TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

July 9, 1980

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. Meek, Monetary Advisor, Federal Reserve Bank of New York
Mr. Kichline, Associate Economist
Mr. Zeisel, Associate Economist
Mr. Axilrod, Economist

Meeting of the Federal Open Market Committee

July 9, 1980

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 Wednesday, July 9, 1980, at 9:15 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Gramley
Mr. Morris
Mr. Partee
Mr. Rice
Mr. Roos
Mr. Schultz
Mr. Solomon
Mrs. Teeters
Mr. Wallich
Mr. Winn

Messrs. Balles, Baughman, Eastburn, and Mayo, Alternate Members of the Federal Open Market Committee

Mr. Black, President of the Federal Reserve Bank of Richmond

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

Messrs. Balbach, J. Davis, T. Davis, Keir, Kichline, Truman, and Zeisel, Associate Economists

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Prell, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Siegman, Associate Director, Division of International Finance, Board of Governors
Mr. Beck, Senior Economist, Banking Section, Division of Research and Statistics, Board of Governors
Mrs. Steele, Economist, Open Market Secretariat, Board of Governors
Mrs. Scanlon, Economist, Division of Research and Statistics, Board of Governors 1/
Mrs. Deck, Staff Assistant, Open Market Secretariat, Board of Governors

Messrs. Czerwinski, Forrestal, Gainor, and Monhollon, First Vice Presidents, Federal Reserve Banks of Kansas City, Atlanta, Minneapolis, and Richmond, respectively

Messrs. Brandt, Burns, Corrigan, Danforth, Fousek, Keran, Parthemos, and Scheld, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Dallas, New York, Minneapolis, New York, San Francisco, Richmond, and Chicago, respectively

Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York

Messrs. McNees, Mullineaux, and Ms. Nichols, Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, and Chicago, respectively

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

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1/ Entered the meeting following the ratification of System open market transactions in Government securities, agency obligations and bankers acceptances.

Transcript of Federal Open Market Committee Meeting of
July 9, 1980

CHAIRMAN VOLCKER. We may have a long day ahead of us. If we don't use it all up with the Open Market Committee meeting, we'll use it up [discussing] monetary reform legislation. With that in mind, we will have lunch around the table in a convivial atmosphere. I am told that people worry about food and drinks being spilled on the rug. We'll see whether we can have lunch in the august Board of Governors meeting room without spilling anything on the rug; if we do spill, we won't be able to have lunch around the table again.

MR. SCHULTZ. Either that or the Governors can't have [a rug]; it's one of the two.

CHAIRMAN VOLCKER. I'd like to welcome Governor Gramley officially to this august body in a new guise. He is completely unfamiliar with the table; I believe we literally have a new table since you were last here. So we welcome you to the table literally and figuratively.

MR. GRAMLEY. Thank you very much.

CHAIRMAN VOLCKER. We have several First Vice Presidents with us today because of the absence--for various reasons--of some of the Presidents, and we welcome you. I don't think we have anything else of that order of business, Mr. Altmann. We need to approve the minutes then.

MR. SCHULTZ. So moved.

CHAIRMAN VOLCKER. Did I hear a second? Without objection the minutes are approved.

MR. SCHULTZ. That's the same problem I have in the Board meetings!

CHAIRMAN VOLCKER. Mr. Pardee.

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

VICE CHAIRMAN SOLOMON. Mr. Chairman, I think it's worth emphasizing one point, which is that the reluctance of the Bundesbank to intervene directly in support of the dollar on as large a scale in the last few days--which means depressing the D-mark--is [related to] the fact that they are at the bottom of the EMS. So there is this contradiction and dilemma for them. Basically, cooperation with them on intervention had been very good, But they have this dilemma, and they are very, very aware of it.

MR. WALLICH. They also seem to take the attitude that if we are going to allow the funds rate to move sharply in response to reserve-based techniques, they logically should let the dollar rate respond more. I don't think we should accept that argument. One could argue just the other way: That precisely because it is necessary for us to tolerate wider fluctuations in the funds rate, we want to make a greater effort to avoid repercussions on the dollar rate. We have to try to persuade them of that; they don't accept that now.

MS. TEETERS. In November of 1978 we put together a $28 billion emergency package. Is that still in existence?

VICE CHAIRMAN SOLOMON. No, we didn't have $28 billion, Nancy. We would have had $30 billion, but that included $10 billion of Carter notes. Of the $10 billion of Carter notes, we actually ended up selling--I don't remember the exact figure.

MR. PARDEE. About $6.5 billion.

VICE CHAIRMAN SOLOMON(?). We still have [our holdings of] Swiss francs pretty much intact; but Treasury balances of Deutschemarks, where the pressure is, are [nearly] depleted. They have ended up, in a sense, more in a hole than we are. If you compare our swap drawing with their using up the balances--they owe that money for a longer term--they're in the hole by about $3 or $4 billion.

CHAIRMAN VOLCKER. When are those first Carter bonds due?

MR. TRUMAN. Not until September of next year.

CHAIRMAN VOLCKER. That's a little more than a year away.

MR. PARTEE. Well, we must have most of the $20 billion.

MS. TEETERS. How much did we have and how much do we have left?

MR. PARDEE. We have about $2 billion left.

MR. TRUMAN. Yes.

CHAIRMAN VOLCKER. That $30 billion was theoretical in the first place.

MS. TEETERS. What did we actually have out of the $30 billion?

MR. TRUMAN. Treasury balances are $2+ billion in marks, not including their swap balances, and $1.2 billion in Swiss francs.

CHAIRMAN VOLCKER. What do we have left in the swaps now?

MR. TRUMAN. In the swaps? They've only used about $1 billion, so we have about $6 billion left.

CHAIRMAN VOLCKER. One billion out of how much that we have in Germany?

MR. PARDEE. We've used $1.1 billion.

CHAIRMAN VOLCKER. And what's the limit with Germany now, $6 billion?

MR. PARDEE. Six billion.

VICE CHAIRMAN SOLOMON. No, it's $9 billion.

MR. PARDEE. The swap line is $6 billion.

CHAIRMAN VOLCKER. It's $6 billion, and the Treasury has $1 billion.

MR. PARDEE. The Treasury considers itself short right now under the Carter notes by over $3-1/2 billion, [so] we are in a hole.

MS. TEETERS. I don't think I got an answer to my question.

MR. PARDEE. The answer to your question is that we can get more resources at some stage if the Treasury wants to go back and negotiate a new Carter note.

MS. TEETERS. All right, but that doesn't tell me how much--

MR. PARDEE. The man who negotiated the last Carter notes is sitting next to you. He's not at the Treasury now.

MS. TEETERS. How much did we actually draw in November of [1978]?

MR. TRUMAN. Governor Teeters, of the $30 billion, we have $20 billion worth of resources [in] notes [and] currencies now available. And there's a net plus, in some sense, in the unused portion of the $10 billion Carter notes, which in round numbers is $4 billion. That's the answer, I think, to the question you asked.

MS. TEETERS. Okay, thank you.

MR. SCHULTZ. How much of the Carter notes come due a year from September?

MR. TRUMAN. A year from September only one comes due and there's another one [due] in December. I think the total amount is about $1.5 billion.

VICE CHAIRMAN SOLOMON. Yes, but then they start coming due about every 6 months for about 2 more years, Fred, because I originally put them out with 3- and 4-year maturities. Then we had scheduled them at 3-1/2, 4-1/2 and 2-1/2 and 3-1/2. So a whole series is coming due. The question of availability depends on how we look at our debt. Looking at it very short term and ignoring the fact that we owe this money and are going to have to get it somewhere else later on, we still basically have sufficient resources. We have quite a few billion dollars, although in previous periods when the dollar came under heavy pressure we spent as much as $5 billion a month [in intervention]. This problem is getting more and more serious, and I think in our considerations of domestic policy we probably have to be a little more sensitive to it than we have been in the last few months.

MR. WALLICH. Even if we are able to repay, which I hope we will be, we won't really be getting out of debt. We'd be substituting dollar debt for D-mark debt, which is an advantage. But that's really the best way to look [at it] until our current account improves.

CHAIRMAN VOLCKER. Our current account, of course, looks relatively good compared to other countries' current accounts. In round numbers, the deficits are $12 to $15 billion in Germany, $15 billion or more in Japan, and $5 billion in France. There's a small deficit in the United Kingdom, despite their oil, whereas our projections are for close to balance this year and a surplus next year. Some people [expect] a surplus this year. If one just looks at current accounts, we don't look too bad; in fact, we look very good. But people obviously are looking at other things, too. Of course, it's affected by the recession.

MR. WALLICH. What about recession?

CHAIRMAN VOLCKER. I think a major question is whether or when we can expect some interest rate declines in the rest of the world. [Foreign officials] are a little ambivalent about it. They're in the same position we are. They want to maintain this psychological posture of getting on top of inflation and not appearing to yield to it. And they haven't had much improvement on the inflation front, although in some countries they've had a little. On the other hand, they're becoming a little worried about a business slowdown and perhaps a world recession and [there is] some sentiment that easing might be a good idea. But nobody wants to be first. Nobody wants to show the white flag on the inflation front. So they're quite ambivalent.

VICE CHAIRMAN SOLOMON. But [I'd point out] one thing. I assume the members of this group are aware that there is one quasi-phony component in our current account calculation. We are figuring in for 1980 $40 billion of services income from abroad. In practice, we are only going to get about half of that because we are counting as services income for the United States all profits earned abroad by American companies, even if those profits are reinvested abroad. Therefore, in terms of what crosses the exchanges, we still need about $20 billion of capital income to validate a so-called equilibrium current account. I think I've made my point clear. If I haven't--

MR. PARTEE. Is this unique to us?

VICE CHAIRMAN SOLOMON. Yes.

MR. PARTEE. Other countries don't do it?

CHAIRMAN VOLCKER. No, the other countries don't do it.

MR. WALLICH. No, they don't do it.

CHAIRMAN VOLCKER. We changed a few years ago, presumably to get on the same basis as other countries. But we have so much more foreign investment. It's much bigger for us than for anybody else.

MR. TRUMAN. I think President Solomon overstated the figures somewhat. If you correct for both sides, as both the inflows and the outflows are counted on that basis, the difference is about $15 billion.

VICE CHAIRMAN SOLOMON. It's $15 billion, not $20 billion this year?

MR. TRUMAN. Yes. Last year, in fact, the adjustment on the reinvested earnings was $14.5 billion or something like that.

MR. WINN. When we look at gold market developments and some of these flows, I wonder if we're not being a little oblivious to the fact that it's not all economic considerations that are causing them, with the Saudi situation now surfacing. In terms of the news, it's a potential Iran. We hear rumblings out of places like Nigeria and South Africa that we may get big money market flows, which have nothing to do with interest rate differentials or the economic outlook or anything of [that nature], although I don't know how to put a number on it.

CHAIRMAN VOLCKER. I think that's right. Common wisdom in the market, however, is that the [noneconomic factors] on balance probably have helped us a little so far. There is some political instability in Europe particularly, but not with so much [unintelligible].

MR. WINN. On the other hand, with our freezing of the Iranian [assets], if you were a Saudi trying to maneuver would [the United States] be where you'd want to put [funds]? I don't know.

MR. SCHULTZ. There is some indication that SAMA is now making direct investments in this country in bits and pieces of $50 to $100 million. We first heard about it from the Texas bankers. It began 5 to 6 months ago and seems to be continuing.

VICE CHAIRMAN SOLOMON. We've had some substantial increases in SAMA purchases of Treasury obligations. But I don't think we are getting the same percentage of their investable surplus.

CHAIRMAN VOLCKER. No, the real difference this year is these other countries with current account deficits. Even the Swiss, the Germans, and the Japanese have advertised the availability of their government securities to the Saudis in particular, which they never did before; and they are selling them. The French also are selling a fair amount of securities to the Saudis. I don't know [whether they are selling] to other people too, though they probably are, but they are selling to the Saudis and they didn't do that before. The Saudis had great difficulty getting investment outlets. Now they have more open to them.

MR. WALLICH. In a sense, every country with a good currency can expect some inflow--in fact, a very large inflow in the aggregate --from these sources. The Germans, the Swiss, the French, and the Japanese probably all benefit from this to an extent that they don't seem to want to admit. So they've generated concern about their deficits that I think is needless. They can count on some financing automatically. They don't have to go out and borrow the money.

MR. BAUGHMAN. Is it considered a political no-no to sell gold in the current environment?

CHAIRMAN VOLCKER. Oh, I don't think so, necessarily. I don't think it's a political problem in the sense that you may be suggesting. It's a question of whether it's very useful or desirable at this stage. [If we sold gold], we'd have to do it alone; I think that's pretty clear. It isn't anything that's ruled out a priori, but it's a practical matter of whether it's a good idea.

MR. BAUGHMAN. Well, it's between selling assets and borrowing money. That seems to me the significant difference.

VICE CHAIRMAN SOLOMON. The psychology, Ernie, is that [selling gold] seems to be much more effective if it's a component of an overall package of forceful measures than if it is done by itself. In the present climate it would look like a major act of weakness. And that might spur some additional dollar selling unless we did it on an enormously massive scale, not just the levels that we have before. On the other hand, if the situation gets to a point where once again we have to begin thinking carefully of a package, then along with some monetary policy measures it would be appropriate and add to the effectiveness--this is my own personal feeling--to do some substantial gold selling. And in that situation I think the Congress would understand that. We'd have less of a political problem also. So I think both factors operate.

CHAIRMAN VOLCKER. I should say, in connection with the political problem, that I don't think there are any great political constraints so far as the thinking in the Administration is concerned. There are politicians who would make a noise that would reflect upon the credibility of the action. If we sell some gold and then immediately get some congressional opposition, the market would say: "Well, they're not going to sell very much because there's too much opposition." And, therefore, it might not be very productive in terms of the impact we'd want to achieve.

MR. BAUGHMAN. There would be some grass roots opposition to it. I can report that, but I don't have any impression--

CHAIRMAN VOLCKER. Perhaps I spoke a little misleadingly because that kind of opposition, I think, does reflect on the credibility of the action. It raises questions about whether it could be sustained and what the [total] amount would be and whether it's really an accepted technique or not, even though in some sense I think it's not a political deal for the Administration except in terms of appraising that reaction. I can't quite see the Congress opposing it in a formal sense but there would be a lot of noise by these limited groups.

We have to ratify these transactions.

MR. SCHULTZ. So moved.

CHAIRMAN VOLCKER. Without objection, they are ratified. Do you have any recommendations, Mr. Pardee?

MR. PARDEE. I'd simply note that first maturities of six swap drawings on the Bundesbank in the amount of $190 million will be coming up over the period before the next FOMC [meeting]. I expect to roll those over, renew them, if we do not have a significant reflow in marks that would enable us to repay them.

CHAIRMAN VOLCKER. We presumably will renew those as necessary--if necessary. Hope springs eternal. Mr. Meek.

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

CHAIRMAN VOLCKER. Let me interrupt you just a second for a clarification. It may be that I was up too many hours yesterday, but did I read the Bluebook wrong? On the first or second page, where the paths were shown, I thought it said we are marginally above the minimum targeted growth. If I look at the figures, it looks as if we are marginally below. Then there was a footnote on page 3 that said we changed the target [for total reserves] and made it a little higher; but it said the original target was $43,377 million and the subsequent target was $43,293 million, which is lower.

MR. SCHULTZ. It's supposed to be the other way around. Steve gave an actual yesterday, if that still stands. The figures are transposed, aren't they, Steve?

MR. AXILROD. Well, no. The figures actually got changed at the last minute, so the marginally above was correct when it was written. It's wrong with regard to M-1A and M-1B; and M2, of course, is well above. It should read that with regard to M-1A and M-1B we were marginally above; the figures were changed at the last minute and the text was not. I think that's the answer.

MR. PARTEE. So the path is below what was originally--

MR. AXILROD. No, the path is above because of M2.

CHAIRMAN VOLCKER. But the footnote seems to be wrong on page 3. I'm just gratified that I read this correctly. I found something the matter with it.

MR. SCHULTZ. Steve, yesterday you gave figures which indicated that the target had been raised over the period by some $170 million.

MR. AXILROD. Yes, the footnote numbers seem incorrect. I'll get those numbers. The $43,377 million is not the original target but the one we now have; $43,293 million was the original target. Those are simply transposed.

CHAIRMAN VOLCKER. I just wanted to demonstrate that I was wide awake when reading your report!

MR. AXILROD. You are quite right; those figures are transposed.

MR. SCHULTZ. Now that we have had that little ego trip--!

CHAIRMAN VOLCKER. Mr. Meek.

MR. MEEK. [Statement continued.]

CHAIRMAN VOLCKER. You were supposed to absorb reserves [to remain on] the path, right? I thought you absorbed less reserves than the path called for.

MR. MEEK. In fact, yesterday there was less demand for matched transactions than we had planned to make. So we wound up doing less than we expected. And there is quite an abundance of excess reserves to be mopped up today.

VICE CHAIRMAN SOLOMON. Your point is that the mopping of the reserves is justified not just by the weakness in the foreign exchange markets but also by the reserve path.

MR. MEEK. Indeed. We had considered going in early, but the dollar began to strengthen at about the time we were prepared to go in, so we held off until our normal intervention hour.

CHAIRMAN VOLCKER. Comments or questions? These actions in the last six weeks do not provoke any questions?

MR. WALLICH. I might say, just to make clear that we are all listening carefully, that I keep hearing about market perceptions that we have moved back to a funds rate objective with a very narrow range. Do you hear that?

MR. MEEK. Yes, I think there has been some feeling in the market to that effect. It is a problem we get into when borrowing at the discount window is at frictional levels because it is somewhat indeterminate whether the funds rate will be in the 8-1/2 to 11 percent range. The result is that when we put in reserves at 9-1/2 percent, people chose to interpret that as being the top of some range; similarly, it has been quite clear that we have been defending 8-1/2 percent as the bottom of the range. It's a box that we tend to get into. I think yesterday's action of mopping up reserves when funds were trading at 3-3/4 percent caused the market to pause at first blush but the action was later construed as being consistent with our normal operating procedures.

MR. ROOS. Isn't that market perception contributing perhaps to the weakening of the dollar and an implication that we may be repeating some of the mistakes we have made previously that were inflationary?

MR. MEEK. Well, there's always concern in the market about the level of interest rates and the general thrust of policy.

MR. ROOS. In other words the markets are really in doubt as to whether we are determined to carry through with a primary emphasis on controlling reserves?

MR. MEEK. I wouldn't say that that is in question.

MR. PARTEE. The market is doubting whether we have an objective of fighting inflation and whether we are going to let interest rates decline or push interest rates down long enough so that it will encourage these flows of funds into marks, Swiss francs, and other currencies.

MR. ROOS. But I mean those market--

MR. PARTEE. Whether we follow the aggregates or not is an academic point. They follow the M1 numbers, which come out on Friday --or this time on Monday. But the emphasis is on the thrust of policy toward inflation.

MR. MEEK. There are two markets that we are talking about here. The government securities market is always very obsessed with trying to invent a federal funds rate range if one doesn't exist. They react to what we do as though it has significance when it doesn't have any.

MR. ROOS. Do you tell them that it doesn't have any significance?

MR. MEEK. Of course.

MR. ROOS. Good.

CHAIRMAN VOLCKER. We have a proposal to raise the intermeeting limit [on changes in System holdings of securities]. What is the intermeeting period?

MR. ALTMANN. It would be for the period through the 12th of August.

CHAIRMAN VOLCKER. I take it the limit is normally $3 billion [and the proposal is to raise it] to $4 billion because we are getting a decline in reserve requirements that is going to have to be offset in the normal course of events.

MS. TEETERS. How much do we have to offset?

CHAIRMAN VOLCKER. What is the decline in reserve requirements?

MR. MEEK. It's $3-1/2 billion in the week of June 30.

MS. TEETERS. Is $4 billion enough if you have $3-1/2 billion to mop up?

MR. MEEK. It's right on the edge on our [staff's] estimates. The Board [staff] has somewhat lower estimates. But it seemed prudent to have adequate room. These estimates are notoriously unreliable.

MR. PARTEE. I think, Mr. Chairman, that we want to be very certain that we mop up any reserves here. I can't understand why in the world the market thinks we won't, but there seems to be some view of that. So if it's right on the edge, I would make it higher; I would propose $4-1/2 billion.

MR. MEEK. Well, $4 billion would be quite adequate, I think.

MR. PARTEE. But you said that was right on the edge.

MR. MEEK. The $3 billion [normal limit] is right on the edge.

MR. PARTEE. Oh, I see. I misunderstood you.

CHAIRMAN VOLCKER. We can always change it again; fine-tuning this figure doesn't have much significance. But if you are convinced that $4 billion [is appropriate], is there a motion to that effect?

MR. PARTEE. So moved.

MR. GRAMLEY. Seconded.

CHAIRMAN VOLCKER. Without objection, we approve until the next meeting a $4 billion limit. We need ratification of the transactions. Can I have a motion to that effect?

SPEAKER(?). So moved.

MS. TEETERS. Seconded.

CHAIRMAN VOLCKER. Without objection, we approve your operations since the last meeting.

[Before] we turn to the economic situation, I might just [raise] another point here so that you are aware of it. You might already be aware of it; I believe you have been sent a copy of the resolution that Mr. Proxmire and Senator Garn have introduced about Federal Reserve policy. This arose essentially out of the report by Arthur Burns' Committee to Fight Inflation, which is made up of an ex-Secretary of the Treasury, an ex-Chairman of the Federal Reserve Board, and a few distinguished ex-Congressmen. Among other things the report said that Congress, as Mr. Burns had suggested in a speech last September, ought to support the long-term thrust of monetary policy toward restraint against inflation and ought to reinforce that commitment by a Congressional resolution. That language was in the Committee's report and apparently Mr. Proxmire read that and thought it was a good idea. So he has introduced a resolution, the language of which I have examined in its present form word by word. It seems fairly unexceptional but I have a little concern, frankly, about the whole exercise. It starts off with all these [whereas phrases]--whereas the Congress has the constitutional power, and whereas the Federal Reserve is an agent of the Congress, and whereas the Congress can tell the Federal Reserve what to do, whereas this and whereas that--[and then says] we support [the Federal Reserve] in this general long-range intention [to restrain inflation]. It seems to me the kind of language that could easily be converted in some other circumstances to say whereas we think interest rates are too high we direct you to lower interest rates. So, it may not be the most desirable precedent in the world, but I'm not sure there is anything we can do about it. I just have a little worry about it. We have not been active in supporting this but we have not been active in working against it either. My own [instinct] is to let events take their course. But there may be an effort--and there's danger in this--to put in some different language in the operative paragraphs that could give us a little difficulty. We will wait and see, I guess. As it is, I think it's unexceptional. I don't know how helpful it really is, but you ought to be aware of it. Maybe it is helpful; I don't know.

MR. MORRIS. Do you think Mr. Proxmire knows the implications of this resolution with regard to real output and employment?

MS. TEETERS. Well, the third paragraph says "to maintain full employment and balanced growth."

MR. PARTEE. Yes, but there is a phrase that says "get back on the targets for the aggregates." I see your point. There are a lot of things in it; they could change it from year to year.

CHAIRMAN VOLCKER. It worries me a little, frankly. I'd just as soon it didn't come up. I discussed it with Arthur and I'm not sure he's so happy himself that this [process] has started. I'm sure he's convinced that he thought it all through, but I don't know what we can do.

MR. SCHULTZ. When did you talk to Arthur Burns?

CHAIRMAN VOLCKER. A couple of weeks ago.

