it may mean [the restraint] is going to be focused again on certain areas of the country. The Sunbelt seems to be almost immune to any sort of restraint. And as we move [rates] around, it make it harder for New England and for the upper middle West, along with other areas of the country. I'm extremely reluctant to raise either the discount rate or the federal funds rate at this point.

CHAIRMAN VOLCKER. I'm not sure it is a fact that everybody's paying more than the prime rate. There are still some reports around that quite a few people are paying less than prime.

MR. MAYO. And the compensating balances.

CHAIRMAN VOLCKER. I don't know why that should be--

MR. BALLES. Well, the competition of the European banks is a major factor.

MR. PARTEE. Well, it's very short-term money.

CHAIRMAN VOLCKER. I'm not sure it's all short term. I think it's probably bigger--

MR. PARTEE. I think Nancy's point is that most borrowers pay something more [than prime] and a 20 percent compensating balance.

CHAIRMAN VOLCKER. There are reports that some banks are still making fixed rate loans at something less than prime.

MR. SCHULTZ. Furthermore, there was actually an announcement by the Bank of America that it was going to make automobile loans at 12 percent--a lower rate just to help out the automobile dealers as a sales mechanism. It would be an unusual situation, but it certainly doesn't indicate much tightening.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I sort of lean [in the same direction as] Dave Eastburn and Nancy Teeters at this juncture. The evidence seems to me to indicate that recession momentum is gathering force very rapidly and that the recession is likely to be more severe than the staff forecasts. I had hoped, since it was the best forecast recession ever, that we would get some restraint on inventory accumulation. But the whopping increase in inventories in July plus the big demand for business loans at banks in the last 4 or 5 weeks suggest to me, even though oil inventories may be down some recently, that we're still getting very big inventory accumulation in August and early September. This, of course, suggests that when we start turning that corner, we're likely to have a pretty big inventory swing, probably bigger than is in the projection. I also agree with Nancy on the point that in the past [several] weeks we've moved short-term rates almost 150 basis points; long-term rates in some cases [have risen] almost 50 basis points. I can't ever remember a month in which we've moved rates more than that. We've gotten a lot of bang for the buck in terms of the relationship of the relatively small move in the funds rate to the very big moves in the rest of the market. I think we have yet to see the effects on economic activity of the actions we have taken. So, I would come out the same place Dave did; I think we ought to behave a little differently going into a recession than we would behave in a continuing boom environment.

All history teaches us that when the inventory accumulation starts to abate we will get a slackening in the aggregates. And I think the long-run track of the aggregates up to now has not been bad. Over the past 12 months [we've had growth of] a little less than 5 percent on M1 and a little less than 8 percent on M2, and I think that's about what we would have wanted to come out with a year ago. So it seems to me that we ought to stand pat for the next month. As far as the discount rate is concerned, it seems to me that we ought to hold that in reserve in case we need to use it. In the event that we get a run on the dollar, it would be nice to have a symbolic gesture in the closet that would permit us to announce another 1 percentage point increase in the discount rate, which would attract a lot of attention in Europe and so on. So I would rather save that weapon for future use. As far as moral suasion is concerned, we might have had that as a part of the package last November 1, but I think it's much too late now. I think the recession will substitute for moral suasion.

CHAIRMAN VOLCKER. Mr. Timlen.

MR. TIMLEN. Mr. Chairman, you expressed some interest in the discount rate actions at the Reserve Banks. Two weeks ago the directors of the [unintelligible] New York Bank voted a 1/4 percent increase in the discount rate. When the officers came in that morning, they were very troubled as to what our recommendation should be on the rate. There was some feeling to do nothing, some feeling to do a 1/4 point, and some feeling to do a 1/2 point. I think on balance the strongest sentiment was to take a small, but not insignificant step and therefore to recommend a 1/4 point. Well, later in the morning we heard that the projections on the monetary aggregates were reduced somewhat, so the officers decided on balance to propose that we wait a couple of weeks. Having made the recommendation to the directors that we do nothing [on the discount rate], the directors expressed some sentiment that it would be well to coordinate the action of the Bank with [developments] in the open market that were identified with the new Chairman, so that on their own initiative our directors moved and voted a 1/4 percentage point increase in the discount rate. [Our board] will be meeting on Thursday of this week and I would suspect with further market developments and administered rates, there might be some sentiment for something more than the action taken two weeks ago. As an aside, I might say that there's a good deal of talk in the markets in New York about the possibility of an impending credit crunch. As we look at the situation in the individual major banks, however, we can't find a commercial bank that may be faced with a credit crunch.

In terms of the general situation, my views are very close to Governor Coldwell's. I don't think the situation is particularly dissimilar from the one we faced last month. Inflation is still for me a matter of major concern. The monetary aggregates still are on the high side, and the dollar--which I don't think Phil mentioned--continues to be under recurring pressures in the foreign exchange markets. I must admit that we cannot overlook signs of weakness in the economy. Unemployment is edging up and there is the question of inventory accumulation. [It's unclear] whether there has been a correction in the automobile industry but that is a possibility. I think it's important that we not have the problem of a General Motors strike. We do have a problem that the settlement was expensive. I think it's important that the Federal Reserve not indicate that it is weakening in any respect in its resolve to fight inflation or restrain growth in the aggregates, so I would favor some further tightening at this time.

CHAIRMAN VOLCKER. Mr. Partee.

MR. PARTEE. Well, I've been gone for a couple of a weeks and I feel a little out of it. A significant recession is not a certainty but it's a high probability. One could read this as an automobile-led correction and a shift in real income from consumers to producers and distributors of oil, both of which have had a marked effect on retail demand. But I guess I'd go along with Frank that the indicators all point to mounting tendencies toward weakness in the economy. And it seems unlikely that we'll get a smooth and easy inventory correction as the staff is projecting. So if in fact these pressures continue to mount, we'll probably have a deeper recession than is forecast by the staff.