MR. SCHULTZ. Well, I talked to him the day before yesterday, and he told me that the resolution as originally introduced had been much more specific and that he had Proxmire make it much more general and so forth. So it was a bigger problem when--

CHAIRMAN VOLCKER. Well, the main difference between [the current version] and what was initially introduced is that the first sentence talked about the long run anti-inflationary policy and so forth--I can't remember the language--but had a phrase in it about long-term interest rates. It said, in effect, that [such a policy] could bring down long-term interest rates in the context of dealing with inflation. Arthur got them to take out the specific reference to interest rates. In fact, the reference wasn't bad because it was in the context of bringing down inflation. But it's illustrative of the kinds of things we could get in a resolution of this sort some time in the future that would be very difficult. Looking at this, my own feeling is that we can't go out and say we don't [favor] a resolution that says Congress supports our long-term efforts to deal with inflation. But I feel a little nervous about the implications of this for the future. Indeed, there may be an attempt to modify this in the present. What I am saying is that if it just died quietly, I wouldn't shed enormous tears; there may be some other aspects of this that aren't apparent. Undoubtedly, I will be asked to comment about it in my testimony. I suppose I am forced to say it's a fine resolution.

SPEAKER(?). What else can you do? It would be like talking against motherhood to oppose it.

VICE CHAIRMAN SOLOMON. Well, I think you would be justified in going on to say that it might create--I don't know how to phrase this but you'd have to handle it cautiously--dangers for the future.

CHAIRMAN VOLCKER. Yes, I could say that I don't think it is wise for these resolutions to be all that specific but that a resolution with this kind of general sentiment is [fine].

MR. WALLICH. Could you say that if Congress wants to influence Federal Reserve policy directly that the appropriate way is to do it by legislation rather than resolution? I would expect that [such] legislation would not [be enacted]. That is a tough statement. But we could be snowed with these resolutions and the pressure--

CHAIRMAN VOLCKER. I did ask if there had ever been a resolution quite like this, referring to policy. And I think it is true--well, at least nobody was able to tell me off-hand--that there has not been. The nearest thing to it was the concurrent resolution, adopted in [1975], which in part gave rise to the whole monetary targeting exercise. In some of its initial versions that did talk about interest rates; [those phrases] were pretty much extracted, so the resolution became largely procedural instead of referring to the objective of policy except in the broadest way. But there have been many attempts to introduce resolutions like this. There has been a resolution circulating in Congress in recent months about bringing down interest rates. It never got anywhere, but it had some signatures on it. There have been other attempts of that kind, which weren't pressed very hard. We weren't able to find any precedent for this kind of thing actually passing in Congress. I don't know if there is anything else to be said about it but I thought I'd ask for any reactions you had. And you ought to be aware of it.

MR. BAUGHMAN. I don't see how it could be opposed.

CHAIRMAN VOLCKER. Well, Mr. Kichline and Mr. Zeisel, it's up to you.

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

CHAIRMAN VOLCKER. Let me interrupt you. If I remember correctly from the Bluebook, this is an artificial 4-1/2 percent in a sense because it doesn't allow for a depression of M-1A from NOW accounts and so forth.

MR. AXILROD. Yes. Whatever shifts occur would be subtracted from that. So if the shift were one point, the number would be 3-1/2 percent; and if it were 2 points, it would be 2-1/2 percent, etc.

MR. PARTEE. A shift over and above what is already assumed in M-1A and M-1B?

MR. AXILROD. These are shifts that could be related to the introduction of nationwide NOW accounts beginning around the end of this year. So the 4-1/2 percent subsumes whatever is going on now. This is the new introduction--

CHAIRMAN VOLCKER. So, if I understand correctly, the target doesn't fully allow for what is going on this year.

MR. AXILROD. Well, given what is going on this year, we think that 4-1/2 percent is more reflective of unchanged policy than 4-3/4 percent because there seems to be a little more movement out of demand deposits into NOW accounts.

CHAIRMAN VOLCKER. So you're just saying that the 1/4 percentage point allows for that.

MR. AXILROD. Yes. It's a small amount. We raised M-1B a bit.

MESSRS. KICHLINE and ZEISEL. [Statements continued.]

CHAIRMAN VOLCKER. That was a very complete and very comprehensive presentation. I'm sure it leaves a certain amount of questions in peoples' minds. I have two or three myself, so I might start. We will spend a little time here on the economic outlook before we get to the aggregates discussion. Your forecast, obviously, has a very low recovery in disposable income in '81 by historical standards. You also have a low increase in productivity. When we have a low increase in productivity somehow we have to have a low increase in disposable income. But there's a certain amount of chicken and egg involved; if we had a faster recovery, we might get more productivity. I guess I'm groping for a question here. How low does the rise in disposable income have to be [to reflect] the fact that productivity is not performing the way it used to and how much is [related to] a sluggish recovery in some sense?

MR. ZEISEL. Well, the point you made earlier applies to virtually all of the variables in the sense that we get low growth in disposable income in part because of the sluggish improvement in employment, which is related to the sluggish improvement in output, which is consistent with the sluggish improvement in productivity. The question is: Where does one get aboard the--

CHAIRMAN VOLCKER. Well, how much of it is the other way around? I'm asking how much [reflects the fact] that anything is going to look less buoyant than it looked before because we get less productivity growth, all other things equal.

MR. ZEISEL. Of course, any improvement in productivity performance would give us the potential for a greater increase in real income. In a sense that's partially endogenous and partially exogenous. Our projection of sluggish productivity growth is consistent, as I mentioned earlier, with our projection of the very sluggish recovery in output growth. But it's also consistent with the longer-term problems that seem to be plaguing productivity performance. We have an underlying trend rate of growth of productivity of less than 1 percent at this point. If productivity were performing, let's say, as we thought it was back in the late '50s and '60s--at another 1-1/2 or 2 percentage points above that--that would give us the potential for a considerably improved outlook. So that could be very significant.

MR. MAYO. Your capital spending assumptions tie into this productivity assumption, too, don't they?

MR. ZEISEL. Well, over the longer haul, obviously, that's correct. Over the short run it would not be a significant variable.

MR. MAYO. I'm thinking really of the capital spending that's already in place or under way.

MR. ZEISEL. The capital/labor ratio, as I'm sure you know, has deteriorated in recent decades and people feel that that has played a significant role in the deterioration of productivity. But a lot of other factors appear to be operating as well.

CHAIRMAN VOLCKER. I'm sure this has something to do with the chart you've labeled "Prices II." There's a striking difference here. In '75-'76 [the percentage rise in] the gross business product deflator went down, my word, from 12 percent to 4 or 5 percent. Now you say it can't go down much. Of course, it had gone up very sharply. But how did we manage to get it down 7 percentage points or thereabouts in only a year or 18 months and now we can't get it down?

MR. PARTEE. Look at the previous [chart], Paul.

MR. ZEISEL. Well, several things are operating. One factor is the behavior of energy and food [prices], and I think we ought to abstract from those. But even [so] we had a very significant deceleration. Part of the answer is the very vigorous recovery in output and productivity during that period. The productivity swing between 1974 and 1975 was about 8 percentage points; it went from about a 3-1/2 percent decline to a 4-1/2 percent increase. We are figuring on a recovery in productivity of a little more than half that. So in a sense we don't get the improvement in unit labor costs and the removal of pressure on prices that such productivity--

CHAIRMAN VOLCKER. You have a 4 point [swing], if I understand you correctly.

MR. ZEISEL. Well, yes.

MR. KICHLINE. Actually, if you flip the page and go back to [the chart labeled] "Prices I," the numbers on the top panel of that chart show the peak was in the fourth quarter of 1974 when unit labor costs were up 14.9 percent [from a year earlier]. The fourth quarter of 1975, one year later, was the low point [when the year-to-year increase was about] 4 percent. So we had [nearly an 11] percentage point swing in unit labor costs in that particular period.

CHAIRMAN VOLCKER. We had an 8 point swing in productivity during that period, so we must have had a 4 point swing or so in compensation?

MR. ZEISEL. I don't have [compensation figures] quarterly; I have hourly wages figures.

MR. PARTEE. Compensation is [charted] on the previous page; that shows around 3 percent, I think.

MR. KICHLINE. It was 2-1/2 percent to 3 percent [unintelligible].

MR. GRAMLEY. Wasn't there another factor going on during that period, though, that affected all of these variables on both compensation and prices? The wage-price control program [affected] 1974. There was an enormous catch-up increase, which inflated the rates of increase; and when that was over, everything settled down again. That was an important part of the improvement that took place.

MR. ZEISEL. That was a very important component. We had an explosion and then a deflation, so that played a significant role temporarily. A combination of forces was operating that I'm afraid cannot be exactly disassociated from one another.

CHAIRMAN VOLCKER. In some sense it could be argued that you are rather pessimistic on both compensation and productivity.

MR. KICHLINE. Well, we are pessimistic relative to past cyclical performance. And I think the productivity assumption is a very tenuous one. There are alternative explanations of why productivity declined, and one could very easily suggest that we may get a bigger rebound. At the same time, on the compensation side we have a situation where real wages have declined for a substantial period of time. In fact, I would view it the other way around on the compensation side: We think we have a good forecast given the assumptions. But one could very easily think that there will be more intense upward pressure on wages and that compensation might not slow as much as we have built into our forecast.

CHAIRMAN VOLCKER. Because real wages are declining?

MR. KICHLINE. Well, in a sense that puts pressure on the bargaining units and on workers who wish to command higher nominal wages to offset that.

CHAIRMAN VOLCKER. All [I'm talking about is] this pessimism relative to earlier cycles. It's pretty deeply related to the productivity picture one way or another.

MR. ZEISEL. It is very deeply related. I think that's absolutely correct.

MR. GRAMLEY. Is that really true? If you had a higher productivity growth plugged into your forecast, unless you had a change in the monetary and fiscal policy, wouldn't the main effect of that simply be a lower rise of employment with the same increase in real GNP and hence the same increase in real disposable income? If you look back at the charts, the biggest increase in real disposable income was in '77, when by no means did we have highly favorable productivity developments.

MR. ZEISEL. We'd also have a good deal less pressure on unit labor costs and prices and presumably the ability, therefore, to move into a different fiscal position as well.

MR. GRAMLEY. If you removed policy constraints and found that policy were more expansive, then you would have a larger rise in real GNP.

MR. ZEISEL. But what we have provides the basis for allowing that, I believe.

MR. PARTEE. I would agree with Lyle. I think you're substituting manhours for lack of gain in productivity. So you don't actually get a difference in real output in the forecast period, but I think it does lead to pessimism on the price front compared to what might otherwise be the case.

CHAIRMAN VOLCKER. To the extent it came out in lower prices, with the same money and fiscal assumptions you get more output.

MR. SCHULTZ. What effect do you get from the fact that energy prices in manufacturing never made very much difference? They were so low in terms of the costs. Now the situation is quite different; a lot of manufacturing firms are thinking in terms of capital expenditures of the kind that lower their energy costs. What does that do? Is there any way to calibrate that sort of thing?

MR. KICHLINE. Well, that's one factor. It tends to cut several ways. One of the arguments is that, given the rising cost of capital, firms will tend to substitute more labor for capital. It depends on the industry. In fact, President Morris had a conference at the Boston Fed about this whole role of energy and productivity and capital investment, and it's a cloudy area. But the balance of thinking is probably that energy prices for many firms are a relatively small part of total costs. So it's hard to sort out where that will fall; one has to do an awful lot of disaggregated work. We think that it probably on net adds something to capital investment demand, but relatively little if you abstract from what's happening in the energy sector directly. And that's obviously a different animal.

CHAIRMAN VOLCKER. Let me just ask one more question. On these charts of econometric exercises with and without tax cuts, is there a lower real GNP in '83 with a tax cut? If I understand it correctly, you also have a lower unemployment rate. Offhand that somehow seems inconsistent.

MR. KICHLINE. Well, unemployment adjusts with a lag. And these are rates of growth. We have a higher level of real GNP but these are rates of growth of real GNP.

CHAIRMAN VOLCKER. Okay, you still have a slightly higher level of [real GNP].

MR. KICHLINE. That's right, but it's reversing. The difference in the unemployment rate in 1982 is 0.8 percentage point and in 1983 it's a half percentage point. So the gains on the unemployment side are disappearing, but with a lag.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Mr. Chairman, that was a fine presentation. I have only two questions. One has to try to put monetary policy in the context with the thrust of fiscal policy, and in the first section of your report you have a table on the federal budget and also one on the high employment budget. My question has to do specifically with the high employment budget assumptions. We've had some discussion of this before, Jerry, as you surely remember. To refresh my recollection, what unemployment rate are you assuming here?

MR. ZEISEL. I think it's about 6 percent. Governor Gramley, do you recall?

MR. GRAMLEY. If it's the official one, it's 5.1 percent.

MR. BALLES. And this uses the official one?

MR. ZEISEL. Yes, we'd be consistent with that.

MR. KICHLINE. In the last several months there was a generalized governmental review of the calculation of this high employment budget and an agreement on the calculations involved. So we're using that.

MR. BALLES. Well, as you know, this calculation is very sensitive to differences in the unemployment rate assumption. A lot of observers, including my staff, think that the non-inflationary full employment rate is somewhat higher than 5.1 percent and may be closer to 6 percent. Have you made any alternative calculations? What would happen if you assume 6 percent, for example?

MR. KICHLINE. We have done that in the past. We have not done that this time. The way we use this high employment budget in our own approach is to look at the change in the budget from one year to another. Differences in the unemployment level used mainly affect the level of the budget rather than the swings from one year to the next. And I might note that for 1980 and 1981 this projection has a fairly dramatic increase. On a calendar year basis we are going from a surplus of roughly $18-1/2 billion in 1980 to [a surplus of] $39 billion in 1981. Now, the levels would be different if we calculated the budget on a higher unemployment figure; but the swing, we think, is indicative of the thrust of policy.

MR. PARTEE. You'd just raise [the non-inflationary full employment rate] by 0.9, would you? Is that effectively what you would do?

MR. BALLES. Well, by how much is the question, Chuck. I'm trying to get some range of estimates here as to how restrictive fiscal policy is going to be and I doubt that it's going to be as restrictive, in terms of the level, as what the staff shows. What I was trying to find out is what the level would be with a 6 percent assumption.

MR. KICHLINE. Well, we have not done that calculation, and I don't have in mind any rules of thumb that would allow me to give you an answer right now.

MR. BALLES. Okay. Maybe we can talk about that later.

MR. KICHLINE. We can certainly do [the calculation] and circulate it.

MR. BALLES. If I may, Mr. Chairman, I have one more question. It's related to the chart entitled "Domestic Nonfinancial Sectors," the opening chart in the fourth section. I'm particularly interested in the reality of what will be going on in financial markets in terms of federal borrowing, broadly defined. The red bars on the chart show federal borrowings. Did I understand you to say that that is on the unified budget basis? In other words, what I'm trying to get at is: Does it include that very large and growing amount of off-budget activities--the mortgage pool, the government sponsored enterprises, and what have you?

MR. KICHLINE. No, it does not. It includes the Treasury issues and a small amount of agency issues. It does not include FNMA or the Home Loan Banks, for example. We have numbers that start at $75 billion for 1980; there's a narrower definition of the budget and it does not include the off-budget items.

MR. PARTEE. $75 billion?

CHAIRMAN VOLCKER. That includes the off-budget agencies, just not the sponsored ones, doesn't it?

MR. KICHLINE. Right.

MR. BALLES. It does include the off-budget?

CHAIRMAN VOLCKER. It depends upon how one defines off-budget. My understanding is that it literally includes the off-budget agencies but it doesn't include the [agencies] not owned by the government, [such as] FNMA and the Home Loan Banks.

MR. KICHLINE. That's right. It captures the [funds raised by] the Federal Financing Bank, for example, as a Treasury issue.

MR. BALLES. How much bigger would the number be if you included the so-called privately owned, government-sponsored enterprises and the mortgage pools? I have a hunch it would be considerably bigger, but I'm not sure.

MR. KICHLINE. Yes. One of the problems here, by the way, is that this chart covers "nonfinancial" [as defined] in our flow of funds accounts. We consider the sponsored agencies to be the financial sector, so we are dealing with a different concept here. But in 1980 we have sponsored credit agencies raising about $11-1/2 billion of funds and in 1981, $20 billion. So [compared] to these numbers, you get [borrowings of] something like $87 billion under that broader definition in 1980 and $120 billion in 1981.

MR. BALLES. That makes a difference, doesn't it?

MR. KICHLINE. Oh, yes.

MR. BALLES. Thank you.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I have one detail question and then two substantive questions. This Administration forecast [that you show] is not yet published, is it?

MR. KICHLINE. No, it is not.

MR. GRAMLEY. This is the one coming out in July?

CHAIRMAN VOLCKER. Is this firm?

MR. KICHLINE. We understand that the economic assumptions are firm as a basis for the midyear review. What are not yet firm are the precise outlays and receipts--the budget side associated with the economic forecast. But it has not yet been presented officially; my understanding is that it will not be delivered until July 21.

MR. GRAMLEY. The first substantive question I'd like to ask Jerry. On the compensation per hour projection, you noted that one element of optimism isn't in the line shown here--the fact that it includes an increase in compensation due to payroll taxes in 1981. So, in fact, in order to get this performance, private compensation would have to improve still more than the line indicates. But isn't there yet another element in it in the sense that this year we are looking at a rise in wage rates of roughly 1 percentage point faster than we had in 1979? And that's not showing up in the compensation per hour figures because we're getting a shift in mix, for cyclical reasons, that is going in the other direction. In 1981 that shift in mix will not be taking place; on the contrary, it will be reversed.

MR. ZEISEL. That's correct.

MR. GRAMLEY. To get the kind of performance in compensation that's shown here we're going to have to have a very significant slowdown in the rate of increase in average hourly earnings adjusted for overtime and mix.

MR. ZEISEL. That's correct, and we do build in a calculation of the effects of mix on the compensation figures. The average hourly earnings index itself declines between '80 and '81 by slightly more than 1 percent. I don't have a figure for the fourth quarter '81; it would be a bit more than that, though, as opposed to a compensation decline over that same period of 0.3. So the point you're making is absolutely correct. The underlying wage adjustment has to be greater than the compensation decline that we show.

MR. GRAMLEY. The second question I'd like to direct to Mr. Kichline. In the discussion of the assumptions on the first page, you've noted that M-1A goes up by 4-1/2 percent. But the Bluebook says something else is involved that I think we need to be aware of, namely that the assumptions about interest rates that are plugged into the forecast include an assumption that the money demand function drops by 3 percentage points both this year and next. So if the demand function had been unchanged, M-1A growth of 7-1/2 percent would be required to give us the same amount of monetary stimulus. Isn't that correct?

MR. KICHLINE. That's right. In effect, the way to view the 4-1/2 percent [M-1A growth] is that it has the power of old-time 7-1/2 percent money, old-time being pre-1974 money.

MR. GRAMLEY. Thank you.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. First, I think the staff forecast is very well put together. My staff's forecast is close to that of the Greenbook but I personally feel a little more pessimistic just because I think we're coming out, I hope, of a very wrenching inflationary experience, which I believe tends to lessen our ability to rely on econometric models. And I think some of our past sins, so to speak, in not encouraging enough capital formation and productivity in this country are catching up with us. Maybe I'm just getting older, but this causes me to distrust even more than usual the figure factory, if I may call it that, on the projections for 1981. So, I'm just a little more pessimistic personally.

I have one detail question on the unified budget. You are more optimistic than the Administration for fiscal '80. Following up on Lyle's point, is this $55 to $60 billion [deficit projected by the

Administration] fairly set at this point or is the [potential] variation really more than you've indicated here? And why are you more optimistic? Is this a shift--shall I call it a political shift--of a deficit from one period to another by the Administration?

MR. KICHLINE. Well, the early number the Administration was working with on outlays was something like $578 billion, $3 billion higher than the staff's estimate. Now, that may come down a little. We looked back at the last eight fiscal years, from 1972 through 1979, and the mid-session review has overestimated actual expenditures by about $2 billion. That's about 1/2 percentage point. So we feel reasonably comfortable that we're close, given past experience. On the receipts side, the Administration had $519 billion as an early number as opposed to [our] $523 billion. That relates, as I understand it, to some tax multipliers, the response of tax receipts to income over the last three or four months. And it's a messy business. So I would view [the two projections for] 1980 as really quite close. The real issue is 1981.

MR. MAYO. Well, [comparing] the $59 billion Administration [preliminary deficit estimate], for what it's worth, and your $52 billion, I take it that you feel the receipts will do a little better. That's part of it?

MR. KICHLINE. For 1980?

MR. MAYO. Yes, for 1980, the year we are in right now.

MR. KICHLINE. Yes. We have $4 billion more in receipts than their preliminary number. And as I say, it's really a technical matter. Their forecast is not materially different from ours for the second and third quarters--the last two quarters of the fiscal year.

MR. MAYO. This is also minor, but do your projections for '81 assume that what the Congress is trying to do on speeding up corporate tax collection [will materialize]?

MR. KICHLINE. Yes, it includes that; it excludes certain other things. It excludes, for example, the withholding of interest and dividends. We made some adjustments where we felt it was quite unlikely that the Congress would be willing to go along with the Administration's proposals.

MR. MAYO. Thank you.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, our differences with the staff forecast have widened a bit this time. For 1980, we believe that the drop in real GNP will probably be greater than the staff is projecting. This concern stems mainly from three factors: the growing evidence that the international situation may be weaker than we've been assuming, the conditions in the construction industry--and specifically housing--and retail sales. If you plot housing starts and retail sales in real terms opposite similar periods of other postwar downturns, this time they practically drop off the chart; the drop is far greater than anything we've had before. And we don't believe that that weakness has yet spread to other parts of the economy to the extent that it likely will. So, expecting this greater weakness, we think the unemployment rate will probably be higher by the fourth quarter than the staff is projecting, though we think the rise in the deflator will be less. We have estimated the deflator at 8.5 percent versus [the staff's] 9.4 percent for the four quarters ending in the final quarter of this year. And in 1981, more differences [emerge] because we firmly believe that if we stick to our targets on the aggregates, as I think we will, then the outcome will be much better than the staff is projecting. We are guessing that we might have an increase in real GNP in the neighborhood of 6 percent as compared to the 2.5 percent forecast by the Board staff. This would mean a good deal less inflation and it also should mean less unemployment. Our forecast is a guess too, of course, but we feel [the results could be] quite different from what the staff has projected.

MR. PARTEE. Is that because compensation goes up a lot less in your forecast, Bob? How do you have less inflation? That's what I'm asking.

MR. BLACK. Well, we keep the money supply under better control.

MR. PARTEE. I understand that. But looking at the factors of costs and prices, is it better productivity?

MR. BLACK. Yes, I would think so. If we make progress on the inflation front, I think people's expectations are going to turn around very markedly. And we have [projected] more private investment than has been assumed, offering commensurate increases in productivity.

MR. PARTEE. Well, not [until] next year, though.

CHAIRMAN VOLCKER. Mr. Eastburn.

MR. EASTBURN. I was interested in the estimates of uncertainties accompanying the forecast, which were based essentially on a number of simulations. I wonder if you'd take a minute to put that into qualitative judgmental terms and let us know what you think the chances are on the up side and on the down side of the forecast.

CHAIRMAN VOLCKER. In 60 seconds.