I've been concerned over the last 4 to 6 weeks, as Nancy has, about the possibility of overshooting. I think it's important, very important, that we try to keep the aggregates within the ranges that we specify. And I think it was very appropriate that we moved interest rates up significantly over the summer because of the bulge in the aggregates in the spring and summer, which was to a considerable degree unexpected. But we have to remember that those changes in rates affect money growth with a lag. We've had the increase in rates and we have another lagged response yet [to come]. We also have to remember, as Nancy said, that if we look at M1 there has been a significant slowing in demand deposit growth. It was [at anannual rate of] 17 percent in June, 10 percent in July, and is forecast at 3-1/2 percent in August. That has been masked by an explosion in currency. We don't really know [why that has occurred]. It seems most likely to be some kind of aberration; we don't really think it will be sustained. Feeling that we have moved rates quite a bit in the last month or two and that the aggregates are in a lagged way likely to be reflecting that, I also agree with Nancy. I think the best thing to do, as the Committee often has done over the last decade or so, is to pause for a while and see what develops.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I was going to ask Nancy if that explosion in currency is a part of the underground economy that she testified on.

MR. PARTEE. It's the Susan B. Anthony dollar.

CHAIRMAN VOLCKER. How much of that is the Susan B. dollar? There were $300 million of those going out beginning in July?

MR. BALLES. Well, in addition to the Sunbelt, the area west of the Rockies is not feeling very much if any recession yet. Aerospace, electronics, and agriculture in general are all quite strong. One indication is that the [volume of] help wanted ads in the Los Angeles Times is almost unreal. The latest count that I heard from someone was 98 pages [of such ads] in a recent Sunday edition. So a lot of jobs are going begging. We have had, of course, as is true around the nation, some decline in auto sales and in housing starts but considerably less percentage-wise than the country as a whole.

As far as the national outlook, we don't have any huge quarrel with the Board's staff view. We still expect the economy to bottom in the first half of 1980 and quite possibly in the first quarter. There's always the risk that things could get worse than our staff is now forecasting, but I'm reserving judgment on that until we get some evidence that that's a likelihood.

In addition to the input that we bring to these meetings and the usual sources of our own research staff and directors, last Friday when Vice Chairman Schultz visited us in San Francisco we called in a special small group of bankers, businessmen, and academicians for a very frank exchange of views. We sounded them out about their feelings on the economy and on Fed policy, and I must say, Fred, that I thought the reactions were quite candid and somewhat humiliating in a way. The bankers generally expressed the view that as yet there's very little evidence that the high level of interest rates is having any significant total effect on cutting off credit demand. Now, one has to add to that the expressions we got from them in our usual go-around with bankers and bank directors that these high rates are having a cutting effect on the so-called middle market for business borrowers--the smaller firms--and for mortgage loans and some small farmers. That's where the incidence of the high interest rate effect has been felt thus far in our part of the country. But as a general matter, even if the businessmen present were mostly from big concerns, they simply indicated that the higher rates per se are not having any effect at all on their capital projects. If a project is worthwhile, it's not going to get cut off by a one or two percentage point increase in the cost of funds. A minority expressed the view that this is leading to some greater caution on inventory policy, which is already being viewed as quite cautious. One major real estate developer present indicated that the higher rates are just built into their projects and aren't having any dampening effect at all.

It was by the economists that we really got blasted. They came from Stanford, Berkeley, the University of California at Davis, and from a number of major banks in town. Quite frankly, they were highly critical of what they called pro-cyclical Fed policy and the extreme swings in the growth rates of money and credit that they've witnessed over the past year--the very low rate from, say, October to

March and the very high rate on balance from April to September. The clear majority view in that group--and the bank economists were quite similar to the academic economists--was that it's vital that we give more attention to that now than to what would be a more conventional counter-cyclical policy. My own view is that [we should make] an attempt at the gradualism that we announced several years ago. I remember your predecessor twice removed I guess, meaning Chairman Burns, [said] that the System's strategy would be to gradually lower the rate of monetary growth as a long-run strategy for getting inflation under control. What happened, I'm afraid, is that while the ranges have been brought down a little in the last several years, we've seen a great deal of evidence of the actual rates of monetary growth accelerating. I continue to feel, as I expressed last month, that we're going to get some automatic cushioning effect to this recession from fiscal policy, perhaps supplemented--there seems to be more and more talk about it [though I don't know] whether anything will happen or not--by discretionary tax cuts. So I lean toward the view that we may have to use monetary policy as the principal weapon to break inflationary expectations and to get some deceleration in the actual rate of inflation.

Our directors clearly voted to increase the discount rate to reinforce what they thought should be a further snugging up in our efforts to get the rate of growth in the aggregates down somewhat. Almost fortuitously we've had a counter-cyclical policy since spring. If in fact the first quarter proves to have been the peak of the previous cycle, then in the second and third quarters we've had a counter-cyclical policy of considerable magnitude given the rate of monetary expansion that has taken place. And perhaps it's a bit too much to also get on top of the inflation problem. Bottom line I come out pretty much as Phil Coldwell, Henry Wallich, and Bob Black did. I think we should lean toward a little higher funds rate and a little better control in linking our short-term targets with our long-term targets if there's to be any success on the inflation front. I think it was last April, Steve--at just about the wrong time--that I raised with you in front of God and everybody here the fact that you had been overforecasting the rate of monetary growth. You sure got that fixed! Correct me if I'm wrong--I don't have the exact figures with me--but I think month by month the Bluebook forecasts have in fact understated, and perhaps by a significant margin, the subsequent [monetary] growth we've experienced. I may again be raising that issue at the wrong time, but the recession will take care of that.

MR. PARTEE. It's a good leading indicator, John!

MR. BALLES. Until I see it, I guess I'm not going to believe it. I am concerned on balance that it may not have been bad that we had a real surge in monetary and credit expansion because of this recession. But I think we may have overdone that in view of the continued problem of getting inflation under control. So I would vote for a little snugging up.

CHAIRMAN VOLCKER. Mr. Rice.

MR. RICE. Mr. Chairman, probably not surprisingly, I would associate myself with the remarks made by Dave Eastburn, Nancy Teeters, Frank Morris, and Chuck Partee. I can therefore be very brief. I think it's time to give more weight to what is happening in the real economy. The economy is clearly weakening; the staff analysis is very clear on this. It's really very hard to see where the strength in the economy is that some people are worrying about. Most of the indicators seem to me to point toward weakness and further weakening in the economy. Retail sales in real terms have been declining since last May. Industrial production has turned down. GNP is projected to decline further after the current quarter, which is close to an end. It seems to me that, as Governor Wallich pointed out, we are faced with a problem of timing. And I would say that at this time it would be inappropriate to take any monetary action that would have the effect of further weakening an already weakening economy. In response to the concern about inflation, which I share, I would have to say that in my judgment any action that we might take today is unlikely to have any effect on the inflation rate within the next 6 to 9 months. So whatever tightening of policy might be adopted today would be largely symbolic. Also, I would note that even at the current federal funds rate--even with the current degree of tightness --the monetary aggregates, M1, M2, and M3, would probably fall within the long-run ranges of growth that have been set for the period from the fourth quarter of '78 to the fourth quarter of '79. Given the outlook, there's a strong prospect that the growth in the monetary aggregates will indeed decline. Therefore, in the current circumstances I would not favor any increase in the federal funds rate nor would I favor an increase in the discount rate. I would want to stand pat. I would not argue at this time for an easing of policy, but I would certainly argue that any further tightening would be a dangerous step to take.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. I guess we're going to have to rearrange the seating here a little; we're kind of [taking] sides and I'm out of place here in terms of my approach! I think we're dealing with expectations in a variety of ways, and when we [focus on] our cyclical analysis we forget the changes in price behavior that we're faced with. [Prices] are not going to behave in the traditional way in the future, but they're still one of the canker sores we have to deal with. With the publicity we've had recently [regarding] our behavior we have a real problem of expectations and a growing cynicism in the markets. The markets don't believe that the System has the resolve to cope with these problems; [they think] that we tend to shift our targets and keep our interest rates stable so that if we miss our target we just push it up and say we're going to catch up later on. They're getting rather pat in the way they view our activities. I feel that we need to change their expectations about us in terms of our behavior, as I argued last time.

Consequently, I'd be in favor of widening the federal funds rate spread and I'd let the rate behave on the basis of what actually happens marketwise. Secondly, I'd use this opportunity to change the discount rate because it doesn't really change market [rate] levels; it would change expectations because there isn't an immediate foreign exchange pressure that forces us into doing some of these things. We can use it to have an announcement effect without actually changing the level of rates marketwise, reinforcing a resolve to do things a little differently and, therefore, changing expectations. I'm not in favor of really hiking the rate level at this stage unless the aggregates do continue their rapid growth.

I'd point out to those who mentioned the decline in demand deposits that this represents part of the continual shifting and changing in the nature of the money concept, as people take advantage of opportunities to keep their funds at work with RPs and other things. Consequently, I am still concerned about our overshoot in this area. With all of our comments and people pointing to us as being concerned about this development, I'd like us to show by some action that we are concerned without necessarily changing the rates significantly. In terms of expectations, I have one that is different from those of the group: I'm not sure we're going to get a mild [recession] next spring. I think we're going to get an uptick this quarter. That is going to change expectations for the final quarter and we may get a stronger final quarter than projected. I think the basic forces of decline are with us. What I can't see is the bail-out after we get into a substantial decline. I don't see the forces there to provide the uplift. So I think it can degenerate into a somewhat larger decline than has been projected, with the fiscal implications and the consequent problems with respect to continued price inflation. And I'm worried on that score.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With respect to economic conditions in the Tenth District, we are enjoying--as others have said regarding the agricultural area--probably the finest crop in history. And it's a reality; most of it is already [harvested] or is ready to come into the bins. The problem has been more real in the sense that Bob Mayo mentioned; [producers] cannot move that crop, particularly to the port facilities for export, because of the shortage of rail cars as well as the Rock Island strike. It is putting some pressure upon the financial community to continue to finance inventories that had built up a year or two years before. But it also is fairly clear that some weakness is developing, particularly in retail sales--as affected by the auto situation--but also in residential sales. To my knowledge--and I have inquired around the region--I can find no area within our District where any speculative houses are being built at the moment. Everything is being built on contract. If there is no contract, there is no building.

Turning to my own view of the staff's expectations for the national economy, it seems to me that they are quite reasonable, though maybe a bit bullish. I would expect to have a bit deeper and more prolonged recession from the actions that have already been taken. Traditionally, when consumer expectations turn, they turn and don't come back very quickly.

With regard to growth in the aggregates, as has been mentioned, to be sure over the year [M1] looks very reasonable at about 5.3 percent without ATS. I believe that is the figure. But equally important, it seems to me, both last month and again this month we've been looking at accelerating rates of growth in the aggregates. If you focus on M1, the staff projection is almost 10 percent for September. But I would like to point out that most of that has already occurred in the first two weeks of September. And two events have taken place, both the Social Security payment as well as the anticipation of the September 15 tax payment date. From here on out the staff projections are essentially flat. It would seem to me that if the seasonals play any part in the first two weeks of

September--about which there seems to be some doubt--we may not be getting the aggregates growth now that we tried to react to in August.

Lastly, I would join with others who have said that we have moved very rapidly. So it seems to me time to pause now to see [the effects of] what we've done. We talk about the 13 percent not cutting, but it hasn't been in place very long. People either had been committed before and haven't backed off or they haven't made judgments as to whether they're going to continue to borrow in the future. I would say that in the financial area of the Tenth District, the 13 percent rate has already taken a toll; several correspondent bankers have told me that at a 13+ percent rate they are withdrawing from requests to finance additional cattle operations simply because the economics don't pan out. As a result we could quite likely see in the future a withdrawal of the inventory levels of cattle that would have been coming on stream in the period ahead.

In talking to staff and others and seeking advice, I would note that one person characterized the situation we're looking at right now as a situation akin to preparing a chicken for the table. That is, the chicken's activity increases substantially right after you cut off his head. If you react to that increased activity by striking with the ax again, that greatly increases the risk of damaging the meat. That may be exactly where we are now. So with that, I would propose that we stand pat at the moment with respect to the federal funds rate but use the discount rate for an announcement effect. As Willis pointed out, the discount rate has no real effect on market interest rate levels and the alignment issue is beginning to be a problem in our District. Thus, I would propose that the discount rate be raised at least 1/4 point, or perhaps 1/2 point.

CHAIRMAN VOLCKER. Well, I think we've had some barnyard reasoning! Mr. Roos, would you like to make a few comments?

MR. ROOS. First of all, being from the other end of the same rural state, I would have to disagree with Roger's analogy. When one prepares a chicken for serving, one usually has the best results if the dish is served up without any guts, whereas I think monetary policy--well, I'll stop at that.

I'd like to take up very briefly some of the things that have been said. First of all, I'd invite your attention to page 10 [of the Bluebook], the upper graph showing the growth of M1 during this year. [Some would] conclude that [policy has been appropriate] because the average of M1 for the year appears to fall between our targets. I would point out that the roller coaster effect that we've experienced is really very damaging to stability. If you remember your friend's button that I wore to one meeting--and was nearly fired as a result--I implied that that dip early in the year would result in recession. The dip occurred and we are experiencing a recession. I don't think the up and down movement is a good thing. I also am concerned--

CHAIRMAN VOLCKER. Are you projecting a boom now for the next 6 months, Mr. Roos?