MR. KICHLINE. As you know, we do recognize that forecasting point estimates is not the way to go in terms of associating some degree of [certainty with the forecast]. We believe there is a standard error associated with any forecast, and that's why we've attempted to work with the model in generating ranges of uncertainty or confidence intervals. In that memorandum we used the model to try to calculate the probabilities of hitting the Humphrey-Hawkins targets as defined by the Administration's forecast.

CHAIRMAN VOLCKER. I wasn't clear on that. Let me make sure I understand. The Humphrey-Hawkins targets are the Administration's forecast in the terminology you're using?

MR. KICHLINE. Well, in the short term, yes. The first two years are defined as the short term; they represent projections but in fact are short-term Humphrey-Hawkins targets.

CHAIRMAN VOLCKER. When you say Humphrey-Hawkins targets do you mean the Administration's projections that are in these charts?

MR. KICHLINE. That's right.

MR. MORRIS. That's not what Messrs. Humphrey and Hawkins had in mind, though.

MR. KICHLINE. In general, I would say that with the monetary policy we have assumed--looking at the model results in both years, particularly 1981--there is a fairly small probability of [an outcome] within a narrow range of those targets. I didn't go into this in the presentation, but a good deal of the difficulty revolves around the Administration's [forecast of] 13-3/4 percent growth in nominal GNP with interest rates not much higher than they are currently. That tells you something: Really, their implicit monetary [growth] assumption has to be high. So the exercise we've gone through suggests that there's a fairly wide range [of uncertainty] associated with the point estimates we've presented for the broad aggregates, for 1981 in particular. And looking at the Humphrey-Hawkins targets, there's a fairly low probability of [an outcome] within a narrow range of those targets--particularly of hitting the unemployment and price projections simultaneously.

MR. EASTBURN. May I follow up and ask another related question, which is a simple one? How confident do you feel in your Greenbook projections and what side are the errors on?

MR. KICHLINE. Well, given the policy assumptions, I feel fairly comfortable with the real side forecast that we have. I know there's been a tendency for economists to underestimate the strength in the economy at turning points. But in general we have built in very restrictive monetary and fiscal policy assumptions relative to past cyclical experience. At the same time, on the price side I feel reasonably comfortable. I find it very difficult to expect much greater price improvement next year, particularly in light of what is happening on energy; and food prices aren't going to help. Both of those were positive forces in 1975. So I feel reasonably comfortable with [our forecast of] both prices and real GNP. If we're wrong, it may well be that some of the assumptions are wrong. And I would prefer to stop there.

SPEAKER(?). In other words, two plus two still equals four but maybe it's--

CHAIRMAN VOLCKER. All this depends upon one's judgment of this 3 percent shift in M1 demand. What was that shift in the past year, say?

MR. KICHLINE. Very little, if you mean over the course of 1979.

CHAIRMAN VOLCKER. I was thinking of the past 12 months.

MR. AXILROD. From reading the model--which is all this is talking about--in the year 1979 there was virtually no shift. There was a little downward shift, but I wouldn't take the model that seriously on that. For the year ending in the second quarter of 1980 there was a shift of about 3 percentage points, all of which occurred in the second quarter.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. As far as the forecast is concerned, which I view as very well done, I find myself much closer to the Administration's than to the staff's, certainly for 1981. I think we have to count on a high nominal GNP, quite possibly a good rise in real GNP, and an even higher deflator than either the Administration or the staff have. The latter is based on [our past] experience of always tending to underestimate inflation. We've had a very patient labor force. Outside the strongly unionized sectors wage increases have been very low, and one must anticipate that at some time there will be a concerted push to make up for that. We also have to bear in mind that, in a sense, our staff forecast is a formal exercise based on an assumption of a given rise in money supply. And that is interpreted optimistically with a 3 percent [demand] shift. We have never been successful in sticking by our money supply targets and I fear that the same thing will happen again. That means that we have no very clear ceiling on the up side and that there's a real possibility of going to higher rates of inflation and much higher rates of nominal GNP than any of this says.

Well, let me just ask one small technical question. Jerry, you were skeptical about business fixed investment spending, partly on the grounds of low capacity utilization. Isn't there a chance that we are once more overestimating our true capacity, as I think we did the last time round, and that the pressure begins at lower capacity use levels? And secondly, given the high increases in wages that firms [already have implemented] and that seem ahead, isn't it possible that they may put more emphasis on modernization than expansion?

MR. ZEISEL. As far as the first point is concerned, it's always possible that we are estimating capacity incorrectly. But we have tended to scale down the effective capacity level in our index by introducing a factor of downtime that is much greater than we had earlier. So I think we're far more realistic in terms of effective capacity than we were, let's say, 6 years ago. As far as the latter point is concerned, certainly that [possibility] is there. The tendency to shift toward capital because of the [high] relative price of labor versus capital has existed and continues to exist. We have tried to build that in. What we've viewing here is a cyclical performance rather than the longer-term secular considerations which really bear upon that to a greater degree. We also are moving out of a period in which pollution control and related expenditures have borne such a heavy weight relative to total expenditures, as they did a few years ago. So that's a factor lowering the possibility for [business investment] expenditures.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. My question has been answered.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I'm curious about your projection [for the external sector]. I know you said yesterday that the real growth of our trading partners was strong--and Japan's was quite strong--in the first quarter. But [these countries] seem to me to be subject to the same pressures that we are: high interest rates and rising oil prices. What makes you think that we're not going to export our recession and have a worldwide recession, which I assume would weaken your forecast markedly?

MR. TRUMAN. I'd make several points. We are definitely assuming that [other countries] will have a slowdown. [We expect real GNP] growth to go from approximately 4 percent in the last two years, 1978 and 1979, to 1 percent. To some extent zero is an artificial number in this context; indeed, the same forces will be operating on them, including higher energy prices. On the other hand, as shown in the second [international] chart called "Activity Ratio," they also didn't expand as rapidly, so they in some sense are in a less strongly pronounced cyclical position than we are. As I said, for two of the countries we are expecting what one would classify as a recession this year. Those basically are the answers I would give you.

As far as exporting our recession, clearly [our economic performance] has some impact on them but it's easy to exaggerate that effect these days. We are [relatively] less important in the world economy. In fact, we now account for under 20 percent of world trade whereas a number of years ago we were a third of world trade. There's less feedback effect on the rest of the world, with probably two important exceptions. One is Canada, which had negative growth in the first quarter--2 percent at an annual rate. And their statistics are looking just like ours, with housing starts falling out of bed and so forth and so on. There's Japan, too. The automobile situation suggests--[unintelligible] other factors determining it--that there may be a little less of an impact on Japan than one would normally expect because of the continued demand for small cars.

MS. TEETERS. But that is one of the risks in the forecast. Things could be considerably worse--

MR. TRUMAN. Yes, but we may be going through the same phenomena. I've asked the staff about that. We're worried about that with a nine-month lag, right? In general, we've been forecasting a slowdown in every [Greenbook] and we haven't seen it yet in the numbers. After real growth in the first quarter on the order of 3 percent, depending on how you cut the numbers--which is a healthy annual rate--we estimate that the G-10 countries will get something like 1 percent growth for the year. That means growth is going to have be something very close to zero on average [over the final three quarters].

CHAIRMAN VOLCKER. There will be a few further complications if the LDCs don't get financed. Governor Partee.

MR. PARTEE. I'm fairly comfortable with the forecast. I have a feeling that the staff might be on the optimistic side with regard to prices. I noticed that food price increases are really nothing exceptional at all in this forecast and intuitively I would have expected a considerable burst in food prices later this year and early next year as animal inventories are reduced and can't go any lower and we get a very substantial reaction in meat prices. I also agree with Lyle that the pressures on compensation are all going to be on the up side of this forecast rather than the low side. And then I'm not really sure about energy; that's a wild card. [The staff has] a 16 percent increase year-end to year-end, which is fairly modest; on the other hand, one could make a case that a surplus would make even that a rather large increase. I'm just not sure about that. If we did have a little more in prices, we might have a little less real growth, given the policy assumptions. And that would be the tendency, I think, as the year goes on. In addition, there is no allowance here for shocks. One can't have an allowance for shocks, but in fact many of the main features of our economy in the last few years have been conditioned by unanticipated shocks. And there could be more in the future--the large country difficulties, large company difficulties, large bank difficulties, whatever they might be--that could adversely affect the outlook.

As far as the money number is concerned, I think assuming that 3 percent demand shift is a very conservative stance for the staff to take. Remember what that means. If the demand shift were less than 3 percent, interest rates would be higher than forecast given GNP; and they're already forecast to be pretty high. Back in '75 we didn't put in much demand shift, and we [forecast] very high interest rates rather early on in the recovery, [and those rates] never materialized. So I think taking a sort of midpoint figure for a continued demand shift is conservative and the proper way to go. If it's [more] than this, we'll have credit conditions that are a little easier than forecast. But given the great uncertainty in this area--and I don't understand the thing nor do I think the model is much good--the staff assumption seems proper and conservative. And we ought to keep that in mind.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. I think this balance sheet ratio page is telling us something. It shows us very clearly that compared to 1974-75 the corporate sector is less liquid, the household sector is substantially less liquid, and the commercial banks are less liquid. At the same time, we are going into a recession of about roughly the same scale as the one in 1974-75, but we are coming out with a much more sluggish recovery than we had in 1975 and 1976. And throughout the whole period debtors will be carrying substantially higher interest rates than they've ever carried through a recession. This seems to me to add up to a much higher level of business failures and loan losses at banks than we've seen before. Would you want to comment on that?

MR. KICHLINE. I don't know that I'd say "before" and refer to 1974 and 1975. We had very special factors then, involving particularly the REITs. I do think, however, that the combination of high inflation, which is really the problem behind this whole chart, as well as sluggish income growth in general portends difficulties for individual units in the business sector, in the household sector, and probably in the state and local government sector as well. I don't know that I would want to [compare the current situation with] what I would view as a very special period complicated by the recession in

1974-75, but there is clearly a potential for delinquencies and business failures that should not be ruled out.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. I think somebody ought to be optimistic here and try to search for what might be a more positive approach or we are going to have all the probabilities on the wrong side of the forecast. Your housing starts figure, as I understand it, is for single-family homes.

MR. KICHLINE. No, it's both single-family and multifamily.

MR. ZEISEL. Combined.

MR. WINN. Well, the inventory of single-family homes is rather a puzzle in terms of the overhanging supply, which may be larger than it seems. But in apartments and the whole commercial area, one can't beg, borrow, or steal space. One gets the feeling that that could snap back somewhat more quickly than it has in other cycles. So that's a positive [note].

CHAIRMAN VOLCKER. One can't beg, borrow, or steal space, but with the rent control laws and all that does anybody want to build?

MR. WINN. Yes, it's starting to pick up in some areas. At least the builders and the people in the financing area are talking about a fairly sharp turnaround, Paul. So that's a positive. Second, if one looks at these declines, how much is psychological and how much is real in terms of the shock effect that we had? And to what extent can we have factors that will go the other way? For example, my guess is that while the 1972 to 1979 budget experience indicates that expenditures fell short [of the estimates], I have greater confidence in the Administration this year so I think that may not be the case. We may get a bigger deficit in 1980 than has been projected, [particularly] if we get the tax cut--and at least the discussions of that seem real. And perhaps people are not being sophisticated in their analysis and are simply taking the present deficit and then adding on the tax cut, whatever that may be. You talked about a deficit in the area of $110 billion for next year. In that environment what kind of reaction will we get in terms of peoples' behavior? Third, [in the area of prices] I realize the animal problem gives one pause but, on the other hand, the grain prospects look quite good. So I don't know to what extent we might get a stand-off on the food side. Psychologically we have the problem that gasoline is about to run out our ears in terms of storage. What happens if we start to cut gasoline prices? I realize the Saudis and others are talking about raising [prices for] crude, but what kind of psychological impact will we get from that kind of development and from the scare [tactics]--the "look what lies ahead with $110 billion deficits" and that kind of talk? Will we again get some psychological reactions?

We have talked about the shift in demand for money and so forth. But when we look at these capital ratios, have we made allowance for that shift in terms of how they will behave, even though you've commented on the deterioration that has occurred versus previous cycles? So, I'm trying to search for things that could give us a positive push at this time rather than the more negative kinds of inputs that we hear.

CHAIRMAN VOLCKER. I thought you were going to introduce some animal spirits to overcome the animal inventories! Well, one of the difficulties of having so comprehensive and able a presentation is that it provoked a great deal of discussion and [consumed] a great deal of time. Nothing looks very happy, except Mr. Winn's last interjection. As I judge this, we have a problem in that if we base our analysis on any kind of traditional analysis, econometric or other, we run into all sorts of dilemmas. And it makes one wonder how all this can be reconciled except by saying: "Let's have a more expansive budget and a more expansive monetary policy and then everything will look all right on these traditional grounds." That's if we ignore the inflationary implications, which I take it we can't ignore. That is the dilemma we have. We don't have a situation where we can play the game the way we have played it traditionally. I don't think we can, anyway. Well, if we are going to have any coffee break at all, we can go chew on that physically as well as mentally for a few minutes and come back and enter into the policy discussion.

[Coffee break]

CHAIRMAN VOLCKER. We spent a long time on the business outlook; I think we should have spent a long time because [the staff presentation] was interesting and illustrated some of our problems very amply. But I don't think we are going to get beyond the long-term ranges before lunch, so I suspect we will [continue the meeting] after lunch. We have to consider these forecasts a little, in preparation for the Humphrey-Hawkins testimony. We have some figures, as you know, from the Presidents and from the Board members, and we ought to have at least a little discussion about how they came out and how they should be presented. Let me defer that for later. I guess it could be argued that we ought to do that before the policy [decision], but I won't be that logical. I'll do it afterwards. But I do think we need some time to discuss non-monetary policy matters. So [the meeting] may run a fair amount of time this afternoon. I won't try to finish before lunch; our meeting will have to continue afterwards anyway. I hope to finish [our work on] the long-term aggregates before lunch at the very least.

I have the sense, as I suggested before, that this presentation of the business outlook, which is based upon past relationships and past performance of the economy, does point up very well our dilemmas and the basic issue we face. It's a philosophical question almost as to how we approach a system which in some sense has run out of steam in terms of the postwar presumptions, if I can put it so grandly. The economy has been getting less liquid for 30 years. We have had rising inflation for 15 years, I suppose. Both of those factors, and I'm sure some others, have changed the nature of the economy and the nature of expectations, and they have implications for cyclical analysis. If one assumed that expectations were stable in some sense and weren't affected by inflation, the overwhelming thrust of what comes out of the business analysis is that we should have a big tax cut, an easier budget, and a substantial increase in the monetary aggregates, and everything will go along happily on past cyclical grounds. We'd have room for a bigger recovery and everything would move as it did in previous cycles. We could look ahead, if not happily, on a more or less even course [consistent] with past history. I doubt that it will be so simple because expectations will be affected. We will get financial market repercussions from that kind of policy that are probably inconsistent with that [historic] evolution. We'll get exchange market reactions that would be inconsistent with following that course. I don't think there's so simple an answer. It's not the answer that our policy to date, anyway, has suggested. On the other hand, the opposite view--that if we just keep clamping down on the money supply all the problems are going to disappear nicely and the inflation rates are going to come down much faster than these projections show and the various dilemmas will be reconciled in the next year or two in a very happy kind of way--doesn't leave one feeling entirely comfortable in the pit of one's stomach. At least not me.

I suppose it's a matter of raising the questions; it's not only what we should be doing, but what we think the analog should be in other public policies, whether fiscal policy or wage-price policy or otherwise. Those are appropriate questions, particularly for me. I think they are always appropriate for the Committee but there's a certain spate of testimony we have to deliver in the next couple of weeks on a whole range of economic problems, from monetary policy to fiscal policy, to wage-price policy, to silver, to the Monetary Control Act and everything else. So we do have to think implicitly or explicitly about complementary policies as well as about our own policy and approaches. With that very general introduction, maybe Mr. Axilrod can set out the more specific considerations with respect to where we go on the aggregates this year and next.

Let me just say one other thing in that connection. We obviously have to review the aggregates and announce a rather specific conclusion for this year. We also have to say something about next year, but the degree of specificity with which we state [our objectives for] next year is quite an open question. We can go all the way from saying these are our preliminary ranges--we wouldn't say final in any event--for M-1A, M-1B, M2, M3, and bank credit in a manner similar to what we would do for 1980 to the other extreme of indicating a qualitative direction. Or we can alight anyplace in between those two extremes. It is an open question we should resolve regarding whether we want to go with one of those extremes or some place in between in terms of what we say in the Humphrey-Hawkins report. I think it's useful to be as specific as we can be in the first go-around here--as specific as we can in getting individual views, however generally we want to [cast it] as a consensus for the Humphrey-Hawkins report.

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

CHAIRMAN VOLCKER. You did not consider the possibility--maybe it shouldn't be considered, but let me raise it--of correcting, in a sense, the M-1A/M-1B relationships for what has gone on so far.

MR. AXILROD. Well, we did. We assumed that an unchanged policy from what was adopted in February meant that M-1A growth could be about 1/4 point below the midpoint of the range and M-1B growth about 1/2 point above the midpoint.

CHAIRMAN VOLCKER. But that's not reflected in the ranges you are proposing.

MR. AXILROD. We didn't change the ranges, but we spelled that out as an assumption.

CHAIRMAN VOLCKER. Theoretically, we have the option of--

MR. AXILROD. That's right. That's why I particularly stressed M-1A and possibly M-1B; but M-1A is a more logical candidate.

CHAIRMAN VOLCKER. Just to put this in context: The charts that you have drawn later [in the Bluebook] for the short-run ranges are based upon what we know through June. M-1A and M-1B are both below the cone [for the year thus far]; in fact, they're below the channel. If we took the estimate you have for July--which may be in a state of flux, but just so the Committee can appreciate it--M-1B would be just about at the lower end of the cone, whereas M-1A would still be below the cone. You have M-1B almost back in the cone--not quite, I guess, but very close to it.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. Projecting M2 into July--June is already [plotted on the chart]--it looks a little more clearly above the midpoint.

MR. AXILROD. That's right. We expect that by the time the year is out, M2 will have grown [at a rate] somewhat above the midpoint.

MR. PARTEE. And M3 will be just a little below the midpoint.

CHAIRMAN VOLCKER. Do you have an M3 estimate for July? I don't know whether you do or not.

MR. AXILROD. I do have one. The July rate of growth for M3, at 5.8 percent, is weaker than that for M2 and M1 because we still have very weak bank credit demands and consequent reductions in large CDs.

CHAIRMAN VOLCKER. What you basically have for the July projection is: M-1A below the cone, though probably within the channel; M-1B just about at the lower side of the cone; M2 higher in the range; M3 a little low in the range; and bank credit--what, below the bottom of the range?

MR. AXILROD. Yes, well below the range.

MR. PARTEE. After having run for a year or more above the top of the range. It does suggest that we could reduce the M-1A range on technical grounds; I guess one could justify a half point reduction in the lower end.

CHAIRMAN VOLCKER. Yes, one of the considerations--to repeat what Steve just said--is that for this year one might take the point of view that M-1A particularly should be reduced. If we do that, just keep in mind what we might want to do for '81 and what visual appearances we want to give of--

MR. PARTEE. I mentioned the lower end of the range. Your point about the top end is very well taken.

MR. SCHULTZ. I would have some arguments against doing that in addition to the problem that it creates for '81. Number one, the credibility issue of having stated targets and leaving them alone at this point is worth thinking about. The other is that if we start fooling around with these ranges and try to get them a bit tighter or [the expected outcome] a little more in the middle of the range, it's likely to get us into trouble. We have to fight Proxmire all the time anyway because he is always trying to get us to narrow the ranges; and at some point that is going to give us problems. I think we should try to hold out for somewhat broader ranges.

CHAIRMAN VOLCKER. I will remind you in that connection, as Fred just implied, that we got some criticism last year--I don't think it was serious--that the logic was to reduce the width of the ranges at [the midyear review]. I don't suggest that we should necessarily do it, but we should have that in mind. That is, we ought to reject it consciously if we don't do it, because one can make the argument in pure logic that we ought to be a little more certain now about where we are going to end up at the end of the year than when the year began. Let's hear what you have to say in general about this matter, Mr. Eastburn.

MR. EASTBURN. Well, I'd like to [harken] back [to] what you said earlier and what Fred just said. The thrust of your introductory comments was that [people] behave differently these days because of expectations than they would ordinarily.

CHAIRMAN VOLCKER. One might argue that anyway.

MR. EASTBURN. Well, I think it's very true. In light of that, it seems to me that this exercise we go through twice a year goes beyond policymaking so far as the aggregates are concerned and goes to the public impact in terms of creditability and expectations. I would prefer your statement to be fairly simple. I'd say, first of all, that we are reaffirming the anti-inflation stand that we have been maintaining and, consistent with that, that we are going to maintain the targets we had established for 1980. I'd indicate the uncertainties involved in doing that. We talked at great length here about the shifts and the uncertainties involved in the shifts; and if we are uncertain about them, [why] talk about that publicly at great length? It seems to me that would not enhance our credibility but would create a great deal of public confusion. And I would not indulge in a lot of fine-tuning among the various averages. That to me would even further compound that problem. So for 1980 I would stick with what we have; I'd do any qualitative explanations necessary but leave the numbers where they are. I would confine comments on 1981 to a qualitative statement that we intend to pursue our long-term policy of gradually reducing the rate of growth of the money supply without being specific about the numbers at this time.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I am very close to where Dave is on this. I think it would be a terrible mistake to adjust these ranges. This probably will be the first real test from a credibility standpoint of whether we are fulfilling what we announced our policy would be last October. To horse around or to adjust the range to accommodate what is happening rather than what we set out to achieve would be very detrimental to our credibility. I think consistency is terribly important. I part company [with Dave], if I understood Steve's remarks about the inflationary consequences of moving back up into the range, in that I think that we should say publicly--I think you should tell Congress--that we have fallen below the lower limits of our announced ranges for the narrow aggregates and that we are going to do what is necessary to get back within the ranges. But no one should construe that as having inflationary implications other than over a very short period of time. We are going to get back into these ranges because we do not want to exacerbate the recession we are in. We don't want to make it worse by continuing [to foster] growth of the narrow aggregates below the ranges. And I think we should make at least a strong statement--we don't want to be specific--that going into 1981 we are going to reduce gradually the rate of growth of the narrow aggregates. Incidentally, our people did a study of M2 and they feel that M2 is not an accurate predictor of GNP, so I'd resist moving to place greater emphasis on our M2 targets. But I think we ought to tell Congress what we are going to do--that we are going to correct for this [current] undershoot and that next year we are going to continue our policy of gradually reducing the rate of money growth. We will enforce our credibility by being candid. I don't think we ought to play games.

CHAIRMAN VOLCKER. Well, I don't think we ought to associate a change in the ranges--if we think we have good grounds for a change --with playing games or horsing around. All "B" is arguing is that a technical adjustment is required.

MR. ROOS. Don't you think, given the tendency of the Open Market Committee in past years toward base drift, that people--or at least interested market participants and others--knew that we were playing games in those days to make ourselves look good?

CHAIRMAN VOLCKER. I think there is something to what you say, looking at history. And I'm not arguing for changing the ranges; but I just don't want to associate any change, particularly in this case when we could argue that we have a technical reason for making the change, with playing games. We said a certain range was valid at one point; I don't think we can say that it's valid forever just because we happened to say it [once]. Don't change the ranges lightly without a good reason is what I think you are saying. Don't revert to changing them automatically because we change them every quarter to take account of what has happened. I just don't want to overstate the case for not changing. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, as to the general economic and psychological setting, I am persuaded that we are in a situation where our conventional belief no longer stands up that monetary and fiscal policy, if handled appropriately, have the capacity for nudging the economy along a path toward full employment and price stability. And I am persuaded that we will not be able to achieve those desirable objectives without engaging in some direct interference in some of the price and wage making processes. But even if that's true, it seems to me that the best contribution monetary policy can make is to behave as if that were in fact the situation and hope that somewhere along the way the necessary [steps] will be taken to address the structural rigidities in the economy.

CHAIRMAN VOLCKER. Pardon me for interrupting you, Ernie, but you reminded me: I would appreciate it if people, when they are making their comments, would express any assumption they are making about fiscal policy or wage-price policies--as you have just done to an extent--and say what they think is appropriate. Your comment on wage-price policy just reminded me of it.

MR. BAUGHMAN. Well, turning to what's immediately at hand, I think it's a close call as to whether to make any adjustments in the targets that were announced last February. I can make a fairly persuasive case either way, I think. It seems to me that we are under rather strong pressure to do something with the 6 to 9 percent range on bank credit. Of course, if we do that, then we have made a change and that opens up the whole set of ranges for other changes. If it were not for that, I would come out on balance for no change. If we were to come out [for no change], we could just incorporate some words rationalizing that any time we are aiming at a family of targets, we obviously are not going to be able to hit all of them. And in this circumstance we are simply pursuing policies which, as things have developed, give greater priority to the money measures than to the credit measures.

With respect to next year, we have a choice of being either fairly specific or quite general. If we go the route of being quite general, we should reiterate with some firmness of conviction, as already has been suggested and as we have done previously, that we are of a mind to move to lower rates of monetary growth until such time as we get to that level of growth which is judged to be consistent with full employment under conditions of price stability. But as next year has the potential of giving us a fairly unusual looking set of numbers, until such time as we get to the point of presenting those numbers it might be appropriate now to take a little time to elaborate on the point that as the new legislation goes into effect, we think it's going to have a substantial impact. Just by way of illustration, its impact could be such that a posture of moderate slowing in the rate of growth of our narrowest money measure might bring our target for growth of that particular measure down to zero. So I would want to try to get across that idea. It seems to me that if we are going to get much benefit in the economy from monetary policy in this next year or so, it has to flow pretty much from getting across the idea that we are going to impose a policy that will continue to move in the direction of being consistent with price stability, whatever those numbers might be. That's all I have right now.

CHAIRMAN VOLCKER. You assume a tax cut next year or the desirability thereof?

MR. BAUGHMAN. Well, I take it as a given that there will be one. It's not something that I have endorsed in any of the speeches I have made.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, I'm quite comfortable with alternative 1 as stated, [namely to maintain] the present ranges. I would, of course, do the proposed revision of the bank credit range. But I don't consider that in the same box as the four aggregates. As a matter of fact, I think we have gone out of our way to make it clear to the [Congressional] Committee--I'm relying on memory here, so someone can correct me if I am wrong--that [our aggregates targets] would be "associated with" bank credit expansion of such and such. We've said that bank credit isn't a target in the sense that the aggregates are a target. As far as next year is concerned, I subscribe also to the idea of [describing our objectives] qualitatively.

I see no reason though, Mr. Chairman, why you in your testimony couldn't indicate that we are at a different point in terms of the outlook for the ranges for this year--that at this time we are closer to the low end of the range for M-1A and a little higher than the midpoint for M-1B, and so forth. You could do it qualitatively without disturbing your credibility; I think it would enhance your credibility. And for next year, somewhat differently from Larry, I would put a little more reliance on M2 because I think it is a more stable aggregate against which to measure than M-1A or M-1B. We are going to have a lot of volatility and unpredictability even [though we're more than] a third of the way through the year. So I would lean toward more reliance on M2 looking forward. It isn't as important in calendar year '80, but I think it is very important in calendar year '81. So, I think you can indicate qualitatively [how] we are leaning in our thinking without getting into quantities and without disturbing credibility. Fred Schultz's point is very apt that Proxmire would like nothing more than to see us try to fine-tune some of these ranges. He would say: "Aha, you are working in my direction but you are too cowardly to come out with a point estimate." I would argue very vociferously against either fine-tuning or a point estimate.

CHAIRMAN VOLCKER. One problem you remind me of--it is more of a potential problem--is that if we put more emphasis on M2 and also say qualitatively that we are going to reduce its range, my impression is that we may maximize the tension between the economic projection and the monetary projections.

MR. MAYO. Well, you have to go further than I indicated, Paul, in that M2 has certain qualities that remove it a little from transaction accounts. That's why we have M1. I don't see any harm in indicating that we may not be able to reduce M2 but that we expect or hope to have slightly lower M1 ranges. I don't think that would get you in too much trouble because M2 does include the ingredients of housing finance and so forth. That would not detract from the credibility of a qualitative statement of that type.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I don't think there is a compelling case to change the ranges this year, although I wouldn't object to revising M-1A down by 1/2 of one percentage point. For next year, I disagree with most people who have talked so far. I think we ought to give some numbers for next year. If we fail to do so, we could generate some adverse psychology to the effect that the Federal Reserve is not willing to speak except in very vague generalities. On the other hand, the problems of setting ranges for M1 numbers for next year are really formidable. I disagree with the staff recommendation that M-1B should be boosted by only 1-1/2 percentage points next year; that's much too low. If in the current situation we are getting a boost of 1-1/4 points to M-1B and then we go to national NOW accounts, [the effect will be greater]. The NOW account is a much more marketable concept than the ATS account; furthermore the S&Ls, since they do not have demand deposits, cannot [offer] ATS accounts. So the 1-1/2 points seems much too low. Now, if we go with 2-1/2 points, which is closer to where I think we are going to come out, then we will get some very strange numbers. For example, for M-1A we will get a range of -2 to +1 percent and for M-1B, 5-1/2 to 8 percent. I just think our ability to set ranges for M-1A and M-1B next year is so limited that we'd be much better off simply telling Congress that, due to this new technology change coming next year, we can't do a very good job at estimating and, therefore, we are only going to set a target for M2 next year. Now, we could add M3 to that and set targets for M2 and M3. And I would say for M2 that we are going to scale down the range by 1/2 percentage point to 5-1/2 to 8-1/2 percent. If we are not willing to make any commitment, even a tentative one, on what we are going to do in '81--particularly if you are [testifying] at a time when the foreign exchange markets are very turbulent--we are likely to get adverse psychological feedback. I don't see any real hazard to [my suggestion]. We are going to have to come up with some scaling down of the [ranges] and 1/2 percentage point is about as small as I can accept.

CHAIRMAN VOLCKER. Despite the fact that it's inconsistent with the economic outlook as presented? It's only 1/2 percentage point more inconsistent than the present range.

MR. MORRIS. I don't think 1/2 point is going to make very much difference, Mr. Chairman.

MR. SCHULTZ. Except that it is in the wrong direction.

CHAIRMAN VOLCKER. What would you say about taxes and wage-price policy?

MR. MORRIS. We ought to scrap wage-price policy. I don't think it has contributed anything in 1980, and in an environment such as we are going to have in the next couple of years I think the marketplace could do a better job than presidential guidelines. Presidential guidelines might end up providing a floor for wage increases in the kind of soft situation we are contemplating.

CHAIRMAN VOLCKER. Do I infer from what you are saying that you are much more optimistic about the wage outlook than the forecast suggests?

MR. MORRIS. Yes, I am, because I think we can affect expectations if we really demonstrate to the marketplace that things are changing, that we are doing things differently.

MR. BAUGHMAN. We can't affect existing contracts.

MR. MORRIS. Yes, but remember, 80 percent of the American labor force is non-union. It doesn't [work under] any contract. On taxes, I would urge the Congress to set that issue aside until they come back in the next session and treat it as a tax reform issue rather than as a consumption stimulus issue. One could make a good case for offsetting the increase in social security taxes for the consumer and one could certainly make a case for investment stimulus. This, of course, is essentially what is in the package. It seems to me, again psychologically, that it would be better to do this when the economy is turning up rather than having the Congress make a panicky, seemingly fine-tuning, effort before it goes out for re-election.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, like several of the others who have spoken, our preference for 1981 would be the retention of the existing ranges. I come out pretty close to where Dave Eastburn and Larry Roos came out but, of course, I wouldn't want to overstate my case as you said Larry was close to doing. So, I feel pretty much the same without overstating it. Just attribute [the overstatement] to him! If we lower our targets now--and because of where we are I know there is a real temptation to do that--people are going to interpret it as meaning that we have just forgiven our misses as we have done in the past. That's just one step away from their concluding that if we overshoot on the up side as we come out of this--which is where we usually have made our mistakes in the past--we will do that just as readily [this time]. So, that is the principal reason I would stick with these targets. But we ought to recognize that there are other aspects of credibility involved, and one is that to achieve these targets--to get anywhere near the adjusted midpoints of the ranges for M-1A and M-1B--we have to have pretty darn rapid rates of growth in those aggregates between now and the end of the year. And I'm convinced that a substantial body of the financial public is apt to conclude that we have thrown in the towel [on fighting inflation] unless we do a very good job of explaining that. I think you, Mr. Chairman, and the rest of us will have to combat that in talks if indeed we do decide that is what we want to pursue.

I am also aware that this course will probably weaken the dollar temporarily, but if we don't go ahead and move our aggregates up [into the ranges], the intensification of the recession here will probably damage our trading partners to a considerable extent and there will be feedback effects here. And those effects may even be more serious so far as domestic activity is concerned. We also ought to bear in mind that the real way to deal with the foreign exchange problem is to deal with inflation rather than to worry about temporary differences in interest rates. And I do think this policy will be the best way to deal with inflation over the long run. So on these grounds, we would favor approaching the adjusted midpoints--maybe I should say asymptotically or rather slowly anyway--of the ranges for M-1A and M-1B and we would weigh M-1B considerably more heavily than the others. We also would favor shorter-run specifications that would be consistent with that kind of long-run policy.

For 1981 I think it's vital that we follow through and announce that we have lowered our targets, as we have been promising to do every time we have [testified]. I'd make an effort to lower these gradually, but steadily. I think Frank Morris made a good point in suggesting that we ought to avoid saying much about the technical adjustments now. I would favor lowering all of the ranges about 1/2 percentage point but point out that we will have to make adjustments later on. I know that's not going to eliminate all the confusion that will emanate from this statement, but it might reduce it.

So far as the last question you asked, I would not favor a tax cut but it seems inevitable given the political situation, so I am assuming that one will take place. And I agree with Frank Morris that jawboning is practically useless. I would say it might have a marginally positive effect if monetary and fiscal policy are doing what they are supposed to be doing. But a tax cut is probably inevitable, so I imagine we will have it in some form.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I feel we ought to reduce the ranges for 1980. I realize it looks a little like base drift in fitting the goals to suit the achievements, but the alternative of bringing the achievements back within the ranges that were our goals could be very damaging. That would mean a rapid [rate of] increase in the aggregates. We'd have to go for a number of months at rates of growth in M-1A, and M-1B even more so, that in the past have been regarded as indicating inflation and perhaps a reversal of our policy. We would have to drive interest rates down somewhat further to severely negative rates. And then we would have to make a turnabout at some point in order to get back on track; [with money growth] having sharply risen back to track, we'd have to slow it down, thereby suddenly raising interest rates after [previously] having driven them down. I think all these gyrations would be damaging, and we are not likely to do them [when needed]. We will find ourselves missing or somehow avoiding the very painful issues involved in these interest rate movements. So I would favor bringing down the M-1A and M-1B ranges 1/2 point for 1980.

For the next year I share the philosophy that we ought to announce a reduction. I am very apprehensive that we will be far out of reach with regard to the development of nominal income on one side and the reduced monetary aggregates targets are concerned. I see the additional problem of M-1B. I, too, would be surprised if there weren't a more rapid switch [to NOW accounts], causing M-1B to increase more rapidly and M-1A to slow. It looks as though M-1A is really a diminished, vanishing species as far as most people are concerned. And I think perhaps Frank Morris' suggestion of focusing on M2 and M3 for '81 and explaining that under these conditions we cannot be very specific about M-1A and M-1B is a way out. We would do what we should do--indicate a reduction; that is what I would recommend. But we wouldn't quite trap ourselves in so difficult a situation as we would if we named lower numbers for the M1 aggregates.

CHAIRMAN VOLCKER. Wages, prices, and taxes?

MR. WALLICH. My response there is that we ought to go to a tax oriented incomes policy. I see in the Washington Post today that they are revising--

MR. PARTEE. Last gasp.

MR. WALLICH. It just won't die because it's a reasonable suggestion. As for a tax cut, if we had the choice, I would postpone it into late '81.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. I'm quite satisfied with the specifications of the ranges at this point. Remember, they are ranges, and if we get into the lower parts of them or the upper parts of them we've met our targets. We don't have to hit the 4-1/2 percent or 4-3/4 percent [midpoints] right on the nose. It seems to me that it would not be wise to lower them, simply for credibility reasons, even if we say it's a technical adjustment. Just leave them alone. I'd also point out to you that I don't think there is an overwhelming need to change the bank credit number because we know there has been a tremendous substitution of commercial paper for bank credit. And if we take [account of] the total sources of credit in [that measure], then the 6 to 9 percent range is one that is achievable. It's just a technical development in the market rather than anything that should make us change our targets.

CHAIRMAN VOLCKER. If I can just interrupt, I meant to ask--and maybe you already said this Steve, though you don't have it this way in the table--if we keep the ranges unchanged, is the technical case intellectually, in the sense of your best forecast, overwhelming for changing bank credit or not?

MR. AXILROD. Yes, our forecast for bank credit is literally 4-1/2 percent.

CHAIRMAN VOLCKER. That's fourth quarter-to-fourth quarter?

MR. AXILROD. Yes, December to December it's around 5 percent.

CHAIRMAN VOLCKER. That's consistent with these--

MR. AXILROD. Yes, that's consistent with the 4-1/2 percent [forecast for M-1A], etc.

MS. TEETERS. But if you add in commercial paper what happens to it?

MR. AXILROD. I don't have that rate of growth in mind, but I don't think it would be that low.

MS. TEETERS. It probably would bring growth within the range, if we [took into account] the substitution in commercial paper.

MR. AXILROD. I'd have to calculate it.

MR. MORRIS. It has been several billion dollars in the last couple--

MS. TEETERS. Yes. It strikes me as the same kind of animal. [Issuers of commercial paper] have just shifted where they are getting [funds]; and due to the technicalities of the prime rate relative to market rates it's a reasonable thing to do. So, we could just explain that there has been a shift in the way the market is [behaving] and keep the same range.

For next year, I really am disturbed that everybody wants to lower [the ranges]. Have you not looked at what the federal funds rate would be if we lower them? The funds rate in the fourth quarter of 1981, if we lower our targets, would be 15 percent. How much mortgage activity do you expect to have if fed funds are at 15 percent? There's a limit to how far we can push down on money growth and not just absolutely strangle this economy. And given the uncertainties of the outlook at this point, I think the safest thing to do is to say that we are going to stay within the same ranges next year. We have wide enough ranges to lower the actual outcome, to come in at the low end. But to set out now to push short-term rates up to the 15 percent area seems to me outrageous, frankly. It would almost completely negate any real growth that we are going to get over this period. The housing market certainly won't come back. The thing to do is to say that we will aim to get within the ranges and that we aren't sure we are going to hit the midpoint of every one of them. I'd stick to the bank credit range as modified, and then say at this point that we simply plan to continue [those ranges] through next year rather than that our total task in life is to reduce the rate of increase in the money supply year after year. I don't think that's what it is.

CHAIRMAN VOLCKER. Wages, prices, and taxes?

MS. TEETERS. On wages and prices, I don't see that we have a hope of getting it through Congress. On taxes I think the most beneficial tax cut we could get--this should sound familiar--is to cut out the social security tax increases, which would probably do more to lower unit costs than anything we could do at this point. That has a direct impact on wages. They can take out the increase in January and dress it up as a removal of health insurance [unintelligible]. And if the accelerated depreciation were put in, we'd probably get the best combination of tax reduction and one that goes directly into people's incomes right away. It wouldn't get all tied up in a refund a year later, in the way it has been done several times before. So, if we state our preferences, I'd certainly go for social security relief.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Let me start with the tax issue first. I agree with Frank that we ought to encourage the Congress not to consider this until after the general election. I think the chances of getting a well-structured tax cut would be much better if it could be considered later this year rather than in the heat of election politics. I would like to see a significant part of the tax reduction go to a reduction in payroll taxes, but not all of it. We ought to strongly encourage the Congress to allocate a substantial share of the overall tax reduction to business investment incentives because I think that's critically needed for the future. On wage-price policy, the way wages and prices behave in a complex modern economy leaves really no alternative but to try to use voluntary guidelines to supplement monetary and fiscal policies. I wish I could agree with Governor Wallich that a TIP would work, but I don't see any kind of TIP that is feasible.

So far as the targets are concerned, I want to start with 1981 and work backwards. If I have understood correctly, the staff is saying that if we want to keep the unemployment rate from going up further, from roughly 9 percent at the end of 1980, we are going to have to provide for an increase in M1, however defined--not worrying for the moment about NOW accounts and so on--of roughly 7 percent unless we have a very favorable shift in money demand. And Steve is saying that the chances of not getting that favorable shift in money demand are not trivial. I would say that, indeed, they are not trivial; it may not happen at all. So I think it would be a serious mistake for us to decide at this juncture that we ought to lower the target growth rates for the narrow monetary aggregates for next year. I'm more pessimistic than the staff on the outlook for inflation next year. But we can't possibly run a viable long-run monetary strategy to reduce inflation if we follow a strategy that pushes the unemployment rate well above 9 percent. I just don't think that's viable. Now, the logic of my position for 1980 and my interpretation of what has been happening recently says we ought to lower the growth ranges; substantively I agree with Governor Wallich completely. But I don't think we can lower them now for the rest of 1980 and then raise them for 1981. So, I would be inclined to leave the targets where they are for 1980; but I would be entirely happy, unless we have a reverse shift of the money demand function, to see the actual growth rate of the narrow monetary targets fall below the targets for this year. I would be quite prepared to explain to the Congress that when we have a shift in money demand to pump out enough money supply to stay within those ranges is murder. It would just ruin any chances we have for getting inflation under control over the long run. So far as M2 is concerned, my feeling is that we have a range that looks inconsistent with the M-1A range and that we ought to be prepared to raise that. And if we are reluctant to raise the whole M2 range, then I'd raise the upper end. It is a new kind of aggregate.

CHAIRMAN VOLCKER. Are you talking about '80 and '81?

MR. GRAMLEY. 1980. What I would do for 1981 is simply say that at this juncture we have no basis for changing our views on the appropriate growth rates and for now I'd leave them where they are.

CHAIRMAN VOLCKER. If I understand you, for M2 for 1980 you would--

MR. GRAMLEY. I would be inclined to raise the range for M2 for 1980. One way to do it would be simply to raise the upper end and say 6 to 10 percent.

MR. PARTEE. Or let it go a little over.

MR. GRAMLEY. Yes.

MR. PARTEE. Chances are that M3 will be within [its range] and we could be a little over on M2 and a little under on M1.

MR. GRAMLEY. I'd be prepared to [accept] that, too.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Mr. Chairman, my posture would be to emphasize the rapidity of change we've experienced and the likelihood that we may encounter continued rapid changes down the road. I'd indicate the kinds of changes that have taken place and that may take place in the future. I would keep monetary policy unchanged but stress that maintaining policy might involve some fluctuations in interest rates ahead, some of which may be adverse. In view of the rapidity of change and the many uncertainties, I would be extremely hesitant to be very specific about next year. Inflation developments may go one way or the other in the fall, which may influence [our decision]. We have the technological changes with nationwide NOW accounts. We have the uncertainty with respect to taxes and a whole set of [unintelligible]. So I would be more concerned [about making sure] that policy is appropriate with respect to the changed circumstances, whatever they might be. And I'd say that [ranges] will be announced in February, with the thought of then being very specific.

With respect to taxes, I would be inclined to talk about tax reform, not just the deficit side of the picture, and to stress the importance of waiting until there is a chance to consider those moves deliberately rather than hastily. I am very sympathetic to the social security tax problem--what it means cost-wise, income return, and all the impacts--and the need to do something on the investment incentive side. That may require a cut in expenditures, depending on the circumstances when [the Congress] starts to consider this. So I think they are caught in that. As for wage-price policy, I don't feel that does much good; I'd [rely once again on] market forces.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Mr. Chairman, earlier on you raised the question of the Proxmire resolution and didn't get much of a response. I was mulling over the opportunities as well as the risks of supporting that resolution and I would come out recommending that you support it if you're forced to take a position. If at some future date the Congress goes down the road that you fear it might and begins talking about setting interest rate levels, we could resist that kind of resolution at the appropriate time. To resist the current proposed resolution I think would be a mistake. Such a resolution would strengthen our hand in terms of not following a usual vigorous countercyclical policy in view of the ongoing very serious nature of inflation.

CHAIRMAN VOLCKER. If I may just make clear my own position at the moment, which is always subject to change, it is not to resist it or to support it. In other words, if I get asked "Is this a good resolution?" I'd say it's a fine resolution. But I'd try not to be out there in front.

MR. BALLES. Yes, I think that would be wise. The dilemma that you so well described earlier is going to come home to roost, obviously, in your testimony. I agree with a number of other observations made around the table a little earlier that the markets, both domestic and international, are going to be extraordinarily sensitive to all the nuances of what you have to say. And I think it is quite important to separate policymaking from public perceptions at this point because the impact of the announced ranges on inflation psychology and what is assumed to be the course of actual growth is going to be extraordinarily important. I certainly agree that we ought to resist any narrowing of those ranges, if you get pushed into speaking to that either in your testimony or in response to questions. We should try to keep the maximum flexibility because of all the changes going on both in the economy and in financial innovations; with nationwide NOW accounts pending we are going to need that flexibility I am sure.

You asked us to speak about assumptions on tax cuts and wage-price policy. I am pretty cynical regarding the ability of wage-price policy, if it's continued, to do anything realistic to change the way the world runs. If I were a betting man, I'd bet that there will be a tax cut sometime in '81. If we have an opportunity to speak to how it ought to be structured, I would certainly support the statements others on the Committee have made that we ought to aim for tax reform designed to stimulate productivity and capital investment and take the edge off the impact of high and rising payroll taxes. My own hunch is that there is going to be little, if any, real restraint on the fiscal policy side in terms of the actual budget or even the high employment budget. That's because if you look back at what happened to the unemployment rate during this period of expansion that ended last January, we never even got close to getting down to a 5.1 percent unemployment rate. So I think that rate is very unrealistic when calculating the impact of a full employment budget. That leads me to the conclusion that monetary policy is still about the only game in town in terms of exerting any anti-inflation effect. But we are faced with the usual dilemma that there is a long lag between the time we move toward restraint and when it shows up on the price front, which may not be until several years from now.

Having wrestled with whether or not to change the ranges, I think we would be well-advised just to keep the present ranges and not change their width either. There would be too many problems to explain if we begin tinkering with the ranges for 1980; therefore, I would [support] the views already expressed not to fuss with them. But, of course, in terms of policymaking in future months, we want to reserve for ourselves the right not to hit the present midpoints for all the reasons that have been set forth.