MR. ROOS. Yes. I hear some of my friends say that we have moved interest rates up 100 basis points. I don't think we moved those rates; I think strong credit demand and inflationary expectations moved those rates up. If anything, we have leaned against what the [increase in rates] would have been had we not expanded the money supply. Furthermore, for those who feel that a further rise in interest rates would have the effect of lengthening and deepening the recession, I would point out that if--in order to maintain the fed funds rate at its present level--we permit [such] growth of the aggregates to continue, the public perception [will be one] of excessive aggregates growth. And I think the result will be interest rates that are even higher than they are now, in spite of our attempt to keep rates where they are or to stand pat.

Specifically, I think we have no choice but to do whatever we can to bring M1 growth back under control. I would urge two steps. One, our board was unanimous in its recommendation that the discount rate be moved up 1/2 point. [Second], whatever the range for M1, I think the upper limit of the M1 range for the period ahead should not exceed 5 percent exclusive of ATS or 6-1/2 percent with ATS. I think the best thing we have going for us is [the public's] belief--in reaction to the excellent statements by our Chairman--that we are determined to maintain monetary discipline. If we do anything that can be interpreted as a move toward ease, I think our last thread of credibility will be lost. And a very important new policy that has been enunciated by Chairman Volcker will be less than truly effective if we do that. So, that's my thinking.

CHAIRMAN VOLCKER. Have you any brief wisdom from the upper Midwest, Mr. Gainor?

MR. GAINOR. I will be brief, Mr. Chairman. We feel a bit behind the times in the Ninth District. We hear in the national press that the recession is half over and it hasn't even hit us yet. Unemployment is very low in our District, less than 3 percent, and labor markets are tight. Industrial production is strong. The only questionable areas have been tourism, which was affected earlier in the summer by the gasoline shortage, and [agriculture where] we have a problem with the transportation of grain, as was alluded to earlier.

With respect to the national perspective, we continue to be concerned about inflation and about the international position of the dollar. We believe the Committee should try to get the numbers under control while it's still politically feasible to do so. Our directors have recommended an increase in the discount rate change of 1/2 percentage point, which we suggested. And we would favor further limiting growth of the aggregates.

CHAIRMAN VOLCKER. Mr. Schultz.

MR. SCHULTZ. Well, I've only been on this [Committee] for six weeks and we're having a little barnyard humor, so I'll just say that unfortunately I feel like the little boy who dropped his bubble gum in the barnyard! It's a very difficult time to be here. I think we have a Hobson's choice. It seems to me that the likelihood is that the economy is going to weaken and we're going to get accused of overkill, overstaying [a restrictive policy]. The problem is, if we look at it on the other side, that's conjectural; the facts are that the aggregates continue to grow. And it's hard to find where monetary policy is biting very much. We see a little in real estate, and a few banks talk about their consumer credit [lending] at a fixed [interest] rate so they're beginning to slow down. But by and large it's hard to find very much bite any place. I call around the country and I don't find very many people screaming very hard. There just isn't very much pain out there. I'd love to believe these numbers but the problem is I don't know what inflation is doing to them. I don't know what people are really doing in response to that and what kind of variances we have. So I'm afraid I just have to go with what I can see and what I know to be the facts. And those are that the economy still looks pretty strong and the aggregates continue to rise.

So I come down on the side of some further tightening. I would go with an increase in the discount rate and some moderate tightening in the federal funds rate, though probably not very much. I would like to see the range widened to at least 100 points and at some point in time deal with the stimulative problem that President Eastburn talked about when we start coming out [of recession]. I'd like to see us go to an aggregates directive but now probably is not the time, with all the volatility. But my feeling is that we need to take another [tightening step].

CHAIRMAN VOLCKER. I have failed in one of my objectives, which was to get us out to the coffee break early. Perhaps reflecting my long experience in this particular chair, Mr. Schultz, the decisions don't get any easier from meeting to meeting. If we have a geometric progression, I'll really be in trouble at the next meeting!

Let me just make a couple of comments before we go out for coffee. There is a very strong possibility of recession on the one side. We've had that possibility for almost six months now and we still have the unemployment rate at a level that some consider to be the natural rate. I don't know whether it is or it isn't, but we had a lot of discussion earlier, which may be reflected in some of the comments about labor markets still being fairly tight. And, obviously, we have inflation as strong as ever. We have a difficult timing problem. Difficult or not we have a timing problem if the business outlook develops more or less as projected, in that we don't have a lot of flexibility--at least flexibility in a tightening direction--in terms of what we can do in the midst of a real downturn.

As I read the recent business news, which is always difficult, I feel a bit reassured by the most recent trends. There's a little more stability in retail sales in real terms and some decline in production. What we [believe] is happening in inventories is probably consistent with the type of outlook the staff has projected of a rather mild recession. I think the major risks are still on the lower side, but what we see now is not inconsistent with that kind of situation evolving. In looking at the business outlook, it does seem to me that the main problem lies in the area of income and consumption. I noticed on one of the [Greenbook] tables that you have indicated an effective tax rate and it shows [a rise that] in one sense looks rather gradual. But in an historical perspective I suspect there's a rather sharp increase in effective tax rates, which has been draining off income. And of course we have the higher oil prices draining off real income. That does seem to me to be the heart of the business problem we have.

We've had some questions raised about what monetary policy can do about inflation. I understand those questions, but there's the other question about what monetary policy can do about this particular conjuncture of adverse business developments--if they are adverse. The heart of the problem really lies in consumption and income. That suggests to me that perhaps the appropriate cyclical action when we get to it lies mainly in a tax policy rather than in the financial markets easing and the money supply growing. In terms of what we can do with monetary policy, we do have this question of what happens to wages in the short run. I don't think we have a situation that some of my friends in the Bundesbank think they deal with--that when the monetary authorities say something, the labor unions jump. I don't think that is quite the situation we face here! But we are in a rather crucial period in terms of how much the probably deteriorating inflationary expectations now get built into the wage structure. In a general way that has something to do with what we do. It's awfully hard to evaluate the significance of the gold price speculation, but I can't imagine that it's very good in terms of confidence in either inflation or the financial structure.

Exchange markets remain in a very tender position, even though--and this came out quite clearly at the meeting last weekend--the expectation is very strong that if we wait a while, and we have to wait some months, the current accounts are moving quite nicely [toward] what is called equilibrium. I don't know whether one can quite call it equilibrium if it's achieved at the expense of a recession. The German and Japanese current accounts are both deteriorating quite a lot, partly under the impact of oil. Ours has gotten better. We expect it to get quite a lot better by next year, although not in coming months. And I feel reasonably encouraged that growth is pretty strong abroad. There are worries there about the impact of the oil situation but that is not very visible yet. It does seem to have some momentum, at least in Japan and Germany, which I think is a favorable background. We don't yet clearly face a situation where the United States going into a recession tips the whole world into a recession. There are some areas of support there that I think are quite important.

Well, I don't know where that leaves us precisely. I share the view that has been widely expressed that this isn't the time for any easing, in the visible sense, of interest rates. I would hope that that's an ingredient of whatever we decide. I also share the view that has been quite widely expressed that we have to show some resistence to the growth in money. I would note that that remains a source of political support for us. It's not every day that we get a letter from the leader of the Black Caucus [in the House] exhorting us to show more restraint on the money supply side. So I'm going to carry that letter close to my heart, whatever we decide today. And [he was] speaking on behalf of the whole subcommittee, at least, of the House Committee on Banking and Currency--the Subcommittee on Domestic Monetary Policy. So, I do think that those two ingredients at least ought to be in whatever policy we decide here. With that, why don't we break briefly and come back and be prepared to decide what we will do.

[Coffee break]

CHAIRMAN VOLCKER. I don't think this gavel has ever been used before in these meetings. It's not very tight. Mr. Altmann, will you please take care of repairing the gavel?

Well, let me just try to get something on the table that seems to approach most closely a concensus in numerical terms and you can take whatever shots at it you would like. As I listened, among the voting members of the Committee at least, I think there was a majority desire--but clearly not unanimous--to make a little move on the federal funds rate. So I would propose 11-1/2 percent on that at this point. I am not particularly eager to make a major move now or in the foreseeable future, so I would suggest that we put a band around that of 11-1/4 to 11-3/4 percent, which ought to [result in a] reconsideration before a very major step on the funds rate. There is a desire by most people to constrain the aggregates and that may require going [with ranges] below any of these alternatives we have [in the Bluebook]. Consistent with the notion that we're not looking for any easing in the immediately foreseeable future, it may make some [sense] to broaden the M1 aggregate [range] on the down side. Let me suggest 3 to 8 percent for M1. And in the interest of symmetry, I think that means about 6 to 10 percent on M2.

MR. PARTEE. You shouldn't cut a point and a half off the top of M2 for that M1 change. M1 is about half the [M2] total.

CHAIRMAN VOLCKER. Are you saying that is consistent?

MR. PARTEE. No, it is not consistent.

MR. MAYO. 6-1/2 to 10-1/2.

MR. PARTEE. Yes, that might be pretty close.

CHAIRMAN VOLCKER. The current projection for M2 is what?

MR. ALTMANN. 9-1/2 percent.

CHAIRMAN VOLCKER. 9-1/2. All right, let me modify my suggestion for M2 to 6-1/2 to 10-1/2 percent. Who wants to shoot?

MR. KIMBREL. Please state them again, Mr. Chairman.

CHAIRMAN VOLCKER. For M2, with Mr. Partee's modification, 6-1/2 to 10-1/2 percent; 3 to 8 percent on M1; 11-1/4 to 11-3/4 percent on the funds rate, meaning we would go to 11-1/2 percent. And I would interpret this to mean that we wouldn't go above 11-1/2 percent unless the aggregates got to or above the upper ends of the ranges that we're talking about.

MR. WALLICH. This is a money market directive?

CHAIRMAN VOLCKER. I think that probably implies a money market directive but in a sense, if we give full weight to the projections we now have, we're starting out in the upper part of the ranges.

MS. TEETERS. We're above the range [for M1]. Isn't September projected at 10 percent?

CHAIRMAN VOLCKER. Well, I was talking about the two-month projection.

MS. TEETERS. What is the projection?

MR. AXILROD. 7 percent.

CHAIRMAN VOLCKER. It's 7 percent, so we're within the range but in the upper part of it. In effect by moving to 11-1/2 percent [on the funds rate], if we adopt this philosophy, we wouldn't move further unless growth actually got to or above the upper ends of these specified ranges. I'm just putting this on the table. Let's hear what comments you have.

MR. KIMBREL. I'm very much in tune with that, Mr. Chairman. That's almost my prescription.

CHAIRMAN VOLCKER. Larry Roos.

MR. ROOS. I believe our range last month for M1 was 4 to 8 and you would adjust it to 3 to 8 percent. The 8 percent bothers me, Mr. Chairman, because that 8--when we add 1-1/2 for ATS--means we really would tolerate a 9-1/2 percent growth in M1 if we let M1 go to the top of these specifications. That's a heck of a growth rate if we're trying to correct the overshoot that we probably already have. That's my only reaction. I repeat that I really don't think [we should have] anything over 6-1/2 percent as the upper limit; the upper limit is much more important than the lower limit under the present circumstances.

MR. COLDWELL. Except that the lower limit does keep us from moving [the funds rate] down.

MR. WALLICH. Well, we're already there if September comes in as expected at 10 percent; that is 5 percent for the two months. So it would take 6 percent [growth] to move up. That's not a great deal and yet it is a very high rate if, as Larry says, [we tolerate] 8 percent plus 1-1/2 for ATS. On the down side, the 3 percent, we'd have to get minus 4 percent for the second month, which strikes me as pretty extreme. It's a useful precaution but I would prefer to achieve the same objective by having a skewed [funds rate] range of 11-1/4 to 12 percent or so and go to 11-1/2 percent.

CHAIRMAN VOLCKER. You're assuming in these calculations that we know the second half of September, which we don't really know.

MR. AXILROD. May I say, Mr. Chairman, technically the ATS effects recently have been running only 1/2 percent, not 1-1/2 percent.

MR. BLACK. May I ask a question about the ATS effects? Is that for the whole year, Steve, or were you talking about recent months?

MR. AXILROD. I was referring to the recent months.

MS. TEETERS. I'm sorry, Henry, I didn't understand your recommendation.