With respect to 1981, I would also agree with the view expressed earlier by many other speakers that we should avoid getting overly specific and try to avoid getting pinned down to explicit numbers, especially in view of all the uncertainties connected with the impact of pending nationwide NOW accounts. I favor keeping [our targets for] 1981 as much as possible in qualitative terms but I hope on balance that your testimony would imply, if not make explicitly plain, that in terms of longer-run strategy we are still working very hard at getting the inflation rate down, even if that involves more aggregate growth for next year than we may have for this year. That's about all I have on that.

CHAIRMAN VOLCKER. Mr. Schultz.

MR. SCHULTZ. Well, my point of view is strongly driven by something that we haven't talked about yet, and that is that we are still kind of on a honeymoon and that the tough times are ahead. The technique that we are using implies that at some point in time, when the economy begins to strengthen, unemployment will still be high and probably rising and interest rates will begin to go up. And that is when the moment of truth will arise. That is the period that Governor Wallich is afraid of in that he thinks it will put us in the cowardly camp. I don't believe that's correct. But it is important that we follow a strategy that gives us the best opportunity to stick to our guns in spite of what may be at that point considerably more pressure than we are presently feeling. Therefore, my approach would be to hold to the present targets and to ease toward them reasonably slowly, which would mean aiming to reach them in December. I would not like to see us [promote rapid growth] to reach them in September, which would mean that the fourth quarter would be the period in which we will start to see interest rates rising rapidly. It would put us in that box quickly.

For 1981 I believe the 4-1/2 percent figure is sufficiently restrictive for us to be using in our thinking at this time. However, it's very important that we give ourselves as much leeway as we can. I would like to suggest that for 1981 we comment along the lines that the aggregates will be generally at or below the present targets. We are all very uncertain about the state of the economy. We all recognize how difficult forecasting is currently and it would not help us much at this point to be specific. I would like to see us have the opportunity to have a little more running room at the end of the year. So far as the bank credit figures are concerned, I don't think they are very critical. The monetary aggregates are much more important. I certainly would not be opposed to Governor Teeters's approach that we say [bank credit] is running below the target range but that's because of a shift in the type of debt [being used] or something like that.

So far as wage and price guidelines are concerned, I don't think they make much difference at this point. There is a possibility that somewhere down the road they may make some difference. There is something to be said about rational expectations in terms of getting inflation down over time and, although we can't have a social contract like they have in other countries, I believe that some wage-price guidelines together with a variety of other things can make a difference. As far as the tax cut is concerned, I favor one; I favor a tax cut that will help on inflation and help in terms of savings and productivity. Therefore, I would agree that we ought to do something about depreciation or investment tax credits or something in that area. I agree the timing would be much better if it could be put off until next year. If it can't, let's have it as late as possible.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I agree 100 percent with Nancy. I would use the same ranges again, recognizing that for 1980 we expect--and to some extent plan--to come in at the bottom end of the range on M1 and maybe well up in the range on M2. I think that's probably better than making any kind of technical adjustment. And I agree that we can explain bank credit by emphasizing [commercial] paper, the way Nancy did, rather than corporate debt generally because people understand that paper is a direct substitute for bank borrowing, depending on rate relationships.

For 1981, I agree with both Nancy and Lyle. I don't see any chance of reducing these ranges without possibly having considerable impacts on the economy. Now, a number of people have said they don't know what to do with M1, so let's reduce M2. But M2, as somebody pointed out earlier, is a source of housing credit in substantial part and has the money market mutual funds in it, which are still growing pretty rapidly. The top end of our range now is 9 percent. We can't ignore the fact that nominal GNP is going to have to go up quite a bit because, much as we dislike it, there's going to be quite a lot of inflation. And [reducing the M2 range] isn't the way to stop that inflation. Therefore, it seems to me that we'll be lucky if we can keep M2 within that 9 percent [upper limit] next year. The strategy I would follow would be to say that 1981 is a long time off but we anticipate having something like the same kinds of ranges for 1981 that we have had this year and we would hope to reduce growth within these ranges as inflationary pressures abate--assuming they do. You can make that comment: We will do it as we are able to do it, as inflationary pressures are reduced.

On wage-price control, I would get rid of that program as soon as possible. I think it is totally discredited in the country and it is best to get rid of [that bureaucracy] and let it rest for a year or two and maybe try something better next time. We can say that market forces are going to lead toward more moderate settlements in labor [contracts] later. One of the difficulties in continuing the program is that we have to recognize the cost of living. And if we do, that's going to lead us as it did this year to raise the Reserve Bank budgets rather than reduce them. The change in the wage-price guidelines led us to increase Reserve Bank salaries and that's a very fine example of a counterproductive effect from that [program]. It's our own salaries that have to be limited--not somebody else's, but everybody's in this room.

I don't see any sense in arguing the tax issue. There will be a reduction next year. It needs to include some consumption tax reduction because consumers are too hard pressed, but I like the idea of making it a payroll rather than a general income tax reduction.

MR. RICE. I agree with everybody. It's obvious to me that there is going to be a tax cut next year. I just hope it's a good one--that is, one that consists in part of a reduction in payroll taxes but also increases investment incentives. From my point of view it should have at least these two objectives: To increase investment incentives, and hopefully have the effect of increasing productivity, and to reduce the payroll tax burden. I would also add that it's terribly important to get people to start to think in terms of tax reform as soon as possible. This is separate, of course, from the immediate tax cut issue that is going to have to be dealt with. But the sooner we begin to think in long-range terms about tax reform, the better, because it has all kinds of implications for productivity and stimulating investment, and so forth.

With respect to wage-price policies, I have a good deal of sympathy for Henry's tax-based incomes policy. I don't think there is much chance of getting it, but I certainly would have a good deal of sympathy for it. Absent a high probability of getting it, I would probably find myself agreeing with Governor Partee that we should just forget about the wage-price guidelines. But, again, I don't know how politically realistic that is at the present time.

With respect to the aggregates, I would favor maintaining the current ranges for the reasons that have been given already. I think the credibility problem--I'm speaking now about 1980--is a real one. We ought not be in a position of having it said that when the aggregates move in a way that's uncomfortable for us we adjust the ranges. I don't think we ought to tamper with the ranges for 1980. Therefore, I would support alternative I, maintaining the present ranges, and not worry too much about where the aggregates come in within those ranges.

With respect to 1981, I would favor strategy 1, again for reasons that have already been given. We ought to say that we have no reason at this point to adjust the ranges downward in 1981. I hasten to add that six months or a year from now, when we are considering them again, we might well want to adjust the ranges. But I see no reason to commit ourselves now to reducing the rate of growth in the aggregates. To do so would run the risk of reducing the rates of growth in money at a time when unemployment is rising. That is a realistic possibility, it seems to me, and I would not want to be in a position of mechanically having to follow a policy which requires us to reduce money growth at a time when unemployment is still rising. So I would favor stating that we see no reason at the present time to change the targets for 1981; however, if the situation unfolds in such a way six months from now or a year from now that it seems necessary or feasible, we will certainly consider it.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. It seems to me that the question is not what assumption the Federal Reserve is making in regard to tax policy, but how you will answer questions on policy recommendations that the Committee will ask you. Substantively I certainly agree with Lyle Gramley and a lot of others that the responsible thing to say--and I hope you will say this, Mr. Chairman--is that the size and the composition of the tax cut should be considered early in the year. However, I'd like to make a point which I sometimes think the American public doesn't quite understand [regarding] why, if everybody says a tax cut is inevitable next year, it shouldn't be legislated now. So I think you have to point out two factors: One, that the tax cut and the composition of that cut can't significantly affect the course of the economy for the rest of the year; and secondly, if you choose to, and you may not choose to, that the politics involved in an election year are not conducive to the kind of carefully studied and deliberately planned tax cut that is appropriate.

I also feel that wage-price guidelines, even though they have not been very effective in the last two years, are an absolute essential. I think it's appropriate to point out that they worked in periods during the '60s, that there will be an opportunity for whichever Administration is in power to start with a fresh slate, and that certainly if they can be made much more effective they will add both to a better recovery and higher employment as well as a lower inflation rate. And they should go hand-in-glove with consideration of the tax-cut policy.

As far as the aggregates go, I also share the overwhelming consensus [developing] here that we should not change the aggregates for 1980. But I think it's important to point out at least that we expect M-1A and M-1B to come in toward the lower end of their ranges. If we don't say that, we may get a very adverse market impact.

As for 1981, I am similarly concerned about what the market impact will be both in domestic markets--[that is], long-term market rates--and the foreign exchange markets if we fail to say or at least to imply that there will be some edging down of the targets. In a certain sense, it has almost become widely expected of the Federal Reserve. I'm not disregarding the substantive problem that Nancy and Chuck pointed out, and I realize that we shouldn't lock ourselves into anything. Certainly we should not be specific, but I am a little concerned about the market impact. If we were to fail to [say something of that nature], that would be a noticeable omission, and I would hope that with your usual skill you will be able to waffle. I hope you will bear in mind that we are talking with one eye on the market. I guess that pretty much summarizes [my views].

CHAIRMAN VOLCKER. I would just note in connection with that last comment that it is not a question of my dancing around and answering the questions. That is one thing. But in our lovely staff report we have to put in black and white what we believe the prospects are for next year, however vaguely that is stated. The official distillation of our intentions for next year is going to be there in a sentence or two or three sentences or whatever. It's a little harder to waffle without being obvious about it.

MR. PARTEE. Perhaps we could invent a typo for this and scramble the sentence--

CHAIRMAN VOLCKER. Have we heard from everybody except our First Vice Presidential associates?

MR. ALTMANN. That's correct.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. Perhaps I should begin by saying that when Governor Partee talks about Federal Reserve salaries I would take some exception, but perhaps I'll save that for another forum.

MR. PARTEE. That's what everybody always does when they talk about their own salary.

MR. FORRESTAL. With respect to the longer-term targets for 1980, Mr. Chairman, I think the choice is a difficult one between maintaining the status quo and lowering them. I have some sympathy for the view Governor Wallich has expressed, but on balance I would prefer to see the targets remain unchanged for 1980. Having said that, I do think we ought to strive to come in at the lower end and certainly not exceed the midpoint of those ranges. And we should state publicly that we will be coming in at the lower end so as to avoid any market misinterpretation of our ultimate motives.

With respect to 1981, my present feeling is that we should probably reduce the ranges, but I think it's premature to be very specific about our intentions because of the uncertainties that everyone else has [mentioned]. I think a tax cut is inevitable in

1981. My own preference would be to have it in the form of tax reform and be later rather than sooner, but in the present political environment I expect a tax cut will come at least in 1981 if not sooner. On wage and price policy, I don't have much to say except that I don't think that policy has been very effective and the sooner we dismantle the bureaucracy that's administering those programs the better off we'll be.

CHAIRMAN VOLCKER. Mr. Gainor.

MR. GAINOR. With respect to wages and prices, I agree entirely with Bob Forrestal that the best thing we could do is dismantle the program as soon as possible and I'd recommend that. On the issue of a tax cut, we assume a cut of the magnitude projected, around $28 billion. We'd prefer that we not have it. If we have to have it, though, we'd like it to be deferred, preferably until after the election.

With respect to 1980, we favor continuation of the existing ranges, alternative I. I think that's consistent with what we told Congress and everyone else earlier in the year and we should follow through on that commitment. As to 1981, we favor strategy 2, which supports the concept of an orderly reduction over time in the ranges that we're aiming toward. In deference to the point that Ernie made about legislative uncertainty and so on, it's probably better to waffle on how we state our plans for 1981 but I definitely think strategy 2 is the right one.

CHAIRMAN VOLCKER. Mr. Czerwinski.

MR. CZERWINSKI. Mr. Chairman, there is little that I can add to what has already been said. Our position with respect to wage and price policy would be identical to what Bob Forrestal has enunciated.

CHAIRMAN VOLCKER. I think the First Vice Presidents' position on wage-price policy is related to their dislike of wage-price policies by the Federal Reserve Board.

MR. RICE. I don't understand the implications. We don't have to raise them as much.

MR. CZERWINSKI. With respect to taxes we, too, think that a cut is inevitable and would prefer to see it come late in 1981 if possible. On the long-run targets for 1980, our preference would be to maintain the existing [ranges]. For 1981, we would favor some slight reduction.

MR. ROOS. Mr. Chairman, would you just record me--because you hadn't asked the question on wage and price controls--as being strongly opposed to them.

CHAIRMAN VOLCKER. That's a big surprise!

MR. BLACK. I think he understated his case, Mr. Chairman!

CHAIRMAN VOLCKER. Well, let me try to summarize so we can conclude, if feasible, before lunch. On taxes, first of all, let me just say that I [expect] to be asked to testify formally on taxes, as it will be coming up before other committees. In a sense, what I say would be my personal testimony, but the question is to what extent I can speak for a wider group if asked. There seems to be a consensus, though not everybody spoke to the point of what we want as opposed to what we expect, that there is no eagerness for moving on taxes immediately in a broad-brush way. There may be differing degrees of sympathy for a tax cut eventually. I think everybody would say it depends partly on conditions. But the idea of trying to [delay its enactment] is certainly widely accepted [by this group] as nearly as I can see [as is the view that] the cuts ought to be gauged as much as possible in terms of their direct impact on prices and costs and productivity. There is considerable sentiment--I don't know what I think about this frankly--[for reducing] the payroll tax. I recognize the benefits but I also worry about the future of the social security discipline if payroll taxes are [not imposed] directly. But I recognize that it is a major avenue to look at in connection with the tax cut program. I could probably speak pretty broadly by saying that there is a desire for this to be looked at later and not right now and not be too definite about the later. The later could conceivably mean at least September but preferably after the election.

On the wage-price issue, there's a greater difference of opinion, obviously. I don't have any set view on this at the moment but I have a feeling that the pessimism [about the effectiveness of the program] that has been expressed by the staff is widely accepted in our thinking in terms of the difficulty of [making progress on] the wage side of the [equation]. I'm not sure there's anything to be lost, frankly, by saying that if you people in the Congress are talking about a tax cut, a pre-requisite you ought to think about among other things, is a concord between labor, business and government on a guideline that's substantially below the present guideline. [This has to be done] in the context of all the problems we have, including the potentially inflationary implications and all the rest. I don't think it does much good to talk about guidelines in the present area. But I'm not sure there's anything the matter with stating that as an objective at the moment. And to the extent we raise the issue, it may even slow down the immediate drive for a tax cut until we all see how things develop over the remainder of the year. Now, that's purely a personal reaction at this stage, but I'm not sure there's anything to be lost by it. I'd go all the way by somehow relating it more specifically to wage increases but I don't know how to do it. If anybody had a bright idea on that score, it probably would have been thought of already. Not that your idea wasn't bright, Henry. I don't suppose I could speak more broadly about that approach but I have some sympathy for putting it that way as part of an argument for deferring consideration of the tax cut at the moment.

On monetary policy itself, the consensus is pretty clearly to keep the ranges unchanged for 1980. I basically agree with that in terms of simplicity in presentation. It bothers me a little because some things are going on that would justify a change, and in ordinary circumstances they ought to be recognized. Even on a technical level, on the relationship between M-1A and M-1B--which is a pretty darn technical matter due to the NOW accounts--ordinarily we would say we [now] have more experience and we ought to adjust that relationship. But I recognize the arguments that were presented pretty fully around the table for taking the simple approach. Most people suggested, and

I would certainly agree, that consistent with that approach we would not be disturbed if, as is likely, the M1s came in at the low end of the ranges. We might also say that it's possible M2 will come in at the upper end of its range and that M3 will be in the middle or lower part of its range. But the ranges are there and we are not changing them partly because they are ranges. Nevetheless, we don't consider it undesirable or inconsistent with our intentions if we have that kind of pattern among the ranges. In fact, if we don't say that, we're almost forced to change the ranges because of the apparent inconsistency in the relationships among the different Ms. On bank credit we may be able to finesse along the lines that have been suggested. That's a little harder to do than if we hadn't put so much emphasis on that measure in connection with the credit control program, but let's suggest that bank credit may come in even below the lower end of its range. However, due to the rise in commercial paper and so forth that does not disturb us so greatly that we have to take it into account.

Let me just stop there. Does all that express the consensus for 1980 clearly enough? We don't change the ranges, but explicitly in my comments we say that we are satisfied with a low M-1A and also recognize that M-1A probably should be low relative to M-1B in terms of the ranges but that this is a technical matter. Thus the M1s generally might well come in quite low in their ranges and that would not disturb us. M2 similarly could come in high in its range and that would not disturb us, and M3 may be near the middle of its range. And that is the basis upon which we are reaffirming the ranges this year.

MR. BLACK. Mr. Chairman, if we are satisfied that M-1B will come in fairly low in its range, are we going to be willing to have it come in higher in '81?

MR. PARTEE. It's going to have to.

CHAIRMAN VOLCKER. We can reopen the question of '80, but at this stage before considering '81, have I captured the consensus for the staff and the writing they have to do for the testimony? In a very formal sense the numbers are the same, but the interpretation is of some considerable importance here.

VICE CHAIRMAN SOLOMON. I think that captures it exactly.

CHAIRMAN VOLCKER. Okay. For '81 I think we are in much more difficulty, frankly. We have a real dilemma, inconsistency, tension, or whatever you want to call it between the projections and what we'd like to see happen in the economy. If the staff estimates mean anything, in a very straightforward way what they imply for the aggregates--I'm not saying we should accept it--is higher [rates of growth]. On the other hand, we can express the conflict very directly by looking at this resolution that Mr. Proxmire has prepared, which I was urged to accept and I'm prepared to accept. The final clause of that resolution says we are going to gradually reduce the rates of growth in monetary and credit aggregates in a firm and stable manner. If we accept that resolution one day, that presumably means we should be reducing the monetary and credit aggregates in a firm and stable manner, including in 1981. I take it that virtually everybody--there were one or two contrary opinions--in resolving this dilemma said [we should express our targets for] 1981 in qualitative terms and in effect waffle a bit. I think I agree with that. I will just tell you that it's easier to say it around this table. When we say that in public, people will ask: "You've been putting more emphasis on numbers and you've said you were going to reduce the ranges, so why do you now refuse to say more straightforwardly that you are going to reduce them even by 1/2 or 1 percentage point or something? You couldn't possibly have been suggesting that you were going to go more slowly than that." I attach great significance to that [argument] and I think there will be a market reaction, too. The market will attach some significance to the fact that we are not willing to go up [to the Congressional hearing] and say we are putting forth a lower number. It's not that I really disagree with the fact that we had better be qualitative. But it's not as easy [to carry out] as the comments around here suggested; that in itself will have some implications for how our actions are interpreted. Dave?

MR. EASTBURN. I think you're entirely right. It's not easy. On the other hand, if you surround your discussion of 1980 with a good deal of qualitative explanation about the uncertainties regarding the shifts in demand for money, and so forth--and extend that into 1981--you will have provided the background for a good deal of waffling.

CHAIRMAN VOLCKER. I don't think that avoids the problem, but I agree with what you are saying. Whatever else we say about '81 we ought to say that there is a lot of uncertainty about the M1s and particularly about the relationship between M-1A and M-1B. Somebody here put it very dramatically with zero on one and 7 percent on the other or something like that. I don't know where we will come out at the end of the year when we have to make those projections, but there ought to be some discussion of that problem and the fact that those particular numbers may look quite different but in a meaningless way in a sense. When we actually put forward the numbers they might look different--both of them--from what we had in '80. One may be significantly lower and the other may be significantly higher.

VICE CHAIRMAN SOLOMON. One possibility would be to say that our presumption at this very early stage is that the Committee will wish to continue its long-run fight against inflation by some gradual reduction of the aggregate targets but, given the uncertainties on all these technical aspects such as the shift in the demand for money and a few other things, we feel it's definitely premature to come up with even tentative or preliminary [numbers].

MS. TEETERS. [Unintelligible.]

MR. SCHULTZ. Either that Nancy, or leave the top where it is and drop the bottom a little and that will make it look as if we're cutting it down some.

MS. TEETERS. Look, one of the problems we are likely to face next year is that we will be tempted to set a target that is too low and we will exceed it. And it seems to me that our credibility in the long run is going to be worse off if we exceed it than if we are realistic about what we can accomplish. Given the fact that it's 12 to 18 months off, it seems to me very reasonable to widen the ranges at both ends at this point.

CHAIRMAN VOLCKER. What do we have to say in the directive, Mr. Secretary, about 1981? Nothing, do we? This isn't a directive question, is it?

MR. ALTMANN. I can answer that perhaps by telling you what we said at this time last year. After citing the ranges for 1979, the directive said: "The Committee anticipates that for the period from the fourth quarter of 1979 to the fourth quarter of 1980 growth may be within the same ranges, depending upon emerging economic conditions and appropriate adjustments that may be required by legislation or judicial developments affecting interest bearing transaction accounts." That language was in the directive adopted [in July 1979] and was repeated each month.

CHAIRMAN VOLCKER. In what [part of the] directive does that appear--in the operating [paragraphs]?

MR. PARTEE. It's in the longer-term paragraph, isn't it?

MR. ALTMANN. That's right.

CHAIRMAN VOLCKER. Why do we need it in there now?

MR. ALTMANN. That was the decision made at the time that the Committee considered it.

MR. PARTEE. I thought that's what the Humphrey-Hawkins Act called for.

CHAIRMAN VOLCKER. It calls for a decision, but I don't know that it says how it has to go in [the directive]. We have to put down some language in the report anyway, but I don't quite see why it has to be in the directive.

Steve has some [suggested] language. Let me just try it out in terms of the tenor of it. "Looking ahead to 1981, the Committee decided to work toward a further slowing in monetary growth rates that is consistent with an orderly reduction in the rate of inflation, while taking into account the impact on individual aggregates of the introduction of NOW accounts on a nationwide basis, a change in public preference for deposits and closely-related assets and emerging economic conditions." I suppose it's that last phrase that--

MR. PARTEE. And of the need to keep some of our [citizens] employed.

MR. MAYO. I think you forgot to include the international considerations.

MR. GRAMLEY. I'm not sure I would want that first sentence.

CHAIRMAN VOLCKER. I just looked at this language a minute ago. It takes the approach of saying we would like to get them lower but then putting a caveat on it. I suppose the question is whether we want to say--

MR. GRAMLEY. Suppose M-1A comes in at 3.55 percent for 1980, just within the lower end of the band. Would we really want to say that for 1981 our objective is to get a lower figure?

CHAIRMAN VOLCKER. Well, it probably will be for M-1A; M-1B is going to give us the trouble, I think.

MR. GRAMLEY. M-1A would come in better only because of what happens to NOW accounts.

CHAIRMAN VOLCKER. That's right, only because of what is--

MR. PARTEE. [Unintelligible] talk about ranges. We might want to have somewhat [narrower] ranges but even that is too risky, I think. But certainly we wouldn't want to say that in 1981 growth is going to be lower than the point estimates that we have for 1980.

CHAIRMAN VOLCKER. Well, we can get a certain amount of leeway in the M1s because of the technical problem. I think we just ought to say flatly that in the case of M-1A and M-1B, NOW accounts are likely to have a big influence. So M-1B could well be above what it was this year and M-1A might be below. But that's just taking account of the shift between the two categories; it somewhat obscures whether in fact it's lower on the average, if we want to take that approach.

MR. BLACK. If we have the maximum shift on M-1B of 5 percentage points, with a midpoint of 5-3/4 percent the midpoint could be 10-3/4 percent. If we have the maximum shift on M-1A, the midpoint would be 1-1/2 percent.