MR. WALLICH. I think that 8 percent is high, and I think the 3 percent, while it accomplishes my purpose of avoiding a decline [in the funds rate] is almost unrealistic because it means, assuming September comes in as projected, that we have to have minus 4 percent [M1 growth] in October. And that doesn't seem very likely. So just in the interest of plausibility, I would prefer to modify this M1 range, but I don't feel strongly. If that's the best way of qualifying the funds rate movements, it can be done that way.

CHAIRMAN VOLCKER. As I observe these figures from week to week, there is nothing one can assume about the last two weeks of September.

MR. COLDWELL. Well, Mr. Chairman, I have just a slight reservation on this on the 8 percent side. I guess I'd rather have 11-1/4 to 12 percent [on the funds] range, using 11-1/2 as the "midpoint" but also using 11-3/4 as a possibility if those [aggregates] start moving up strongly toward the top of the range. I'm a little bothered about just nailing the rate at 11-1/2 percent and saying that's what it's going to be and we're going to reassemble if anything happens on either side of it. If that's the way we're going to work the game, then why don't we just say it?

CHAIRMAN VOLCKER. Well, I'm not quite saying that. If the aggregates were strong enough, I think we could use this whole range here.

MR. COLDWELL. If the aggregates were strong enough? You would say that [M1 growth] would have to get up to the full 8 percent in order to move even to the 11-3/4 percent?

CHAIRMAN VOLCKER. Well, we're not so far from that on the current projection. It's just a matter of judgment. At this particular phase in the business cycle, should we be moving more than that without at least having a telephone call? I don't think there is any question about that.

MR. COLDWELL. I have no objections to having a telephone call. I'm a little bothered about saying that [M1 growth] has to be at 8 percent [before we confer] because I think 8 is too high. If it means that we've got to go up to 11-3/4 percent, then I'd rather take the decision now that we're going to go to 11-3/4 percent if [M1 growth] is up in that area.

MR. BLACK. Phil, what would your preference be on ranges?

MR. COLDWELL. If I had a preference straight out, the range would be 3 to 7 percent, but I'm persuaded that with the present projection 8 percent growth is a possibility. All I'm saying is that I'd much prefer to make sure that we do use some of the [funds] range if we're approaching that [upper limit]. I just think 8 is too high. If it got up in the 7 percent range, I'd like to see us nibbling toward usage [of the upper part of the funds range].

MR. TIMLEN. If I had my preference, I'd have the same ranges suggested by the two governors: [a funds range] of 11-1/4 to 12 percent with an M1 range of 3 to 7 perent--I think the 8 percent looks very high--and an M2 range of 5-1/2 to 9-1/2 percent. I don't feel that this is strongly different from the numbers you put down. And I agree with Phil that if the numbers are coming in pretty high, I would [want to] feel that we could go to 11-3/4 percent and not be blocked by the 11-1/2 percent.

MR. COLDWELL. I wouldn't mind the 11-3/4 percent top on it, Tom, if we were going to use that top as [M1 growth] moved up toward the 8 percent. But I wouldn't require it to get to 8 percent before we use [the top of the funds range].

MR. BLACK. Use an aggregates directive and it becomes much more acceptable to me with those ranges.

MR. PARTEE. If I had my preference, I would put 9 percent as the top because I think we will have a large [number in] September. [M1 growth] will be probably on the order of 10 percent; it could be 12 or it could be 8 or something like that. Why, when October [M1 growth] is moving down, would we raise the funds rate? There's an inconsistency about the whole thing. Also, I might point out that a 9 percent increase in money with the rate of inflation that we have and cannot stop--it will be there in fuel and in food prices over this period--is not a terribly high increase in the money supply.

MS. TEETERS. Mr. Chairman, I think setting this 11-1/4 to 12 percent [funds range] and a 7 percent top on [the M1 range] just automatically assures that we're going to start raising the interest rates again.

CHAIRMAN VOLCKER. That's not what I proposed.

MS. TEETERS. I would go with 3 percent [as the lower limit] and I would put 9 percent [as the top]. I think your proposal is being pretty [forceful] in putting it so low. I have noticed that the aggregates only work on the up side. During the long period of time the money supply was declining, we ignored the bottom level of [the M1 range] for six solid months--for [apparently] good reasons. I didn't think it was the right thing to do at that time. But we only seem to get excited when M1 growth goes over the top of its range rather than when it goes to the floor.

CHAIRMAN VOLCKER. We have had a little more experience going over the top.

MS. TEETERS. Not in my--

MR. WALLICH. Like disorder in the exchange market, it only occurs on the down side.

CHAIRMAN VOLCKER. Bob Mayo.

MR. MAYO. I didn't elaborate on my own position earlier but I find I am much more comfortable with Alternative B as presented [in the Bluebook]. I would not object to going to the 11-1/2 percent midpoint with the 11-1/4 to 11-3/4 percent range. I don't think I would widen the range right now though, to 11 to 12 percent, say. I don't find the 9 percent [for the M1 range] too high either; I think 5 to 9 and 7-1/2 to 11-1/2 are all right. Once I decide that I want the midpoint [of the funds range] at 11-1/2 percent, I think [the question] is about the tightening that I want to see done. And, like Mr. Guffey and Mr. Winn, I would rely on a little psychology here and move up the discount rate a half percentage point and have that be our announcement effect rather than have any tightening other than what I might say is more of an accommodation to the market. If the market tightens, I wouldn't have any problem going to 11-1/2 percent but I wouldn't do any more than that. I think we have to keep the pressure on; I don't want to see any sign of easing whatsoever. And I think we can do it with that prescription.

CHAIRMAN VOLCKER. John Balles.

MR. BALLES. Well, I guess I could live with the ranges that you proposed, Mr. Chairman, if we had an aggregates directive. When I keep in mind that part of the proposal was a money market directive that does bother me. [I say that] simply in the sense that at some point if we have any intent at all of coming within even the upper end of the ranges we've specified--and I think we've got to do that if we're going to make any progress gradually on inflation--we're going to have to do something to keep from moving farther and farther away from both the midpoints and the upper end. So I'd like to throw out the possibility, while we're still in the discussion phase here, of an aggregates directive to accompany these ranges that we've talked about. On the federal funds rate specifically, I would join those who think we ought to set the range a little higher, at 11-1/4 to 12 percent.

CHAIRMAN VOLCKER. Now, that's a real difference. I'm not sure the other difference as stated is particularly significant as I read it. If we're starting off at 11-1/2 with a 7 percent current projection, we haven't got much room anyway whether we have an aggregates or a money market directive. I suspect they're the same on the up side; they might be different on the down side. Because we haven't got any room in there anyway, you've in effect taken the move.

MR. BLACK. I think, Mr. Chairman, we could move [the funds rate] to 11-1/2 percent and then wait a week and take another look at the projections. Chuck mentioned a while ago that October is going to come in very low but I'm not at all sure that is true. I know that's what the projections say. So, that's what I would do.

CHAIRMAN VOLCKER. Well, if that's the case, we'd have to move up under either [form of the directive].

MR. BLACK. Well, if we move it to 11-1/2 percent, I think we've done it for the time being and we can wait until the projections come in and move further. I would align myself exactly with John on his specifications, with an aggregates directive. I have the same problem with a money market directive. That takes us further off target than we now are.

CHAIRMAN VOLCKER. I think we're in the area of religion rather than substance.

MR. BLACK. Well, I don't think it's that, Mr. Chairman. I think it's a question of how serious we are about the aggregates. And as I guess everybody knows, I'm right serious about them.

MR. MAYO. Well, I am too, Bob, but I have trouble paying too much attention to the two-month figures.

MR. BLACK. I do too, Bob, but we have had year after year of excessive growth and at some point we have to act in the short run if the long run is going to come out right. And I don't think we have, though recently we've done pretty well.

MR. MAYO. That's what I'm arguing for, Bob. I think we've got a position in place now where we have the pressure on. Sure, we ought to be ready to reverse but I think we ought to be very careful not to tighten unnecessarily more than the 1/8 point we're talking about.

MR. BLACK. I hope you're right, Bob, because I don't want to see interest rates go up. But I'm afraid they'll have to if we're to avoid [even] higher rates, a more serious recession, and more unemployment further down the road.

CHAIRMAN VOLCKER. Who else would like to get into this?

MR. GUFFEY. Mr. Chairman, I'd like to join Bob Mayo with respect to the "B" ranges and standing pat at the moment. I would like to suggest--this is not a substantive issue--that if we have an aggregates directive with a 9 percent top [on the M1 range] that's really about the same thing as if we have a money market directive with the ranges that you have already suggested. Either one of those is acceptable to me.

MR. COLDWELL. I think there's a possibility, Mr. Chairman, of some compromise here. To take off on Bob Black's suggestion--

CHAIRMAN VOLCKER. Well, let's hear from the others first. Governor Wallich, you didn't give ranges, or at least Mr. Altmann didn't record them.

MR. WALLICH. I would go with 3 to 8 and 6-1/2 or 6 to 10; that would be my preference.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. I would go with Alternative B.

MR. WALLICH. I should have added that I would prefer a money market directive because of the sensitivity of any interest rate movement now.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, first I think the Board should approve the half percentage point increase in the discount rate for those Reserve Banks that have in a request for that. Secondly, along with those who would like to see more emphasis on the aggregates, I think it would be desirable to go to an aggregates directive. In terms of the ranges, I could accept either those you have specified or those in Alternative C. Yours are a little more restrictive than those in "C," but with an aggregates directive hitched to Alternative C they would not be greatly different. And along the lines of Willis Winn's suggestion--and also consistent with the argument for more attention to the aggregates instead of a very narrow funds range--I would allow a little more [flexibility] on the funds rate with a range such as 11-1/4 to 12-1/4 percent.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. I would support Alternative B, but I do think the arguments for a discount rate increase are good and I'd be prepared to recommend that.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I would certainly subscribe to your recommendation, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. I'd just spread the [range on the funds] rate, Mr. Chairman, but I wouldn't quarrel too much [with your proposal]. I'd go with 11 to 12 percent and an aggregates directive.

CHAIRMAN VOLCKER. Mr. Gainor.

MR. GAINOR. We prefer an aggregates directive, Mr. Chairman, and we could go with the ranges you prescribed.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. I'm happy. At some point in time I'd like to see us go with a wider [federal funds] range and the aggregates directive but right now, considering the volatility problem, I'd be happy with your proposal.

CHAIRMAN VOLCKER. Well, there's no question that on the aggregates 3 to 8 percent is the [best compromise for M1]. It hits both the majority and the midpoint of all the concerns; there are some higher and some lower, but there is a majority for that. It's the same for M2 at 6-1/2 to 10-1/2 percent. The difference of opinion lies more on where to put the upper point of the [funds range]. There was some dissent perhaps, but the great majority wanted to or are willing to go to 11-1/2 percent now. There is some difference of opinion on the upper point of the range; there is one who disagreed on the lower end of the range. I count 5 who would like to go higher on the upper end. And there is obviously a disagreement on the [selection of an] aggregates or money market directive.

I would just make two comments, both of which have already been made. One is [that it's hard to] go much lower on the aggregates ranges if we've got two high weeks in September already. Even if the rest of September comes out on the low side, it's got to get pretty damn low. And if we go down very far on that aggregate, we would be raising rates. There's quite clearly a possibility of raising rates in the midst of a pronounced decline in the growth of the aggregates from week to week. I question whether we want to do that.

The other comment is on the aggregates against the money market directive. There may be a difference; I find it hard to see what the difference is on the up side. I see some difference on the down side. With an aggregates directive we might [move the funds rate] down more rapidly and sharply if the [aggregates] came in weak. But if we had 8 percent on the up side and we're at 7 percent to start with, then the difference [of opinion] may be, if it stays at 7 percent, [whether] we go up still further. I think that is the only substantive difference and it is a substantive difference. I guess I contemplated in my proposal that 11-1/2 percent is in fact above the midpoint, so we would already have gone above the midpoint and we would not move any further if the projection remained unchanged. It would take a further increase in the aggregates projection to raise the federal funds rate all other things equal, including the exchange market and everything else that might influence what we do. That's what the argument is about, as I see it, apart from the difference on the down side. Do you want to go above the 11-1/2 without the current aggregates projection for the two-month period changing? If it went up as much as a percentage point, we might go up under either formulation [of the directive]. If it stayed the same, on my original formulation we presumably wouldn't move. If the people who favor an aggregates directive mean that we should move under that circumstance, you ought to say so. I think that's what they would be voting for. I don't think this difference is enormous.

MR. STERNLIGHT. We'd also appreciate some guidance as to the Committee's feeling if [the projection] went up something less than that full percentage point. I know these are fine lines to draw, but we have to make those decisions.

CHAIRMAN VOLCKER. It's a very fine line as far as I'm concerned.