CHAIRMAN VOLCKER. Because of that complication for next year, which we can explain without quantifying, we in a sense get off the hook. The real bind is M2, which isn't changing in concept, isn't subject to these distortions, and isn't subject to the same so-called demand shift as M1. I'm not sure we can say this, but at one point I thought we might say that in general we are moving these ranges lower and we are going to move as fast as we can but it may not be possible to do that next year for M2. That implies it's possible for M1, but nobody will ever know what M1 is because of all these shifts. But it gives some warning that we may not reduce the M2 range.

MR. MAYO. We still have the housing market out on M2. We wouldn't want to emphasize reducing that on a long--

CHAIRMAN VOLCKER. No, I'm saying we would tell them we may not reduce M2 and leave every implication that we're reducing M1. Then when they ask by how much and we have to give them some figures that are affected by NOW accounts and one can't tell--

MR. MORRIS. M-1B is going to be increased.

CHAIRMAN VOLCKER. It will be. We would explain that M-1B will go up because of [the NOW accounts], but it's not a real increase; it's only a statistical increase.

MR. SCHULTZ. I think the markets would like that even less than if we were more general. That may get us in trouble.

MS. TEETERS. May I ask a technical question? Is it possible to target on M2?

MR. AXILROD. Oh, sure. We were giving some consideration to elevating M2 in emphasis in our targeting procedures this time. In the end that seemed [unlikely to] solve the Committee's problem and it involved a little more difficulty in terms of the continuity of the presentation. As you say, next year there's an obvious case for it. But, again, I would stress that money market funds are in M2 and RPs are in M2, and we don't have a lot of experience with how those components are going to behave.

CHAIRMAN VOLCKER. We can target on M2 but of all the aggregates it's the least easily controlled, and we're going to have more misses.

MS. TEETERS. We have enough trouble with the M1s. Why go to M2 when it includes two things we have absolutely no control over?

CHAIRMAN VOLCKER. One way we can resolve this target for next year is the way Fred suggested. I don't know whether we want [to or not]. It's fairly straightforward to say the [1981] targets are going to be at or below [the 1980 targets]. I think it's a [choice] between saying that and saying in effect what this other statement says, which is that we'd like to be a little below [1980] but we are not sure we can be.

MR. BALLES. Mr. Chairman, I would like to emphasize what Governor Teeters said. There's a real trap in setting M2 targets that we think we can achieve because, with these new monetary instruments, we can't. As Steve just pointed out, M2 is loaded with [components] over which we don't have even indirect control--the money market funds, overnight Eurodollars, RPs, and what have you. I think that's a real snare that we ought to be very cautious about.

MR. MORRIS. I question that proposition. I don't think M2 is going to be any more difficult to control than M1.

MR. BALLES. Well, we have a difference of opinion. That's what makes horse races and stock markets.

MR. WALLICH. Well, M2 is getting more stable. In the past it has slowed when interest rates went up. Money market mutual funds are likely to go up when [rates rise] so that's a stabilizing element.

CHAIRMAN VOLCKER. There are two conflicting forces working. It's less directly controllable in one sense, but it has a much more stable relationship with the economy than--

MR. MORRIS. And these shifts in balances tend to take place within M2 rather than out of it into something else.

CHAIRMAN VOLCKER. Well, for '81 the consensus [though we're not unanimous] is that we have to be qualitative rather than precisely quantitative about it. Nobody wants to propose an increase. I would suggest, and it seems to capture the majority but not the full consensus, that we make subtle noises about how we'd like to get [the ranges] down but heavily qualify it. The alternative is to be more neutral about it and say we're either going to have [the ranges] the same or lower.

MR. BLACK. Mr. Chairman, could I make an observation? On M-1B, if we had known when we set these long-run targets that we would hit the midpoint or the revised midpoint of 5-3/4 percent, I think we would have been reasonably happy with that. We had expansion of M-1B in 1978 of 8.2 percent and in 1979 of 7.6 percent. And if we get it down to 5-3/4 percent [this year], that degree of deceleration seems plenty rapid to me. If we do that, then I don't have any problem with decelerating further in 1981. But if it comes in at 2 or 3 percent or something like that [in 1980], we have a problem for 1981. I would like to see us push that [growth rate] up toward the midpoint [while] we're in a recession which I think is probably going to be as serious or more serious than any postwar recession. And then next year, I think we can do what we said we would do.

MR. ROOS. I agree with you totally, Bob.

VICE CHAIRMAN SOLOMON. Do you ever formulate the preliminary targets for [the year ahead] in relation to the targets rather than the performance?

CHAIRMAN VOLCKER. Well, we are relating it now to the targets, which I think is part of the difficulty. Where we would want to come out in terms of changing [the ranges] and the actual number we would want next year does depend upon where we come out this year. If growth in the M1s comes in very low this year, as is possible, certainly we might want [their growth] to be higher next year. And it would not be inconsistent with this gradual deceleration notice. But we really are talking now about the imagery of target against target rather than target against actuality.

VICE CHAIRMAN SOLOMON. That was my presumption until I heard Bob's comments just now. Of the two choices you've put to us--hope to get [growth] down but heavily qualified as against being neutral--I prefer the [former]. My reason is that if it's heavily and sufficiently qualified, it's not a constraint on our flexibility to do what we decide later on has to be done in view of the situation at that time. But I think it will come as a bit of a shock to the market if we are neutral, for the reasons I [mentioned] earlier. So it seems to me that in this imperfect world we live in, we're better off making a bound in the right direction even though it's qualified enough so that we reserve the flexibility of the Committee to do what it thinks best--

CHAIRMAN VOLCKER. Let me suggest that whatever we decide we put a footnote, in effect, in the report--I don't know that it literally would be a footnote--noting that we are talking about a target here. We don't know where 1980 will come out but if M1 did in fact come out very low in 1980, [our] target in 1981 may in fact [be consistent with] a higher M1 in 1981 than in 1980. So we would encompass that possibility, which I think is very likely to happen.

MR. PARTEE. I think we're better off just talking about the ranges, Paul. It will exacerbate Tony's problem if we have a footnote that says we may have a higher M1 and we may not.

MR. ROOS. Why don't we do what is necessary to keep M1 where we want it, in the middle of the range? Why do we feel that we have to wait and see where it comes in when, indeed, through open market operations we have it within our ability to have it come in, at least over a period [of time], roughly where we want it?

MR. WALLICH. Would you do that even if the last two months required us to go to some fantastic growth rate, say, 20 percent?

CHAIRMAN VOLCKER. Well, we can resume with that as the subject of our agenda immediately after lunch. I think we agree, at least tentatively, on an unchanged range [for M-1A] this year and for expressing the view that it might come out in the lower part of that range.

MR. WALLICH. But I understood the consensus to imply that we wouldn't do anything extreme to force M-1A into the range if it happens to grow slowly all the rest of the year except the last couple of months.

MR. PARTEE. By "anything extreme" what do you mean other than to reduce interest rates?

CHAIRMAN VOLCKER. We can only answer that question with a subsequent discussion [in which we characterize our views] with precision. It's a little difficult because we don't have precise words in front of us. I suppose Steve's formulation of words, hastily done, is one option in which we express a hope but not a commitment to get [growth in the aggregates] down next year. But the approach that Tony just supported seems to be consistent with what a lot of people said. Let me ask: How many people would rather do it that way?

SPEAKER(?). Which way?

CHAIRMAN VOLCKER. That we say in general terms that we'd like to see the aggregates lower but whether it's possible or not depends upon a reassessment at the end of this year in the light of all the circumstances, and we are going to look at it [then].

SPEAKER(?). That's really the point.

CHAIRMAN VOLCKER. Yes.

MR. ALTMANN. Now [the question is] whether we put it in the directive.

CHAIRMAN VOLCKER. Well, let me worry later about whether we put anything in the directive. The [policy record] is going to include a discussion of the difficulties surrounding M1 next year anyway because of the NOW accounts problem. All that should be in there in qualitative terms in any event. But just in terms of giving the thrust, our basic policy over a period of years is to reduce these [ranges]. We're not exempting '81 from that approach, but we're not committing now to saying that it can be done. We'll decide more precisely six months from now in the light of all the circumstances at that time.

MR. ROOS. Mr. Chairman, how does that differ from four years ago when Arthur Burns said in commencement addresses that we're going to gradually reduce the rate of money growth and we equivocated and procrastinated and that's why we're in this pickle today?

CHAIRMAN VOLCKER. In that particular respect, it does not differ. It's the same as what he used to say four years ago. But I am assuming that the Committee is not prepared, which I think is the question you asked, to say right now that tentatively the ranges [for 1981] will be X, Y, and Z and that those ranges are lower than the ones for this year. I excluded that [option] because there wasn't much support in the Committee for it.

MR. GRAMLEY. Mr. Chairman, don't the facts indicate that the Committee has not equivocated in that respect? If I remember the numbers right, in 1977 the growth rate of M-1A was 7.7 percent; in 1978 it was 7.4 percent; in 1979 it was 5.1 percent; and in 1980 it will undoubtedly be less yet. The problem is, Larry, that money and prices do not track closely together. And while that deceleration in monetary growth was taking place, the rate of increase in prices accelerated. That's what we have to live with, whether we like it or not.

MR. ROOS. But, Lyle, we believe that there is a direct tracking of the rate of growth of money and prices and also the rate of growth of money and output.

CHAIRMAN VOLCKER. Well, I think we have lunch approaching.

MR. SCHULTZ. Before we got into that discussion, what you said just prior to that sounded pretty good to me. It was somewhat in accordance with your talents: It was even more waffling than what Steve had to say!

MR. PARTEE. Steve is not waffling enough for me.

MR. SCHULTZ. I would like to waffle a bit more than what Steve said, and I thought you had done that very effectively.

MR. GRAMLEY. I could certainly agree with your waffle. Your waffle I like.

MR. SCHULTZ. Yes.

CHAIRMAN VOLCKER. Has my waffle been recorded?

SPEAKER(?). Just put a little syrup on it and we'll--

MR. PARTEE. That's what you're likely to do!

CHAIRMAN VOLCKER. Was somebody listening to that [closely] enough to try to [put some wording together] after lunch?

MR. AXILROD. I would suggest that your waffle, Mr. Chairman, is probably one that would fit better in the policy record. And the Committee could be silent in the directive.

CHAIRMAN VOLCKER. I'm not quite sure why we need anything in the directive. It's not a decision. This kind of vague statement isn't going to affect what we do before the next meeting anyway.

MR. PARTEE. I'm told that my subcommittee, of which you were a member at the time, proposed that it be in the directive. I can't remember why.

CHAIRMAN VOLCKER. Well, I can't remember why either. Unless somebody can think of a reason, let me propose that it be in the report but not in the directive. I don't see off-hand what purpose it serves in the directive since it's a vague statement anyway.

VICE CHAIRMAN SOLOMON. Coming back to this proposed waffle: Before you ask for a show of hands you ought to make people understand what the alternative is--the second thing they're going to be asked to show their hands on--which I gather is a completely neutral statement.

CHAIRMAN VOLCKER. Completely neutral? It's not neutral in the sense of raising the range, but neutral as between changing it or not changing it.

VICE CHAIRMAN SOLOMON. Okay. Even though I welcome the adherence of Chuck and Lyle, I'd like to--

CHAIRMAN VOLCKER. That makes you suspicious of it?

VICE CHAIRMAN SOLOMON. Well, what you said in your reformulation of Steve's [wording] is that consistent with our long-run policy, we would like to see the aggregates lower in '81 as well, but we don't know if we can make it for such and such reasons. What I would like to suggest we say--again because I'm thinking of the market impact, which could be very damaging to all of us--is that consistent with [our long-run policy], it is too early for us to indicate anything specific because there are too many caveats and we just don't know where we are going to come out. In other words, to say to the market that we don't know if we can make it--

CHAIRMAN VOLCKER. Well, that is not the language that I would use. I would suggest, particularly since it's 2 o'clock, if there is a willingness to work in this direction--and that seems to be the consensus--that we see if our staff can come up with a formulation before the end of the meeting that incorporates words that we can look at a little more specifically. We can't resolve it just--

MR. ROOS. We're not committing to the waffle, though, by doing this?

CHAIRMAN VOLCKER. Not at this stage, no. Why don't we have a few sandwiches for the time being.

MR. SCHULTZ. We're suggesting that the staff, rather than have lunch, eat their work!

CHAIRMAN VOLCKER. Well, we have sandwiches right next door, I believe.

MR. AXILROD. Mr. Chairman, with regard to President Solomon's point on--

MR. PARTEE. If we work on this waffle, it finally will be a pancake.

CHAIRMAN VOLCKER. We are going to have waffles for lunch!

VICE CHAIRMAN SOLOMON. The Open Market Committee will be known as the International House of Pancakes!

MR. AXILROD. Tony, the law says the Committee has to say something about it.

CHAIRMAN VOLCKER. It does? In the directive?

MR. AXILROD. No, not in the directive, but in the report.

[Lunch recess]

[Secretary's note: Typically, after lunch the Chairman would have called the meeting to order and made some opening comments. No such remarks by the Chairman were captured on the tape and included in the raw transcript.]

MR. ROOS. I don't want to get there by September; that's what has me--

CHAIRMAN VOLCKER. Well, growth may [not] even be to the midpoint in September [but] then it would have to slow down after September.

SPEAKER(?). Is that what it says? I didn't recall that.

MR. PARTEE. You made me think that this [unintelligible].

CHAIRMAN VOLCKER. No, at least to the midpoint [by the] end of the year. But [alternative B] brings us to the midpoint at the end of year. If you're satisfied with [ending] up below the midpoint--

SPEAKER(?). Then you are between "B" and "C."

MR. SCHULTZ. I don't mind that much, but I don't want [growth] to get too high in September. That makes me nervous.

CHAIRMAN VOLCKER. I can't make a subtle [technical] statement without you here, Mr. Axilrod.

MR. AXILROD. We've been waffling.

CHAIRMAN VOLCKER. Well, I assume you've been waffling. But let's leave the waffling until a little later and go to the short-run decision, which may confirm or not confirm the decision on the long-run for 1980. When I look at the alternatives put down for us [in the Bluebook] for these ranges on the monetary aggregates, I would reject alternative A on a number of grounds, including the immediate implications it may have for the market. But perhaps even equally important is the consideration that Governor Schultz and others mentioned about going full speed ahead with a high aggregate figure at the moment and a low interest rate only to have to screech in the opposite direction in a relatively short period of time. I have some of the same reservations about "B." But "B" brings us, if I understand this correctly, arithmetically to the midpoint of the existing M-1A range--

MR. AXILROD. Well, to 4-1/2 percent.

CHAIRMAN VOLCKER. --or just a hair below the midpoint of the existing M-1A range by December. It's not much, if at all, above the July figure, I guess. It would surround the July estimate, so that doesn't change it much. Alternative C would bring us inside the range but not to the midpoint by the end of the year, if I am correct.

MR. AXILROD. Under "C" [growth for the year] would be 3-1/2 percent.

MS. TEETERS. "C" is below.

CHAIRMAN VOLCKER. It's not below the range.

MS. TEETERS. Yes, it is.

MR. PARTEE. By the end of year, he said. You'd have to extend [that growth rate for the period from] September to December.

MS. TEETERS. If I read that chart right, "A" gets us to the middle of the range by the end of the year, "B" gets us just barely [in] it, and "C" gets us below [the range].

MR. AXILROD. No, by year-end--

CHAIRMAN VOLCKER. The chart shows a September plot.

MR. AXILROD. By year-end "C" gets M-1A to the bottom of the range, 3-1/2 percent. Continuation of that 6 percent [growth rate results in] 3-1/2 percent growth for the year.

CHAIRMAN VOLCKER. I would reject "A" myself. If I do that, I can see two ways of proceeding, though I would have a rather strong preference for one of them, that seem consistent with what we've just said about the longer-term ranges--namely, that we won't change the ranges this year, but we would not be disturbed by being in the lower part for M1, particularly for the M-1A number. Consistent with that approach toward the longer-term ranges, it seems to me we could theoretically operate on "B." And if we didn't like the results we were getting in one direction or another, we'd accept the shortfall. I say in one direction or another, which operationally in the short run might mean running into the lower federal funds rate constraint. Alternatively, we could adopt "C" for the initial path-making exercise, [using] the same approach as we did in June when it worked out, maybe by coincidence, to everybody's satisfaction. That involves setting a minimum growth path, which is again consistent with what we just said about the long-term, but if the number comes up higher--consistent with both the growth path and the federal funds rate constraint we set for ourselves--we'd accept the higher growth, for awhile anyway. Presumably we wouldn't accept it forever if it gets too high. But in the short run, presumably until the next meeting, we'd accept it unless it was very violently high. If we look at the period since May, that's what we did. It happened to come up, although we may have had some recent [revisions] so it's a bit higher than what we were projecting at the time. It certainly came up higher than we projected it for June. Essentially we did not permit the federal funds rate to rebound up to the point it would have rebounded had we held June to the number we notionally had in mind for that month. The results that were achieved, both in terms of the interest rate pattern and the aggregates pattern, seemed to me to put us further toward our ultimate objectives than we might otherwise have been. It worked out very well.

I would interpret "C" in a modified way as a kind of minimum growth path we'd set, should we adopt that. It's not really "C" in a sense; it's an indication of the minimum growth path, and we'd accept in the short run any upward deviation in that--within some reasonable bound--by readjusting the path consistent with the interest rate constraints of the type we now have. That's what I would feel most comfortable with. We may achieve the same result, but with different kinds of risks, by starting with "B" and saying in effect that we would undercut "B" if we ran into the interest rate constraint on the down side. We would be more likely to run into the interest rate constraint on "B," assuming we have a constraint in the general neighborhood of where we now have it. It seems to me that those are the two practical choices to focus on, consistent with our present stand on the long-run ranges. Let me put them on the table and see what your reactions are.

MS. TEETERS. Well, when we were talking about getting into the lower [part of the] range, I didn't mean the bottom. We don't have to slide around the bottom of that to say we're still in it. I'd rather go with "B" and make sure that we're approaching it. I don't think it would hurt us to have an 8 percent rate of increase in money supply over the next several months.

MR. WALLICH. I think it would look terrible. Nobody would remember that we had a shortfall before. Besides, they'd say that was just the way things should be. It's like somebody who is dieting and has missed a few meals and therefore feels he has to catch up on the caloric quota by eating something extra.

MS. TEETERS. But, Henry, that is just the reverse of what you used to argue. You always had to offset the overshoots.

MR. WALLICH. In this particular case I think we have had a shift in the demand function.

CHAIRMAN VOLCKER. Let me say what I think is going to be relevant here, whatever [route] we take: The proposal I made for "C" suggests we'll probably exceed the 6 percent [shown in the Bluebook for "C"]; the suggestion I made with "B" is that we wouldn't be above the 8-1/4 percent [shown] so, therefore, we might be below it.

MR. PARTEE. I don't think it means we would exceed [the 6 percent]. We would target on that and if we went over it, as we did last time--I agree with you that it worked out very well even though I voted against it--

CHAIRMAN VOLCKER. I just mean in terms of a frequency distribution. I don't know whether we would exceed it but presumably we bias [the outcome] in that direction. Let me just say that in either event, I think it's crucial where we put the federal funds constraint, if [we have one] at all. That is a variable that will be prominent in our discussion for the next few meetings, I suspect.

MR. WALLICH. I have one problem with the approach. "C" is what I'd like in principle; but the technique of accepting, by raising the path, whatever actual level of reserves is realized does get us back into a federal funds rate target with a very narrow range. The market thinks [we're doing] that already, and they're going to have it confirmed if we do it for a second period.

MR. MORRIS. It's not likely to recur in this period, though, Henry. That occurred because we gave the manager specific instructions that if [money growth] was coming in on the high side to let it go. I don't think we want to give him those instructions today.

MR. WALLICH. Well, if we were to limit the excess over "C" in a plausible way, I could see it.

CHAIRMAN VOLCKER. I didn't mean to imply--maybe I did--that wherever [growth] goes above "C" we would accept; I just meant within some reasonable range. If we had a 10 percent growth rate in one month, we might well accept that. Ten percent in two months we might not. At least it would raise a question; we'd have to decide that.

MR. GRAMLEY. What would this mean if the Board staff's projections on M-1A in July turned out to be correct? They're now projecting 8.7 percent.

CHAIRMAN VOLCKER. We'd accept it.

MR. GRAMLEY. We'd accept it?

MR. PARTEE. That's what [Henry] means--that it really does mean sort of running on the funds rate so long as the aggregate is reasonably--

CHAIRMAN VOLCKER. I cannot deny that we'd begin running to some degree on the funds rate.

MR. GRAMLEY. That doesn't bother me when we're looking at an unstable money demand function. For a month or two, or maybe for the whole quarter, we may have to do that until we see how this goes.

MR. MAYO. Mr. Chairman, we could accept the logic you're propounding here and come up with [a set of targets] halfway between "B" and "C" but keep the 8-1/2 to 14 percent [funds rate range of "B"]. That's the way I would lean. I'd say 7, 8, and 8 percent--to the extent that we like point targets [for M-1A, M-1B, and M2] and we seem to have gone toward point targets in the short run for simplicity--as long as we understand what we are doing.

MR. PARTEE. That was my inclination, too; I would go along with Bob on that.

MS. TEETERS. Are you sure you don't want to drop the funds rate range on that one?

MR. MAYO. I don't want to change it.

MR. PARTEE. I'd leave it at 8-1/2 to 14 percent. That's what it is now, isn't it?

MS. TEETERS. An alternative is to go to 8 to 14 percent.

MR. PARTEE. The funds rate is well above 8-1/2 percent now.

CHAIRMAN VOLCKER. We have a blended proposal here. I just want to make sure I understand you. You're clear on the funds range at 8-1/2 to 14 percent and clear on the numbers, which are basically halfway between the numbers [shown in the Bluebook for alternatives B and C]. What is not clear, for instance, is whether you would accept right now that 8.7 percent or whatever is projected for July. In other words, would you allow a little tolerance on the up side should the figures come out that way? What we're talking about is from now until August--when is the next meeting scheduled?

MR. ALTMANN. It's August 12, in five weeks.

CHAIRMAN VOLCKER. August 12. We are talking about the next five weeks literally.

MR. MAYO. I don't see any problem in accepting the 8.7 percent for July if it turns out that way.

VICE CHAIRMAN SOLOMON. I'm trying to refresh my memory--

CHAIRMAN VOLCKER. Actually, the latest data tend to shade that down, don't they? The data ordinarily are not very good but they are worse than usual today because of July 4th, as I understand it. But [the recent information seems] consistent with a somewhat lower estimate for July, I take it.

MR. AXILROD. That's right, and [money supply growth] has even weakened a bit more since I had a first report earlier today. It's in such a state of flux I hesitate to mention it at all.

VICE CHAIRMAN SOLOMON. In the operational paragraph do you have to give pinpoint percentages for the third quarter or could you give a range? The way I read the language for the third quarter it says at annual rates of ___ percent, ___ percent and ___ percent [for M-1A, M-1B, amd M2].

CHAIRMAN VOLCKER. Well, we can do what we want to do, but the [practice] has been to give a single point. We've often said "about" or "around" or we've given a percentage rate and said "or above." Consistent with what I said, certainly if we took "C" we would say at that rate or above, which we've said on a number of occasions. I don't think we've ever given a range.

MR. AXILROD. We need a number to construct a path.

CHAIRMAN VOLCKER. Yes, we need a number to construct a path. And in a way a range sounds as if we're being very precise in that we're not going to accept anything below or anything above. So I react a little adversely to a range. But we have often used words like "about" or "above" to convey some [sense] of that.

VICE CHAIRMAN SOLOMON. Well, I'd go along with Bob Mayo's suggestion, which Chuck supported, about taking the arithmetic average between "B" and "C."

MR. MAYO. I'd round them off, too. [Using] quarters on the growth rate percentages strikes me as silly.

VICE CHAIRMAN SOLOMON. What do we do about M2, though? That's all right for M-1A and M-1B.

MR. MAYO. We could use 8 percent for M2, couldn't we?

CHAIRMAN VOLCKER. I just presumed that if this table was logically put together and we compromised on the others, we'd end up compromising on M2, too.

MS. TEETERS. But M2 is running high; if anything, we'd have to make it a little higher.

CHAIRMAN VOLCKER. No, this is the staff's projection of where it will run. The projection may be wrong, but I assume this takes account of the staff's best judgment of what is consistent between these numbers, looking ahead.

MR. AXILROD. Yes, that's right.

MR. ROOS. What are the figures, Mr. Chairman?

CHAIRMAN VOLCKER. Well, Bob proposed 7, 8, and 8 percent. I suppose we would say "about" 7, 8, and 8 percent consistent with that. I take it that doesn't give us any great problem in July; if anything, those July projections are going to be reduced at the moment you have to go make up a path.

MR. AXILROD. That's right.

MR. BLACK. That suggests to me, Mr. Chairman, that we ought to take a look at the low end of that funds rate range. We may not be getting the shift in demand that we thought; we may have our equations misspecified.

MR. PARTEE. Undoubtedly we do; it's just a question of how much.

MR. MORRIS. We can change that during the month if we find that to be the case.

CHAIRMAN VOLCKER. I would suggest that we have a real problem in lowering that at all significantly now, in view of both the domestic uncertainty but more precisely the exchange market uncertainty at the moment. My own feel for this situation, though one never knows, is that if the exchange market begins running--and it's on the verge of it now--that will raise the question and force it to our minds. I'm sure we'd have differing opinions about whether we have to make some overt "tightening" move to deal with the exchange market situation; I think that would be more inconsistent with what we're trying to do than accepting this delicate business of trying to skate through this period without getting the psychological screws loose. And they're very close to being loose.

MR. SCHULTZ. At some point it would be very nice if we could get the discount rate down a little more. I think we need to be so careful that--

CHAIRMAN VOLCKER. I might say a word about the discount rate, too, because I think it's relevant here. The logic is to get it down for basically two reasons. I don't see any reason why we should in concept have the discount rate impede reductions in the prime rate, which at some point it may do psychologically. Beyond that, as somebody alluded to this morning, if and when we get a reversal in interest rates, the question is [whether] that might occur in a time period we are worried about. The discount rate then does have operational significance because it tends to put a ceiling on the funds rate or at least slow down any increase in the funds rate. And since presumably we don't want a big reaction upward in the funds rate from a fairly technical and maybe passing change in the money supply numbers, it would be nice to get the discount rate lower. It would be more than nice; I think we ought to try to do it.

The problem we run into again involves domestic and international psychological problems. We've done a little exploration among the foreign central banks in the last few days to see what the chances are for taking the curse off a further movement [down in interest rates]. If [such a move] is interpreted as an easing, whether it's the discount rate or something else, what are the prospects that this would be hidden or submerged in other rate changes? The answer, I think, is ambiguous at the least. It's another dimension that can be thrown in here. It is not an irrelevant consideration in the framework of the next week or so because I can't say there is no possibility. If it doesn't happen pretty soon, I think [our foreign colleagues] will all go away on vacation and it probably won't happen until September. But it is a matter that is under consideration in a number of countries--so far with a negative answer. The situation is such that if one country moved, everybody probably would move; but nobody wants to lead the parade.

SPEAKER(?). Would they follow us?

CHAIRMAN VOLCKER. No. I think we're irrelevant to this. We're not totally irrelevant, but they consider us off on a course of our own and somewhat irresponsible anyway. Whether we move or not doesn't have the same bearing as somebody important within Europe moving, or even if the Japanese move. I don't think there's much chance of the Japanese leading the parade, although they might.

VICE CHAIRMAN SOLOMON. The logical one to move would be France because she's also at the top of the EMS.

CHAIRMAN VOLCKER. There are all sorts of conflicts involved. They are in the same dilemma as we are basically. They'd like to move in terms of the business outlook but they don't want to give any sense to their own public, externally or internally, that they've given up on inflation. They're very sensitive to that. And the Germans are in a peculiar position because they're at the bottom of the EMS exchange rate [band]. So they ask how they can go first when the DM is already weak in their terms. The currency that is strong in the EMS is the French franc. The trouble with the French [making a move] is that they have a rising inflation rate at the moment. They're about the only country left where inflation is still rising. And while they have a sluggish business situation, they also say: How can we give a signal about inflation when the inflation rate is still rising?

VICE CHAIRMAN SOLOMON. They have a correlation between money supply and the rate of inflation. Both are running 13-1/2 percent.

MR. SCHULTZ. Well, if we show a willingness to tolerate an 8 percent funds rate before we do anything on the discount rate, it clearly limits our ability to move on the discount rate. So I would think that we would want to keep the 8-1/2 percent [lower limit] at this point.

CHAIRMAN VOLCKER. My own feeling about the discount rate is that we ought to move as soon as it's--I was going to say "safe." It's not going to be safe; as it stands we can't be sure there's going to be no reaction. But as soon as we feel there's enough protection somehow and that the risks of setting off something in the exchange market are minimized, we ought to go. I don't know when that will be.

VICE CHAIRMAN SOLOMON. But we're so close to the logical level of, say, 10 percent that it would make a lot of sense given the enormous instability right now in the exchange markets. We've spent $600 million [in exchange market intervention] in the last three days; we ought to consider moving half a point, rather than a full point. We don't have the kind of spread that we had before.

MR. PARTEE. Except that we're in great jeopardy that the prime rate will be below the discount rate. I think we're 2 points too high on the discount rate. It ought to be 9 percent.

VICE CHAIRMAN SOLOMON. Two points?

MR. PARTEE. Yes.

MR. SCHULTZ. Well, it would be nice to move a full point but we just don't know whether we can or not at this point. We're arguing in a vacuum here because we don't really know.

MS. TEETERS. Well, as long as we keep it above the market rate, we've going to have no borrowings at all. That's going to influence our paths and everything else that--

VICE CHAIRMAN SOLOMON. If we get the discount rate down in two moves, to 10 percent, they may very well be in the same range. We don't know what the fed funds rate is going to be.

MR. MAYO. Well, I didn't mean to get us off the track.

CHAIRMAN VOLCKER. I don't think we ought to debate that precisely, but those are some of the background considerations to where this federal funds limit is set. What we have on the table is 7, 8, and 8 percent [for the monetary aggregates] and 8-1/2 to 14 percent [for the funds rate range].

MR. GRAMLEY. Could we have some more explicit comment by the proponents of this proposal as to what we would do if in fact the aggregates exceed these amounts by 1 percentage point, 2 percentage points, [etcetera]. I don't want to see the funds rate go below 8-1/2 percent, but I certainly wouldn't want to see it go to 14 percent between now and [our next meeting].

CHAIRMAN VOLCKER. Well, I don't know about the proponents but I would operate this [along the lines of] what I said on "C," which is that we would tolerate some increase over 7 percent--just to look at that particular number--in the short run before the next meeting without pushing the federal funds rate up to anything like 14 percent. Now, [the interval before] the next meeting is so short that I really can't conceive of these numbers getting to the point where we'd want to exert very strong restraint, but I suppose they could. To try to be specific, suppose we got a fairly big July--significantly bigger than this [projection]--and we were coming into August, but [before the] meeting, and the August projection was for a 12 percent increase. I suppose we'd let the federal funds rate begin to go up and we wouldn't fully adjust the path to take care of a 12 percent increase, say, on top of a 10 percent increase--just to pick two numbers out of the air.

MR. BLACK. Steve, what does July look like?

MR. WALLICH. I think it would be helpful if the lower limit were a little higher. We're going to be operating as if we were on a funds rate target even though we're not. Then at least the market should not get the signal that we've lowered these targets. I think they suspect that 8-1/2 percent is the lower limit, so if we went to 9 to 14 percent--

MR. PARTEE. But they're going to read on Friday that 8-1/2 percent was the lower limit [set at the May meeting]. It has--

MR. WALLICH. Well, they will know it [for that meeting], but they won't know [what it is] for the future.

MR. PARTEE. Will they think that we've raised the limit?

SPEAKER(?). They may think we've lowered it.

MR. WALLICH. I wouldn't want them to think we've lowered it and I'd rather not have them think that it is 8-1/2 percent at this point.

MR. AXILROD. Well, Mr. Chairman, as I understand the thrust of this, if the Committee opts for 7 percent and we wake up tomorrow and it looks as if our best projection is 8 percent, we'll set a path that will achieve 8 percent but the funds market can behave pretty much as it has been behaving. If [our projection] goes up to 9 percent, [the funds market] may still be behaving that way but we'll be getting to the point where we'll have to consult with you to see if we're getting outside the bounds.

CHAIRMAN VOLCKER. I think we'd probably accept 9 percent--I'm just giving a qualitative judgment--provided the federal funds rate is behaving as expected. If growth began getting above 9 percent, I think we'd probably have to consult.

MR. AXILROD. The problem that might come to the Committee more immediately is weakness because that would get reflected rather more quickly in a drop in the funds rate, and we won't know where it will stop.

CHAIRMAN VOLCKER. And we'd be operating at the constraint; that's why the constraint is important.

MR. AXILROD. That's right. So the constraint could become operational if there's any weakness right away, and we'd have to come back to the Committee [almost immediately].

MS. TEETERS. Is July a particularly difficult month as far as projections are concerned?

MR. AXILROD. We've done research on that and they all are difficult! [Laughter]

MR. ROOS. I agree completely with the staff.

MR. MORRIS. None is as [difficult] as April, though.

MR. WINN. Mr. Chairman, we've talked about the impact on the international scene, which I recognize. Is there any impact on fiscal policy in terms of what we do in this period? For example, if [money growth] comes in low and we don't lower the funds rate, are we really pinning ourselves to the wall in terms of people saying we are not going to support anything [to spur the economy], so it has to be done with fiscal policy? Then we might get a bigger tax cut than we'd otherwise get. I don't know the answer to that, but we don't want to miss that side of the equation either.

CHAIRMAN VOLCKER. My general answer would be that whatever influence [our actions] have on that is going to be related more to what happens to interest rates than to what happens to the money supply in a very short-run perspective.

MR. WINN. Well, let's say the money supply falls short.

MS. TEETERS. I think it's going to be more influenced by some of the other data. If we get another 8 to 10 percent [decline in GNP and] an increase in the unemployment rate, we won't--

MR. WINN. That's right; I mean that whole area.

MS. TEETERS. And if we get a sharp revision in the second-quarter number or something of that sort, that's going to put more pressure on fiscal policy than a one-month miss on the money supply.

VICE CHAIRMAN SOLOMON. I don't understand Henry's point. If I understand you correctly, you feel that maintaining the 8-1/2 percent floor [on the funds rate range] would give the impression that we've eased policy. Why?

MR. WALLICH. Well, it increases the perception, or the misperception, that we're operating on a funds rate target.

MR. PARTEE. Then we ought to lower it, shouldn't we, to get it away from where the money supply is?

MR. ROOS. Is that a misperception, Henry?

MR. WALLICH. Well, it depends on how one looks at it. I share your doubts.

MR. ROOS. There's a fellow in Florida who always [proposes] as a toast "Confusion to the enemy." Maybe we'll do that, Henry; we'll confuse the enemy this time.

VICE CHAIRMAN SOLOMON. But the funds rate hasn't been at the floor. After all, we're always looking at the weekly averages. The weekly average has run 9 to 9-1/2 percent in the last few weeks. We haven't been at the 8-1/2 percent floor even though we've been following the reserve paths.

MS. TEETERS. I certainly wouldn't want the record to show that we raised the floor after the second quarter we've had.

MR. ROOS. If we were to adopt "C" or anything like "C," the record would show that we took action in terms of the monetary aggregates that would definitely deepen and lengthen the recession. We can be pinned on being too restrictive at this stage, too, which worries me.

MR. WALLICH. If we are too easy now, we'll soon have to face higher lower limits than we do now. Suppose the aggregates develop some momentum and then we have to slow them down in the last few months [of the year].

MR. PARTEE. We could then [let the funds rate] move up through that range of 8-1/2 to 14 percent. We'd have to change the lower limit [if we ease too much in the near term].

VICE CHAIRMAN SOLOMON. If the staff is anywhere near right, "B" assumes we get to 4-1/2 percent [M-1A growth] by December and "C" assumes we get to 3-1/2 percent by December. If we're taking a middle figure, we're definitely coming in somewhere along those lines, as Paul said, consistent with the earlier statement we agreed on.

CHAIRMAN VOLCKER. I think the various considerations have been pretty well laid out. Let me see what the sentiment is for 7, 8, and 8 percent--using the word "about" in the directive--with these numbers for the federal funds range, which are unchanged from a month ago.

MR. ALTMANN. From May 20.

MR. GRAMLEY. In this 7, 8, and 8 percent, with 8 percent for M2, is the M2 going to mean anything or is it going to be a throw-in as I--

CHAIRMAN VOLCKER. I think it means something. It doesn't mean [anything for the path]; the path is not set on that number. But for purposes of an example, suppose M2 came in very high relative to this [8 percent] number and the M1 numbers came in significantly low. I think that would affect our judgment as to how hard we pushed on M1 because we would be running high on the one and low on the others.

MR. GRAMLEY. Would we give these about equal weight?

CHAIRMAN VOLCKER. Let me say there's an approximation here.

MS. TEETERS. To me it would depend on why M2 was going up; if it were money market funds going out the window, I'd say no.

MR. GRAMLEY. Well, if money market funds were going up instead of people holding demand balances, I'm not at all sure the implications of that are bad.

CHAIRMAN VOLCKER. One might argue that if money market funds were going up, that ought to be weighed because they have some of the characteristics of a transactions balance.

MS. TEETERS. What are we going to do about it if [M2] goes up?

CHAIRMAN VOLCKER. Squeeze down harder on the others.

MS. TEETERS. Which may make the money market funds go up even faster.

MR. PARTEE. What will look better will be the 2-1/2 year certificate. Money market funds have been doing very well; they probably won't do that much better. But the 2-1/2 year certificate could improve and could give us expanded--

CHAIRMAN VOLCKER. We haven't been this precise recently; we used to be. But let me further amend the motion and say as an approximation that we will put some weight on M2, maybe 50-50.

MR. PARTEE. Well, 50/50 is a lot. It's not consistent with the reserve targeting process that we have.

MR. GRAMLEY. One thing we want to remember about giving M1 and M2 50/50 weight is that if M2 consists about half of M1, a 50/50 weight means we're giving independent components of M2 a 25 percent weight.

CHAIRMAN VOLCKER. It's much less. M1 used to be half of M2; it's not anymore.

MR. PARTEE. Yes, that fraction has changed some.

MR. SCHULTZ. One of them is about $400 billion and the other one is almost a trillion dollars.

MR. GRAMLEY. Well, I'm using very rounded numbers.

MR. AXILROD. Mr. Chairman, the [tenor] of this discussion means that when M2 is running a lot stronger than the targets--let's say it's running 12 percent and the target is 8 percent and it's all [caused by] money market funds--and everything else is running stronger, the staff has not in such a situation in the past cut back on reserves because the multiplier in M2 was off. If we did, as Governor Teeters said, interest rates would go up faster. And as a consequence of that, money market funds would go up faster and--

CHAIRMAN VOLCKER. Then interest rates would go down more slowly.

MR. AXILROD. Well, either way. But, for example, in the last [intermeeting] interval we could have been cutting back on reserves because the money market funds were growing very rapidly. [Had we done so] interest rates would be higher and the MMFs would be growing even more rapidly.

CHAIRMAN VOLCKER. Well, we may be a bit inconsistent in saying this. I have to amend this motion further. The conflict comes between saying equal weight and saying we are going to tolerate an overrun. And I guess I've said both. So in a sense we wouldn't tighten up, even if consistent with tolerating an overrun the M1s arithmetically came out on target. We'd let them go for--

MR. PARTEE. It's only five weeks until the next meeting.

CHAIRMAN VOLCKER. Yes, I know.

VICE CHAIRMAN SOLOMON. It's an asymmetrical equal weighting.

SPEAKER(?). Sure! What is that?

CHAIRMAN VOLCKER. We probably ought to avoid trying to be technical about equal weighting. But [M2] is a consideration. Let's just end it there. So with these [nuances], the directive would say about 7, 8, and 8 percent, 8-1/2 to 14 percent [for the funds rate] and there's an understanding of some tolerance of being above [the growth rates cited]. And we don't ignore M2--that is the way to put it--when we're judging how much above to tolerate.

MR. WINN. Why don't we move the M2 rate up to 9 percent and make it 7, 8, and 9 percent?

MR. BLACK. It's easier to remember!

CHAIRMAN VOLCKER. I just have no basis for doing that. The staff tells me that this is the most likely relationship, and I don't have any independent--

MR. WINN. But they tell us that M2 is going to be out of line, so what the heck.

MS. TEETERS. We could move it to 8-1/2 percent.

CHAIRMAN VOLCKER. I think what the staff has said is that M2 has been rising relatively rapidly compared to these others, but they don't expect that to be the case in the future.

MR. ROOS. Has the staff said that 8-1/2 to 14 percent on fed funds is consistent with 7, 8, and 8 percent [which are] compromises?

MR. AXILROD. Well, at the time we wrote the Bluebook if we had had to say something--it would have been fine-tuning of a silly nature--we would have raised the lower limit from 8-1/2 to 8-3/4 percent or something like that. Given the data I now have on the aggregates, I wouldn't have. The data are in a state of flux; that's why it's better to have this meeting on a Tuesday.

MR. ROOS. What is the rationale, though, on preferring the compromise over alternative B?

CHAIRMAN VOLCKER. We don't have to push so hard.

MR. PARTEE. It's a little lower number but it's a tolerable number, Larry.

MR. ROOS. I'd prefer "A," obviously, beause it would get us [there] theoretically. We know that. The question is how much--

MR. SCHULTZ. And then we'd need at least $40 billion to support the market.

CHAIRMAN VOLCKER. Well, how many people find the proposal that is on the table acceptable?

SPEAKER(?). Voting members?

MR. ROOS. This is an acceptance with a waffle.

CHAIRMAN VOLCKER. It looks nearly unanimous, doesn't it? I think enough hands were raised that we can vote. We are voting now on the short run.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Morris	Yes
Governor Partee	Yes
Governor Rice	Yes
President Roos	Yes
Governor Schultz	Yes
Governor Teeters	Yes
Governor Wallich	Yes
President Winn	Yes
President Balles	Yes

Unanimous, Mr. Chairman.

CHAIRMAN VOLCKER. Well, after that display of unanimity, let's return to the long run. I would interpret that vote as consistent with what I said earlier about the long-run targets for

1980, if we can call 1980 long run at this point. I don't know whether I can repeat what I said [with regard to] keeping the ranges unchanged numerically. We will explain that there are technical problems with the M1 relationships, but that's not central. We're not recognizing here that the ranges are [unintelligible]. We understand and accept that and we even think it's likely that the M1 number will come in toward the lower part of the range we have targeted. We think M2 will probably come in toward the higher part of the targeted range and that M3 will be someplace in the middle. We think bank credit may come in low and we'll explain that. I think that's the substance for 1980. Since we're just reaffirming numbers, maybe we can have a vote on this one part.

MR. WALLICH. This is a sort of [unintelligible]. The short run wasn't very good but one goes along with it and now here comes the second shoe.

MR. SCHULTZ. That's a Solomonic tactic. This is the Arabian [Solomon] of the Arabian Nights.

MR. PARTEE. We will assert that these are consistent with the Administration's targets?

VICE CHAIRMAN SOLOMON. I think that's a very respectable position.

MR. PARTEE. We have to do that. We have to say whether they are consistent.

CHAIRMAN VOLCKER. Well, let's have a little discussion about that whole issue. It's going to be even more relevant for '81. In substance that is what we're saying.

MR. WALLICH. After all, these longer-run targets are mostly for '80. We're not talking about '81 now?

CHAIRMAN VOLCKER. I'm dividing it into two pieces just to make it manageable, I hope. It's not really a Solomonic tactic; it's a manageability tactic. Can we have a vote on '80? Do you understand what it is? Numerically it's just where we are, but the discussion implied [nuances] which will appear in the report.

MR. ALTMANN.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Morris	Yes
Governor Partee	Yes
President Rice	Yes
President Roos	Yes
Governor Schultz	Yes
Governor Teeters	Yes
Governor Wallich	No
President Winn	Yes
President Balles	Yes

CHAIRMAN VOLCKER. For 1981 we have a more difficult problem. I don't know whether you have any language for us, Mr. Axilrod. Have you had a chance--?

MR. AXILROD. I have around 15 lines of language, which I--

CHAIRMAN VOLCKER. Of language or anguish?

MR. AXILROD. Both! It might be worth my reading it to you to see if it's even worth typing up and distributing.

SPEAKER(?). Humility.

MR. BALLES. It depends upon how many nuts you threw into that waffle!

CHAIRMAN VOLCKER. Before we get to the language, [let's return to our earlier] discussion about what [needs to be] in the directive. In substance--but the lawyers may want to talk to this--I don't see why we need any [elaboration] in the directive. And therefore, I would say we're talking about the language that will provide the core of the report for talking about '81. But [the directive] could be further elaborated with language, particularly with some mention of NOW accounts and all that business and why we arrived at this conclusion.

MR. MORRIS. Is this something we have to take a vote on?

CHAIRMAN VOLCKER. I don't think we necessarily have to take a vote on it, frankly. On the other hand, the argument for taking a vote is that the law specifically asks us to state--I forget the [precise wording of] what the law asks us to do. It asks for a Committee judgment--

MR. PRELL. It asks for a statement of the Committee's plans and objectives with respect to money and credit growth.

CHAIRMAN VOLCKER. We must give the Committee's statement of its plans and objectives, so I lean slightly--but I don't think it's compelling--toward having a vote on it as a Committee statement. But we have to have some method of indicating it's a Committee consensus. Maybe we can just indicate that this is the Committee's consensus without arguing over it.

MR. PETERSEN. I think that would be legally acceptable as far as the rules of procedure of the FOMC and the Humphrey-Hawkins Act itself are concerned. Going back to the earlier point on the directive, there is no requirement in the Humphrey-Hawkins legislation [regarding what you include] in the directive. Nor is there such a requirement under our rules of procedures.

CHAIRMAN VOLCKER. I don't know why it was in there before. I may have had some very persuasive reason myself; I don't even remember the discussion. But it doesn't seem to be operative in terms of anything we're doing now.

MR. BLACK. All I can conclude is that the other members of that subcommittee were more influential than the two who are here!

MR. ROOS. What would happen though, Mr. Chairman, if you were asked in your testimony whether this was unanimous? How would you answer [if] we didn't take a vote? In other words, there is a difference of opinion, I'm sure, on this '81 situation. How do we resolve that in terms of reporting to Congress?

MR. MAYO. We talk in terms of consensus.

MR. SCHULTZ. Why don't we see how close we can come to a consensus? If we can get a strong enough consensus, maybe we'll take a vote; if not, we--

CHAIRMAN VOLCKER. There's no doubt that I have to be able to say it's a consensus. Now, I don't know if we have to take a formal vote to say it's a consensus.

VICE CHAIRMAN SOLOMON. After all, the very fact that it's a fairly general statement and a very preliminary one makes it more logical that it was a consensus view rather than a vote.