MS. TEETERS. Well, with the lower limit of 3 percent we wouldn't move. The possibility of coming in at 3 percent is just about zero, as far as I can see.

MR. PARTEE. It's not zero, but it's very low.

MS. TEETERS. It's probably a negative probability! [Laughter] You've got this stacked in one direction.

CHAIRMAN VOLCKER. Well, does it make a big difference, Nancy, whether we make it 3 to 8 or 4 to 8?

MS. TEETERS. Not much.

MR. PARTEE. Not much.

CHAIRMAN VOLCKER. I don't think it does. A range of 3 to 8 says we really don't want to move [the funds rate] down unless something important happens. Well, let's leave the money market/aggregates issue open for the moment. I guess I'm left thinking--I'm reluctant to say this because it's what I said before--that the nearest thing to a consensus is 3 to 8 percent for M1, 6-1/2 to 10-1/2 percent for M2, go to 11-1/2 percent now on the funds rate and make the range 11-1/4 to 11-3/4 percent. Any discussion? I don't know whether these are all absolute preferences, but there seems to be a majority for that. The major difference among those three specifications is whether [the funds rate range] should be 12 percent on the upper side.

MR. WALLICH. I could live with that. We would have a conversation if [M1 growth] strikes at the up side and go to 11-3/4 percent. We'd have a second conversation to go beyond that.

CHAIRMAN VOLCKER. My basic feeling is that I think we ought to have a conversation at this stage of the game if we want to put the funds rate up that high. We shouldn't just put it on automatic pilot at this point.

MR. COLDWELL. Even to 11-3/4 percent?

CHAIRMAN VOLCKER. I could think of a marginal circumstance in which we might want to have a conversation but I could think of nonmarginal circumstances where if that is the directive, we would go ahead. I think you'll just have to leave that up to me. That kind of decision also depends some on the economic news we get and to some extent certainly [on developments in] the foreign exchange market--the typical reservations we always put on these things. Maybe we ought to have a renewed expression of views; not everybody expressed themselves. Let's assume those were the specifications. How many of the voting members would want an aggregates directive? 1, 2, 3, 4, 5. How many would want a money market directive? We'll see how many don't vote! 1, 2, 3, 4, 5. There is somebody besides myself who didn't vote.

MR. RICE. Me. I didn't vote.

CHAIRMAN VOLCKER. You don't like either one.

MR. RICE. That's right. Well, I would prefer a money market directive.

CHAIRMAN VOLCKER. But the whole thing is [beyond] your pale. I would feel somewhat more comfortable with the money market [formulation] under existing conditions. I think we are very much probing the outer limits of what we should do at the moment in terms of the basic economic situation. So I guess we'll just put the vote that way: 3 to 8 percent, 6-1/2 to 10-1/2 percent, 11-1/4 to 11-3/4 with an 11-1/2 percent midpoint, and a money market directive.

MR. MAYO. A very technical point Paul: 6-1/2 to 10-1/2 percent is a smaller range for M2 than we have for M1. Does that make sense? Should it be 5-1/2 to 10-1/2 percent? It's the least important [number] we're talking about.

CHAIRMAN VOLCKER. I don't have a strong opinion on that one. Does anybody else want to comment?

MR. MAYO. Or at least have the same [width] range.

CHAIRMAN VOLCKER. I would judge that we may already have stretched some people's tolerance in making the M1 range 3 to 8 percent, Bob. So maybe we ought to leave it at that.

MR. MAYO. It's a question of consistency.

MR. PARTEE. I'm concerned about that M2 number because I do believe we're getting considerable shifts [of funds] from the S&Ls to the commercial banks. But that, of course, would tend to result in a higher number rather than a lower one. It wouldn't go the other way unless market rates were quite a bit lower, which isn't in prospect.

MR. MAYO. It just seems, if we're going to have a 5-point range on M1, that we should have no less than a 5-point range on M2.

CHAIRMAN VOLCKER. Is there a strong preference for the 5-point range?

MR. BLACK. Just to show my flexibility, Mr. Chairman, I'll say that I would go along with that.

CHAIRMAN VOLCKER. Let's just have a quick expression of preference on that. Do most people want to join Mr. Mayo on making this amendment?

MR. BALLES. I'm sorry, would you repeat the numbers?

MR. MAYO. I'm suggesting 5-1/2 instead of 6-1/2 percent on the lower end of the M2 range.

MR. WALLICH. Just as a general principle.

CHAIRMAN VOLCKER. I don't notice any upswelling of support.

MR. MAYO. I don't either, but I don't [hear] any objection.

CHAIRMAN VOLCKER. I wouldn't have any great objection myself but let's stick with where we were. I guess we are ready for the vote.

MR. ALTMANN.

Chairman Volcker	Yes
President Balles	No
President Black	No
Governor Coldwell	No
President Kimbrel	Yes
President Mayo	Yes
Governor Partee	Yes
Governor Rice	No
Governor Schultz	Yes
Governor Teeters	Yes
First Vice President Timlen	Yes
Governor Wallich	Yes

The vote is 8 for, 4 against.

CHAIRMAN VOLCKER. We have one other item on the agenda, as I recall. We can cover it quickly, I think. You have a memo, which I assume you have all read, which concludes that we should continue the practice of lending securities to government security dealers in case they need them to make up for failures. We would charge them roughly three times as much as the market rate.

MR. STERNLIGHT. Well, it's either double or three times.

CHAIRMAN VOLCKER. Charging three times the market rate is a practice we have been following for some years, and I take it we review that practice periodically.

MR. STERNLIGHT. It has been on about a 6-month review.

CHAIRMAN VOLCKER. Are there any questions of Mr. Sternlight or Mr. Peterson?

MR. PARTEE. A very well argued brief there!

MR. MAYO. Splendid.

MR. WINN. Paul, marketwise, is there any way we could make this shift [in the funds rate] today rather than tomorrow, to throw the markets a little off balance in their shooting duck attitude toward us?

MR. STERNLIGHT. Well, the way the funds market has gone this week, the funds rate has been averaging, through yesterday, 11.39 percent. But actually, the funds rate on the day yesterday was about 11-1/2 percent and today it was starting out on the firm side. We went in early because the funds rate had moved to 11-5/8 percent, so we were trying to hold down the funds rate at--

CHAIRMAN VOLCKER. Sounds like an easy transition. I take it there is no objection to the lending of securities. The meeting is adjourned, and it's one minute before one o'clock.

END OF MEETING