CHAIRMAN VOLCKER. Well, [not having] a vote doesn't say it wasn't a consensus. [Whether or not] we're voting, that's what this is.

MS. TEETERS. Yes, but it's not as [unintelligible].

MR. MAYO. If we try to sharpen this pencil too much, we're going to be voting on what words you use in the testimony. I think this is getting ridiculous.

CHAIRMAN VOLCKER. That's right. I'd like to stop short of that, frankly.

MR. MAYO. Yes, I think this is putting the Chairman in a very peculiar position.

MR. GRAMLEY. I really thought we had enough agreement in substance to leave the drafting of the words to you and the staff, Mr. Chairman.

CHAIRMAN VOLCKER. I'm happy to accept that view without even introducing the complications that can be quibbled about. If it is the consensus that it can be left to the staff and myself and the understanding is that it's--

MS. TEETERS. As long as you don't commit us to lowering the ranges.

MR. PARTEE. On that we want a vote.

MR. WALLICH. Do you accept that we will try to lower the ranges but that the announced--

MS. TEETERS. No, I don't, Henry. I'm really not committed to that.

VICE CHAIRMAN SOLOMON. It's not "committed." [The Chairman] will use that earlier language that we talked about.

MS. TEETERS. I'm not sure I even want to try to lower them.

MR. ROOS. Obviously there are some, Nancy, who are committed to a consistent lowering [of the ranges]. So how do we--

MS. TEETERS. No, we are not committed to a consistent lowering.

MR. PARTEE. He said some of us are.

MR. ROOS. I said there are some.

MS. TEETERS. Some of you are, but I'm not, frankly.

MR. ROOS. And how is that difference--the fact that it isn't unanimous one way or the other--described in the record?

MR. WALLICH. It seems to me that we could say we will work toward lowering the ranges. Whether this will be possible and to what extent can only be determined in the light of the circumstances that we meet then. That wouldn't be a commitment as far as you're concerned.

MS. TEETERS. That's further than I want to go, Henry.

MR. GRAMLEY. Couldn't we put out a statement which said that it's the consensus of this Committee that policy in 1981 is going to aim toward contributing further to a reduction in inflation. With that in mind, the Federal Reserve will adopt its specific targets for the aggregates at the beginning of next year, but the objective will be to follow a policy which extends money and credit at rates that are consistent with a further reduction of inflation. We could all agree [on that] and make the specific decision later on. I think that [squares] with what everybody is saying.

CHAIRMAN VOLCKER. Yes, but that's saying almost nothing.

MR. GRAMLEY. I agree, but I think maybe we can get away with that.

MR. WALLICH. Inflation would probably rise next year.

MR. BAUGHMAN. He will be asked the question of whether that means lower numbers.

MR. GRAMLEY. Well, then he can talk about the technicalities of M-1A and M-1B and so on during periods of--

MR. RICE. Do we have to reflect unanimity on this?

CHAIRMAN VOLCKER. No, I don't think so. We'd like to have it all the time but if there's a real difference of opinion, I think we're stuck and we just don't reflect unanimity.

MR. RICE. Well, I'm afraid there is [a difference of opinion].

CHAIRMAN VOLCKER. I [suspect so], too. I don't think this [draft language] quite does it, Steve. It talks a lot about the technological complications, which I think should be in the statement someplace, but it doesn't seem to me to reflect adequately the views of all the members of the Committee in that there is a real uncertainty involved in the economic outlook itself. And that's going to affect--

MR. AXILROD. I was a little afraid that would argue strongly against lowering [the ranges]. It makes it very clear.

MR. GRAMLEY. Couldn't we adopt Governor Schultz's earlier suggestion? Could we agree on that--that we all want aggregate targets for 1981 at or below the 1980 ranges?

CHAIRMAN VOLCKER. Well, I would hope that that's a minimum we could agree upon. The real [problem] is that I am not sure that's right. I'm not sure that goes far enough for some people. I admit the difference isn't very large but I suspect it's real. And the only way I can see going further--just to try again out loud--is to say it is the general policy and intention of the Committee to seek lower growth rates over a period of time consistent with countering inflationary forces. The Committee will be examining 1981 in that light specifically, but the extent to which progress toward that objective can be made in 1981 will have to be evaluated in the light of all the circumstances at the time.

MR. ROOS. Doesn't this get us to the nub of the whole philosophical issue of whether we put a greater priority on reducing inflation and enduring a certain amount of pain or bitter medicine--which are words we've all used regarding that process--or whether we will opt, if push comes to shove, for bringing relief to the economy at the risk of perpetuating inflation? It's very fundamental it seems to me.

CHAIRMAN VOLCKER. Well, that is part of it. The other part is how much one is persuaded about monetarist doctrine in general. I think those two considerations are entering in here, which makes it difficult.

MR. ROOS. I don't know if you hear this, Mr. Chairman, or if it is just a product of where I live and work. But we hear constantly the overpowering, almost pleading, request from the groups we bring in, including labor leaders: "For heaven sakes, do what is necessary to bring down inflation, even if it means high unemployment for a while." There is a passionate pleading of that sort, and I really don't exaggerate when I say that.

CHAIRMAN VOLCKER. Well, it's easy to be influenced by the short run, and I recognize the trap that we can conceivably get into next year. But I feel uncomfortable right at this stage. It seems to me that it's perfectly illustrated by this [Proxmire] resolution, which presumably I have to support, however lukewarmly. If we come out with a statement for '81 that somehow seems inconsistent with that, there will be a lot of explaining to do that seems troublesome to me in terms of questioning our whole outlook [and] modus operandi.

MS. TEETERS. Can't we put it in terms of not really knowing what is going to happen in the next six months?

CHAIRMAN VOLCKER. Well, I'm willing to go so far [and make] the kind of statement I just made: That while this is our general intention, specifically how far or whether we can do it in 1981 remains to be seen. Nevertheless, our bias is in that direction.

MR. SCHULTZ. Can't we even say that the Committee is committed to bringing the money supply growth down to non-inflationary levels over time and that for 1981 we will have the monetary aggregates generally at or somewhat below the figures for 1980 depending upon conditions in the economy?

MS. TEETERS. But you're getting yourself into a box, Fred. We've been bringing the rate of the money supply growth down for the past four years and inflation has been going up. What is a non-inflationary rate of growth in the money supply?

MR. ROOS. There's a lag though, Nancy, isn't there?

MR. RICE. We don't know; we will keep bringing it down until we find out.

MS. TEETERS. We don't know.

CHAIRMAN VOLCKER. It must be lower than what we've had.

MR. PARTEE. Or we have to do it longer.

MR. BLACK. Mr. Chairman, if we don't at least hit that lower part of the ranges--and in fact if we begin to report month by month what the market is apt to perceive as pretty rapid [money growth] rates--I think we will have an extremely severe credibility problem.

MR. SCHULTZ. Say that again.

MR. BLACK. I'm saying that during the next few months, if [money] growth comes anywhere near what we're projecting, as we approach the midpoint of the target range we're apt to have a problem if we don't explain very carefully that we're just trying to get growth back up within the target range. If we do that and then when Paul testifies he doesn't say something about a lower range for next year, we're going to be hit by both sides on the credibility problem, I'm afraid. I'd really want to emphasize lower [ranges] if we could possibly persuade everybody to do that.

CHAIRMAN VOLCKER. Just to get to the substance, whatever the exact words are, my own feeling is pretty strong that we have to say something about a bias toward lowering the ranges next year. I'm willing to put in an escape hatch that says in the end it may not be possible. But there has to be some minimal expression of a bias in that direction--looking at both sentences in effect--or we will get ourselves in a difficult problem in the short run. We will anyway, I think, with the escape hatch, but it would be moderated. I recognize that when one looks at these projections of the economy and all the rest, one has to wonder how the hell we can do it. But I'm saying we've got to face up to that question. Put off the problems of tomorrow until tomorrow, right?

MS. TEETERS. Yes, but even with a 4-1/2 percent rate of growth in the money supply we'd have a very anemic recovery.

CHAIRMAN VOLCKER. I know, but it's still all a projection too, and--

VICE CHAIRMAN SOLOMON. I find it ironic that we've reached agreement fairly quickly on 1980 and the next quarter and we're having so much trouble on the longer term with very general language. We basically have had three points of view expressed. There are those who would like to say simply that we'll be reducing the aggregate targets next year. There's the other extreme, which stays basically neutral and says we don't know yet. And there's the middle one, which you put forward, which shows some bias and some hope but not a commitment [to reduce the targets] and says that the situation has to be assessed at the time. It seems to me we ought to take a vote on all three or get enough people to raise their hands in support of the middle ground.

CHAIRMAN VOLCKER. I'm inclined to think that we're probably going to have to--or maybe should--end up with a vote. What I would propose is that we put together what you describe as the middle ground, indicating a bias but with a caveat. I can circulate the language and get a reaction to the precise language. If you don't want to bias it in that direction and feel strongly that you want a much more neutral statement, vote against it. And if asked whether this was unanimous, I'd say "no;" some people were doubtful and enough doubtful that we were going to make progress in that direction next year that they wanted to allow themselves, in effect, a bigger escape hatch. That may reflect the reality. I think we're better off doing that than trying to waffle on the whole point of [consensus].

MR. ROOS. Mr. Chairman, if we expressed the intention to reduce the aggregates next year and conditions in February were such that it was just unreasonable, couldn't we take our action at that time instead of expressing the caveat and reluctance now? After all, this is purely a projection. If conditions deteriorated to where we wouldn't want to act on that projection in February, we'd still have the option of not making the reduction, would we not? I don't know what we accomplish by--

CHAIRMAN VOLCKER. Sure. We can do anything in February we want to do in the end. This obviously biases what we do in February. I'd just like to get a showing of hands on this and maybe [consider] some kind of voting procedure. We don't want to take a formal action, or a final action anyway, right now. I will circulate some language in any event. I will attempt to reach the widest area of agreement [along the lines of] what was described as the middle course: Some bias about [lower targets for] the long term, which encompasses 1981, with a statement that whether that will be possible specifically in '81 is going to depend upon an evaluation not only of all the technical factors but also an evaluation of economic conditions and the relationships between money and the economy when we have to make a final judgment in February or January or whenever it is.

MS. TEETERS. You can try another caveat in that we really don't know what fiscal policy is going to be; that's still a wide-open area.

CHAIRMAN VOLCKER. Sure, that can be implied, too.

MR. BALLES. Paul, there's another phrase you might want to use and that is: "It's the present intent of the Committee..."

CHAIRMAN VOLCKER. Well, let me worry about the precise language. It will be circulated. Do I capture a sufficiently wide area of Committee opinion to make this the likely candidate to be worked on, subject to fiddling around with the language?

MR. RICE. So long as it's not assumed that this is our expectation.

CHAIRMAN VOLCKER. Well, you'll have to judge that in itself in the end. Some people may want to [express] a different opinion. I'm trying to say something here, though not very much. I'm trying to express a bias without locking us into it. That's the intention.

MS. TEETERS. Yes. I don't want to be faced in February with having it said that in July I promised to do this.

CHAIRMAN VOLCKER. I think it's clear that nobody is going to be faced with something like "I promised to do it." But I still want to maintain the bias. I sense that that's likely to capture the biggest number and come as near to a consensus as we can get. It may be a complete consensus. Is that right? Is that near a consensus?

MR. WALLICH. I can go with that.

CHAIRMAN VOLCKER. That seems to be the case, so let's operate [on that assumption]. We'll get some language out before the end of the week and have some form of assent or vote or something so that I can say that it's a consensus of the Committee. Okay. Does that complete the meeting?

VICE CHAIRMAN SOLOMON. There's just one minor technical presentational point, which I think is worth calling to your attention. The way the operational paragraph has been drafted, by putting M2 for the first time down at the bottom of the paragraph instead of saying M-1A, M-1B, and M2, it will give the markets the impression that we're downgrading M2. That's not the intention from the discussion, I gather. What was the reason for that switch?

MR. ALTMANN. It's not the first time. This is a reversion to what was the regular practice until the last meeting.

CHAIRMAN VOLCKER. It was not intended to downgrade M2, I take it?

MR. ALTMANN. No.

CHAIRMAN VOLCKER. Up until the last meeting it was done that way?

MR. ALTMANN. It was changed at the last meeting because there were no numbers in the directive at the last meeting. We simply have reverted to what has been the practice.

CHAIRMAN VOLCKER. I had the same question Tony did when I glanced at it. But if it was just a reversion to what was done in all the meetings up until the last one, I don't think it's a--

MR. GRAMLEY. If in fact we're going to give M2 some weight in the decisionmaking process, then I think Tony's suggestion ought to be considered. Maybe we ought to put it in the body of the operational paragraph instead of hanging it on the end.

CHAIRMAN VOLCKER. We're going to give it some weight, yes. I can do it either way. I don't think it's important that we've always done it the other way. I would go along with that; it's probably slightly better. This is just a question of whether we list M2 along with the M1s. Is that agreeable? Okay, the only other item on the agenda is that the next meeting is August 12th.

MR. GRAMLEY. What about the forecasts?

CHAIRMAN VOLCKER. Oh yes, thank you--the forecasts. Do you want to hand those [tables] out? I don't know that we have to spend a lot of time on this but we'll see.

SPEAKER(?). You're just trying to get the range, right?

CHAIRMAN VOLCKER. I'll show you. Do you all have copies?

MR. KICHLINE. No, they're down at that end of the table.

CHAIRMAN VOLCKER. What we've done, as you will see, is to take the numbers that you submitted and that the Board members talked about. The Chairman exerted his prerogative of not putting down precise numbers. But we've divided it up to give a little sense of [the views of] the Board members, the voting Presidents, and the non-voting Presidents. My overall impression is that, for some reason, not voting may breed irresponsibility or something. But the ranges are very similar and fall within the range of the Board staff's projections for the major variables in both '80 and '81. There were a couple of outliers among the non-voting Presidents. We are not committed to any particular treatment of this in the report. What we did in the last two reports, I believe, was to show a range for Board members. I was asked the last time why we didn't include all Committee members. I didn't commit myself [to a change], but I acknowledged that that was a reasonable question. So my presumption is that we might as well show the range for all Committee members this time. I'm not sure there's any particular point in dividing it up between Board members and others. We could include non-voting Presidents or not, but the specific request was "Committee members" so my [suggestion] would be to combine the Board members and the Presidents and say this is the Committee's range. We've never tried to narrow the range very far. We've had among the Board members some discussion of whether the more outlying [views] couldn't converge someplace. There were some problems that arose when we discussed this among the Board, which relate to the problem that Chuck just raised, and I think we ought to discuss this a bit. We decided on the ranges.

We're a little vague about next year, but we have to discuss their consistency with the forecast of the Council [of Economic Advisors]. Mr. Kichline says on the basis of his scientific investigation that they are consistent, with a low order of probability. What do we say about that? How do you feel about the way we present these forecasts? And do any of you want to change your mind about the numbers you've already submitted very tentatively?

MS. TEETERS. Are you likely to be asked the question--

CHAIRMAN VOLCKER. Excuse me, Nancy, but while I think of it, the most important question presentationally seems to me whether we present these forecasts with no tax cut, with a tax cut, or both. I am afraid, frankly, of just presenting a projection which says "with a tax cut" because I don't know how to avoid the implication that the Federal Reserve takes it for granted that there will be a tax cut and that it's desirable. The only argument against presenting it at least both ways is that the numbers look so sour without [a tax cut]. There's the problem of presenting a very sour economic forecast. How that gets resolved is beyond me. But that's the most important presentational issue.

MR. PARTEE. Also, if we do it both ways, one can subtract and see what the effect of a tax cut is.

CHAIRMAN VOLCKER. If we do it both ways [the questions is] why not have the tax cut. It's as if all these projections surely show: Mirabile dictu! If we have a tax cut, we get more growth and no more inflation, and anybody except a damn fool would have a tax cut. In fact, instead of a $30 billion tax cut, why not make it $60 billion because then we'd get still more growth and--

MR. PARTEE. Yes, why not make it twice as big?

VICE CHAIRMAN SOLOMON. Paul, I would suggest that we present projections assuming no tax cut and then go on to say that if there is a tax cut of, let's say, $25 to $30 billion, then the picture would change. How it would change depends upon the composition and the timing of implementation because that makes an enormous difference as to how much stimulus would occur in fiscal '81. I'd give them some ranges. There is a good deal of uncertainty depending on the composition of the tax cut, so I'd make that a little more general.

CHAIRMAN VOLCKER. Well, I would prefer to approach it the way you are approaching it. But how does one handle this question? It sticks out even more sharply than it otherwise sticks out that our projection is for an extremely sour business picture and a very high unemployment picture for another 18 months, so why aren't we using policy--?

MS. TEETERS. The question you're going to get on this, regardless of how we present it, is how much of this is due to the difference in our fiscal policy assumption and how much is still due to the difference in our monetary policy assumption, because the CEA has a much easier monetary policy assumption than we have. That could be almost as embarrassing as whether we have [assumed] a tax cut.

CHAIRMAN VOLCKER. Is the CEA assuming an easier monetary policy or do they have a different assumption as to that wonderful demand shift that's--

MS. TEETERS. Oh, they have lower interest rates.

MR. PARTEE. 6 percent.

CHAIRMAN VOLCKER. They have lower interest rates. How do they get them?

MR. GRAMLEY. The public projection that goes up to Congress has an interest rate forecast now that's purely fictitious. That is, they are using a rule of thumb which says that for interest rate projections we will adopt the rule that real interest rates are unchanged. That [procedure] was adopted two years ago when they had to discontinue using the old rule, which was that nominal interest rates were unchanged. So to keep from having to forecast interest rates they said: Let's switch to a rule of real interest rate assumptions. And that's all that this monetary policy assumption means. It isn't a real assumption; it's just a plug.

CHAIRMAN VOLCKER. Another question that arises in our projections, now that I think of it, is that they show very little improvement on the inflation side--

MS. TEETERS. Very little improvement on anything.

CHAIRMAN VOLCKER. --from year to year. In fact, for the non-voting Presidents the range is exactly the same and for the voting Presidents it's exactly the same.

MR. KICHLINE(?). We excluded some outliers like--

CHAIRMAN VOLCKER. No, I'm looking at the wrong comparisons here. They're not exactly the same, but there's little difference; they show a decline [in inflation] of a quarter percentage point from year to year.

MR. BALLES. Well, it is an opportunity, Mr. Chairman, for educating the [Congressional] Committee about the long run.

CHAIRMAN VOLCKER. I'm looking at the wrong numbers again; they show a difference of one half percentage point.

VICE CHAIRMAN SOLOMON. But the unemployment figures don't look that bad. This says without a tax cut the range is 8-1/2 to 9 percent but with a tax cut--depending upon the composition--it probably would be a percentage point lower than that for the fourth quarter of 1981. So it's down to 7-1/2 to 8 percent.

MR. MAYO. But at the risk of more inflation in '82 and '83 perhaps. I think that has to be put in.

CHAIRMAN VOLCKER. Look at the unemployment rate under any of the projections for next year. I don't see how we can talk about a tax cut without, in effect, saying we should have a tax cut.

VICE CHAIRMAN SOLOMON. Well, we're not saying that we shouldn't have a tax cut. We're saying we should wait a while and see what the numbers are going to be.

CHAIRMAN VOLCKER. [But their question would be]: Why do we have to wait, if that's your--

VICE CHAIRMAN SOLOMON. That's why I said earlier that you have to stress that the composition of it and possibly the magnitude will be affected by events in the economy over the next few months.

CHAIRMAN VOLCKER. Well, this is filled with booby traps, but we can't avoid them all. Along the same line, we used the CPI the last time. For technical reasons the CPI comparison from '80 to '81 will look less good than the other [measure], theoretically; I don't know how it will come out. We just thought tentatively that we'd not give the CPI [forecast] even though it's very good at the end of this year in some people's opinions. Well, we don't have to resolve this finally today but if anybody has great suggestions--and particularly if anybody wants to change his or her projection in a way that would affect any of this--let Mr. Kichline know in the next day or two. I suppose you just have to leave it to us as to how they're presented. Also, please convey any bright ideas on what we should say about the consistency of our whole approach to the CEA's [projections]. They say our computer tells us it's inconsistent, but we know it's consistent.

MR. KICHLINE. Certainly.

CHAIRMAN VOLCKER. I take this silence as assent that we will work out the problem.

SPEAKER(?). It seems it's late in the day.

CHAIRMAN VOLCKER. Now where are we?

MR. WINN. I think it's time for a compliment. I'd like to compliment the Bluebook this time. I thought it was very helpful and very good.

MR. SCHULTZ. On that note, I move we adjourn.

CHAIRMAN VOLCKER. Well, let me say in that connection that I thought the presentations this morning were very good. The Bluebook was well developed. I shudder, as I do every time, when I look at that Bluebook and all that stuff coming out of these computers about the more increase in money supply we have and the more tax cut we have the better everything looks!

MR. AXILROD. Mr. Chairman, that is not, I insist, what the Bluebook says.

CHAIRMAN VOLCKER. It may not be what the language says, but if one looks at those pages with all the alternatives, that's the conclusion--

MR. AXILROD. Well. I don't think that's what the numbers say either. We'd say it even more obviously if we had put '83 in there.

But we tried to compare a tax cut strategy with a no tax cut strategy and to look at that--

CHAIRMAN VOLCKER. I understand that [the outlook is worse] if one looks at a long enough period and all the rest, but I still would hate to see that Bluebook get into the press.

VICE CHAIRMAN SOLOMON. Shouldn't the Bluebook have a paragraph in it about the fact that the reaction of the financial markets may throw this whole scenario off?

CHAIRMAN VOLCKER. I think the Bluebook always should have a paragraph in it saying that there are those who think this is all a lot of baloney and that everything is going to work out much better with the more restrictive policy.

MR. BLACK. They called us outliers and then took our [projections] out of the figures.

MR. SCHULTZ. While we're on the subject of the books, what about the Redbook?

CHAIRMAN VOLCKER. Well, I've had a little discussion about that. I asked Carl Scheld to look at that. Frankly, I find the Redbook less useful than it might be--not in the sense that it's not a very good idea to get these kinds of comments fresh from the market, but in its organization. It goes District by District and it's awfully hard for me--I never get through it, frankly--to get some sense of what is happening in a particular sector of the economy or what the latest feel is, which is what the Redbook is supposed to give, because the information is so dispersed. I'd like to see some reorganization, maybe only in the summary, so that it comes through a little more clearly. What should be clear, looking at all these reports, is that this is the latest feel we have for residential construction or for business investment and that these are the nuances in different areas or sectors of the economy. It's just a matter of organizing the material.

MR. GRAMLEY. I would hope that would be done just in the [summary], because I wouldn't like to lose that District [by District information].

CHAIRMAN VOLCKER. Well, let's pick up these papers with the projections; people are worried about these [getting out]. I worry a lot more about the Bluebook, frankly, than these wide ranges but--

MR. PARTEE. These ranges are so wide that a reader would have to conclude that the Committee didn't know--

MR. SCHULTZ. And that is an entirely reasonable conclusion.

CHAIRMAN VOLCKER. If it's all right, I don't think we need a break unless people want to break just for a minute or two. We want to discuss the Monetary Control Act a little and questions that arise with respect to that.

MS. TEETERS. Couldn't we have a seventh inning stretch?

CHAIRMAN VOLCKER. We can have a seventh inning stretch. We'll have a 5 minute break and come back for other [non-FOMC] matters.

END OF MEETING